BANK OFFICERS HANDBOOK OF COMMERCIAL BANKING LAW WITHIN THE UNITED STATES

CONTAINING THE SECRET RULES
TO AID IN THE CREATION OF MONEY OUT
OF THIN AIR!

My people are destroyed for lack of knowledge... and since knowledge is power.. one then cannot be destroyed.. especially by the bankers!

To
Mary, Caroline, and Katherine Schroeder
and
Edna Taylor

Preface to Sixth Edition

There are few aspects of commercial banking law that are not now in the process of substantial change or that have not recently experienced substantial change. A flood of federal legislation not only has affected traditional bank regulatory issues but also has established a body of substantive law affecting numerous types of commercial transactions of importance to commercial banks. Expanded activity by the federal banking regulatory agencies has accompanied many of these legislative actions. The enlarged responsibility given to the Federal Reserve Board to manage the nation's check collection and payments system in the Expedited Funds Availability Act of 1987 is but one example. Other examples exist in areas involving consumer issues, regulatory enforcement authority, and the scope of commercial bank's powers, as a result of efforts by legislators and regulators to adjust to dramatic changes that have occurred in the markets in which commercial banks compete and the technology governing the manner in which depository institutions conduct their business.

This book is designed to furnish general information about the law relating to commercial banking in three important areas. Part I of the book discusses federal banking regulation. This part describes the general regulatory system, the primary federal regulators, the types of banking institutions that are regulated, and some of the important areas of regulatory control. It discusses the major federal legislation and principal case law to give the reader a general understanding of the complex network of regulatory law that affects the activities of commercial banks and similar depository institutions.

Part II of the book focuses specifically on payment systems and negotiable instruments. It gives an introduction to the basic law governing the rights and liabilities of parties to instruments such as checks, drafts, notes, letters of credit, and other types of commercial paper. It discusses electronic fund transfers, credit card transactions, and transactions involving other forms of payment. It also discusses some of the basic legal principles that govern the relationship between a bank and its customer. This part of the book contains extensive treatment of the Uniform Commercial Code provisions bearing on these subjects, and describes the interrelationship of these UCC rules with other state and federal laws.

Part III of the book covers the general rules applicable to secured lending transactions involving personal property security. This part of the book explains the basic rules provided by Article 9 of the Uniform Commercial Code on creation of a security interest, priorities among creditors, and enforcement of a security interest. The interaction of Article 9 with other federal law, such as bankruptcy and certain consumer credit regulations, is described.

The book is designed to give general information for bankers and commercial lawyers. Given the broad scope of this book, it cannot provide complete, in-depth coverage of all issues. The footnotes, where they have been inserted, are not intended to be a comprehensive statement of all legal authorities on any particular issue, but rather refer to cases and other authorities to illustrate the principles being discussed in the text. For those who are interested in obtaining more detailed information, there are references to supplemental texts, articles, and other authorities. The major cases, statutes, and sources of regulatory action are identified. As a result the book should be useful both as an introductory text for those who seek a general understanding of these areas of commercial banking law and as a general reference and research tool for those with more specific interests. It should assist the banker in understanding the legal framework that supports the activities of commercial banking, alert the banker to areas where legal problems may exist, give notice of areas where the law is in the process of change, and help the banker to discuss and raise questions about issues with legal counsel in an informed manner. The book also should assist bank lawyers and law students to gain a general understanding of the extensive and often exceedingly technical body of state and federal laws that is relevant to commercial banking transactions, to identify the principal sources of statutory and other law bearing on particular problems, and to obtain additional information on numerous subjects through the various references and other research aids provided. To assist research, the abbreviations and citations in the text and footnotes generally conform to *A Uniform System of Citation* (14th ed. 1986), which is published by The Harvard Law Review Association and is generally available in law libraries.

This book is not a substitute for consultation with legal counsel but rather is intended to assist bankers and others to become sensitive to situations where consultation with legal counsel may be helpful. Such consultation is important for several reasons. This book cannot provide a complete analysis or discussion of each subject covered. The applicability of the law to particular situations depends upon both the investigation of specific facts and the performing of complete research and analysis of the particular law of the relevant jurisdiction applicable to the situation. In the commercial banking law area, actions by regulatory agencies are frequent and extensive. In addition, Congress and the state legislatures are engaged in consideration of new laws on many aspects of commercial banking, and state and federal courts are constantly issuing significant decisions. Therefore, proper interpretation of the law is complex, because of the intricate web of state, federal, and regulatory law that is applicable. In general, the cutoff date for the materials on which this book is based is July 1987 although in particular areas more recent developments of significance are noted, as in the case of certain key decisions of the U.S. Supreme Court and the action by the Federal Reserve Board in enacting Regulation CC on the availability of funds and collection of checks.

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MILTON R. SCHROEDER

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I

The Nature and Regulation of Banking: An Overview

1

Introduction to Banking Regulation

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¶ 1.01 DEFINING "COMMERCIAL BANKING"

"Commercial banking" was defined in the previous edition of this book as the activity of a banking institution whose "principal business is to accept deposits, make loans, collect commercial paper, and arrange the transfer of funds."[1] Under the banking law from the adoption of the Glass-Steagall Act in the 1930s until the beginning of the 1980s, there was a distinct demarcation between commercial banks and other financial institutions, such as investment banks, securities firms, and commercial financial services conglomerates.

All this is changing. The types of institutions that can engage in traditional commercial banking functions have enlarged as a result of legislation giving additional powers to thrift institutions. The types of activities commercial banks engage in have expanded as a result of legislation at both the state and federal levels and as a result of judicial decisions dismantling parts of the wall erected by the Glass-Steagall Act to keep commercial banks insulated from the risks of dealing in securities. The "nonbank bank" explosion has started a restructuring of the banking market into holding companies capable of offering an array of financial services. In light of these developments, perhaps the most suitable

[1] F. Beutel & M. Schroeder, Bank Officer's Handbook of Commercial Banking Law 3 (5th ed. 1982).

definition is one offered by an English text: "[B]anks come in all shapes and sizes, with different name tags applied in different countries, often quite loosely. Banks make most of their money from the difference between interest rates paid to depositors and charged to borrowers." Commercial banks are "publicly quoted and profit oriented. They deal directly with the public, taking deposits, making loans and providing a range of financial services from foreign exchange to investment advice. Most countries have settled for between four and ten;" but in the United States there are nearly 15,000 because of "banking laws that have prevented banks operating in more than one state, and in different types of business . . . ."[2]

In addition to commercial banks, there are many specialized depository institutions that have been established to perform specialized roles. Thrift institutions such as savings and loan associations and credit unions are important examples. At their inception, savings and loan associations primarily engaged in home mortgage lending and offering passbook-type savings to consumers. With the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980, thrifts gained expanded authority to engage in commercial banking activities. Further incorporation into the general banking market has occurred as a result of the restructuring brought about by the financial failures and weakened condition of thrift institutions in the 1980s, which led to changes in the law to encourage the acquisition and merger of weak institutions with stronger financial institutions, including banks. These developments are discussed in Chapters 6 and 10. To a great extent, thrift institutions are subject to a regulatory regime similar to that governing commercial banks, and engage in banking functions similar to those of commercial banks. Subsequent chapters discuss how thrifts fit into this regulatory scheme.

There are other specialized consumer-oriented financial companies. Credit unions may be organized under state and federal statutes with the power to maintain customer share accounts against which drafts may be drawn payable in a manner similar to checks. Credit unions are discussed in detail in Chapter 2. There are also personal finance loan organizations authorized under the laws of the several states that loan small amounts of money to consumers, often at specially regulated rates that are higher than the usual interest rates allowed. These organizations normally are not deposit-taking institutions but operate with their own capital and credit. Banks often have their own small loan departments to make the same type of loans, and holding companies may have special consumer loan subsidiaries or affiliate companies.[3]

Although trust activities have become a part of the activity of many commercial banks,[4] this book does not deal with the laws that govern these trustee

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[2] R. Pennant-Rea & B. Emmott, The Pocket Economist 9 (1983).

[3] See 12 CFR § 225.25(b)(1) (1987).

[4] See 12 USC § 92a (1982), which gives authority to national banks to engage in trust

relationships and activities. The competition for funds has led some banks to offer managed investment accounts through their trust departments similar to those offered by mutual funds and other securities firms. These developments are discussed in Chapter 8. Again, there are trust companies organized under state law that operate by accepting money for the purpose of investment where the beneficial interest in the funds remains in the original owner. This book does not address trust companies as such, but these firms may become part of a banking company's corporate structure through affiliation as a subsidiary or other affiliate organization. See Chapter 5 for a discussion of this issue.

There are other types of banking functions and specialized banks: for example, reserve banks, which are really bankers' banks; investment banks, whose chief business is underwriting and dealing in securities, and providing financial advice and aid in corporate acquisitions and mergers; agricultural banks; foreign trade banks; and other specialized banks that have charters to engage in particular types of business. Some examples of these organizations are briefly described in Chapter 2. Further, the peculiarities of federal laws regulating bank holding companies have encouraged the proliferation of various financial institutions that have been chartered as full-service banks but that limit their functions to activities such as consumer lending and credit card operations. These developments are discussed in Chapter 5.

Because of the diversity of functions of commercial banks and the variety of depository institutions involved in them, this book does not attempt a comprehensive survey of all banking activity. Rather, it emphasizes the basic regulatory structure that governs traditional commercial banking institutions and the commercial activities associated with accepting deposits, collecting commercial paper, making payments and transferring funds, and engaging in certain credit transactions. Thus, Part I consists of a review of the body of regulatory law affecting the organization, authority, and supervision of commercial banks and a description of the primary federal banking regulatory agencies—the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Federal Savings and Loan Insurance Corporation, and the Federal Home Loan Bank Board. Part II examines the law that defines the rights and duties related to various types of commercial paper—checks, notes, cashier's checks, letters of credit, documents of title, and other paper, and describes the law affecting bank and customer relations. Part III outlines some of the fundamental law applicable to security transactions in personal property and related credit practices.

As this introduction indicates, the laws and regulations that govern commercial banking are numerous and complex. The various types of financial institutions engaging in commercial banking activities are matched by an equal

activities. The Depository Institutions Deregulation and Monetary Control Act of 1980 also gave thrift institutions chartered by the Federal Home Loan Bank Board the authority to engage in trust activities under certain conditions. 12 USC § 1464(n) (1982).

diversity of statutes and regulations controlling the activities of these institutions. At the federal level alone, responsibility for regulating banking activities has been parceled out among a number of separate agencies; when regulatory authority is shared by state and federal agencies, the complexity of the law is compounded.

In addition, the law governing the transactions of commercial banks is complex. The Uniform Commercial Code has brought a desirable uniformity to the law in many areas, but there are many special purpose statutes, frequently intended to give special consumer protection, that must be taken into account in analyzing banking transactions. There is a growing body of federal law that must be considered along with the state commercial law of the UCC and common law. This book is intended to serve as a beginning guide for the bank officer engaged in these commercial banking transactions and the attorneys called upon to advise in banking matters. It is not a substitute for careful legal counsel, however, and such assistance should be obtained because this book can neither cover all the details applicable in particular matters, especially at the regulatory level, nor report on all the local variations, changes, and new developments. Moreover, the facts of a particular situation will vary in ways that may introduce new legal problems or otherwise affect the legal analysis. Obtaining the advice of competent legal counsel is essential.

¶ 1.02 HISTORY OF BANKING REGULATION

[1] First Bank of the United States

The complex structure of the modern banking system is the product of controversies accompanying the development of banking, and particularly federal involvement in banking, that date from the first days of the nation.[5] Controversy first emerged over the creation of a central national bank. The first Secretary of the Treasury, Alexander Hamilton, supported creation of a national bank. The first Secretary of State, Thomas Jefferson, opposed it. Hamilton prevailed, and Congress created the First Bank of the United States, giving it a charter of twenty years. The bank was not only the largest bank of its time; it was also the largest corporation in the United States. The bank was located in Philadelphia, but had branches in other major cities.[6]

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[5] For a history of the development of banking, see generally J. Norton & S. Whitley, Banking Law Manual (1987); R. Johnson, Historical Beginnings—The Federal Reserve (1980); G. Fischer, American Banking Structure (1968); J. Knox, A History of Banking in the United States (1903). See also Scott, "Patchwork Quilt: State and Federal Roles in Bank Regulation," 32 Stan. L. Rev. 687–742 (1980); Wayne & Spagnola, "The Myth of Bank Deregulation: For Every Action There Is an Equal and Opposite Reaction," 42 Wash. & Lee L. Rev. 383–403 (1985).

[6] Johnson, Historical Beginnings—The Federal Reserve 8 (1980).

The First Bank of the United States was a success because it was able to provide a uniform and reliable currency.[7] Before the establishment of the bank, the currency in circulation (except for coins and some greenbacks) consisted mainly of notes issued by state banks. The notes of the First Bank of the United States came to account for about 20 percent of the notes in circulation. However, some hostility to a central bank existed, and added to this hostility were complaints of foreign domination and charges of unconstitutionality. The growing number of state banks joined the cause against the First Bank of the United States, arguing that the national bank was not necessary in view of the increased number of state banks. The state banks resented the practice followed by the First Bank of retiring from circulation all state bank notes it received by returning them to the issuing bank for payment. This practice required the state banks to maintain larger reserves of funds than otherwise would have been needed. Opposition to the first bank became so strong that when Jefferson's Republican party came into power in 1801, a bill to recharter the bank failed, and the bank died when its charter expired in 1811.[8]

After the first bank's charter expired, the nation experienced serious economic problems because of the lack of an effective banking system. Although a number of state banks existed, the bank notes they issued were often of dubious quality. The disruptions of the War of 1812 heightened this problem. Bank failures became common after 1809,[9] and, with the expiration of the First Bank in 1811, there was no central bank to come to the assistance of the weaker banks.[10] These and other difficulties in managing the federal government's financial affairs without a national bank mechanism persuaded a narrow majority of Congress of the desirability of a national bank, and in 1816 Congress chartered the Second Bank of the United States.[11]

[2] Second Bank of the United States

The Second Bank of the United States was larger than the first, and many came to view it as too powerful, including President Andrew Jackson. During Jackson's first term as President, his political rival, Henry Clay, convinced Congress to pass a bill extending the charter of the bank. Clay, as a presidential aspirant, hoped to exploit Jackson's expected veto of the bill as a political issue in the 1832 presidential election. The plan backfired when Jackson's veto, accompanied by a ringing message attacking the constitutionality of the bank, brought him widespread popular support, and he was reelected by a substantial

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[7] E. Symons, Jr. & J. White, Banking Law 11–13 (2d ed. 1984).

[8] Id.

[9] Id.

[10] Id. at 13.

[11] Johnson, supra note 6, at 8.

margin. Four years later, in 1836, the charter of the Second Bank of the United States expired.[12]

Although the constitutionality of the bank was attacked during this period, the U.S. Supreme Court had upheld the power of Congress to establish a national bank as early as 1819. Chief Justice Marshall, in the historic case of *McCulloch v. Maryland*, ruled that the chartering of the First Bank of the United States was a measure "necessary and proper" to the exercise of Congress's fiscal powers under the Constitution to raise revenue, borrow money, and regulate commerce.[13] Under the supremacy clause of the U.S. Constitution, which makes the laws of the United States superior to state law, Chief Justice Marshall held that the establishment of the bank could not be restricted by inconsistent state legislation. This decision was reaffirmed five years later in *Osborn v. Bank of the United States.*[14]

[3] State-Chartered Banks

After the demise of the Second Bank of the United States, banking was carried on through state-chartered banks. This period saw the enactment of state legislation authorizing "free banking." Much of this legislation, which made it easier to incorporate state banks, was patterned after the New York Free Banking Act of 1838 . Under these statutes, it was no longer necessary to obtain a special state charter; anyone who met the minimum incorporation requirements could establish a bank. As a result, the number of state banks grew.

The system of local state banks that subsequently emerged led to problems. Banks varied greatly in the adequacy of their capital and the reserves retained against bank notes and demand deposits. Some banks engaged in risky lending policies. The bank notes issued by the individual banks were of disparate quality. The amount of credit extended by banks fluctuated erratically without regard to the needs of the economy.[15]

Finally, in 1863, the Civil War increased pressure for a sound financial and monetary system, forcing Congress to adopt the National Bank Act of 1863. This act, together with amendments in 1864 and 1865, reestablished a national banking system. It did not create a central national bank, but it did provide for the charter of national banks. To ensure the strength of the new national banks, the act imposed requirements relating to reserves and to the number of notes that could be issued, as well as restrictions on lending policies. In 1865, Congress imposed a tax on the notes issued by state banks in order to make the notes

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[12] Id. at 10; Symons & White, supra note 7, at 21.

[13] 17 US 316 (1819).

[14] 22 US 738 (1824). The applicability of the supremacy clause in banking law is discussed in Chapter 14.

[15] Johnson, supra note 6, at 10.

issued by the national banks the currency of the United States. The constitutionality of this tax was affirmed by the Supreme Court in a decision upholding in broad terms congressional power to adopt appropriate legislation to "secure a sound and uniform currency for the country."[16] After this decision, state banks were expected either to convert to national charters or to disappear. However, neither event occurred. Instead, the increased use of checks as a means of payment provided an alternative source of funds for the state banks in the form of demand deposits, and state banks continued to exist alongside the national banks.[17]

[4] Federal Reserve Act of 1913

The lack of a central banking system continued to be a weakness in the national economy in the late 1800s. It was difficult to shift bank reserves to meet the credit needs of the country, and the currency provided by the banks was not flexible enough to meet demands for it. The financial panic of 1907 led to extensive examination of the nation's banking structure, and finally, after prolonged political debate and compromise, Congress enacted the Federal Reserve Act. Under the act, Congress authorized the establishment of the Federal Reserve System. However, the act did not create a central national bank. Instead, Congress established a system of regional Federal Reserve Banks, with a central Federal Reserve Board to supervise the system. The act required national banks to become members of the system and gave state banks the opportunity to become members.

The national banking system continued to come under pressure despite the improvements stemming from the Federal Reserve Act. With the onset of the Great Depression, a large number of bank failures occurred. For example, from the beginning of 1930 to the end of 1933, 11,491 commercial banks ceased operations.[18] These pressures on the banking system prompted President Roosevelt to declare an emergency bank holiday in March 1933. When the banks reopened, a series of efforts to increase national regulation and control of the banking industry occurred. In the Banking Act of 1933 Congress created a program of deposit insurance for qualified banks.[19] This act established the Federal Deposit Insurance Corporation, provided insurance for bank deposits, and imposed regulatory requirements designed to strengthen the banking system. Although the insurance was originally limited to member banks of the Federal Reserve System, Congress later extended it to state banks.

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[16] Veazie Bank v. Fenno, 75 US 533 (1859).

[17] Johnson, supra note 6, at 11.

[18] A. Phillips, Promoting Competition in Regulated Markets 346 (1975).

[19] Banking Act of 1933, ch. 89, 48 Stat. 162 (distributed throughout chapters 2, 3, and 6 of 12 USC).

The legislative reforms stimulated by the depression were enacted to deal with perceived widespread abuses in securities activities and conflicts of interest of banks participating in securities underwriting and other brokering and dealing transactions. The Glass-Steagall Act, which was adopted as part of the Banking Act of 1933 and which is discussed in Chapter 8, sharply curbed the authority of banks to engage in securities underwriting and dealing and forced the separation of securities dealers and investment firms from commercial banks. While the Glass-Steagall Act affected banking practices directly, the Securities Act of 1933 and the Securities Exchange Act of 1934 brought federal regulation to the securities markets generally.[20] The Banking Acts of 1933 and 1935 also made the payment of interest on demand deposits (checking accounts) illegal and established regulatory control over interest rates on other types of deposits, such as certificates of deposit and savings accounts.

The legislative outburst of the depression years also produced the Federal Home Loan Bank System,[21] the authority in the FHLBB to charter federal savings and loan institutions,[22] and the FSLIC.[23]

Although substantial changes have occurred since the 1930s, the basic regulatory framework of the U.S. banking system was put in place. The major components of federal regulatory control over banking were established: chartering of national banks, administering the Federal Reserve System, and supervising banks insured by the FDIC.

[5] Banking Since the 1950s

The 1950s and 1960s saw the passage of further federal legislation to control the activities of banks in merging and establishing bank holding companies. These measures are described in detail in Chapter 5.

The 1970s and 1980s marked the beginning of efforts to wrestle with two quite different problems. One problem is the need to accommodate the regulatory structure to the demands of the marketplace as the flow of funds from banks and thrift institutions to other nonbanking competitors places pressure on the depository institutions to become more competitive in the services and products offered to their customers. As this is occurring, the new banking, money management, and electronic fund transfer techniques made possible by computers and

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[20] Securities Act of 1933, ch. 38, tit. I, § 1, 48 Stat. 74 (15 USC §§ 77a–77aa (1982 & Supp. III 1985)); Securities Exchange Act of 1934, ch. 404, title I, § 1, 48 Stat. 881 (15 USC §§ 78a–78kk (1982 & Supp. III 1985)).

[21] Federal Home Loan Bank Act of 1932, ch. 522, § 1, 47 Stat. 725 (12 USC §§ 1421–1449 (1982 & Supp. III 1985)).

[22] Home Owners' Loan Act of 1933, ch. 64, § 1, 48 Stat. 128 (12 USC §§ 1461–1470 (1982 & Supp. III 1985)).

[23] National Housing Act of 1934, ch. 847, 48 Stat. 1246 (12 USC §§ 1701–1750g (1982 & Supp. III 1985)).

electronic technology have contributed to the pressures for change by bringing dramatic changes in the costs of providing many financial services.[24] The other problem concerns the increasing need to police misconduct in the business of banking and in transactions to which banks are parties.

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[24] See A. Phillips, "The Metamorphosis of Markets: Commercial and Investment Banking," 1 J. of Comp. Corp. L. & Sec. Reg. 227, 236–239 (1978); Note, "Savings and Loan Insolvency in the '80's," 15 Akron L. Rev. 441–541 (1982).

2

U.S. Banking System

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¶ 2.01 CLASSIFICATION OF COMMERCIAL BANKS AND THRIFT INSTITUTIONS

As described in Chapter 1, apart from the country's brief experience with the First Bank of the United States and the Second Bank of the United States, banking was conducted through state banks until the National Bank Act of 1863. Although that act began the system of federal chartering of national banks, the commercial banking system was a "dual banking" system with both state-chartered and federally chartered banks operating in the same markets and conducting the same types of business but with responsibility to different supervisory authorities and organized under separate legal regimes. Some of the complexity of modern banking law stems from measures adopted to maintain this dual system by keeping a competitive parity between both types of banks. The laws governing the ability of national banks to establish branches and to engage in interstate operations are primary examples. See Chapter 6 for a detailed discussion of branching and interstate activities.

[1] National Banks

National banks are banks organized under the laws of the United States. These banks receive their banking charters by meeting the standards and qualifications for capital structure, management organization, and other criteria set forth in national banking laws. There are three regulatory agencies having authority over national banks: (1) The chartering and supervision of all national banks is the responsibility of the Comptroller of the Currency;[1] (2) all national banks are automatically members of the Federal Reserve System[2] and are subject to regulation by the Federal Reserve Board; and (3) all national banks are automatically insured by the Federal Deposit Insurance Corporation.[3] See Chapter 3 for a discussion of the Federal Reserve System and Chapters 9 and 10 for the FDIC.

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[1] See 12 USC §§ 27, 481 (1982). For a study of changing charters, see Richard A. Spanogle, Jr., "Accountability and Decision-Making: A Study of Bank Charter Conversions," 12 U. Tol. L. Rev. 269–304 (1981).

[2] 12 USC § 222 (1982).

[3] Id.

[2] State Banks

State banks are organized under the laws of the states in which they are chartered. Although there was originally a common-law right to enter the banking business,[4] banking is now universally recognized as an activity requiring regulatory control.[5] The state regulatory authority is usually called a state banking commission. Thus, state banks receive their corporate charter under state banking laws. The scope of their activity is defined in the first instance by these laws and the regulations of the state banking commission. The requirements for capital, management, and other conditions of chartering are defined by the state's law and regulations.

[3] State Member Banks

State banks may elect to become members of the Federal Reserve System.[6] If a state bank applies for membership, then the bank must meet the standards for member banks, and becomes subject to supervision by the Board of Governors and the Federal Reserve System. As in the case of national banks, a state member bank is also insured by the FDIC. It is not necessary for a state bank to become a member of the Federal Reserve System, and state banks can use the services provided by the Federal Reserve System for check collection and payment transfer on payment of a fee without being a member bank.[7]

[4] State-Insured Banks

A state bank may become insured by the FDIC without being a member of the Federal Reserve System.[8] Most state banks have found FDIC insurance attractive and have become part of the FDIC insurance scheme. These banks must qualify under the requirements established by the FDIC and must submit

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[4] See State v. Scougal, 3 SD 55, 51 NW 858 (1892); Chase Nat'l Bank v. Sanford, 284 US 660 (1931); Northeast Factor & Discount Co. v. Jackson, 223 Ga. 709, 157 SE2d 731 (1967). See also Michie, Banks and Banking 1 (1986).

[5] For a history of the development of banking, see generally J. Norton & S. Whitley, Banking Law Manual (1987); G. Fischer, American Banking Structure (1968); J. Knox, A History of Banking in the United States (1903).

[6] See 12 USC § 35 (1982). See also Chapter 3 for further discussion of the Federal Reserve System.

[7] The Depository Institutions Deregulation and Monetary Control Act of 1980 generally opened the Federal Reserve System check clearance and collection mechanisms, as well as all other Federal Reserve services, to all depository institutions on the same terms as those for member banks. The Federal Reserve is required to establish pricing schedules for these services. 12 USC § 248a(a) (1982). For services covered, see 12 USC § 248a(b) (1982).

[8] See 12 USC § 1815(a) (1982). See also Chapter 11 for a discussion of the federal deposit insurance system.

to regulation by the FDIC with regard to their banking practices and corporate structure.

As a result of the different ways in which state banks are organized, there are four different types of banks: national banks, state member banks, state nonmember FDIC-insured banks, and state banks that are neither FDIC insured nor members of the Federal Reserve System.

Table 2-1 shows the number of banks in each category and gives information on their assets and liabilities; Table 2-2 shows the number of banking offices in the United States.

[5] Other Depository Institutions

There are different types of savings institutions that engage in banking functions similar to those of commercial banks. They may make both commercial and consumer loans, have credit card operations, accept deposits with payment rights like checking accounts, establish electronic terminals for cash and payment transactions, and have trust activities. The most common types of these institutions, referred to as thrifts, are savings and loan associations, credit unions, and savings banks. These institutions may be chartered under state or federal law and are regulated by both state and federal agencies.

At one time, these savings institutions were narrowly limited by their charters and applicable law as to the types of deposits they could accept and the types of loans and investments they could make. These legal restrictions prevented thrift institutions from competing with banks in the performance of commercial banking activities. For example, savings institutions could not allow their customers to draw checks against their accounts.

Enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980[9] authorized savings institutions to engage in a wider range of activities that permit them to compete more directly with commercial banks. As a result, many savings institutions began engaging in activities that formerly only commercial banks could provide. For example, savings institutions could provide checking privileges to their customers.[10] However, these institutions are subject to banking laws pertaining to the payment and collection of checks, drafts, and other forms of commercial paper, including regulations governing the new electronic fund transfer systems that are described in Chapters 14, 18, and 21 of this book.

[a] Savings and Loan Associations. The major impetus behind the establishment of savings and loan associations was the inability of commercial banks to

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[9] 94 Stat. 132 (codified in scattered sections of Titles 12 and 15 USC (1982 & Supp. III 1985)).

[10] See ¶ 3.04[5].

TABLE 2-1 **Number of Insured Commercial Banks by Class and Principal Assets and Liabilities of Each (1986)***

Asset and liability items shown in millions of dollars
June 30, 1986

Item	*Total*	*Member banks*			*Nonmember banks*
		Total	*National*	*State*	
Loans and investment	1,847,784	1,362,285	1,088,052	274,233	485,499
Gross loans	1,429,545	1,086,417	869,696	216,721	343,128
Net loans	1,415,173	1,076,351	861,926	214,426	338,822
Investments	418,239	275,868	218,356	57,512	142,371
U.S. Treasury and federal agency securities	253,205	161,648	131,632	30,016	91,557
Other	165,034	114,220	86,724	27,496	50,814
Cash assets	220,219	170,583	134,379	36,205	49,636
Deposits, total	1,805,885	1,298,430	1,048,265	250,166	507,454
Interbank	63,279	56,234	39,356	16,878	7,045
Other transaction	539,334	402,206	318,165	84,041	137,127
Other nontransaction	1,343,692	934,080	770,128	163,952	409,611
Equity capital	173,666	127,109	98,472	28,637	46,557
Number of banks	14,186	5,954	4,866	1,088	8,232

*All insured commercial banks in the United States. Details may not add to total because of rounding. Information not available for noninsured, nonmember banks.

Source: 73d Annual Report, Board of Governors of the Federal Reserve System, Table 16, p. 247 (1986).

meet the increasing consumer demand for home financing. These institutions are sometimes known as savings associations, building and loan associations, homestead associations, and similar names. Savings and loan associations may be state or federally chartered. The earliest savings and loan association in the United States was the Oxford Provident Building Association of Philadelphia, which was organized in 1831.[11] This association was patterned after the English Building Society, which consisted of a voluntary association of members who pooled savings in order to create a fund for home loans to the members.

There are two forms of organization of savings and loan associations, the mutual association and the stock association. In mutual associations, the voting rights and control of the association reside in the depositors and borrowers of the association. Thus, in a technical sense, the accounts created in a mutual association are not deposits but are shareholder accounts on which dividends, as opposed to interest, are paid. For most practical purposes, however, this charac-

[11] See G. Munn, Encyclopedia of Banking and Finance 661 (1962).

TABLE **2-2 Number of Banking Offices in the United States (1986)***

Type of office and change	*All banks*	*Commercial banks (including stock savings banks and nondeposit trust companies)*						*Mutual savings*	
			Member			*Nonmember*			
		Total	*Total*	*National*	*State*	*Insured*	*Noninsured*	*Insured*	*Noninsured*
Banks, Dec. 31, 1985	15,442	15,068	6,050	4,967	1,083	8,392	626**	358	16
Changes during 1986									
New banks	307	304	154	105	49	90	60	3	0
Ceased banking operation	-148	-148	-56	-46	-10	-78	-14	0	0
Banks converted into branches	-305	-300	-133	-111	-22	-167	0	-3	-2
Other***	-88	-76	-23	-33	10	-4	-49	1	-13
Net change	-234	-220	-58	-85	27	-159	-3	1	-15
Banks, Dec. 31, 1986	15,208	14,848	5,992	4,882	1,110	8,233	623	359	1
Branches and additional offices, Dec. 31, 1985†	45,352	43,092	27,595	22,661	4,934	15,409	88	2,219	41
Changes during 1986									
De novo	1,226	1,098	646	490	156	448	4	128	0
Banks converted	305	300	133	111	22	167	0	3	2
Discontinued	-615	601	-411	-342	-69	-190	0	-14	0
Sale of branch	0	19	16	-8	24	3	0	-19	0
Other***	4	9	419	307	112	-405	-5	33	-38
Net change	920	825	803	558	245	23	-1	131	-36
Branches and additional offices, Dec. 31, 1986†	46,272	43,917	28,398	23,219	5,179	15,432	87	2,350	5

*Preliminary. Final data will be available in the *Annual Statistical Digest, 1986*, forthcoming.
**As of Dec. 31, 1986, includes 14 noninsured state member banks and 2 noninsured national trust companies.
***Includes interclass changes.
†Excludes banking facilities.
Source: 73d Annual Report, Board of Governors of the Federal Reserve System, Table 18, p. 252 (1986).

terization makes little difference, since the accounts are eligible for deposit insurance.[12] In stock associations, the association is controlled by its stockholders as in the typical stock corporation.

Federal savings and loan associations may organize as either mutual associations or stock associations.[13] Federal law provides that "holders of accounts and obligors of an association shall, to such extent as may be provided by its charter or by regulations of the Board, be members of the association, and shall have such voting rights and such other rights as are thereby provided."[14] Under regulations of the Federal Home Loan Bank Board, the holders of accounts and borrowers from a mutual association have voting rights.[15] They may, however, give proxies to the directors of the association.[16] The FHLBB's regulations also permit associations to organize as stock associations. In this form of organization, the stockholders hold the voting rights.[17] In addition, federal mutual associations may convert to stock organizations.[18] In fact, there has been increased activity in converting to stock organizations as thrift institutions have changed in order to facilitate their acquisition by other firms.

[b] **Credit Unions.** Credit unions are cooperative financial institutions that are organized by groups of persons who usually are interested in saving small amounts on a regular basis in order to have access to the installment credit made possible by their pooled savings. Quite often credit unions are organized among persons with a common bond of association, such as common employment. In fact, it is a requirement to the establishment of a federal credit union that the membership "be limited to groups having a common bond of occupation or association, or to groups within a well-defined neighborhood, community or rural district."[19] Credit unions may be organized under state or federal laws.

Although credit unions have been traced back to as early as 1848 in Germany,[20] authority to establish federal credit unions did not exist in the United States until 1934.[21] Federal credit unions originally were established as part of

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[12] Id.

[13] 12 CFR §§ 543, 552 (1987).

[14] 12 USC § 1464(b)(1)(B) (1982).

[15] 12 CFR § 544.1 (1987).

[16] Id. See also 12 CFR § 544.5 (1987).

[17] 12 CFR § 552.3 (1987).

[18] 12 USC § 1464(i)(2) (1982); see also 12 USC § 1725(j)(1) (1982); 12 CFR §§ 552.2-552.5 (1987). An association that was formerly organized as a mutual association under state law also may convert to a federal stock form of association, 12 USC § 1464(i)(1) (1982). See generally Goldberg & Marcotte, Jr., "Mutual to Stock Conversions by Savings and Loan Associations: An Update," 37 Bus. Law. 856–868 (1982).

[19] 12 USC § 1759 (1982).

[20] Munn, supra note 11, at 172.

[21] Id.

the Farm Credit System, but the Federal Credit Union System is now administered by the National Credit Union Administration, which is an independent agency in the executive branch of the government.[22]

[c] Savings Banks. Savings banks are financial institutions that originally were formed to encourage savings among persons of modest means. These institutions originated at a time when commercial banks did not serve this function and other thrift institutions such as savings and loan associations and credit unions were not as prevalent. The concept of a savings bank originated with Daniel Defoe in 1767, who suggested the organization of "friendly societies for provident habits in general."[23] Savings institutions did not develop in the United States until the early 1800s.[24]

Savings banks may be organized as mutual savings banks. Under this form of organization, there is no stock, although the institution is a corporate entity. Some mutual savings banks are governed by a board of self-perpetuating trustees. The depositors in the institution under this approach are viewed as creditors of the bank, and they have no voting power.[25] When the institution is chartered as a federal mutual association, the federal charter gives the account holders of both savings and demand accounts the right to vote based on the value of their accounts.[26] Savings banks can also be organized as stock corporations.

Savings banks may be organized under state or federal law. Federal law recognizes both mutual savings banks and stock savings banks.[27] Federal legislation governing savings and loan associations also applies to federal mutual savings banks.[28] Any state or federal savings bank may qualify to become a member of a Federal Home Loan bank.[29] Federal Savings banks, except those insured by the FDIC, may obtain deposit insurance through the Federal Savings and Loan Insurance Corporation.[30] State savings banks, except mutual savings banks, may qualify for FDIC insurance.[31] A state or federal mutual savings bank may qualify for membership in the Federal Reserve System, even though it is not

[22] See 12 USC § 1752a(a) (1982).

[23] Munn, supra note 11, at 665.

[24] Id.

[25] Id.

[26] 12 CFR § 544.1 (1987).

[27] 12 USC § 1464(i) (1982). See generally Allister, "Federal Charter v. State Charter: New Opportunities for Savings Banks," 98 Banking LJ 908–923 (1981).

[28] 12 USC § 1462(d) (1982).

[29] 12 USC § 333 (1982). For insurance of banks that are members of the Federal Reserve System, see 12 USC § 1814 (1982).

[30] 12 USC § 1424 (1982).

[31] 12 USC § 1726(a) (1982).

organized as a stock company, but it will have to satisfy substitute capital requirements.[32]

¶ 2.02 DEFINITION OF "DEPOSITORY INSTITUTIONS"

For some purposes, federal banking laws apply to a broader class of depository institutions than that of commercial banks. As a result of the Depository Institutions Deregulation and Monetary Control Act of 1980, the term "depository institution" is used in some federal laws and regulations.[33] The following institutions are embraced within this term.

1. *Insured Banks* (12 USC §§ 1813, 1815). These are banks insured by the FDIC. The term "depository institution" also includes "banks eligible to make application to become an insured bank," which include certain qualified state banks and branches of foreign banks and any national nonmember bank engaged in receiving deposits (these are banks located in a U.S. Territory, such as Puerto Rico, Guam, American Samoa, and the Virgin Islands, which banks are not members of the Federal Reserve System).

2. *Mutual savings banks* (12 USC §§ 1813, 1815). These are banks that are engaged in the business of a savings bank, as defined by the federal banking laws relating to federal deposit insurance,[34] but that do not have any capital stock. The earnings of a "mutual" savings bank must go to the benefit of its depositors after payment of the bank's obligations.

3. *Savings banks* (12 USC §§ 1813, 1815). These are banks organized under state laws that limit the banks' activities to operation as a savings bank. The bank must maintain its deposits as time deposits or deposits where the bank reserves the right to require written notice before withdrawal. This term does not include a mutual savings bank. The bank must be subject to regulations of the FDIC on withdrawal of deposits.

4. *Insured credit unions* (12 USC §§ 1752, 1781). These are all credit unions that are insured under the National Credit Union Insurance Fund. The definition of the term "depository institution" also includes credit unions eligible for such insurance.

5. *Members* (12 USC § 1422). Members are institutions that are members of the Federal Home Loan Bank System by having subscribed to stock in a Federal Home Loan bank.

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[32] 12 USC §§ 1813(a), 1813(f), 1813(g), 1814, 1815(a) (1982).

[33] See 12 USC § 461(b)(1)(A) (1982).

[34] See 12 USC §§ 1813(f), (g) (1982).

6. *Insured institutions* (12 USC §§ 1724, 1726). These are institutions insured by the FSLIC. The term "depository institution" includes institutions eligible for such insurance, which includes certain building and loan associations, savings and loan associations, homestead associations, cooperative banks, and savings banks chartered under state law.

7. *Other*. Institutions that are wholly owned by any of the previously named institutions or that are made up of only institutions in the previous categories are "depository institutions" for limited purposes.

¶ 2.03 FEDERAL BANKING REGULATORY AGENCIES

As a result of the historical development of banking in the United States, there are three principal federal agencies that regulate commercial banks: the Office of the Comptroller of the Currency (discussed in Chapters 3 and 4), and the Board of Governors of the Federal Reserve System (discussed in Chapters 3 and 4), and the FDIC (discussed in Chapters 9 and 10). There is some overlap of functions between these agencies, overlap that at times has led to differing views on the policies to be followed in bank regulation. For the most part, however, the agencies have cooperated in exercising their responsibilities.[35] Additionally, there are separate federal regulatory agencies with authority over savings and loan associations, credit unions, and other thrift institutions.

The primary responsibilities of the Office of the Comptroller of the Currency are supervising the activities of the national banks and chartering national banks. The Board of Governors of the Federal Reserve System has regulatory authority over all the banks that are members of the Federal Reserve System and has some authority over depository institutions that are not members of the Federal Reserve System. In this respect, the authority of the Board of Governors overlaps to some extent the authority of the Office of the Comptroller of the Currency, since all national banks must be members of the Federal Reserve System. Insofar as supervision of the banking activities of the member banks is concerned, however, the Board of Governors has generally pursued a policy of allowing the Comptroller of the Currency to be responsible for the examination of member national banks. The Board of Governors, through the individual Federal Reserve banks, is responsible for examining state member banks. The Federal Reserve Board also has regulatory control over the formation and activities of bank holding companies. These issues are discussed in Chapter 5.

The FDIC has regulatory authority over the banks and other depository institutions whose deposits it insures. Since the FDIC insures the deposits of all member banks, there is an overlap of authority between the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Cur-

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[35] Hackley, "Our Baffling Banking System", 52 Va. L. Rev. 565, 771 (1966).

rency. To avoid duplication of effort, the FDIC limits its supervision to those state banks that are not members of the Federal Reserve System but whose deposits are insured by the FDIC.

There are also state banks that are not members of the Federal Reserve System and that do not have their deposits insured with the FDIC. These state banks are regulated by the appropriate state banking agency. However, as discussed in Chapter 3 on the Federal Reserve System, the Board of Governors has some regulatory authority over even these institutions. In addition, state banking agencies also have authority under their state banking laws to supervise the state banks that have become members of the Federal Reserve System or that have become insured by the FDIC. In these cases, state regulation cannot interfere or conflict with federal requirements.

Additional agencies have regulatory responsibility for savings and loan associations. Federal savings and loan associations are chartered and regulated by the Federal Home Loan Bank System, to which they must belong. The FHLBB is the head of this system. Additionally, all federal savings and loan associations must have their deposits insured by the FSLIC, which is responsible for determining that the associations it insures are following safe and sound practices. Since the members of the FHLBB serve as the trustees of the FSLIC, the two agencies pursue complementary policies. The FSLIC, however, has the power to insure the deposits of savings and loan associations that are not members of the FHLBB. When such state associations obtain insurance from the FSLIC, they submit to the authority of the corporation to examine and supervise their activities.

The manner in which credit unions are regulated is described in Chapter 11. The primary federal regulator for insured credit unions is the National Credit Union Administration Board.

Representatives of the federal banking regulatory agencies make up the Financial Institutions Examination Council, which was established by law in 1978 to create uniform standards for the examination of depository institutions.[36] The council is discussed in Chapter 7.

¶ 2.04 STATE REGULATION OF BANKS

Comprehensive federal banking legislation was not adopted until passage of the National Bank Act of 1863 and subsequent amendments to that act. Originally, all banks were controlled by state law, either common or statutory, and many states had constitutional provisions governing banking. As experience with banking grew, state laws proliferated to the point where there is now a

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[36] The council was established by the Financial Institutions Regulatory and Interest Rate Control Act of 1978, 12 USC § 3301 (1982), and is discussed in ¶ 7.01[1].

myriad of statutes enfranchising banking corporations and creating departments of state government to regulate, supervise, and inspect them.

Today there is a dual, state and federal, system of banking regulation. State law governs the regulation of state banks unless preempted by federal law as a result of the supremacy clause of the U.S. Constitution. (Under the supremacy clause, federal law overrides conflicting state law.) Thus, in the case of state banks that are members of the Federal Reserve System and state banks that are insured by the FDIC, there is both state and federal regulation of the banks' actions. State law covers all aspects of the banking business conducted by state banks: issuing charters, which set out in detail the powers necessary to carry on daily banking activities such as receiving deposits; prescribing the size of reserves to protect depositors; making loans; investing in specified securities; owning and managing real estate; trading in commercial paper; issuing circulating bank notes; and financing businesses. In the competitive environment of the 1980s, some states have adopted banking laws that permit state banks to engage in activities that are not permitted to national banks. When state banks chartered under these laws are also insured by the FDIC or are part of a bank holding company structure, they are then subject to regulation by the FDIC, in the case of insured banks, as discussed in Chapters 9–11, and by the Federal Reserve Board, in the case of bank holding companies, as discussed in Chapter 5, which regulation may limit the banks' abilities to engage in the transaction allowed by the state law.

Each state has a department of banking under various titles that supervises and regulates state banks within its jurisdiction. These departments are usually headed by the state banking commissioner, and employ bank examiners and other officials to inspect the operation of state banks. The books of these banks are subject to periodic audits, and the banks themselves are required to issue annual or semiannual financial statements, which are reported to the banking department and which may later be made public.

State banking commissioners, in addition to chartering banks, supervise and regulate banks to ensure their solvency and liquidity. If audits disclose that the banks are not sound, the commissioner may demand that more capital be raised either by assessment of the stockholders or from outside sources. If the commissioner deems the bank to be beyond solvency, he may close and liquidate it, distributing the assets according to law to creditors, depositors, and, if anything remains, to the stockholders.[37]

State banking commissioners also have the power to make rules and regulations to carry out their duties and to implement the statutes. Thus, the binding state rules governing the operation of banks may be found in three sources: (1) the constitution of the state; (2) the statutes passed by the legislature; and (3) the

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[37] See generally Chapter 10. For capital requirements for state banks, see Annotation, "Validity, Construction, and Effect of Statutory Provisions Concerning Capital Requisites of State Incorporation of Bank," 79 ALR3d 1190 (1977).

rules promulgated by the banking commissioner. The constitutions and the statutes are regularly published and should be available at most law libraries; the regulations are a different matter. A few states have official publications similar to the *Federal Register*, which is discussed in Chapter 14, or keep central files, as required by statute, that contain the text of all the administrative regulations having the force of law. However, some states have no such requirements. In these states the regulations are kept on file in the bank commissioner's office, which will usually send, on request, copies of the rules desired. The addresses of the bank commissioners' offices are contained in Table 2-3.

¶ 2.05 SPECIALIZED ORGANIZATIONS WITH BANKING FUNCTIONS

There are many organizations established under state and federal law that perform specialized credit and financing functions. Some of these may engage in transactions similar to those of commercial banks and may generate commercial paper that is purchased by commercial banks. This section briefly describes some of these specialized institutions.

[1] Industrial Banks or Morris Plan Banks

These banks were originally established to provide credit on an installment loan basis to wage earners, and take their name from the founder of the first such bank, Arthur Morris, who established such a bank in Virginia in 1910. These banks are the creatures of state law in the states that authorize them. They may have the power to solicit deposits, issue investment certificates, and make installment loans. Industrial banks are eligible for membership in the Federal Reserve System[38] and for deposit insurance.[39]

[2] Loan and Finance Companies

Many organizations engage in the business of lending money, including small loan companies, business finance companies, and mortgage companies. While these companies may compete with banks where both are engaged in the same functions (e.g. consumer lending) the loan and finance companies generally do not accept deposits but obtain their funds from investors and creditors. These companies are often subject to specialized regulatory regimes established by the states to control these activities through licensing and supervision. Many of these organizations generate large amounts of commercial paper, which are

(text continues on p. 17)

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[38] 12 USC § 321 (1982).

[39] 12 USC §§ 1813(a), 1814(b) (1982).

TABLE 2-3 State Bank Commissioners

Alabama
Superintendent of Banks
Department of Banking
Montgomery, AL 36130

Alaska
Director
Division of Banking, Securities, and Corporations
Department of Commerce and Economic Development
Juneau, AK 99811-0800

Arizona
Superintendent of Banks
Banking Department
Phoenix, AZ 85012

Arkansas
Commissioner
Bank Department
Little Rock, AR 72201

California
Superintendent of Banks
Banking Department
San Francisco, CA 94104-2980

Colorado
Commissioner
Division of Banking
Department of Regulatory Agencies
Denver, CO 80204

Connecticut
Commissioner
Department of Banking
Hartford, CT 06106

Delaware
State Bank Commissioner
Department of State
Dover, DE 19903

Florida
Comptroller
Department of Banking and Finance
Tallahassee, FL 32304

Georgia
Commissioner
Department of Banking and Finance
Atlanta, GA 30341

Hawaii
Commissioner
Division of Financial Institutions
Department of Commerce and Consumer Affairs
Honolulu, HI 96805

Idaho
Director
Department of Finance
Boise, ID 83720

Illinois
Commissioner
Banks and Trust Companies
Springfield, IL 62701-1291

Indiana
Supervisor
Banks and Trust Companies Division
Department of Financial Institutions
Indianapolis, IN 46204

Iowa
Superintendent
Department of Banking
Des Moines, IA 50309

Kansas
Commissioner
State Banking Department
Topeka, KS 66603

Kentucky
Commissioner
Department of Financial Institutions
Public Protection and Regulation Cabinet
Frankfort, KY 40601

Louisiana
Commissioner
Office of Financial Institutions
Department of Commerce
Baton Rouge, LA 70804-9095

Maine
Superintendent
Bureau of Banking
Department of Business, Occupational and Professional Regulation
Hallowell, ME 04347

Maryland
Bank Commissioner
Division of Financial Regulation
Department of Licensing and Regulation
Baltimore, MD 21202

Massachusetts
Commissioner
Division of Banks and Loan Agencies
Department of Banking and Insurance
Boston, MA 02202

Michigan
Commissioner
Financial Institutions Bureau
Department of Commerce
Mail to: P.O. Box 30224
Lansing, MI 48909

Minnesota
Deputy Commissioner
Financial Examinations Division
Department of Commerce
St. Paul, MN 55101

Mississippi
Commissioner
Department of Banking and Consumer Finance
Jackson, MS 39205

Missouri
Division of Finance
Department of Economic Development
Jefferson City, MO 65102

Montana
Commissioner of Financial Institutions
Financial Division
Department of Commerce
Helena, MT 59620

Nebraska
Director
Department of Banking and Finance
Lincoln, NE 68509

Nevada
Administrator
Financial Institutions Division
Department of Commerce
Carson City, NV 89710

New Hampshire
Commissioner
Banking Department
Concord, NY 03301

New Jersey
Commissioner
Department of Banking
Trenton, NJ 08625

New Mexico
Director
Financial Institutions Division
Regulation and Licensing Department
Santa Fe, NM 87503

New York
Superintendent
Banking Department
New York, NY 10006

North Carolina
Commissioner
Banking Commission
Department of Commerce
Dobbs Building
Raleigh, NC 27626-0512

North Dakota
Commissioner
Department of Banking and Financial Institutions
Bismarck, ND 58505

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TABLE 2-3 *(cont'd)*

Ohio
Superintendent
Savings and Loan Associations Division
Department of Commerce
Columbus, OH 43266-0549

Oklahoma
Commissioner
Banking Department
Oklahoma City, OK 73105

Oregon
Administrator
Financial Institutions Division
Department of Commerce
Salem, OR 97310

Pennsylvania
Secretary
Department of Banking
Harrisburg, PA 17101-2290

Rhode Island
Assistant Director
Banking and Securities Administration
Department of Business Regulation
Providence, RI 02903

South Carolina
State Treasurer and Chairman
Office of the State Treasurer
Columbia, SC 29211

South Dakota
Director
Division of Banking and Finance
Department of Commerce and Regulation
Pierre, SD 57501

Tennessee
Assistant Commissioner for Bank Examinations
Department of Financial Institutions
Nashville, TN 37219

Texas
Commissioner
Banking Department
Austin, TX 78705

Utah
Commissioner
Department of Financial Institutions
Salt Lake City, UT 84110-0089

Vermont
Commissioner
Department of Banking and Insurance
Montpelier, VT 05602

Virginia
Commissioner
Bureau of Financial Institutions
State Corporation Commission
Richmond, VA 23205

Washington
Supervisor
Division of Banking
Department of General Administration
Olympia, WA 98504

West Virginia
Deputy Commissioner
Department of Banking
Charleston, WV 25305

Wisconsin
Commissioner
Office of Commissioner of Banking
Madison, WI 53707

Wyoming
State Examiner
Office of the State Examiner
Cheyenne, WY 82002

Source: 1986 National Directory of State Agencies

purchased and dealt with by commercial banks. Some of these organizations may be part of a bank holding company structure. Bank holding companies are discussed in Chapter 5.

[3] Edge Corporations

Edge corporations are specialized corporations for international banking transactions, although they are also permitted to engage in some domestic activities that relate to their international business.[40] The Federal Reserve Board regulates the organization of Edge corporations and supervises their activities.

[4] Export-Import Bank of the United States

The Export-Import Bank of the United States (EXIM Bank) is an "independent agency" of the United States whose directors and officers are appointed by the president with the advice and consent of the Senate.[41] The purpose of the bank is to facilitate and aid in financing exports and imports of the United States. It is authorized to engage in general banking functions but has the special function of arranging financing and guarantees on terms that enable U.S. exporters to compete with foreign competitors.[42]

[5] International Finance Organizations

There are international finance organizations created by treaties or as part of the United Nations with which the United States cooperates and over which the United States has some participation in regulating. Examples are the Asian Development Bank,[43] the Inter-American Development Bank,[44] and the World Bank (known as the International Bank for Reconstruction and Development).[45]

[6] Housing and Mortgage Credit Agencies

The federal government has established many programs that use various financial techniques and create financial institutions to make credit available to those who need housing. There are programs for direct government loans, programs for insuring and guaranteeing loans, and subsidy programs, as well as

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[40] 12 USC § 611a (1982). See generally McPheters, "Formation of Edge Act Corporations," 37 Bus. Law. 593–612 (1982); Satola, "Recent Developments in Edge Act Corporations," 1985 U. Wis. Int'l LJ 115–133 (1985).

[41] 12 USC § 635a (1982).

[42] 12 USC §§ 635, 635a-3, 635a-4 (1982 & Supp. III 1985).

[43] 22 USC § 285 (1982).

[44] 22 USC § 283 (1982).

[45] 22 USC § 286 (1982).

other assistance programs. In addition, a number of financial agencies assist in the financing of housing and the flow of credit into mortgage markets. Some of the more important agencies are discussed in the following text.

[a] The Federal Home Loan Mortgage Corporation. This corporation was established to purchase residential mortgages from federally insured savings and loan associations and other financial institutions whose depositor accounts are federally insured. The board of directors of the corporation is composed of the members of the FHLBB.[46] The corporation engages in purchasing and selling mortgage interests in order to channel credit into the housing market.

[b] The Federal Housing Administration. The Federal Housing Administration (FHA), which is a unit of the Department of Housing and Urban Development, administers programs of mortgage insurance under the National Housing Act and certain other housing assistance programs. The FHA is directed by a commissioner who reports to the Secretary of Housing and Urban Development.[47]

[c] The Federal National Mortgage Association. The Federal National Mortgage Association was established in 1938 to purchase and sell FHA-insured and Veterans Administration (VA)-guaranteed mortgages. By engaging in these purchase and sale transactions, the association channels funds for home mortgage financing from the investors, to whom it sells the mortgages, to the lending institutions from whom it purchased the mortgages. The association is owned by private investors, but is subject to regulation in some respects by the Secretary of Housing and Urban Development.[48]

[d] The Government National Mortgage Association. The Government National Mortgage Association was created in 1968 as a spin-off from the Federal National Mortgage Association. It carries out various programs of the Department of Housing and Urban Development involving special loan programs and the management of certain government-held mortgage portfolios and other securities. It also purchases mortgages that arise under federal programs for providing housing for low- and moderate-income families.[49]

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[46] See 12 USC §§ 1451–1459 (1982 & Supp. III 1985). See also ¶ 2.03.

[47] 42 USC § 3533(a) (1982). See also 24 CFR § 200.4(b) (1987).

[48] See 12 USC §§ 1716–1723e (1982 & Supp. III 1985).

[49] Id.

[7] Special Purpose Federal Agencies with Financing Functions

Often the federal government will establish a loan program to be administered by a special agency to carry out the purposes of some federal program. It is impossible to list all of these federal agencies. They include the Small Business Administration, which makes loans and participates in lending agreements with other financial institutions to assist small business enterprises;[50] the VA, which administers some loan programs for veterans;[51] the Solar Energy and Energy Conservation Bank, which Congress established in 1980 and which promotes energy conservation and the use of solar energy;[52] and the National Consumer Cooperative Bank, which was established in 1978 to assist in the development of consumer and other self-help cooperatives.[53]

[8] The Farm Credit System

The Farm Credit System is the result of federal legislation intended to provide for the special credit needs of farmers, ranchers, and commercial fishing operators. The special federal interest in farm credit stretches back to 1916.[54] The system was consolidated under the supervision of the Farm Credit Administration by the Farm Credit Act of 1971.[55] Additional features have been added by subsequent legislation. As a result of the financial losses agricultural lenders suffered in the mid-1980s, losses that left the farm credit system in a financially weakened condition, Congress made further changes to strengthen the system.[56] Congress adopted farm credit legislation to encourage agricultural producers to participate in the management, control, and ownership of a credit system for their business requirements.[57] Federal law establishes a network of thirty-seven interrelated organizations in twelve geographical districts to provide credit for farming and ranching operations. Commercial fishermen and others who harvest aquatic products are also entitled to participate in the system. As explained later, federal legislation in 1988 set in motion an extensive restructuring of the system and its institutions.

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[50] 15 USC § 631 (1982).

[51] 38 USC § 201 (1982).

[52] 12 USC § 3601 (1982).

[53] 12 USC § 3001 (1982).

[54] Farm Loan Act of 1916, ch. 245, 39 Stat. 360.

[55] Farm Credit Act of 1971, Pub. L. No. 92-181, 85 Stat. 583 (12 USC §§ 2001–2279aa-14 (West 1982 & Supp. VI 1986)).

[56] There were significant amendments in 1985, 1986, and 1988. Farm Credit Amendments Act of 1985, Pub. L. No. 99-205, 99 Stat. 1678 (1985); Farm Credit Act Amendments of 1986, Pub. L. No. 99-509, 100 Stat. 1877 (1986); Agricultural Credit Act of 1987, Pub. L. No. 100-233, 101 Stat. 1568 (1988).

[57] 12 USC § 2001(b) (1982).

The institutions that make up the Farm Credit System are the Farm Credit Administration, which supervises and regulates the system, Federal Land banks, Federal Intermediate Credit banks, Banks for Cooperatives, Federal Land Bank Associations, and Production Credit Associations. These institutions are organized into twelve Farm Credit Districts, each with its own governing Farm Credit Board composed of seven members.[58] Each district has a Federal Land bank, a Federal Intermediate Credit bank, and a Bank for Cooperatives. There also is a Central Bank for Cooperatives. Thus, as of the beginning of 1988, there were thirty-seven banks in the farm credit system. In addition, there are about 400 local associations (Production Credit Associations and Land Bank Associations) that are the vehicles for delivering credit directly to the farmers and ranchers.[59]

[a] Federal Land Banks and Associations. The Federal Land banks are federally chartered institutions and date back to the Farm Loan Act of 1916.[60] They are authorized to make real estate mortgage loans to farmers, ranchers, and aquatic products harvesters for any "agricultural or aquatic purpose and other credit needs . . . . including financing for basic processing and marketing . . . ."[61] The loans are medium to long term, from five to forty years,[62] and are usually secured by a first lien on farm real estate.[63]

The Federal Land banks make loans to Federal Land Bank Associations.[64] These associations are chartered under federal law and are made up of the farmers and ranchers who desire to borrow money from the Federal Land bank. The members of the association must subscribe to stock in the association in amounts depending upon the size of their loans.[65] The Federal Land banks are

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[58] The Federal Land Bank Associations, the Production Credit Associations, and the borrowers of the Banks for Cooperatives within each district each elect two members. The seventh member is elected by the borrowers at large in a district. Thus, the farmers and ranchers participating in the system determine who will be the members of the board. 12 USC § 2223 (Supp. III 1985). The 1988 amendments repealed these provisions and substituted new procedures for electing the directors of system institutions.

[59] H. Rep. No. 295 (I), 100th Cong., 1st Sess., reprinted in 1988 U.S. Code Cong. & Admin. News 2723, 2726 (hereafter H. Rep. No. 295 (I)).

[60] 12 USC §§ 2011, 2012 (1982 & Supp. III 1985). The 1988 act repealed these provisions and replaced them with ones creating the Farm Credit banks, 12 USCA §§ 2011–2023 (West Supp. 1988), which are discussed at ¶ 2.05[8][f].

[61] 12 USC § 2018 (1982). The relevant successor to this provision is 12 USCA § 2019 (West Supp. 1988).

[62] 12 USC §§ 2014, 2015 (1982). The relevant successor provisions are 12 USCA §§ 2015, 2016 (West Supp. 1988).

[63] H. Rep. No. 295 (I), at 2727.

[64] 12 USC § 2012 (1982 & Supp. III 1985). The relevant successor provision is 12 USCA § 2013 (West Supp. 1988).

[65] 12 USC § 2031 (Supp. III 1985). The relevant successor provision is 12 USCA § 2091 (West Supp. 1988).

the dominant holders of farm mortgage credit in the United States. As of 1986, these banks held about 43 percent of all outstanding farm real estate loans.[66]

[b] Federal Intermediate Credit Banks and Production Credit Associations. Each district also may have a Federal Intermediate Credit bank. These banks, which were authorized by federal legislation in 1923 and which are federally chartered institutions, are authorized to make short-term loans and to discount agricultural paper from other institutions and associations. These loans generally are repayable in not more than ten years.[67] The banks do not loan directly to farmers or otherwise conduct a general banking business but channel credit to farmers and ranchers through their purchase of loans from institutions that extend credit directly to agricultural producers. The voting stock of the Federal Intermediate Credit banks is held by Production Credit Associations. Farmers, ranchers, and aquatic products harvesters may organize Production Credit Associations. The associations engage in lending on a short- and intermediate-term basis for agricultural operations and rural housing to their members. The associations obtain funds for these financing activities by discounting and selling the loans made to Federal Intermediate Credit banks. Each Federal Intermediate Credit bank also acts as a supervisor of the associations in its district.[68]

[c] Banks for Cooperatives. Banks for Cooperatives are made up of a central bank and twelve district banks. These banks were created initially in 1933 to provide a source of credit for agricultural cooperatives.[69] The central bank makes loans directly to the district banks and also to large national and regional cooperatives. The district banks serve local agricultural cooperatives. They may also engage in certain financing activities on an international basis to assist the export of agricultural products by their cooperative members.[70]

[d] Farm Credit Boards. The Farm Credit Board for each district serves as the governing board of directors for the Federal Land bank, Federal Intermediate Credit bank, and Bank for Cooperatives in the district, which coordinates policy and management for these various institutions.[71]

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[66] H. Rep. No. 295 (I), at 2737.

[67] 12 USC §§ 2074, 2075 (1982 & Supp. III 1985). The relevant successor provisions are 12 USCA §§ 2011–2023 (West Supp. 1988), on Farm Credit banks.

[68] 12 USC §§ 2093, 2096 (1982 & Supp. III 1985). The relevant successor provisions are 12 USCA §§ 2073, 2075 (West Supp. 1988).

[69] Farm Credit Act of 1933, ch. 98, 48 Stat. 257.

[70] 12 USC § 2128 (1982).

[71] 12 USC § 2224 (1982). The 1988 act repealed these provisions and replaced them with 12 USCA §§ 2012, 2142 (West Supp. 1988).

[e] Farm Credit Administration. The Farm Credit Administration (FCA) has overall responsibility for regulating the system.[72] It is an independent agency in the executive branch of the government. This agency is controlled by the Farm Credit Administration Board, which consists of three members appointed by the president of the United States.[73] Not more than two members of the board may be members of the same political party, and the president designates one of the members to serve as chairman.[74] The chairman is the executive officer of the board and the chief executive officer of the Farm Credit Administration[75] and is responsible for administering the system. There is no express authority in the act allowing the president to remove a member or the chairman. The Farm Credit Administration has regulatory authority over the various institutions within the Farm Credit System and has powers to examine them, establish rules and regulations, and take action to prevent unsafe and unsound practices.[76]

In 1985, Congress directed a major restructuring of the Farm Credit Administration that put in place the three member Farm Credit Administration Board described previously and that substantially enlarged the role of the FCA as an independent regulatory agency for the Farm Credit System similar to the role of other federal banking regulatory agencies.[77] Changes in 1988 further strengthened the regulatory role of the FCA.[78] As a result, the FCA has cease and desist enforcement authority to prohibit unsafe or unsound practices and to compel adherence to its regulations.[79] In addition, the FCA also has the power to conduct examinations of and to require reports from Farm Credit System institutions,[80] the ability to suspend directors and officers of system institutions and to initiate procedures to remove them from office when they have participated in unsafe or unsound practices or breached their fiduciary duties as

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[72] See 12 USC §§ 2001–2260 (1982 & Supp. III 1985). The relevant successor provisions are 12 USCA §§ 2241–2276 (West Supp. 1988).

[73] 12 USCA § 2242(a) (West Supp. 1988).

[74] Id.

[75] 12 USCA § 2244 (West Supp. 1988).

[76] 12 USCA § 2252–2274 (West Supp. 1988).

[77] Farm Credit Amendments Act of 1985, Pub. L. No. 99-205, 99th Cong., 1st Sess., 99 Stat. 1678, reprinted in 1985 U.S. Code Cong. & Admin. News 1678 (codified in scattered sections of 12 USC); H. Rep. No. 425, 99th Cong., 1st Sess., reprinted in 1985 U.S. Code Cong. & Admin. News 2588–2590.

[78] Agricultural Credit Act of 1987, Pub. L. No. 100-233, 100th Cong., 1st Sess., 101 Stat. 1568, reprinted in 1988 U.S. Code Cong. & Admin. News 1568 (codified in scattered sections of 12 USC); H. Rep. No. 295(I), 100th Cong., 1st Sess., reprinted in 1988 U.S. Code Cong. & Admin. News 2723.

[79] 12 USCA § 2261 (West Supp. 1988).

[80] Id. § 2254.

officers of their institutions,[81] and the authority to impose civil penalties on institutions or officers who violate orders of the FCA.[82] The FCA may regulate system institutions to require minimum levels of capital[83] and may appoint a conservator or receiver for system institutions that become insolvent or otherwise are appropriate for such treatment.[84]

When the FCA first came into existence, it approved the interest rates set by system institutions. Congress eliminated this authority in 1986 and expressed its intent that market interest rates should prevail.[85] At the same time, Congress provided that the interest rates on loans from system institutions are not subject to state usury laws and interest limitations.[86]

[f] 1988 Restructuring of the Farm Credit System. The congressional restructuring of the Farm Credit System in 1988[87] will bring about the merger of system institutions to consolidate and strengthen the system. The provisions are complex and include both mandatory merger requirements and procedures for voluntary consolidations. The basic approach is as follows: The Federal Land bank and the Federal Intermediate Credit bank of each district must merge into a new Farm Credit bank for the district. After these consolidations, the institutions in the Farm Credit System will consist of Farm Credit banks, the Federal Land Bank Associations, the Production Credit Associations, and the Banks for Cooperatives.[88] After the formation of the Farm Credit bank in a district, a proposal must be submitted to the stockholders of each Federal Land Bank Association and Production Credit Association in the district for merger of the associations.[89] The legislation also establishes a procedure for formulating a plan of merger for the voluntary merger of the banks for cooperatives into a combined National Bank for Cooperatives.[90] Additionally, the 1988 act encourages volun-

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[81] Id. § 2264. The statute details the circumstances under which the FCA may seek removal or suspension and the procedures to be followed in such cases. See also 12 USCA § 2265 (West Supp. 1988), on the suspension or removal of officers charged with a felony.

[82] 12 USCA §§ 2268, 2269 (West Supp. 1988).

[83] Id. § 2154.

[84] Id. § 2183(b) (West Supp. 1988). Eventually, the Farm Credit System Insurance Corporation will be the statutorily prescribed receiver or conservator. Id.

[85] Farm Credit Act Amendments of 1986, Pub. L. No. 99-509, § 1033, 99th Cong., 2d Sess., 100 Stat. 1877, reprinted in 1986 U.S. Code Cong. & Admin. News 1877 (amending 12 USC §§ 2015, 2075, 2131(a)).

[86] 12 USCA § 2205 (West Supp. 1988).

[87] Pub. L. No. 100-233, § 410(a), 100th Cong., 1st Sess., 101 Stat. 1637, reprinted in 1988 U.S. Code Cong. & Admin. News 1637 (hereafter Pub. L. No. 100-233).

[88] See 12 USCA § 2002 (West Supp. 1988) (effective six months after January 6, 1988).

[89] Pub. L. No. 100-233, § 411.

[90] Pub. L. No. 100-233, § 413.

tary mergers of banks within a district[91] and between banks of the same type that operate in different districts.[92] A special committee will submit a proposal to consolidate the twelve Farm Credit System districts and the Farm Credit System banks formed as a result of the previously described mergers into "no less than six financially viable farm credit banks through inter-district mergers."[93]

The reorganized Farm Credit System enjoys increased powers to finance its activities. Historically, the banks in the system raised most of their money from the sale of Farm Credit securities in the national money markets. Until 1977, Land Banks, Intermediate Credit Banks, and Banks for Cooperatives sold their securities separately. In 1977, the use of systemwide bonds and notes began. These obligations, although systemwide, are the joint and several obligations of all thirty-seven separate Farm Credit System banks.[94] The 1988 federal legislation included measures to assist in the issuance of such systemwide obligations.[95] In addition, the Federal Farm Credit Banks Funding Corporation was created to assist system banks in issuing and marketing obligations to obtain funds and in arranging for the issuance of joint and systemwide obligations.[96] A system is established for encouraging the banks in the system to create pools of mortgages and other obligations to back securities that may then be sold in the secondary market.[97] The Federal Agricultural Mortgage Corporation was established to assist in the marketing of the securities.[98]

The revamped Farm Credit System also includes special mechanisms to supply financial assistance to financially troubled system institutions. In 1985, Congress created the Farm Credit System Capital Corporation to assist in channeling funds to distressed system institutions. However, because of litigation over the ability of the corporation to assess healthy institutions to provide aid to distressed ones and opposition to the manner in which the corporation operated, Congress eliminated the Capital Corporation in 1988.[99] The Farm Credit Assistance Board was created as the successor to the Capital Corporation. When certain conditions are met, the board may authorize a system institution to issue preferred stock to obtain additional capital or to facilitate a merger,[100]

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[91] 12 USCA § 2279a (West Supp. 1988).

[92] 12 USCA § 2279f (West Supp. 1988).

[93] Pub. L. No. 100-233, § 412(a)(2).

[94] H. Rep. No. 425, 99th Cong., 1st Sess., reprinted in 1985 U.S. Code Cong. & Admin. News 2592.

[95] 12 USCA §§ 2155, 2159 (West Supp. 1988).

[96] Id. § 2160.

[97] 12 USCA §§ 2279aa–2279aa-14 (West Supp. 1988).

[98] Id. §§ 2279aa-1–2279aa-3. See H. Rep. No. 295(I). 100th Cong., 1st Sess., reprinted in 1988 U.S. Code Cong. & Admin. News 2737–2740.

[99] Pub. L. No. 100-233, § 207(a)(3), 100th Cong., 1st Sess., 101 Stat. 1607, reprinted in 1988 U.S. Code Cong. & Admin. News 1607 (repealing 12 USC §§ 2216–2216f).

[100] 12 USCA § 2278a-5(a) (West Supp. 1988).

and it may exercise special powers to restore the institution to a financially sound condition.[101] To fund this assistance, the Financial Assistance Corporation[102] was created. This corporation, subject to the approval of the board, may issue certain debt obligations that are guaranteed (as to the payment of principal and interest) under a complex procedure by the Secretary of the Treasury.[103] There is a complicated arrangement for funding the Financial Assistance Corporation and channeling that assistance to the distressed institutions. The Financial Assistance Corporation purchases the preferred stock authorized by the board, as described previously, that is issued by the distressed institution.[104]

The 1988 legislation also creates a Farm Credit System insurance fund to insure the obligations issued by the system banks.[105] The fund is operated through the Farm Credit System Insurance Corporation.[106] The insurance is financed by premiums assessed against system banks based upon the loans made by the banks.[107] The Insurance Corporation has various powers to deal with troubled insured system banks, including providing assistance to prevent a bank from entering receivership and facilitating mergers or consolidations.[108]

[g] **Borrowers' Rights.** Borrowers from Farm Credit System institutions obtained special rights as a result of federal legislation in 1985 and 1988. Lenders are required to disclose interest rates and to make a special disclosure when the loan is a variable rate loan.[109] Borrowers have the right to require lenders to review loans to determine if a proper interest rate was charged and to explain how the borrower might improve his or her credit status to obtain a lower interest rate.[110] At the time the loan is executed, the lender must provide to the borrower copies of all loan documents, copies of appraisals of the borrower's assets, and other documentation.[111] Procedures exist for giving borrowers written notice of action taken on loan applications and a right to obtain review and reconsideration.[112]

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[101] Id. § 2278a-6.

[102] Id. § 2278b.

[103] Id. § 2278b-6.

[104] Id. § 2278b-7(b).

[105] Id. § 2277a-1.

[106] Id. § 2277a-1.

[107] Id. § 2277a-4.

[108] Id. § 2277a-10.

[109] Id. § 2199.

[110] Id. § 2199(b).

[111] Id. § 2200.

[112] Id. §§ 2201, 2202.

There is an extensive procedure that requires lenders to consider restructuring distressed loans prior to initiating any foreclosure proceeding.[113] A qualified lender is required to restructure the loan if the lender "determines that the potential cost . . . of restructuring the loan in accordance with a proposed restructuring plan is less than or equal to the potential cost of foreclosure . . . ."[114] There also are limitations on a lender's ability to require a borrower to post additional collateral, to reduce the amount of principal outstanding, or to accelerate the payment of the loan.[115]

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[113] Id. § 2202a(b).

[114] Id. § 2202(e)(1).

[115] Id. § 2202d.

3

The Federal Reserve System

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¶ 3.01 INTRODUCTION

As discussed in Chapter 1, the United States has continuously chartered national banks since the National Bank Act of 1863. After the demise of the Second Bank of the United States in 1836, however, the country did not have a central national bank. During the recession of 1907, it became apparent that because of this lack of a central bank, the national banking system was seriously flawed. The banking system did not possess the flexibility to channel funds from one region of the country to another when necessary to meet the requirements of national commerce. Problems arose not only because of the difficulty in arranging loans and extensions of credit between areas with excess reserves and those with shortages, but also because currency shortages inhibited the economic growth of some regions. Accordingly, after extensive study and intense political maneuvering, Congress passed the Federal Reserve Act[1] in 1913, which created the Federal Reserve System.[2]

¶ 3.02 THE STRUCTURE AND FUNCTIONS OF THE FEDERAL RESERVE SYSTEM

The Federal Reserve Act created a three-part structure: the Board of Governors, the Federal Reserve banks, and the member banks. The Board of Governors acts as the governing body of the Federal Reserve System. There are twelve reserve districts in the United States, with each district having one Reserve bank, which may have branches as well. The Reserve banks are bankers' banks in that their capital stock is held by the banks making up the Federal Reserve System.[3] Both state and national banks are members of the Federal Reserve

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[1] Federal Reserve Act, ch. 6, § 1, 38 Stat. 251 (1913) (current version at 12 USC §§ 221–522 (1982 & Supp. III 1985)).

[2] See R. Johnson, Historical Beginnings—The Federal Reserve (1980); H. Prochnow, The Federal Reserve System (1959). See also Chapter 1 for a discussion of the history of banking regulation in the United States.

[3] The requirements and restrictions on the capital stock of the Reserve Banks are set forth in 12 USC §§ 281–290 (1982). The stock has a par value of $100 per share. Each member bank, whether state or national, must subscribe to the capital stock of the Reserve bank in its district to the extent of 6 percent of its paid-up capital and surplus and must

System. National banks must be members; state banks may elect to become members. The following sections of this chapter describe the organization and functions of the Federal Reserve System.

The Federal Reserve System provides the institutional framework in which a national banking system can operate; it regulates banks, provides services to improve banking efficiency, regulates the amount of credit and currency in the banking system, and has a substantial voice in establishing the country's economic policy. The role of the Federal Reserve System in setting monetary policy for the United States is not within the scope of this book.[4] Instead, the focus of this book is on the banking functions of the Federal Reserve System. Some of the specific functions of the Federal Reserve System are listed below. These are discussed in more detail in subsequent sections.

1. *Reserve requirements.* Member banks and other financial institutions are required to keep reserves at the Federal Reserve banks. The power of the Board of Governors to adjust reserve requirements gives the Board a mechanism for influencing the supply of money in the economy.[5]

2. *Loans to member banks and other depository institutions.* The Federal Reserve banks are a source of funds for the member banks. The Federal Reserve System affects economic policy by adjusting the interest rate on loans and by setting the terms under which such loans are made. By making loans to depository institutions, it can provide credit to institutions that have liquidity problems or other credit needs. It can provide short-term, "overnight" credit to relieve temporary credit needs, supply longer term credit to smooth seasonal fluctuations, and can act as a lender of last resort when the national interest requires credit assistance to deal with a financial crisis.

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adjust the amount of stock for which it has subscribed as its capital and surplus increases or decreases. 12 USC §§ 282, 287, 321 (1982); 12 CFR § 209 (1987). The member banks may not transfer or pledge their shares. 12 USC § 287 (1982). By statute, dividends on the stock are limited to an annual cumulative dividend of 6 percent of the amount of the paid-in capital stock, after the expenses of the Reserve bank have been satisfied. 12 USC § 289 (1982). When a member bank becomes insolvent, the Reserve bank has an offset against the stock held by the member bank for debts owing to the Reserve bank, and the Reserve bank need pay the receiver of such a member bank only the value of the stock in excess of the debts owed. 12 USC § 288 (1982). Although the act authorized the public to hold a restricted amount of the stock, 12 USC § 283 (1982), this stock is nonvoting. 12 USC § 285 (1982). However, no stock has been issued to the public. It is all held by the member banks. See generally discussion of the Federal Reserve banks at ¶ 3.03[3].

[4] The role of the Federal Reserve System in making economic and monetary policy is discussed in such standard economics texts as P. Samuelson, Economics (10th ed. 1976); T. Cargill, Money, the Financial System and Monetary Policy (2d ed. 1983); J. Sinkey, Commercial Bank Financial Management in the Financial Services Industry (2d ed. 1986); J. Cochran, Money, Banking, and the Economy (1967).

[5] See ¶ 3.04[2].

3. *The supply of coin and currency.* When additional coinage or currency is needed, it is supplied through the Federal Reserve System. In fact, most of the nation's currency consists of Federal Reserve notes issued by the Federal Reserve banks.

4. *Interest rate regulation.* The Federal Reserve System established the interest ceilings that member banks could pay on customer accounts. However, the Depository Institutions Deregulation and Monetary Control Act of 1980 mandated the deregulation of interest rates, which became fully effective in 1986.

5. *Margin requirements for stock purchase.* The Federal Reserve System has the authority to regulate the "margin requirements" for stock purchases. These requirements determine the extent to which stock may be purchased with borrowed funds.[6]

6. *Check collection and fund transfers.* The Federal Reserve System provides procedures for the collection and payment of checks and other instruments as well as electronic procedures for rapidly transferring funds from one region of the country to another.[7] Because these services are a vital component of the national payment system, the rules and policies established by the Board of Governors in Regulations J and CC and other policy statements for the operation of these services have a major effect on the way banks handle such payments.

7. *Open market actions.* The Federal Reserve System can influence the national economy by taking actions that expand or contract the money supply. This is accomplished by the purchase and sale of U.S. government securities. The Open Market Committee of the Federal Reserve System is responsible for the operation of this policy.[8]

8. *Banker for the government.* The Federal Reserve System acts as the banker for the U.S. government. It handles financial transactions for the U.S. Treasury and provides the various services for transactions involving U.S. government and agency securities.

9. *Bank supervision.* The Federal Reserve System has the authority to supervise the activities of all member banks. Since the Comptroller of the Currency exercises supervisory responsibility for national banks, the Federal Reserve System exercises primary supervision over the state banks that are members of the system.[9]

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[6] 15 USC § 78g (1982 & Supp. III 1985).

[7] See ¶ 3.04[5].

[8] See ¶ 3.03[2].

[9] See ¶ 2.03.

10. *Bank holding companies.* The Federal Reserve System has authority to regulate the activities of bank holding companies. See Chapter 5 for a detailed discussion of bank holding companies.

11. *Foreign banking.* The Federal Reserve System has authority to regulate the foreign transactions of its member banks as well as the actions of foreign banks in the United States.[10]

12. *Consumer credit control.* The Federal Reserve System, at various times in the past, has been given the authority to regulate credit under certain conditions to prevent an excessive expansion of such credit from injuring the economy.[11]

13. *Truth in lending.* The Federal Reserve System is responsible for issuing regulations that interpret and enforce the legislation dealing with consumer credit transactions, popularly known as truth in lending provisions. See Chapter 26 for a detailed discussion of consumer credit transactions.

14. *Unfair and deceptive practices.* The Federal Reserve System has the authority to define unfair and deceptive practices by banks, and to adopt appropriate regulations to prevent them.[12]

¶ 3.03 THE ORGANIZATION AND POWERS OF THE FEDERAL RESERVE SYSTEM

[1] Board of Governors

The Board of Governors of the Federal Reserve System consists of seven members appointed by the president by and with the advice and consent of the Senate. No more than one member may be from any Federal Reserve district, as explained later, and their numbers are distributed among agricultural, industrial, and commercial interests. The members are required to devote full time to their duties on the Board at salaries and expenses prescribed by law,[13] and serve for a term of fourteen years. Appointments are staggered by the president so that no more than one member's term will expire every two years,[14] and members are not eligible for reappointment.[15]

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[10] This book does not cover the regulation of foreign banks or of the foreign activities of U.S. banks.

[11] See ¶ 3.04[6][c].

[12] 15 USC § 57a(f) (1982). See also ¶ 26.05[1].

[13] 12 USC § 241 (1982).

[14] 12 USC § 242 (1982).

[15] Id. Because the statute provides that a member shall not be eligible for reappointment "after he shall have served a full term of fourteen years," this prohibition has been

The president, again with the advice and consent of the Senate, designates two members of the Board to serve as chairman and vice-chairman, each for a four-year term. The chairman is the "active executive officer" of the Board.[16] The length of term and method of appointment is intended to insulate the Board from temporary swings of political sentiment that might influence its policies. The Board is required to make an annual report to the Speaker of the House of Representatives.[17] The Board and the Federal Open Market Committee (FOMC) must also report to Congress annually on the condition of the monetary and credit areas of the economy.[18]

The Board does not depend on Congress for appropriations to support its activities. The Board finances its operations from the earnings of the system, and it may assess the district Federal Reserve banks to meet expenses.[19] Table 3-1 summarizes the income and expenses of the Federal Reserve banks for 1985 and 1986.[20]

The Board controls the operations of the Federal Reserve banks and makes rules and regulations that have the force of law for the operation of the entire Federal Reserve System. These regulations are initially published in the *Federal Register* and are subsequently codified in the *Code of Federal Regulations*. The Board also publishes a looseleaf, multivolume *Federal Reserve Regulatory Service*, which contains copies of the Board's regulations and interpretations and is updated frequently. Before the Board may adopt a regulation, it must comply with the procedures prescribed by law for rule-making. When the Board acts in accordance with the proper procedures and adopts regulations within its area of authority, the regulations have the force of law.

The Board also makes numerous administrative decisions and rulings. These materials appear in the *Federal Register* and in the monthly publication of the Board, the *Federal Reserve Bulletin*. The Board publishes numerous studies and data pertaining to the nation's economy and financial institutions. Much of this information is published in the *Federal Reserve Bulletin*, which contains a running summary of all the business of the system and many statistics on general economic conditions. The Board also issues federal publications that are listed as they appear in the *Federal Reserve Bulletin*.

As explained in Chapter 2, the Board shares authority to regulate banks with the Comptroller of the Currency and the Federal Deposit Insurance Corporation. Each of these agencies has independent statutory authority under federal law, which in some cases has resulted in an overlapping of responsibility.

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avoided by having the member resign before the term expires and then be reappointed to a new term.

[16] 12 USC § 242 (1982).

[17] 12 USC § 247 (1982).

[18] 12 USC § 225a (1982).

[19] 12 USC §§ 243, 244 (1982).

[20] 73 Bd. of Governors, Fed. Reserve Sys. Ann. Rep. 213 (1987).

TABLE 3-1 Federal Reserve Banks' Income and Expenses (thousands of dollars)

Item	*1986*	*1985*
Current income	17,464,528	18,131,983
Current expenses	1,156,868	1,127,744
Operating expenses	1,049,159	1,022,527
Earnings credits granted	107,709	105,217
Current net income	16,307,661	17,004,238
Net addition to (deduction from) current net income	1,975,893	1,301,624
Assessments by the Board of Governors	278,118	251,116
For expenditures of Board	97,338	77,378
For cost of currency	180,780	173,739
Net income before payments to U.S. Treasury	18,005,437	18,054,746
Dividends paid	109,588	103,029
Payments to U.S. Treasury (interest on Federal Reserve notes)	17,803,895	17,796,464
Transferred to surplus	91,954	155,253

Details may not add to totals because of rounding.

Source: 73 Bd. of Governors, Fed. Reserve Sys. Ann. Rep. 213 (1987).

The Federal Reserve Act, as amended, gives the Board of Governors the following "enumerated" powers:[21]

1. To examine the "accounts, books, and affairs" of the Federal Reserve banks and member banks. This includes a responsibility to publish reports on the condition of the Federal Reserve banks showing the reserves held and the nature of their investments.
2. To require reports of the member banks, FDIC-insured institutions, Federal Savings and Loan Insurance Corporation-insured institutions, National Credit Union Administration Board-insured institutions, and other depository institutions.
3. To set the interest rate and regulate the rediscounting by the Federal Reserve banks of paper discounted by other Federal Reserve banks.
4. To give short-term suspension of reserve requirements.
5. To supervise and regulate the issue and retirement of Federal Reserve notes.

[21] 12 USC § 248 (1982).

6. To designate reserve cities for the purpose of setting reserve requirements.[22]
7. To suspend or remove officers and directors of the Federal Reserve banks.
8. To require the Federal Reserve banks to write off "doubtful or worthless assets."
9. To exercise supervisory authority over the Federal Reserve banks, including the power to act when there is a violation of the act to suspend the bank's operations; this action includes taking possession of the bank and administering its pending liquidation or reorganization.
10. To establish rules for the safeguarding of collateral, money, and other property held by Federal Reserve agents.
11. To supervise the Federal Reserve banks.
12. To delegate functions other than rulemaking and policy making relating to monetary and credit policies.
13. To employ persons, including attorneys and experts, to assist in conducting the Board's business.
14. To regulate within limits the amount of capital of member banks that may be based upon certain types of secured loans.
15. To regulate the transfer of funds among the Federal Reserve banks, establish clearing house services for the Federal Reserve banks and at the Federal Reserve banks for other depository institutions, and establish charges for these activities.

In addition to the preceding enumerated powers set forth in 12 USC § 248 (1982), the Board exercises powers granted by other statutes. Some of the major areas are as follows:

1. Equal credit opportunity regulations under the Equal Credit Opportunity Act.[23]
2. Home mortgage disclosure regulations under the Home Mortgage Disclosure Act of 1975.[24]

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[22] The Board classifies banks for reserve requirements on the basis of the assets the banks hold rather than the geographical areas or cities in which the banks are located. 12 USC § 141 (1982); 1 Fed. Banking L. Rep. (CCH) ¶ 19,507.01 (1987).

[23] 15 USC §§ 1691–1691f (1982 & Supp. III 1985). The regulations are at 12 CFR § 202 (1987) (Regulation B).

[24] 12 USC §§ 2801–2811 (1982 & Supp. III 1985). The regulations are at 12 CFR § 203 (1987) (Regulation C).

3. Electronic Fund Transfer regulations under the Electronic Fund Transfer Act.[25]

4. Regulation of international banking and foreign banking in the United States under the Federal Reserve Act,[26] the Bank Holding Company Act,[27] the International Banking Act of 1978,[28] the Bank Export Services Act,[29] and the International Lending Supervision Act.[30]

5. Regulation of interlocking management among depository institutions and holding companies under the Depository Institution Management Interlocks Act.[31]

6. Regulation of consumer credit disclosures and consumer leasing disclosures under the Truth in Lending Act.[32]

7. Regulation of loans to executive officers, directors, and principal shareholders of member banks and related companies.[33]

8. Regulation of the circumstances when a member bank may employ as an officer, director, or employee a person who is a dealer in securities.[34]

9. Regulation of the circumstances for reimbursement of costs incurred by financial institutions in providing customer financial records to governmental authorities under the Right to Financial Privacy Act of 1978.[35]

10. Regulation of the extension of credit for the purchase of securities by brokers and dealers, banks, and other persons under the Securities Exchange Act of 1934.[36]

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[25] 15 USC §§ 1693–1693r (1982 & Supp. 1985). The regulations are at 12 CFR § 205 (1987) (Regulation E).

[26] 12 USC §§ 221-522 (1982 & Supp. III 1985). The regulations are at 12 CFR §§ 211, 214 (1987) (Regulations K, N).

[27] 12 USC §§ 1841–1850 (1982).

[28] 12 USC §§ 3101–3108 (1982).

[29] 12 USC §§ 372, 635 a-4, 1843 (1982 & Supp. III 1985).

[30] 12 USC §§ 3901–3912 (Supp. III 1985).

[31] 12 USC §§ 3201-3208 (1982 & Supp. III 1985). The regulations are at 12 CFR § 212 (1987) (Regulation L).

[32] 15 USC §§ 1601–1667e (1982 & Supp. III 1985). The regulations are at 12 CFR §§ 213, 226 (1987) (Regulations M, Z).

[33] 12 USC §§ 248(i), 375a, 375b, 1817(k) (1982). The regulations are at 12 CFR § 215 (Regulation O).

[34] 12 USC § 78 (1982). See also 12 USC § 248 (1982). The regulations are at 12 CFR § 218 (1987) (Regulation R).

[35] 12 USC § 3415 (1982). The regulations are at 12 CFR § 219 (1987) (Regulation S).

[36] 15 USC §§ 78c, 78g, 78h, 78q, 78w (1982 & Supp. III 1985). The regulations appear at 12 CFR §§ 207, 220, 221, 224 (1987) (Regulations G, T, U, X).

11. Regulation of bank holding companies and changes in bank control.[37]
12. Regulation of unfair or deceptive practices under the Federal Trade Commission Act.[38]
13. Regulation of state member bank compliance with the Community Reinvestment Act of 1977.[39]
14. Regulation of the prices charged to depository institutions for services provided.[40]
15. Regulation of the process for the collection and return of checks and other methods of payment under the Expedited Funds Availability Act.

As a result of the 1980 act, the Federal Reserve Board is obligated to make its services available to both member and nonmember depository institutions.[41] These services expressly include currency and coin services, check clearing and collection services, wire transfer services, automated clearinghouse services, settlement services, securities safekeeping services, Federal Reserve float, and "any new services which the Federal Reserve System offers, including but not limited to payment services to effectuate the electronic transfer of funds."[42]

Table 3-2 is a complete list of the regulations issued by the Board of Governors showing the part of the *Code of Federal Regulations* in which the regulation may be found.

[2] Open Market Operations

Open market transactions are probably the single most important procedure available to the Federal Reserve System for implementing monetary policy. These transactions are conducted by the FOMC. Although the statutory authorization for the committee did not exist until 1933, the history of the committee goes back to 1921. At that time, the separate activities of the individual Federal Reserve banks in buying and selling government securities, primarily in the New

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[37] Authority to regulate is found in the Bank Holding Company Act of 1956, as amended, 12 USC § 1844(b) (1982); the International Banking Act of 1978, 12 USC §§ 3106, 3108 (1982); the Federal Deposit Insurance Act, as amended by the Change in Bank Control Act of 1978, 12 USC § 1817(j)(13) (1982); the Federal Deposit Insurance Act, 12 USC § 1818(b) (1982); and the International Lending Supervision Act of 1983, 12 USC §§ 3901–3912 (Supp. III 1985). The regulations are at 12 CFR § 225 (1987) (Regulation Y).

[38] 15 USC § 57a(f) (1982). The regulations are at 12 CFR § 227 (1987) (Regulation AA).

[39] 12 USC §§ 2901–2905 (1982). The regulations are at 12 CFR § 228 (1987) (Regulation BB).

[40] 12 USC § 248a (1982).

[41] 12 USC § 248a (c)(2) (1982).

[42] 12 USC § 248a(b) (1982).

TABLE 3-2 **Regulations of the Board of Governors of the Federal Reserve System**

12 CFR Pt.	*Subject Matter*	*Reg.*
	SUBCHAPTER A—BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM	
201	Extensions of credit by Federal Reserve Banks	A
202	Equal credit opportunity	B
203	Home mortgage disclosure	C
204	Reserve requirements of depository institutions	D
205	Electronic fund transfers	E
206	[Reserved]	
207	Securities credit by persons other than banks, brokers, or dealers	G
208	Membership of State banking institutions in the Federal Reserve System	H
209	Issue and cancellation of capital stock of Federal Reserve banks	I
210	Collection of checks and other items and transfers of funds	J
211	International banking operations	K
212	Management official interlocks	L
213	Consumer leasing	M
214	Relations with foreign banks and bankers	N
215	Loans to executive officers, directors, and principal shareholders of member banks	O
216	Minimum security devices and procedures for Federal Reserve banks and State member banks	P
217	Interest on deposits	Q
218	Relations with dealers in securities under Section 32, Banking Act of 1933	R
219	Reimbursement to financial institutions for assembling or providing financial records	S
220	Credit by brokers and dealers	T
221	Credit by banks for the purpose of purchasing or carrying margin stocks	U
224	Borrowers of securities credit	X
225	Bank holding companies and change in bank control	Y
226	Truth in lending	Z
227	Unfair or deceptive acts or practices	AA
228	Community reinvestment	BB
229	Availability of Funds and Collection of Checks	CC

(continued)

TABLE 3-2 *(cont'd)*

12 CFR Pt.	*Subject Matter*	*Reg.*
245	Loan guarantees for defense production	
250	Miscellaneous interpretations	
261	Rules regarding availability of information	
261a	Rules regarding access to and review of personal information in systems of records	
261b	Rules regarding public observation of meetings	
262	Rules of procedure	
263	Rules of practice for hearings	
264	Employee responsibilities and conduct	
264a	Reserve Bank Directors—actions and responsibilities	
264b	Rules regarding foreign gifts and decorations	
265	Rules regarding delegation of authority	
266	Limitations on activities of former members and employees of the board	
267	Rules of organization and procedures of the Consumer Advisory Council	
268	Rules regarding equal opportunity	
269	Policy on labor relations for the Federal Reserve Banks	
269a	Definitions	
269b	Changes of unfair labor practices	
	SUBCHAPTER B—FEDERAL OPEN MARKET COMMITTEE	
270	Open market operations of Federal Reserve Banks	
271	Rules regarding availability of information	
272	Rules of procedure	
281	Statements of policy	
	SUBCHAPTER C—FEDERAL RESERVE SYSTEM LABOR RELATIONS PANEL	
290–299	[Reserved]	

Source: 12 CFR pts. 200–299 (1988); 3 Fed. Reserve Regulatory Service, ch. 9 (1988).

York City market, tended to disrupt the securities market, much to the concern of the U.S. Treasury and the banking system. The committee was established to coordinate the open market actions of the Reserve banks.[43] The statute, which now applies to the committee, provides that the open market operations of the Federal Reserve System "shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country."[44]

There are twelve members on the FOMC. The seven members of the Board of Governors are automatically members of the committee. The other five members are representatives of the twelve Reserve banks. One member is elected by the Board of Directors of the Federal Reserve Bank of New York; one by the boards of directors of the Reserve banks of Boston, Philadelphia, and Richmond; one by the boards of directors of the Reserve banks of Cleveland and Chicago; one by the Boards of Directors of the Reserve banks of Atlanta, Dallas, and St. Louis; and one by the Boards of Directors of the Reserve banks of Minneapolis, Kansas City, and San Francisco. The committee meets in Washington, D.C., at least four times a year.[45] By tradition, the chairman of the Board of Governors serves as chairman of the FOMC. The president of the Federal Reserve Bank of New York serves as vice-chairman.

The FOMC has withstood several challenges to the constitutionality of its organization. In *Riegle v. Federal Open Market Committee*,[46] a U.S. senator challenged the constitutionality of the procedures for making appointments to the FOMC, but the court held it should not interfere with the legislative process by taking action but rather should exercise its discretion to dismiss the action. In *Open Market Committee for Monetary Reform v. Board of Governors*,[47] the court held that private persons who allege damage from the monetary policy established by the Board do not have standing to challenge the constitutionality of the FOMC.

Decisions by the FOMC involve sensitive questions of monetary policy. Premature disclosure of the actions taken by the committee could encourage speculation and other responses that might frustrate achievement of the objectives of the FOMC. The secrecy of the committee has been challenged, but a federal district court ruled that the federal Freedom of Information Act[48] does not require the FOMC to publish its actions immediately. The committee may

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[43] 3 Fed. Banking L. Rep. (CCH) ¶ 35,590 (1983).

[44] 12 USC § 263(c) (1982).

[45] 12 USC § 263(a) (1982).

[46] 656 F2d 873 (DC Cir.), cert. denied, 454 US 1082 (1981). See also Melcher v. Federal Open Market Comm., 644 F. Supp. 510 (DDC 1986).

[47] *766 F2d 538 (DC Cir. 1985). See also Reuss v. Balles, 584 F2d 461 (DC Cir.), cert.* denied, 439 US 997 (1978).

[48] See 5 USC §§ 552–552b (1982 & Supp. IV 1986).

delay the public release of its actions until one month after they become effective.[49]

The FOMC directs all the open market operations of the Federal Reserve banks. The Federal Reserve Act authorizes the Federal Reserve banks to engage in open market transactions in government securities and other commercial paper subject to the regulations of the Board of Governors,[50] but the FOMC controls when, how, and who may enter into these transactions.[51] The committee sets guidelines for the purchase and sale of government securities, bankers' acceptances, bills of exchange, bonds, notes, and other types of commercial paper. These purchase transactions are made for the account of the separate Federal Reserve banks but are generally executed by the Federal Reserve Bank of New York, which acts as agent for the Federal Reserve banks.

Open market activities have an important impact on the economy because they may be employed to expand or contact the amount of bank credit in the monetary system. When the Federal Reserve System engages in purchases of government securities or other assets, the system is injecting additional bank credit into the economy. The funds paid by the Federal Reserve System to the sellers of the securities eventually adds to the deposits of the member commercial banks. This increase in deposits permits those banks to expand their reserve accounts and their lending capacity. When the Federal Reserve System sells securities, the reverse process occurs. The buyers of the securities withdraw funds on deposit with the member banks in order to acquire them. Therefore, funds are drained from the banking system and the reserve position of the member banks shrinks.[52] The FOMC is required to include in its annual report to Congress details of its open market transactions.[53]

[3] Federal Reserve Banks and Directors

The backbone of the Federal Reserve System is the twelve Federal Reserve banks and their branches. These Reserve banks are located in twelve Reserve districts covering the entire United States; each Reserve bank has territory and branches as authorized by the Board of Governors[54] located for the convenience

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[49] Merrill v. Federal Open Mkt. Comm., 516 F. Supp. 1028 (DDC 1981) (on remand from the U.S. Supreme Court, 443 US 340 (1979)).

[50] See 12 USC §§ 353-359 (1982).

[51] 12 USC § 263(b) (1982), "No Federal Reserve bank shall engage or decline to engage in open-market operations under [12 USC §§ 353–359] . . . except in accordance with the direction of and regulations adopted by the Committee." See also 12 CFR § 270 (1987).

[52] See generally Board of Governors, The Federal Reserve System, Purposes & Functions (1984).

[53] 12 USC § 247a (1982).

[54] 12 USC §§ 222, 521 (1982).

of the banking community. The boundaries of these districts and their branch territories do not follow any political subdivisions but are set for the maximum efficiency of the Reserve banks.[55] A map of the Federal Reserve districts is set out on the next page.

The Federal Reserve banks themselves are corporations chartered by the federal government; their certificates of organization are filed with the Comptroller of the Currency.[56]

Each Reserve bank is a banker's bank. Its capital stock is held by the national banks and state banks that are members of the Federal Reserve System. Each state and national bank may become a member of the system by subscribing to an amount of stock equal to 6 percent of its capital and surplus.[57] National banks are required to be members of the Federal Reserve System and therefore must subscribe; a state bank may choose to become a member of the Federal Reserve System, but in order to become a member it must subscribe to the stock in the same manner as national banks. State member banks can withdraw from the system and submit their stock for cancellation.[58] Although the original provisions of the Federal Reserve Act provided for the sale of nonvoting stock to the public, no stock was ever sold. All the stock of the Reserve banks is held by the member banks. *National and state bank members are subject to examinations* prescribed by the Board of Governors, who has the power to delegate its duty to the states for state banks.[59] Because the Comptroller of the Currency has statutory authority to examine national banks, the Board follows the practice of having the comptroller exercise primary responsibility for examination of national banks while the Board takes responsibility for examining state member banks. However, the Board has general supervisory power over the Reserve banks.[60]

Profits from the operation of the Reserve banks, up to 6 percent of the face value of its capital stock, are paid to the stockholder banks; other surplus earnings go into each Reserve bank's surplus account.[61] The stock also carries double liability for the debts of the Reserve bank,[62] but so far the operations have been profitable and no assessment has been necessary. The Reserve banks are exempt from taxation by federal and state governments except for real estate taxes.[63]

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[55] 12 USC § 222 (1982). The Board has the power to revise district boundaries.

[56] 12 USC § 341 (1982).

[57] 12 USC § 282 (1982).

[58] 12 USC §§ 321, 328 (1982).

[59] 12 USC §§ 325, 326 (1982).

[60] 12 USC § 248(j) (1982).

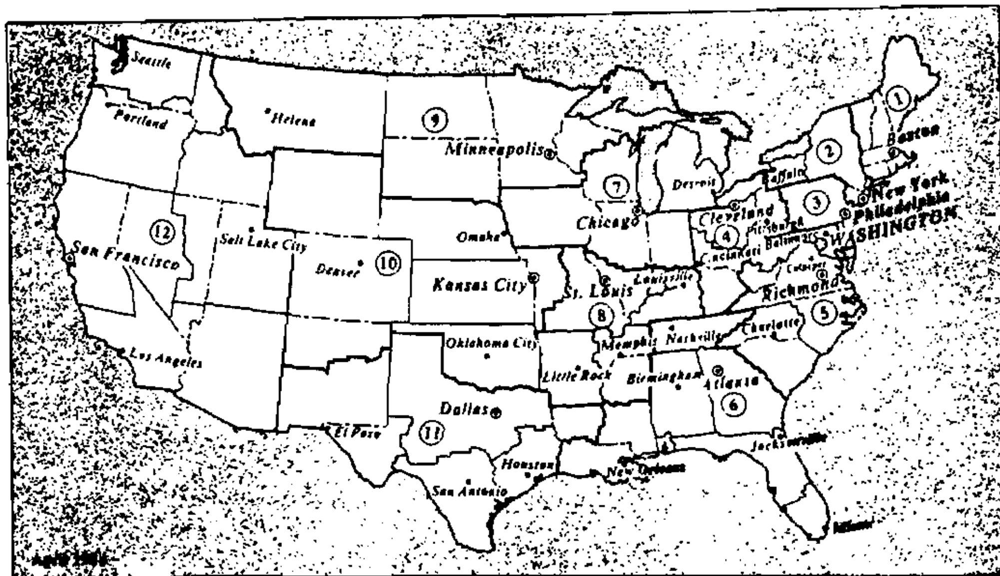
[61] 12 USC § 289 (1982)

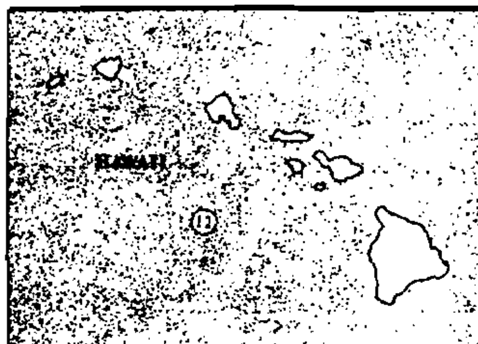
[62] 12 USC § 502 (1982).

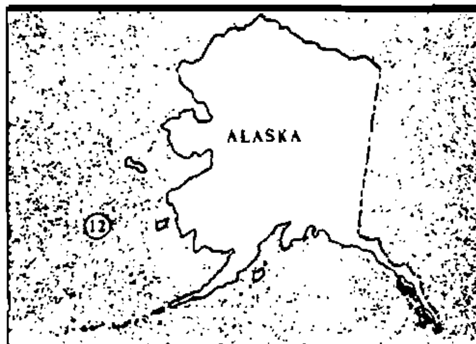
[63] 12 USC § 531 (1982).

The Federal Reserve System

Boundaries of Federal Reserve Districts and Their Branch Territories







LEGEND

— Boundaries of Federal Reserve Districts

— Boundaries of Federal Reserve Branch Territories

✪ Board of Governors of the Federal Reserve System

◉ Federal Reserve Bank Cities

• Federal Reserve Branch Cities

· Federal Reserve Bank Facility

Each Federal Reserve bank has a nine-member board of directors that guides the daily business of the bank under the regulation of the Board of Governors. Each board of directors is divided into three classes of directors, with each class containing three directors. Class A directors may be bankers. Class B directors are required to be persons engaged in agriculture, business, or industry. A and B members are elected by the stockholding member banks. Class

C directors are named by the Board of Governors. The chairman and vice-chairman of the board of directors of each Federal Reserve bank are designated by the Board of Governors from the class C directors.[64] The chairman also serves as the Federal Reserve agent and is required to maintain a local office of the Board of Governors at the Federal Reserve bank. The Federal Reserve agent is the official representative of the Board of Governors.[65] Each director's term of office is three years; one third of the terms expire each year.[66]

Each branch of a Federal Reserve bank has its own board of directors. A majority of the directors for the branch are appointed by the Federal Reserve bank, with the remaining directors appointed by the Board of Governors.

The twelve Federal Reserve banks and their branches, operating under the supervision of the Board of Governors, perform a number of banking functions. Some of the more important functions include the following:

1. Holding the reserves of the member banks;
2. Loaning funds to member banks by advancing funds and discounting commercial paper;
3. Serving as a lender of last resort for the banking system, generally in order to provide a source of emergency relief;
4. Issuing Federal Reserve notes that circulate as currency;
5. Providing mechanisms and procedures for collecting checks and transferring funds from one region of the country to another;
6. Engaging in the examination of member banks to assure their business is conducted in accordance with safe and sound banking principles; and
7. Serving as the banker for the U.S. Government by handling the financial transactions of the U.S. Treasury and other governmental agencies.[67]

These functions are described in further detail in other sections of this chapter.

The powers of the Federal Reserve banks are conferred by federal statute. When these provisions conflict with state law, federal law prevails unless it is

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[64] 12 USC §§ 304, 305 (1982).

[65] 12 USC § 305 (1982).

[66] 12 USC § 308 (1982).

[67] The powers of the Federal Reserve banks are set forth in 12 USC §§ 341–360 (1982). These sections enumerate the specific types of commercial paper that may be discounted or purchased by the banks and the circumstances under which loans and advances may be made by the banks. This topic is covered in ¶¶ 3.04[4], 4.03, 7.01[2]. The Federal Reserve banks have, in addition to the specific powers granted by the Federal Reserve Act and other statutes, "such incidental powers as shall be necessary to carry on the business of banking" within the limitations set by statute. 12 USC § 341 Seventh (1982). See Federal Reserve Bank of Richmond v. Duffy, 210 NC 598, 188 SE 82 (1936); Armano v. Federal Reserve Bank of Boston, 468 F. Supp. 674 (D. Mass. 1979). This grant of authority is similar to that for national banks. See discussion of the authority of national banks at ¶ 4.03.

clear that Congress intended to defer to the state law. Thus, state law procedures have been found ineffective to limit the exercise by the Federal Reserve banks of their authority to terminate employees. Under 12 USC § 341 Fifth (1982), Federal Reserve bank employees are subject to dismissal at the pleasure of the bank. Because of this statute, procedural protections under state law for employees are not available to bank employees and the employees can claim no "process or tenure rights."[68]

[4] Member Banks

As discussed previously, all national banks automatically are members of the Federal Reserve System. The Comptroller of the Currency supervises the granting of charters for national banks and is the primary federal regulator. As a result, the Federal Reserve Board concentrates its examinations and supervisory activities on the state banks that are members of the Federal Reserve System. This section discusses the requirements for state bank membership and how membership may terminate. Subsequent sections discuss national banks.

Federal law permits "any bank" incorporated under the special or general laws of a state, including "Morris Plan banks and other incorporated banking institutions engaged in similar business" to apply to the Board of Governors for membership in the Federal Reserve System.[69] The statute directs the Board of Governors to consider "the financial condition of the applying bank, the general character of its management, and whether or not the corporate powers exercised are consistent with the purposes of" the Federal Reserve Act.[70] The bank must be insured by the FDIC in order to become a member of the system,[71] and must agree to subscribe to capital stock in the Federal Reserve bank in its district under the same terms applicable to national banks.[72] When a state bank is admitted to the system, it becomes subject to the capital and reserves requirements under federal law.[73] Member banks are bound by federal laws that limit

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[68] Bollow v. Federal Reserve Bank of San Francisco, 650 F2d 1093, 1098 (9th Cir. 1981), cert. denied, 455 US 948 (1982) (employment contract of Federal Reserve bank employee would be void and unenforceable against the bank).

[69] 12 USC § 321 (1982).

[70] 12 USC § 322 (1982). The Board's regulations on the membership of state banks in the Federal Reserve system (*Regulation H*) are in 12 CFR § 208 (1987).

[71] 12 USC § 1814(b) (1982). The Board of Governors must certify to the FDIC that it has considered "the financial history and condition of the bank, the adequacy of its capital structure, its future earnings prospects, the general character of its management, the convenience and needs of the community to be served by the bank, and whether or not its corporate powers are consistent with the purposes of [the FDIC Act]." 12 USC § 1816 (1982).

[72] 12 USC § 321 (1982). The capital stock requirements are discussed at ¶ 3.03[3].

[73] 12 USC § 324 (1982). The Federal Reserve Board exercises a continuing supervision of the adequacy of the state bank's capital and reserve position. Continental Bank &

the payment of dividends and also restrict the bank's engaging in transactions in its own stock.[74] Member banks must submit reports as to their condition as required by the Board of Governors.[75] These reporting responsibilities extend to information on their relationship with affiliates.[76] The Board of Governors and the Federal Reserve banks have authority to conduct examinations of the state member banks.[77] There is also a specific prohibition against state banks engaging in lotteries.[78] State member banks can establish branches under the same rules and in the same manner as national banks.[79]

State member banks may only engage in securities dealing and underwriting to the extent allowed national banks[80] under the provision of the National Bank Act, which provides the following:

> The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: Provided, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe . . . .[81]

State member banks are expressly prohibited from certifying checks without having on deposit funds to cover the amount of the check, and the bank may forfeit membership in the Federal Reserve System for violations of this prohibition.[82]

In general, state member banks are subject to all the requirements the Federal Reserve Act, as amended, establishes for "member banks" other than

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Trust Co. of Salt Lake City v. Woodall, 239 F2d 707 (10th Cir.), cert. denied, 353 US 909 (1957). See also 12 USC § 329 (1982) which provides that no bank may be admitted to membership in the Federal Reserve System "unless it possesses capital stock and surplus which, in the judgment of the Board of Governors of the Federal Reserve System, are adequate in relation to the character and condition of its assets and to its existing and prospective deposit liabilities and other corporate responsibilities . . . ."

[74] 12 USC § 324 (1982).

[75] Id. The section imposes a $100 per day penalty for failure to file reports required by the Board of Governors. Id.

[76] 12 USC § 334 (1982).

[77] 12 USC § 325 (1982). Bank examinations are discussed at ¶ 7.01.

[78] 12 USC § 339 (1982).

[79] 12 USC § 321 (1982).

[80] "State member banks shall be subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as are applicable in the case of national banks under paragraph "Seventh" of section 24 of this title." 12 USC § 335 (1982). See generally the discussion at ¶ 8.01.

[81] 12 USC § 24 Seventh (Supp. III 1985).

[82] 12 USC § 331 (1982).

the provisions for examination by the Comptroller of the Currency.[83] Subject to these limitations, the state bank, although a member of the Federal Reserve System, "shall retain its full charter and statutory rights as a State bank or trust company, and may continue to exercise all corporate powers granted it by the State in which it was created, and shall be entitled to all privileges of member banks . . . ."[84] However, the Board imposes as a condition of membership that, except as permitted by the Board, "the bank shall not cause or permit any change to be made in the general character of its business or in the scope of the corporate powers exercised by it at the time of admission to membership."[85]

State banks may voluntarily withdraw from membership in the system by giving six months' written notice and surrendering their holdings of capital stock in the Federal Reserve bank for cancellation.[86] The Board of Governors may terminate the membership of a state bank for noncompliance with the Federal Reserve Act or the Board's regulations or when the bank ceases to exercise its banking functions without a receiver having been appointed for the bank.[87] If the FDIC terminates the bank's status as an insured bank, the bank automatically loses membership in the system.[88]

[5] The Relationship of the Federal Reserve System to Nonmember Depository Institutions

The Federal Reserve Act of 1913, which established the Federal Reserve System, viewed the system it was creating as a network of commercial banks. The Board of Governors and the Federal Reserve banks were given responsibility for the regulation and control of the network of commercial banks that make up the Federal Reserve System. The act did not provide for the Board or the Reserve banks to exercise any responsibility with respect to other depository institutions.

With the growth of the nation's economy, the Federal Reserve System, and the Board of Governors in particular, came to serve an increasingly important role in determining the economic policy of the country. Yet the existence of state banks that were not members of the Federal Reserve System and of savings institutions that were not subject to the regulatory authority of the Board of Governors, which in modern times have come to represent a substantial portion of the banking market, limited the ability of the Federal Reserve System to control monetary conditions in the economy. At the same time, concern devel-

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[83] 12 USC § 330 (1982).

[84] Id.

[85] 12 CFR § 208.7(a)(1) (1987).

[86] 12 USC § 328 (1982).

[87] 12 USC § 327 (1982).

[88] 12 USC § 1818(o) (1982).

oped that the obligations placed on member banks to maintain reserves, as required by the Board of Governors, encouraged banks to withdraw from the Federal Reserve System. In addition, a movement began to reduce the differences in functions between commercial banks and savings institutions, allowing for competition in areas such as checking and payment services, savings accounts, and consumer lending.

These developments are reflected in the terms of the Depository Institutions Deregulation and Monetary Control Act of 1980. The 1980 act fundamentally changed the role of the federal government in banking. It expanded the powers of thrift institutions and enlarged the role of the Federal Reserve System by opening the system's network of services to other depository institutions.[89] The specific provisions of the 1980 act are outlined in the following text.

1. All depository institutions (commercial banks, savings banks, savings and loan associations, and credit unions) are permitted by the act to engage in providing customers with checking services or their equivalents through Negotiable Order of Withdrawal (NOW) accounts, and to enter the growing area of electronic payment mechanisms.[90]
2. The Federal Reserve System acquired increased dominance over all of the nation's depository institutions through both the reporting requirements, which the act imposes, and the reserve requirements, which must be met by all depository institutions having transaction accounts or nonpersonal time deposits.[91]

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[89] In 12 USC § 248a (1982), Congress provides that the Board of Governors must establish a fee schedule for its services. These services must include the following:

1. Currency and coin services;
2. Check clearing and collection services;
3. Wire transfer services;
4. ACH services;
5. Settlement services;
6. Securities safekeeping services;
7. Federal Reserve float; and
8. Any new services which the Federal Reserve System offers, including but not limited to payment services to effectuate the electronic transfer of funds.

The act also provides that "All Federal Reserve bank services covered by the fee schedule shall be available to nonmember depository institutions and such services shall be priced at the same fee schedule applicable to member banks, except that nonmembers shall be subject to any other terms, including a requirement of balances sufficient for clearing purposes, that the Board may determine are applicable to member banks." 12 USC § 248a(c)(2) (1982). The fees are to be based on "all direct and indirect costs actually incurred" in providing the services plus certain "imputed costs". 12 USC § 248a(c)(3) (1982).

[90] See ¶ 2.01[5].

[91] See ¶ 3.04[2].

3. The availability to all depository institutions of the services of the Federal Reserve System and those provided by the Reserve banks, such as the procedures for the collection of instruments and transfer of funds, makes it possible to create an integrated national payments and funds transfer network that encompasses a broad range of depository institutions.[92]
4. The ability of other depository institutions, which must maintain reserves under the act, to use the borrowing privileges offered by the Federal Reserve System may also draw such institutions as savings and loan associations and credit unions more closely under the wing of the Federal Reserve System.[93]

¶ 3.04 BANKING FUNCTIONS OF THE FEDERAL RESERVE SYSTEM

The Board of Governors has a major role in determining monetary policy for the United States and devising strategies to manage the supply of money and credit to achieve the nation's economic objectives. The Federal Reserve System also exercises various banking functions. This section describes some of the most important of these banking functions.

[1] Depository Functions

The Federal Reserve banks function as depositories for the reserves of member banks. Each member bank maintains a deposit account in its regional Federal Reserve bank. Member banks may draw checks against this account, transfer funds through this account, or employ the account for various other transactions.[94] In addition, financial institutions that are not members of the Federal Reserve System may be required to maintain reserves if they have transaction accounts.[95]

[a] Reserve Accounts. The reserve accounts with the Federal Reserve banks may be used for depositing advances from the Reserve bank to the member bank, for crediting the proceeds of collection of commercial paper, for depositing the proceeds on the rediscount of paper with the Reserve bank, for handling deposits of coin and currency, and accruing credit for other assets that the member bank may turn over to the Reserve bank for liquidation or collection.

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[92] See ¶ 3.04[5].

[93] See ¶ 3.04[4].

[94] 12 USC § 464 (1982).

[95] See ¶ 3.04[2].

The Reserve bank may charge the member bank's account for various obligations of the member bank. This ability to charge or credit the member banks' accounts permits the Reserve banks to establish a national network for transferring funds between such banks both by check and by electronic order. It also assists the Reserve banks to carry out other duties in handling the financial affairs of the government, including the purchasing and selling of government securities and the transferring of funds to pay obligations of the government to Social Security benefit recipients, pension recipients, taxpayers, and other beneficiaries. It also enables the Federal Reserve to operate a "net settlement" service for clearinghouses and ACHs. These systems settle the net positions of the participants at the end of the day by debiting and crediting the participants' accounts with the Federal Reserve banks.[96]

[b] Fiscal Agents and Depositories for the United States. The Secretary of the Treasury is responsible for determining who may act as depositories and fiscal agents of the United States and the procedures that must be followed in conducting these activities on behalf of the United States. The Federal Reserve Act gives the Federal Reserve banks general authority to receive deposits of government funds and to act as fiscal agents of the United States when directed to do so by the Secretary of the Treasury.[97] Also, except for temporary accounts, most government corporations must maintain their accounts with the Treasurer of the United States, or with the permission of the Secretary of the Treasury, with a Federal Reserve bank or other approved federal depository.[98] There are additional statutes that make the Federal Reserve banks depositories for other specific agencies, such as the Commodity Credit Corporation, the Federal Home Loan banks, the Federal Land banks, and many others.[99]

Federal law also permits member banks and other depository institutions to act as depositories of the United States. Under regulations of the Secretary of the Treasury, the following institutions are eligible to act as depositories and fiscal agents of the United States:[100]

1. All banks insured by the FDIC;
2. All institutions insured by the FSLIC;

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[96] See ¶ 3.04[5] and Chapter 18.

[97] 12 USC §§ 342, 391 (1982).

[98] 31 USC § 9107 (1982). The Government Corporations Control Act, 31 USC §§ 9101–9109 (1982), established general requirements for the banking and payment activities of government agencies.

[99] See 12 USC §§ 393, 395, 1435 (1982). See generally the compilation at 1 Fed. Banking L. Rep. (CCH) ¶¶ 16,110–16,133 (1984).

[100] 12 CFR § 201.2 (1987). See also 12 USC §§ 265, 266, 1464(k), 1709(a), 1725(d), 3101, 3102 (1982).

3. All credit unions insured by the Administrator of the National Credit Union Administration; and
4. State depository institutions whose accounts are insured by the state or a state agency, and certain branches of foreign banking corporations.

In order to be designated a depository and fiscal agent, the financial institution must have the authority under the laws and regulations that control its organization and powers to perform the services required by the Secretary of the Treasury. The financial institutions also must be authorized to pledge collateral to secure public funds because the Secretary may require the institution to post collateral when public funds are deposited with the institution in amounts that exceed its insurance limits.[101] By statute, the Secretary of the Treasury determines the security necessary "for the safe-keeping and prompt payment of the public money" deposited with national banks.[102] The statute also authorizes national banks to give security for the deposits of funds by state governments, agencies, or political subdivisions "to the same extent" as the law of the state permits for other banks in the state.[103] The statute similarly authorizes national banks to give security for deposits of federally recognized Indian tribes.[104]

Institutions that serve as depository and fiscal agents engage in a variety of functions. One important function involves the handling of securities issues for the government, such as the sale of U.S. savings bonds and notes and the issuing of U.S. Treasury bonds, Treasury notes, and Treasury bills.[105]

[2] Reserves

All member banks of the Federal Reserve System are required to maintain reserves for the payment of outstanding accounts. These reserves consist of (1) cash in the member banks' vaults and (2) the balance on deposit with the Federal Reserve bank.[106]

Until enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980, only banks that were members of the Federal Reserve System had to observe the reserve requirements. The act dramatically enlarged the Federal Reserve System's control over the nation's depository institutions.

The act defines depository institutions to include all state and national banks that are insured by the FDIC and all banks that are eligible to apply for

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[101] 12 CFR §§ 201.2, 201.3, 201.4, 201.6 (1987).

[102] 12 USC § 90 (1982).

[103] Id.

[104] Id. The security may be in the form of United States bonds or "otherwise" as the Secretary of the Treasury prescribes.

[105] See generally 12 CFR §§ 306–354 (1987); 1 Fed. Banking L. Rep. (CCH) ¶ 16,001 (1984).

[106] 12 USC § 461(c) (1982).

such insurance; all savings and loan associations that are insured by the FSLIC and all savings and loan associations that are eligible for such insurance; and all credit unions that are insured or eligible to be insured under the Federal Credit Union Act.[107]

The provisions of the act that call for state-chartered banks that are not members of the Federal Reserve System to post reserves with the Federal Reserve Board have been upheld.[108] The court found that the congressional objective of stopping the flight of banks from the Federal Reserve System in order to help the Federal Reserve System control the nation's money supply was a rational and valid purpose. The court also upheld the act's scheme for phasing in compliance with the reserve requirements.

Under the act, all depository institutions having "transaction accounts" or "non-personal time deposits" must maintain reserves.[109] Transaction accounts include checking acounts, NOW accounts, automatic transfer accounts, and share draft accounts.[110]

All demand deposits are transaction accounts.[111] A transaction account also includes other types of accounts, such as accounts on which the depository institution has reserved the right to require at least seven days' written notice prior to withdrawal and that are subject to check, draft, negotiable order of withdrawal, or similar item except for qualifying money-market deposit accounts. Thus, the term "transaction account" includes accounts that are not "demand deposits." (The different types of accounts are discussed in Chapter 19.)

The result of this distinction between "transaction accounts" and "demand deposits" is that member banks in the Federal Reserve System may be free to pay interest on deposits that do not qualify as "demand deposits,"[112] but banks are required to maintain reserves against those accounts because they qualify as "transaction accounts" under Regulation D. The Federal Reserve Board revised Regulation D to incorporate into the definitions of accounts subject to reserve requirements some of the distinctions that were previously contained in Regulation Q, which specified the requirements for accounts on which banks could pay interest. For example, under Regulation D, a depository institution must impose an early withdrawal penalty of at least seven days' simple interest on amounts withdrawn within the first six days after deposit on "time deposits," or they will have to treat such deposits as "demand deposits" subject to reserve require-

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[107] 12 USC § 461(b)(1) (1982). See discussion at ¶¶ 2.02, 3.04[2][c].

[108] First Bank & Trust Co. v. Federal Reserve Board, 605 F. Supp. 555 (ED Ky. 1984).

[109] 12 USC § 461(b)(2) (1982).

[110] 12 USC § 461(b)(1)(C) (1982). These accounts are discussed in Chapter 19.

[111] 12 CFR § 204.2(e) (1987) (Regulation D).

[112] See ¶ 19.02[2].

ments.[113] Similarly, in order to avoid classification as a transaction account for purposes of the reserve requirements, the accounts must meet restrictions similar to the former interest-payment restrictions that limited the number of transfers that may be made to third parties from the account.[114] Eurocurrency holdings are also subject to reserve requirements.

[a] Reserve Requirements. The act establishes reserve requirements that may be adjusted within certain ranges by the Board of Governors. On transaction accounts over $25 million, the range is 8 to 14 percent with an initial rate of 12 percent. Reserves on accounts below $25 million are initially set at 3 percent. The original $25 million cutoff changes on the basis of an indexed formula.[115] As of 1988, the cutoff was $40.5 million.[116] On nonpersonal time deposits, the act establishes a range of zero to 9 percent of required reserves, with an initial rate of 3 percent.[117]

The general reserve requirements for depository institutions as of December 31, 1987 are provided in Table 3-3.

When at least five members find that extraordinary circumstances are present, the Board of Governors may impose reserve requirements beyond the statutory ranges for successive periods of 180 days.[118] The Board also may impose a supplemental reserve requirement on transaction accounts within a range of an additional zero to 4 percent on a finding that monetary policy cannot effectively be implemented with reserves otherwise authorized.[119] Such reserves must be uniform for all depository institutions and carry interest at the average rate earned by the Federal Reserve securities portfolio.[120]

The 1980 act phases in these reserve requirements over eight years for nonmember institutions and four years for member banks. To remove any incentive for banks to withdraw from membership in the Federal Reserve System, the 1980 act provided that any bank that was a member of the Federal Reserve System on July 1, 1979 remains subject to the reserve requirements of the system notwithstanding its withdrawal from membership.[121] The Garn-St

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[113] 12 CFR §§ 204.2(b)(3), 204.2(c)(1), 204.2(e)(1) (1987) (Regulation D).

[114] The Federal Reserve Board's action in amending its regulations to accomplish these results is reported at 51 Fed. Reg. 9629 (1986). See also ¶ 3.04[6][b].

[115] 12 USC § 461(b)(2) (1982).

[116] 12 CFR § 204.9 (1988).

[117] 12 USC § 461(b)(2) (1982).

[118] 12 USC § 461(b)(3) (1982).

[119] 12 USC § 461(b)(4) (1982).

[120] Id.

[121] 12 USC § 461(b)(8) (1982).

TABLE 3-3 **Reserve Ratios (Regulation D, § 204.9, 12 CFR Pt. 204)**

Category	*Reserve Requirement*
1. Net Transaction Accounts	
$0 to $40.5 million	3%
Over $40.5 million	$1,215,000 plus 12% of amount over $40.5 million
2. Nonpersonal Time Deposits (by original maturity or notice period)	
Less than 1-1/2 years	3%
1-1/2 years or more	0%
3. Eurocurrency Liabilities	3%
4. Reserve Requirement exemption	
$3.2 million	0%

Source: 1 Fed. Reserve Bd. Regulatory Service ¶ 2-207 (1988).

Germain Act of 1982[122] modified these requirements by establishing a phase-in period for banks that withdrew from the Federal Reserve System between July 1, 1979, and March 31, 1980.[123]

The 1982 act exempts institutions from reserve requirements when the liabilities that are subject to reserve requirements are below a minimum amount.[124] This provision eliminates the administrative and reporting expenses for small institutions, such as credit unions and thrift institutions, that have some accounts (e.g., negotiable order of withdrawal (NOW) accounts or other transaction accounts) that would be subject to reserve requirements.

[b] Reserve Requirement Exemption. There are minimum amounts of reservable liabilities of each institution that are exempt from reserve requirements. Subject to some constraints, the institution may designate the reserves that will receive the benefit of the exemption. The amount of this exemption is shown in Table 3-3 as the Reserve Requirement Exemption. The 1982 act initially set a floor of $2 million for this exemption. The 1982 act directs the Board of Governors to adjust this $2 million floor upwards in accordance with a statutory formula relating to the percentage increase in the total reservable liabilities of all depository institutions. Reservable liabilities are transaction accounts, non-

[122] Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of titles 12, 15, and 18 USC).

[123] 12 USC § 461(b)(8)(D) (1982).

[124] 12 USC § 461(b)(11)(A) (1982).

personal time deposits, and all net balances, loans, assets, and obligations that are, or may be, subject to reserve requirements under the Federal Reserve Act.[125]

[c] Reserves of Nonmember Banks. The rules for how nonmember institutions must hold reserves vary from the requirements for member banks. Subject to Board regulation, member banks must hold reserves either in vault cash or in balances maintained at the regional Federal Reserve bank. Nonmember depository institution reserves may be held in the form of balances with other depository institutions maintaining reserve balances at a Federal Reserve bank or a Federal Home Loan bank or the National Credit Union Administration Central Liquidating facility. The institutions where these balances have been deposited, in turn, must pass them through to a Federal Reserve bank.[126] In this fashion, all reserves required under the Act will ultimately be held by the Federal Reserve banks and will be subject to the control of the Federal Reserve System as it establishes reserve requirements to carry out monetary policy.

[d] Reserve Requirements for Reserve Banks. At one time, the Reserve banks were in turn required to maintain reserves covering their accounts with member banks. These reserves originally were required to be in lawful money, gold, or gold certificates. This requirement was later amended to include special drawing rights as the rules on gold and gold certificate circulation changed. The reserve requirements for the Reserve banks, which were originally 35 percent, were later changed to 25 percent in gold, gold certificates, or special drawing right certificates. Currently, each Reserve bank is required to issue notes bearing a distinctive letter and serial number assigned by the Board of Governors to each Reserve bank.[127] The notes must be backed by adequate collateral as described in the next section. (The role of Federal Reserve bank notes as money is discussed in Chapter 14.)

[e] Reserve Requirements and Monetary Policy. The Board of Governors' authority to adjust reserve requirements is an important tool in carrying out monetary policy. Changes in reserve requirements produce corresponding changes in the policies of the depository institutions that maintain the reserves. When reserve ratios are lowered, depository institutions may increase their volume of deposits and associated loans and investments. On the other hand, when reserve ratios are increased, the volume of liabilities and credit the banking system can support on the reserve supply is reduced. Thus, when the Board of Governors increases reserve requirements, it is acting to restrict the money

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[125] Id. See also 12 USC § 461(b)(1)(E) (1982).

[126] 12 USC § 461(c) (1982).

[127] 12 USC § 413 (1982).

supply, and when it decreases reserve requirements, it is acting to expand the money supply.[128]

[3] Currency Issues

Like the national banks before them, the Federal Reserve banks are empowered to issue notes that circulate as lawful money. Under the original Federal Reserve Act, there were two classes of notes: Federal Reserve bank notes and Federal Reserve notes. The Federal Reserve notes now constitute almost all of the United States paper money and are the backbone of the currency.[129] These notes, printed by the Treasury or by the mints, may be issued by the Federal Reserve agent, who is a member of the board of directors of each Reserve bank. Under the direction of the Comptroller of the Currency and the Secretary of the Treasury, and upon the request of the Reserve bank, the Federal Reserve agent issues the notes in return for 100 percent collateral. (Federal Reserve notes that are held in the vaults of the Federal Reserve banks are not required to have collateral backing them.)[130] The collateral may consist of the following items:

1. Drafts and other commercial bills of exchange;
2. Bills of exchange or bankers' acceptances purchased in open market operations;
3. Special drawing right certificates;
4. Gold certificates; or
5. Other obligations of the United States.[131] These government obligations may include "any obligations which are direct obligations of, or are fully guaranteed as to principal and interest by, the United States or any agency thereof . . . ."[132]

The Reserve banks were once required to keep a portion of this collateral in gold certificates, but that requirement was eliminated.[133]

The Federal Reserve notes thus issued may be held or paid out by the Reserve banks as lawful money, and the collateral funds are held for their redemption. The notes themselves, the obligation of the issuing Reserve bank and the U.S. government, are redeemable at the U.S. Treasury or at any Reserve bank.

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[128] See Board of Governors, The Federal Reserve System, Purposes & Functions 78–80 (1984).

[129] Id. at 48.

[130] 12 USC § 412 (1982).

[131] Id.

[132] Id.

[133] 12 USC § 413 (1982) (amended 1968).

The collateral funds are required to be collected and replaced so that at all times their total is 100 percent of the outstanding Federal Reserve notes owed by each Reserve bank.[134] The number of notes that are issued and withdrawn is monitored by the Federal Reserve agents. If the Board of Governors believes additional security is needed for notes that have been issued, the Board "may at any time call upon a Federal Reserve bank for additional security to protect the Federal Reserve notes issued to it."[135] The Federal Reserve agents are empowered, under the direction of the Comptroller of the Currency, the Regulations of the Board of Governors, and the Secretary of the Treasury, to redeem current notes and to replace those no longer fit for circulation.[136]

The Federal reserve notes are "obligations of the United States and shall be receivable by all national and member banks and Federal reserve banks and for all taxes, customs, and other public dues. They shall be redeemed in lawful money on demand at the Treasury Department of the United States . . . or at any Federal Reserve bank."[137]

[4] Reserve Bank Lending Authority

There are two methods by which a member bank borrows funds from its Federal Reserve bank: by a discount or by an advance. Both methods are authorized by statute, but the most common method today is the advance.[138]

Both methods of borrowing require the member bank to give the Federal Reserve bank full collateral for the loan. Discounts and rediscounts involve the transfer of eligible commercial paper to the Reserve bank with the indorsement of the transferring member bank. Technically, the Reserve bank purchases the commercial paper from the member bank. The law and the regulations of the Board define what constitutes eligible paper.

The Federal Reserve Act contains detailed descriptions of collateral the Reserve banks may accept in making loans or may acquire in discounting or rediscounting commercial paper.[139] There is also general authority to advance funds to member banks on their "time or demand notes having maturities of not more than four months and which are secured to the satisfaction of such Federal Reserve Bank."[140]

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[134] 12 USC §§ 412, 416 (1982).

[135] 12 USC § 412 (1982).

[136] See 3 Fed. Banking L. Rep. (CCH) ¶¶ 35,630–35,690 (1983).

[137] 12 USC § 411 (1982).

[138] 12 USC §§ 343–347d (1982). See generally Board of Governors, The Federal Reserve System, Purposes & Functions (1984).

[139] 12 USC §§ 343–347d, 355 (1982).

[140] 12 USC § 347b (1982). See also 12 USC § 347 (1982). The extension of credit by the Reserve banks is discretionary. See Billings Util. Co. v. Advisory Comm., Bd. of Governors, 135 F2d 108 (8th Cir. 1943); Raichle v. Federal Reserve Bank of NY, 34 F2d 910 (2d

At one time, the Board of Governors required that commercial paper be negotiable in order to be eligible for discounting, although the Federal Reserve Act did not impose this requirement. In addition, the Board's regulations did not allow the discounting of commercial, agricultural, or industrial paper that was not negotiable.[141] In 1970, however, the Federal Reserve Board eliminated the negotiability requirement.[142] Member banks may still decide in individual cases to decline to accept nonnegotiable paper.

[a] Advances. An advance is a loan evidenced by a promissory note of the borrowing bank and secured by adequate collateral. The customary collateral for these advances is U.S. government or agency securities. Since many member banks maintain their holdings of these securities at the Federal Reserve bank for safekeeping, it is a convenient form of collateral for such loans.

Member banks usually borrow for very short periods only, often no more than a few days. Banks often take out these loans in order to make a temporary adjustment in its reserves, enabling it to deal with unexpected increases in loan demand or sudden deposit losses, or unanticipated problems in raising funds from the money market. The Federal Reserve banks scrutinize the borrowing process carefully to make sure it is not for speculative purposes. Member banks may also borrow from the Federal Reserve banks when seasonal credit demands make it difficult for them to satisfy the credit demands in their communities. In addition, the Federal Reserve stands as a source of emergency credit to banks in times of financial crises.[143]

Regulation A describes the circumstances under which the Board of Governors makes its credit facilities available. The regulation states:

> (b) *Purpose.* This part establishes rules under which Federal Reserve banks may extend credit to depository institutions and others. Extending credit to depository institutions to accommodate commerce, industry, and agriculture is a principal function of Reserve banks. While open market operations are the primary means of affecting the overall supply of reserves, the lending function of the Reserve banks is an effective method of supplying reserves to meet the particular credit needs of individual depository institutions. The lending functions of the Federal Reserve System are con-

Cir. 1929); Huntington Towers, Ltd. v. Franklin Nat'l Bank, 559 F2d 863 (2d Cir. 1977), cert. denied, 434 US 1012 (1978). See also Corbin v. Federal Reserve Bank of NY, 458 F. Supp. 143 (SDNY 1978).

[141] See 12 USC § 343 (1982). See also 12 CFR § 201.3(a) (1970); 9 Fed. Reserve Bull. 559 (1923).

[142] 35 Fed. Reg. 6116 (1970).

[143] For a description of the role of the Federal Reserve system as lender to Continental Illinois National Bank and to Maryland thrift institutions in order to prevent collapse of these financial institutions, See F. Solomon, W. Schlichting, T. Rice & J. Cooper, 4 Banking Law §§ 82.03[8], 82.03[9] (1987).

ducted with due regard to the basic objectives of monetary policy and the maintenance of a sound and orderly financial system. These basic objectives are promoted by influencing the overall volume and cost of credit through actions that affect the volume and cost of reserves to depository institutions. Borrowing by individual depository institutions, at a rate of interest that is adjusted from time to time in accordance with prevailing economic and money market conditions, has a direct impact on the reserve positions of the borrowing institutions and thus on their ability to meet the credit needs of their customers. However, the effects of such borrowing do not remain localized but have an important bearing on overall monetary and credit conditions.[144]

[b] Discounts. Each Federal Reserve bank sets a discount rate, which is the interest rate it will charge for member bank borrowing. This rate is established by each Federal Reserve bank under the review and guidelines of the Board of Governors. Of course, the Board of Governors can influence the extent of bank borrowing by adjusting the discount rate.

Under the Depository Institutions Deregulation and Monetary Control Act of 1980, the privilege of borrowing from the Federal Reserve banks was extended to all depository institutions that are subject to the reserve requirements of that act. These institutions "shall be entitled to the same discount and borrowing privileges as member banks."[145] This provision opens up the Federal Reserve banks' discount window to thrift institutions. Moreover, in administering the discount and borrowing privileges, the 1980 act directs the Board to take into account "the special needs of saving and other depository institutions for access to discount and borrowing facilities consistent with their long-term asset portfolios and the sensitivity of such institutions to trends in the national money market.[146]

[c] Federal Reserve System Credit. Federal Reserve banks are authorized to make credit available for the following purposes as described under Regulation A: short-term adjustment credit, extended credit for seasonal needs, and other extended credit.[147] Additionally, "in unusual and exigent circumstances," a Reserve bank may give credit to persons who are not depository institutions if necessary to protect the economy. The Board's regulation states:

§ 201.2 Availability and terms.

(a) *Short-term adjustment credit.* Federal Reserve credit is available on a short-term basis to a depository institution under such rules as may be

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[144] 12 CFR § 201.1(b) (1987).

[145] 12 USC § 461(b)(7) (1982).

[146] Id.

[147] 12 CFR § 201.3 (1987).

prescribed to assist the institution, to the extent appropriate, in meeting temporary requirements for funds, or to cushion more persistent outflows of funds pending an orderly adjustment of the institution's assets and liabilities. Such credit generally is available only after reasonable alternative sources of funds, including credit from special industry lenders, such as Federal Home Loan banks, the National Credit Union Administration's Central Liquidity Facility, and corporate central credit unions have been fully used. Under certain circumstances, a surcharge may be imposed above the basic rate of interest normally charged by Reserve banks.

(b) *Extended credit—(1) Seasonal credit.* Federal Reserve credit is available for periods longer than those permitted under adjustment credit to assist smaller depository institutions in meeting regular needs for funds arising from a combination of expected patterns of movement in their deposits and loans. Seasonal credit is available only if similar assistance is not available from other special industry lenders. Seasonal credit will ordinarily be limited to the amount by which the depository institution's seasonal needs exceed certain percentages, established by the Board of Governors, of the institution's average total deposits in the preceding calendar year. Such credit will be available if the Reserve bank is satisfied that the institution's qualifying need for funds is seasonal and will persist for at least four weeks. Need for credit at depository institutions will also be given consideration when institutions are experiencing unusual seasonal demands for credit in a period of liquidity strain. To the extent practicable, a depository institution should arrange in advance for seasonal credit for the full period during which such credit is expected to be required. Under certain circumstances, a surcharge may be imposed above the basic rate of interest normally charged by Reserve banks.

(2) *Other extended credit.* Federal Reserve credit is available to depository institutions under extended credit arrangements where similar assistance is not reasonably available from other sources, including special industry lenders. Such credit may be provided where there are exceptional circumstances or practices involving only a particular depository institution. Exceptional circumstances would include situations where an individual depository institution is experiencing financial strains arising from particular circumstances or practices affecting that institution—including sustained deposit drains, impaired access to money market funds, or sudden deterioration in loan repayment performance. Extended credit may also be provided to accommodate the needs of depository institutions, including those with longer term asset portfolios, that may by experiencing difficulties adjusting to changing money market conditions over a longer period, particularly at times of deposit disintermediation. A special rate or rates above the basic discount rate established by the Reserve banks, subject to review and determination by the Board of Governors, may be applied to other extended credit.

(c) *Emergency credit for others.* In unusual and exigent circumstances, a Reserve bank may, after consultation with the Board, advance credit to individuals, partnerships, and corporations that are not depository institu-

tions if, in the judgment of the Reserve bank, credit is not available from other sources and failure to obtain such credit would adversely affect the economy. The rate applicable to such credit will be above the highest rate for advances in effect for depository institutions. Where the collateral used to secure such credit consists of assets other than obligations of, or fully guaranteed as to principal and interest by, the United States or an agency thereof, an affirmative vote of five or more Board members is required before credit may be extended.[148]

[5] National Payments System: Fund Transfer and Check Collection

[a] Check Collection. The Federal Reserve System provides essential services in check collection and electronic funds transfer systems, and in generally overseeing the national payments system. Through the Federal Reserve banks, branches, and check clearing centers, the Federal Reserve System provides facilities for processing checks for the depository institutions that choose to use the Federal Reserve facilities.[149] The Board of Governors estimates that about 40 percent of the checks that are processed by the Federal Reserve System are payable through an office located outside of the area where they were deposited.[150] A significant number of the nation's checks are processed through the Federal Reserve System check clearing facilities. In 1986, the system processed some 16.2 billion separate checks with a total value of over $11 trillion.[151] Table 3-4 illustrates the importance of the system.

Checks are handled for collection as "cash" items under which credit is made available in a prompt manner according to availability schedules established by the Board. The system also provides a noncash collection service. This service provides a mechanism for collecting payments for banker's acceptances, bills of lading, documentary drafts, certain municipal securities, and checks that cannot be processed through the normal check collection procedures.[152]

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[148] Id.

[149] The Board of Governors reports that there were 48 check clearing centers in operation at the end of 1983 at the various facilities mentioned in the text. They were engaged in collecting some 57 million items each business day. Board of Governors, The Federal Reserve System, Purposes & Functions 106 (1984).

[150] Id. at 107.

[151] This broke down into 584 million U.S. government checks at a value of $606.0 billion, 140 million postal money orders at a value of $11.1 billion, and 16.2 billion other checks at a value of $11.1 trillion. 73 Bd. of Governors, Fed. Reserve Sys. Ann. Rep. 244 (1987). These data report each check separately. In prior years, the data recorded some checks more than once if they were handled by more than one Federal Reserve check-processing center. It is not known whether the data in Table 3-4 count a check handled by more than one Reserve bank more than once.

[152] Id. at 111.

TABLE 3-4 **Number of Checks, Total and Collected by the Federal Reserve, Selected Years, 1920–1983**

	Billions of checks		
	Total	*Collected by the Federal Reserve*	
Year	*checks written*	*Number*	*Percent of Total*
1920	n.a.	0.5	n.a.
1930	n.a.	0.9	n.a.
1940	n.a.	1.1	n.a.
1952	7.0	2.3	33
1967	17.9	5.4	30
1973	22.5	10.0	44
1981	35.5	15.9	45
1982	36.9	13.9	38
1983	38.4	14.3	37

n.a. = Not available.
Source: Board of Governors, Federal Reserve System, Purposes & Functions 108 (1984).

The Depository Institutions Deregulation and Monetary Control Act of 1980 generally opened the Federal Reserve check clearance and collection mechanisms, as well as all other Federal Reserve services, to all depository institutions on the same terms as member banks. The Federal Reserve is required to establish pricing schedules for these services.[153] Some believe that having the Federal Reserve System "unbundle" its service pricing and charge separately for the services it makes available will encourage competition in the provision of these services from private organizations. Because this act aims to equalize competition with private enterprise, the prices charged by the Federal Reserve must include a private sector adjustment factor for the overhead expenses that private service suppliers would incur but that the Federal Reserve does not.[154]

The Board has implemented the policies of the 1980 act by amending Regulation J to define "bank" to include any depository institution within the act. This amendment expands access to the Federal Reserve check collection services by granting access to all depository institutions.[155] The Board publishes fee schedules for the check collection, wire transfer, currency and coin transportation and other services it makes available.

[153] 12 USC § 248a (1982). See ¶ 3.03[5].

[154] 12 USC § 248a(c) (1982).

[155] 12 CFR § 210.2(b) (1987), incorporating the definition of bank in the Federal Reserve Act, 12 USC § 461(b) (1982).

Before the 1980 act opened up the Federal Reserve collection facilities to all depository institutions, the Board had refused to collect drafts issued by a savings and loan association. The Board took the position that such drafts were illegally issued and that the savings and loan association lacked the authority to pay interest on demand accounts. When a savings and loan association sued the Board to force the Federal Reserve to collect the drafts, the federal district court granted the relief requested in a preliminary injunction. The court ruled that the Board had no authority to enforce the provisions of the federal statute prohibiting interest on demand accounts by denying access to its collection facilities.[156]

On one occasion when the Board of Governors revised its procedures for check collections in order to speed up the process, a group of private air couriers objected to the changes. The couriers had contracted with banks to provide transportation for the banks' check collections but the court ruled they did not have standing to challenge the changes made by the Federal Reserve System under the 1980 act.[157]

[b] Fund Transfers. The Federal Reserve System provides a mechanism for transferring funds without using paper checks.[158] Through the use of telephonic communication, computer processing, and other technological advances, the system can quickly transfer funds in large amounts across the country. The Federal Reserve facility for handling these transfers is called FedWire. In 1983, FedWire handled an estimated 38 million transactions at a value of $84 trillion.[159] By 1986 the Board estimated it was processing approximately $500 billion every business day and handling as many as 50 million transactions for

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[156] Otero Sav. & Loan Ass'n v. Board of Governors, 497 F. Supp. 370 (D. Colo. 1980), aff'd, 665 F2d 275 (10th Cir. 1981). See 12 USC § 1832 (1982). Compare Independent Bankers Ass'n of Am. v. Board of Governors, 500 F2d 812 (DC Cir. 1974), where the court permitted the Board to distinguish between member and nonmember banks in providing check collection services as long as the Board did not act arbitrarily. The court held the Board had a responsibility to nonmember banks not to unreasonably jeopardize or prejudice their operations through changes in the way the service is administered, but that responsibility did not require nonmember banks to be treated identically to member banks. In this case, a nonmember bank charged the Board with unfair treatment because the nonmember bank was not granted a lowering of reserve limits as were member banks. The court found, however, that reserve requirements of nonmember banks were established by state law, and the Board had no power to lower them.

[157] Jet Courier Servs., Inc. v. Federal Reserve Bank of Atlanta, 713 F2d 1221 (6th Cir. 1983).

[158] See generally Board of Governors, "The Federal Reserve and the Payments System: Upgrading Electronic Capabilities for the 1980's," 67 Fed. Reserve Bull. 109 (1981); N. Penney & D. Baker, The Law of Electronic Fund Transfer Systems (1980 & Supp. 1987); J. Vergari & V. Shue, Checks, Payments, and Electronic Banking (1986).

[159] Board of Governors, Federal Reserve System, Purposes & Functions 109 (1984).

the year with a value of about $124 trillion.[160] The Board describes the FedWire service as follows:

> FedWire is typically used to transfer large dollar payments. All such transfers are completed on the same day, usually in a matter of minutes, and are guaranteed final when the receiving institution is notified of the credit to its account. FedWire may be used by depository institutions to transfer funds for their own account that result from purchases or sales of federal funds, to move balances at correspondent banks, and to send funds to another institution on behalf of customers. Transfers on behalf of customers include flows of funds associated with the purchase or sale of securities, the replenishment of business demand deposits, and other time-sensitive payments. The Treasury Department and other federal agencies use FedWire extensively to disburse and collect funds.

FedWire is a high speed, technologically sophisticated facility for transferring large sums of money. The average transaction exceeds $1 million, and the service handles billions of dollars in transactions each day. Its use has increased as business customers have sought methods for obtaining close control and management of their funds. Users can make transfers either by telephone or through on-line computer linkups. In 1986, the number of funds transfers increased by 10.6 percent over the prior year for a total of 49.9 million transactions.[161] This service and net settlement service (discussed later) earned revenues of $82.7 million against costs of $79.6 million in 1986 illustrating the minimal fees which customarily are charged for this service notwithstanding the large dollar amounts of each transaction.[162]

The Federal Reserve System also offers automated clearinghouse (ACH) facilities. ACHs allow participating institutions to clear payments that are generated by electronically transmitted debits and credits. The Board describes the operation of these ACH settlement and clearing networks as follows:[163]

> In an ACH operation, depository institutions, acting on a customer's instructions, transmit debits and credits via delivery of magnetic tapes or telecommunications links to the local ACH facility, much as they would physically deliver checks to a check-clearing facility. For example, with the authorization of the payees, businesses and governments can make many of

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[160] Federal Reserve Bank of Dallas, Financial Services Information, "Cross Roads," 4 (summer 1987).

[161] 73 Bd. of Governors, Fed. Reserve Sys. Ann. Rep. 210 (1987).

[162] Id. For additional description of FedWire and large dollar electronic funds transfer see N. Penney & D. Baker, The Law of Electronic Fund Transfer Systems (1980 & Supp. 1987). The law relating to the rights and liabilities of parties to these transactions is discussed in Chapter 18.

[163] Board of Governors, Federal Reserve System, Purposes & Functions 109–110 (1984).

their recurring payments for salaries, wages, commissions, interest, dividends, annuities, social security, welfare, pensions, and the like through ACHs, with the proceeds credited directly to the payee's account at his or her depository institution without the prior issue of a paper check. Consumers may also authorize their depository institutions to make regular, recurring payments through ACHs for such obligations as mortgages or utility and insurance bills.

The Board reported that by 1986, the ACH systems "processed 363 million commercial transactions, 28 percent more than in 1985,"[164] with the U.S. government being one of the largest users of this system.

The national and regional ACHs that are part of the Federal Reserve System operate in cooperation with local ACHs and other private ACHs throughout the country. A report from the Federal Reserve Bank of Dallas states that, "With the exception of the second Federal Reserve District in which the ACH is operated by a private group, each Federal Reserve bank operates one or more ACH processing facilities in cooperation with local ACH associations. The Fed's roles include acting as the processing agent, serving as the settling agency in regard to ACH transactions, and acting as an originator of federal government payments such as payroll, social security and certain military retirement funds and payrolls."[165] The Treasury also instituted a program for making payments to persons who have supplied goods and services to the government through the ACH network.[166]

The following description from the Federal Reserve Bank of Dallas gives a good explanation of how an ACH works:

> There are at least five participants in an ACH transaction. They include the customer or employee, the company or employer, the originating financial institution, the automated clearinghouse and the receiving financial institution. The initial participant is the customer or employee who authorizes electronic entries into his account. For payroll entries, the employer is authorized to credit the employee's account each payday. Debits are also preauthorized, allowing billing companies to collect their payments on the appropriate day.
>
> The company or employer's financial institution originates the ACH payments data through either a magnetic tape or through a direct electronic connection to the Federal Reserve. The originating financial institution receives the data from the company. It retains entries pertinent to its accounts and forwards the remaining data to the ACH. The automated clearinghouse receives the entries from the originating financial institutions, creates new files of ACH credit and debit information and distributes

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[164] 73 Bd. of Governors, Fed. Reserve Sys. Ann. Rep. 210 (1987).

[165] Federal Reserve Bank of Dallas, Financial Services Information, "Cross Roads" 5 (summer 1987).

[166] Id. at 6.

the electronic entries to the appropriate receiving financial institution. The final participant in an ACH transaction is the receiving financial institution. It receives the data from the ACH and posts the entries to the accounts of its customers.[167]

The Federal Reserve System also provides "net settlement" service. This service assists the participants in private check clearing houses or ACHs or wire transfer systems to settle with each other at the end of the day. The Federal Reserve bank will enter the net debits or credits of each participant resulting from the day's clearings to the accounts these institutions have with the Federal Reserve System. This gives the participants a prompt settlement in federal funds.[168]

The Federal Reserve System's communications and data processing services are also used for the transfer and management of ownership of U.S. government securities and some agency securities such as the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation. Most U.S. Treasury securities are now in "book-entry" form rather than in paper certificates. For 1986, "the Federal Reserve processed 6.0 million transfers of Treasury securities, 98 percent of which were on line." The Federal Reserve also processed some 1.8 million federal agency securities in 1986, 98 percent of which were on line.[169]

[c] Regulatory Activities to Manage the Payment System. As a result of the importance of the Federal Reserve System in the nation's payment system, the Board of Governors is extensively involved in regulatory activities to manage the payments system and in research and policy making for the development of legislation. Regulation J contains the Board's rules for the Federal Reserve check collection and wire transfer procedures.[170] These rules are superior to the provisions of Article 4 of the UCC on check collection as discussed in Chapters 14 and 18.[171] The scope of these rules is discussed in Chapter 18.

The Federal Reserve System's authority to regulate the payments system has been amended and expanded over the past few years. In 1987, the Expedited Funds Availability Act of 1987[172] greatly expanded the Board's authority to regulate the payments system. The Electronic Fund Transfer Act[173] gave the

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[167] Id. at 5.

[168] Board of Governors, Federal Reserve System, Purposes & Functions 110 (1984).

[169] 73 Bd. of Governors, Fed. Reserve Sys. Ann. Rep. 211 (1987).

[170] 12 CFR § 210 (1987).

[171] UCC § 4-103.

[172] The Expedited Funds Availability Act is Title VI of the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 635 (1987).

[173] 15 USC §§ 1693–1693r (1982).

Board authority over the payments system by conferring power to regulate certain electronic fund transfers. These rules are found in Regulation E. The Electronic Funds Transfer Act and the Board's regulations are discussed in Chapter 18.

In overseeing the operation of the payment system, the Federal Reserve has addressed current issues of monetary and social policy in its research activities and regulatory roles. One area of concern has been the extent of "float" created by the system; the Board has developed rules for minimizing float and pricing it for those who are advantaged by it.[174] Federal Reserve "float" is credit that is created as a result of the time it takes the check collection process to be completed. Because of this delay in collection, it is possible for credit for a check to be on the books of the depository institution but not be removed from the books of the payor institution. In 1986, daily average float was $446 million. This is a significant reduction over previous years. Only five years earlier, float was at a level of $4 billion per day.[175]

Another area of ongoing concern has been the management of risk on large dollar wire transfer networks and ACHs. Because of the large dollar amounts processed daily over these networks, the failure of an institution to settle its liabilities to other participants on the network at the close of business could have gravely serious ripple effects throughout the national banking system. To deal with such potential problems, the Board has adopted a policy on large dollar transfers and proposed additional rules for other areas.[176]

Other examples of Board policies studies include the development of experimental programs for testing revised procedures for handling check returns of small item checks dishonored for insufficient funds[177] and studies conducted in consumer related areas. The Board is considering the need for requiring banks to provide "basic banking" services and is studying techniques for speeding up the time it takes to receive notice of dishonor of checks so that the delay that some depository institutions require before customers may withdraw funds for deposited checks in the process of collection may be reduced.[178]

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[174] 73 Bd. of Governors, Fed. Reserve Sys. Ann. Rep. 212 (1987). See also Board of Governors, Federal Reserve System, Purposes & Functions 107-108 (1984).

[175] Id.

[176] 73 Bd. of Governors, Fed. Reserve Sys. Ann. Rep. 193-194, 205-206 (1987). See also D. Baker & R. Brandel, The Law of Electronic Fund Transfer Systems § 9.02[2] (Supp. 1987).

[177] The Board approved a policy authorizing collecting banks to automatically redeposit dishonored checks that are in small amounts. The various Federal Reserve banks will each determine what amounts will qualify checks for the redeposit program. This policy was adopted after a pilot study demonstrated a high percentage of such checks were paid when re-presented. 48 Banking Rep. (BNA) 566 (Mar. 25, 1987).

[178] 73 Bd. of Governors, Fed. Reserve Sys. Ann. Rep. 210 (1987).

[6] Credit and Interest Controls

The Board historically has exercised regulatory authority over interest and credit in three areas: (1) interest rates payable by member institutions on deposit accounts; (2) by means of its margin requirements, the extent to which securities may serve as collateral for loans for the purchase and holding of stock; and (3) use of broad controls in times of serious economic inflation to limit the extension of credit. As of 1988, the Federal Reserve is engaged only in regulating the extension of credit in securities transactions. The control of interest on deposits phased out in 1986 in accordance with federal law. The authority to exercise general credit controls expired in 1982. As these functions may be of continued interest, this section briefly describes the Board's powers in these areas.

[a] Margin Requirements for Securities Credit. The Securities Exchange Act of 1934 gives the Board of Governors authority to regulate the use of credit for the purchase and carrying of certain securities. The purpose of regulating securities' credit is to minimize fluctuations in stock values from speculative dealing encouraged by easy credit arrangements. The Board explains its policy in the following statement:

> The main purpose of margin requirements is to inhibit undue fluctuations in stock prices that might be fostered by the excessive use of credit in the purchase of securities or by highly leveraged short sales or transactions in options. Although sharp changes in stock prices are always possible, restrictions on the use of credit may limit cumulative price increases and decreases and reduce the risk that fluctuations in the stock market will have destructive effects on financial markets and the economy generally, as well as on the individual investor.[179]

The Board implements this policy through a set of regulations aimed at different groups of credit extenders and users. Regulation T governs brokers and dealers; Regulation U applies to banks; Regulation G covers other lenders; and Regulation X extends the requirements of the three regulations previously stated to transactions in securities where credit was obtained outside the United States and requires all persons in the United States who use securities credit to comply.[180]

Under Regulation U, the Board exercises authority to determine the extent to which a bank may extend credit for the purchase of equity securities. The amount of credit a bank may extend is based upon a percentage of the current

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[179] Board of Governors, Federal Reserve System, Purposes & Functions 72 (1984).

[180] 12 CFR § 207 (Regulation G, Securities Credit by Persons Other than Banks, Brokers, or Dealers); § 220 (Regulation T, Credit by Brokers and Dealers); § 221 (Regulation U, Credit by Banks for the Purpose of Purchasing or Carrying Margin Stock); § 224 (Regulation X, Borrowers of Securities Credit) (1987).

market value of the stock as established by the Board. This percentage is called the margin requirement. Thus, if the Board sets the percentage at 60 percent, a purchaser of stock must pay for 60 percent of the stock based on its current market value. This purchaser then would be able to borrow the remaining 40 percent of the value of the stock to finance the acquisition. In situations where the bank has extended credit based on the market value of the stock at the time the loan was made and the stock subsequently declines in market value, the margin rules do not require the bank to demand additional collateral. The loan remains in compliance with the margin requirements notwithstanding fluctuations in the price of the stock as long as there was compliance at the time the credit was extended.[181] The bank may have other reasons for requiring the borrower to either reduce the indebtedness or provide additional collateral, such as the desire to have the loan adequately secured at all times. The regulations do not prevent the bank from exercising such judgment in its lending arrangements.[182]

The Regulation U margin requirements apply to "margin stock." This includes, among others, equity securities traded on national securities exchanges and certain over-the-counter stocks designated by the Board.[183]

If the transaction involves margin stock and the extension of credit is secured, directly or indirectly, by that stock, the bank is prohibited from extending credit in any amount in excess of the loan value of the stock under the margin rules. The regulation states:[184] "No bank shall extend any purpose credit, secured directly or indirectly by margin stock, in an amount that exceeds the maximum loan value of the collateral securing the credit." The Board regulation further defines how to measure the credit extended under different financing situations.

[b] Interest Rate Controls. The Board of Governors previously exercised control over the amount of interest and dividends paid to customers by member banks; the other federal banking regulatory agencies had similar authority for the banks under their supervision. Federal law prohibits member banks from paying interest on demand deposits "directly or indirectly, by any device whatsoever."[185] A similar statutory prohibition exists with respect to the demand

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[181] 12 CFR § 221.3(a)(2) (1987).

[182] See the explanation of the margin requirements in Board of Governors, Federal Reserve System, Purposes & Functions 72-73 (1984); see generally, Annot., "What Constitutes Violation of Provisions of Margin Requirements for Banks Under § 7 of Securities Exchange Act of 1954 (15 U.S.C. § 78(g)) and Regulation U Promulgated Thereunder (12 C.F.R. §§ 221 1 et seq.)," 34 ALR Fed. 332 (1977).

[183] *12 CFR § 221.2(h) (1987).*

[184] 12 CFR § 221.3(a) (1987).

[185] 12 USC § 371a (1982).

deposits of insured nonmember banks.[186] But interest may be paid on other types of deposits that are not "demand deposits." In the past, the regulatory agencies controlled the extent to which interest could be paid on those accounts. Federal legislation required the agencies to establish interest rate ceilings that would maintain a differential between the rates paid by insured banks and savings and loan associations to permit savings and loan associations to pay a higher rate. The Board regulations on the interest rate banks could pay on various time deposits and savings accounts were contained in Regulation Q.[187]

In 1980, Congress decided to terminate interest regulation over a phase-in period. Congress accomplished this with the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980.[188] This act affected the former scheme of interest controls in two ways. Firstly, it permitted depository institutions such as savings and loan associations, credit unions, and banks to offer accounts that were not "demand deposits" but that were accounts that gave the customer rights to make payments by check. It authorized the creation of NOW accounts for eligible individuals and nonprofit organizations on which interest could be paid but that also allowed checking privileges, and it liberalized the rules on linkages between savings and checking accounts.[189] (The different types of accounts are discussed in Chapter 19.) Secondly, the act put in place a program for deregulating the control of interest rates.

In enacting the 1980 act, Congress responded to two problems that it believed the regulation of interest rates created for savers and depository institutions. These problems were (1) when the market rate for money was higher than the legal rate for depository institutions, small savers were penalized to the extent that they did not place their funds in alternative investments and the

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[186] 12 USC § 1828(g) (1982).

[187] Regulation Q is codified at 12 CFR § 217 (1987). The interest rate differential between banks and thrift institutions was eliminated by the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 207(b)(1), 94 Stat. 144 (1980) (codified at 12 USC § 3506(b)(1)) and further repealed by the Garn-St Germain Depository Institution Act of 1982. Pub. L. No. 97-320, § 326, 96 Stat. 1469 (1982) (codified at 12 USCA § 3503 note).

[188] Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of titles 12, 15 USC) (1982).

[189] 12 USC §§ 1785(f), 1832 (1982). See also generally Annot., "Power of Savings Banks or Similar Institution to Provide Checking Facilities or Negotiable Orders of Withdrawal (NOW) to Customers," 64 ALR3d 1314 (1975); Annot., "Authority of Credit Union to Engage in 'Share-Draft' Business," 14 ALR4th 1355 (1982). Prior to congressional approval, there was some litigation over efforts by thrift institutions to offer checklike accounts on which interest was paid. See Hondo Nat'l Bank v. Gill Sav. Ass'n, 696 F2d 1095 (5th Cir. 1983) (federal statute prohibiting paying interest on demand deposits does not create an implied cause of action enforceable by commercial banks); Otero Sav. & Loan Ass'n v. Federal Home Loan Bank Board, 665 F2d 279 (10th Cir. 1981).

depository institutions were injured to the extent they were unable to compete with the alternative investments and (2) the structure of different maximum rates for different classes of depository institutions created competitive imbalances. In Congress's view, the solution was to deregulate the control of interest rates; thus, it created a process to eliminate interest rate controls by member banks, insured banks, and other depository institutions by April 1, 1986.[190] To accomplish this, the Depository Institution Deregulation Committee was created. This committee was responsible for the gradual elimination of controls according to target rates set by the act.[191]

The phaseout of interest rate regulation was accomplished on March 31, 1986; thus, there are no longer any limitations on the amount of interest that depository institutions covered by the 1980 Act may pay for deposits other than demand deposits. The Deregulation Committee went out of existence on the same date and transferred whatever residual authority it had to the Assistant Secretary of the Treasury.[192]

Although federal regulation of the amount of interest depository institutions may pay was terminated, member banks of the Federal Reserve System continue to be subject to the prohibition of the payment of interest on demand deposits. Therefore, the distinction between demand deposits and other deposits remains relevant. In addition, the reserve requirements an institution must maintain are based upon the type of accounts the institution holds.[193] When the account has checking features, it is classified as a transaction account, for which reserves must be maintained at a level set by the Board. If the account is a "nonpersonal time deposit," the Board requires reserves as well. As a result, many of the distinctions previously incorporated in the Board's Regulation Q on interest rates have been carried forward into Regulation D on required reserves.

The Board of Governors continues to regulate the advertising of interest on deposits. When advertisements refer to an interest rate, the rate must be the annual rate of simple interest. In addition, advertisements must include a "clear and conspicuous notice" of any penalties for early withdrawal that depositors may be subject to. Advertisements must be accurate and may not mislead or misrepresent the nature of the bank's deposit contracts.[194]

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[190] 12 USC § 3506b (1982).

[191] The committee was composed of the Secretary of the Treasury, the chairman of the Board of Governors of the Federal Reserve System, the chairman of the Board of Directors of the FDIC, the chairman of the Federal Home Loan Bank Board, and the chairman of the National Credit Union Administration Board. The Comptroller of the Currency was a nonvoting member. 12 USC § 3502 (1982).

[192] 51 Fed. Reg. 9767 (1986). For a special report on the effectiveness of the Deregulation Committee, see 49 Wash. Fin. Rep. (BNA) 154 (July 26, 1982).

[193] See ¶ 3.04[2].

[194] 12 CFR § 217.6 (1987).

[c] **Credit Controls.** At various times Congress has made the Federal Reserve System responsible for managing the availability of credit in the national economy. The Board exercised these controls during World War II and the Korean War.[195] The most recent experience with credit controls occurred for a brief period in 1980. Although there is no longer authority for the Board to exercise such credit controls, a brief description of the 1980 experience is appropriate in view of the importance of such regulatory measures.

On December 23, 1969, Congress enacted a statute giving the Board of Governors authority to impose credit controls, including (upon presidential authorization) the power to (1) establish license requirements for persons who engage in credit transactions; (2) prescribe the maximum amount of credit that may be extended in connection with any loan, purchase, or other credit transaction; and (3) prescribe the maximum rate of interest, maximum maturity, minimum periodic payment, or any other specification or limitation of the terms and conditions of any extension of credit.[196] On March 14, 1980, President Carter authorized the Board to exercise all the authority conferred by the statute.[197] Upon receiving this authority, effective the same day, the Board put into place a broad program aimed at constraining the amount of credit.[198]

The Board took a number of actions designed to make the extension of credit more expensive. A major part of the program consisted of consumer credit constraint measures that required various consumer lenders to maintain special non-interest-bearing deposits of 15 percent on increases over a base amount on many types of consumer credit. The program also included similar deposit requirements for certain liabilities held by nonmember commercial banks, deposit requirements for money market mutual funds, voluntary guidelines on the growth of bank loans, and restrictions on access to the Federal Reserve discount services. These controls were short-lived. The president revoked the Board's powers, which finally expired on October 31, 1980.[199] The act itself expired in 1982.

The program adopted by the Board in 1980 illustrates the extensive power Congress had conferred on the Board. The voluntary credit restraint program applied to domestic commercial banks, bank holding companies, finance companies that extended business credit, and U.S. agencies and branches of foreign banks financing U.S. residents. It provided that lending increases should be consistent with announced growth ranges for money and credit, with growth in bank loans conforming to an upper limit growth rate of 6 to 9 percent. Banks

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[195] See Board of Governors, Federal Reserve System, Purposes & Functions 71-72 (1984).

[196] 12 USC §§ 1901–1910 (1982).

[197] Exec. Order No. 12,201, 45 Fed. Reg. 17,123 (1980).

[198] See 45 Fed. Reg. 17,924–17,936 (1980).

[199] Exec. Order No. 12,225, 45 Fed. Reg. 45,571 (1980).

with slow growth patterns were supposed to confine their growth to the lower percentage. Banks were also urged to restrain unsecured consumer lending, including credit card and other revolving credit extensions, although no numerical guidelines were established. Automobile, home mortgage, and home improvement credit extensions were treated in the usual manner. The program discouraged financing for corporate mergers and takeovers except where justified by efficiency considerations, and discouraged financing for speculative commodity and other transactions.

The program did not establish guidelines on the terms and pricing of bank loans, but it did urge lenders to establish rates reflecting the marginal cost of funds. Banks were expected to adjust their rates and terms to accommodate the special needs of small businesses. The program also included extensive reporting requirements. Banks and other financial institutions with assets over $1 billion were required to supply monthly reports. Banks with assets from between $300 million to $1 billion were required to supply quarterly reports.

The consumer credit restraint program covered not only commercial banks but also finance companies, credit unions, savings and loan associations, mutual savings banks, retail establishments, gasoline companies, and travel/entertainment card companies. A broad range of consumer credit was covered—credit cards, overdraft and check credit plans, unsecured personal loans, loans secured by preowned borrower collateral, open accounts and thirty-day credit arrangements. Automobile loans, mobile home loans, furniture and appliance loans, and home mortgage and improvement purchase money financing were not covered.

The experience of this period illustrates the far-reaching emergency powers that Congress in the past has given the Board of Governors to manage the use amount of credit in the economy.

4

National Banks

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¶ 4.01 OVERVIEW

National banks, or national banking associations, as they are termed by the National Bank Act, are chartered under federal law. This section discusses the organization, powers, and restrictions affecting national banks.

[1] Organization of National Banks

The Comptroller of the Currency is the primary supervisor and regulator for national banks and must approve the creation of a national bank.[1] The comptroller has considerable discretion in determining whether to grant or deny an application to establish a national bank.[2] Also, as described in Chapter 3, national banks are members of the Federal Reserve System and so must comply with the limitations placed upon member banks by the Federal Reserve Act of 1913 and its amendments. They must subscribe to the capital stock of the Federal Reserve bank for their district,[3] and they are subject to the limitations applicable to holding stock in a Federal Reserve bank.[4]

National banks must be insured by the Federal Deposit Insurance Corporation before they can engage in business as banks.[5] Thus, restrictions applicable to insured banks imposed by the Federal Deposit Insurance Act also are applicable to national banks.[6] Before a national bank can be approved for insurance, the Comptroller of the Currency must certify to the FDIC that consideration was given to "[t]he financial history and condition of the bank, the adequacy of its capital structure, its future earnings prospects, the general character of its management, the convenience and needs of the community to be served by the bank, and whether or not its corporate powers are consistent with the purposes of [the Federal Deposit Insurance Act]."[7]

The comptroller has adopted regulations to govern the procedures for obtaining a national bank charter.[8] These procedures include the opportunity for interested parties to submit written comments on the application, which must be made available in a public file, and to request a hearing on the application. The procedures also include a statement of policy by the comptroller on the factors that will be considered in passing upon an application. This statement includes the following comments:

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[1] The provisions of the U.S. Code dealing with the Comptroller of the Currency are found at 12 USC §§ 1–14 (1982), and those dealing with national banks as such are at 12 USC §§ 21–216 (1982 & Supp. III 1985). Before a national bank can begin business, the comptroller must approve. 12 USC §§ 26, 27 (1982).

[2] See City Nat'l Bank v. Smith, 513 F2d 479 (DC Cir. 1975); First Nat'l Bank v. Smith, 508 F2d 1371 (8th Cir. 1974), cert. denied, 421 US 930 (1975); Bank of Commerce v. City Nat'l Bank, 484 F2d 284 (5th Cir. 1973), cert. denied, 416 US 905 (1974); Sterling Nat'l Bank v. Camp, 431 F2d 514 (5th Cir. 1970), cert. denied, 401 US 925 (1971).

[3] 12 USC §§ 282, 287 (1982).

[4] See discussion in ¶¶ 3.03[3], 3.03[4].

[5] 12 USC § 1814(b) (1982).

[6] The provisions of federal law dealing with the FDIC are found at 12 USC §§ 1811–1832 (1982 & Supp. III 1985). The FDIC is discussed in Chapters 10, 11.

[7] 12 USC § 1816 (1982).

[8] 12 CFR pt. 5 (1987).

The statutory factors the Office must consider in deciding whether to approve or disapprove applications to establish new banks are:

(1) The bank's future earnings prospects;

(2) The general character of its management;

(3) The adequacy of its capital structure;

(4) The convenience and needs of the community to be served by the bank;

(5) The financial history and condition of the bank; and

(6) Whether or not it has complied with all provisions of the National Bank Act and whether or not its corporate powers are consistent with the purposes of the Federal Deposit Insurance Act.

(d) *Policy.* The purpose of this policy statement is to set forth the analytical framework within which the Office seeks to fulfill its responsibilities to determine whether a proposed bank is likely to be operated in a safe and sound manner, possesses reasonable prospects for success and can be expected to help meet the credit needs of its entire community. This policy statement is also intended to facilitate applicant and public understanding of the decision process, to aid in the structuring of new bank proposals and the development of information necessary for the evaluation of proposals, and to minimize the filing of unwarranted proposals. It should be emphasized at the outset that administration of the statute necessarily involves a rigorous appraisal and a weighing of the relevant statutory factors in the context of the economic and competitive conditions of the community (market) to be served. Because of complex relationships among the factors, evaluation of the application is based upon both objective facts and subjective judgments that reflect the experience of the Office as the principal supervisor and regulator of national banks. In making these judgments, the Office is guided by the following principles: the Office has responsibility for maintaining a sound banking system; the marketplace normally is the best regulator of economic activity; and competition allows the marketplace to function and promotes a sound and more efficient banking system that better serves customers. Accordingly, it is the policy of the Office to foster competition through the chartering of national banks proposed by organizers and proposed directors (hereinafter, "the organizing group") whose experience and resources, plans for establishing and operating a bank (hereinafter "the operating bank"), financial strength, competency and honesty indicate that within the context of the economic and competitive conditions in the market to be served, the proposed bank will have a reasonable likelihood of success and will be operated in a safe and sound manner. It is not the policy of the Office to ensure that a proposal is without risk nor to protect existing competitors from the competition a new bank will provide.[9]

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[9] 12 CFR § 5.20 (1987).

When the application is on behalf of a bank holding company or is on behalf of applicants who have had previous experience in banking, the comptroller explicitly takes into account the applicant's record of past performance.[10]

The comptroller determines the adequacy of the capital of the proposed bank. Federal law requires that all of the capital stock of a national bank be paid in before the bank begins business.[11] It also imposes limitations upon the use of preferred stock and the payment of dividends. In addition, federal law contains provisions to protect shareholders' rights to vote for directors of the bank.[12] At one time the shareholders in national banks had a double liability for the debts of the bank, but the additional liability beyond the amount of their investment in the bank's shares was eliminated in 1953.[13]

There must be at least five directors[14] but not more than twenty-five directors for a national bank.[15] Directors must be U.S. citizens who reside in an area near where the bank will be located, and they must invest a minimum of $1,000 in shares of stock in the bank.[16] There are additional restrictions on directors that deal with management interlocks with other financial and commercial firms.[17]

[2] Charters for Nonbank Banks

As discussed in Chapter 5, until the Competitive Equality Banking Act of 1987, the Bank Holding Company Act defined a "bank" (for the purposes of that legislation) such that corporate organizations were permitted to acquire financial institutions that were chartered as banks by the comptroller or other banking agencies but that were not entities that came within the Bank Holding Company Act definition. As defined under the Bank Holding Company Act, an enterprise was not a bank unless it both accepted demand deposits and made commercial loans. Therefore, a bank that did not make commercial loans was not regarded as a bank for purposes of the act. Because of concern that these "nonbank banks" represented a threat to the regulatory structure of the national banking system, the comptroller initiated a moratorium on the granting of charters for such banks.[18] When Congress did not pass legislation addressing the issue, the comp-

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[10] 12 CFR § 5.20(d)(iv) (1987).

[11] 12 USC § 53 (1982).

[12] See 12 USC §§ 51a, 51b, 51b-1, 60, 61 (1982).

[13] 12 USC § 64a (1982).

[14] 12 USC §§ 71, 71a (1982).

[15] 12 USC § 71a (1982).

[16] 12 USC § 72 (1982).

[17] See ¶ 9.02[6]. Restrictions related to affiliations with firms engaged in securities business are discussed at ¶ 8.01.

[18] The comptroller's announcement is reported at 5 Fed. Banking L. Rep. (CCH) ¶ 58,825 (Apr. 13, 1983).

troller ended the moratorium and began acting on pending applications to establish nonbank banks. This stimulated litigation to prevent the comptroller from issuing new charters for nonbank banks. An injunction was entered against the comptroller in a Florida law suit.[19] The litigation challenged the ability of the comptroller to charter banks that did not engage in a full range of banking functions.[20] However, this question may remain unresolved. After the passage of the Competitive Equality Banking Act of 1987, the parties moved to withdraw the litigation. The nonbank bank is discussed in Chapter 5.

[3] Changes in Names and Locations of National Banks

A national bank must have the word "national" in its name.[21] Under earlier legislation, a national bank could not change its name[22] or change the location of its main office without obtaining the approval of the comptroller. Federal law now provides that the name may be changed upon notice to the comptroller. Likewise, the location of the bank's main office may be changed upon notice to the comptroller if the change is to an authorized branch location within the city where the bank is situated; otherwise, the comptroller's approval is necessary for a change in location.[23]

Branch banking, mergers, and acquisitions are discussed in Chapters 6 and 13.

[4] Suits Against National Banks

Before the enactment of the Garn-St Germain Depository Institutions Act of 1982, Congress had limited the places where national banks could be sued. The National Bank Act contained a special venue provision that provided that

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[19] Independent Bankers Ass'n of Am. v. Conover, No. 84-1403 (MD Fla. Feb. 15, 1985).

[20] The nonbank bank provisions of the Competitive Equality Banking Act of 1987 are discussed in Chapter 5. A similar argument was unsuccessfully made in Clarke v. Securities Indus. Ass'n, 107 S. Ct. 750 (1987), where the court held that a discount brokerage subsidiary was not engaged in "core banking" functions and so was not a branch bank within the meaning of the federal statute. See the discussion of this case in ¶ 6.01[1].

[21] 12 USC § 30 (1982).

[22] See North Dakota v. Merchants Nat'l Bank & Trust Co., 634 F2d 368 (8th Cir. 1980), in which the court held the comptroller's approval of a name change by a national bank preempted state unfair competition law, which, it had been argued, prohibited the use of the new name. With the elimination of the comptroller's authority to approve name changes, the results in such cases may well be different. See also Pioneer First Fed. Sav. & Loan Ass'n v. Pioneer Nat'l Bank, 98 Wash. 2d 853, 659 P2d 481 (1983). For a case upholding the discretion of the comptroller under the prior law, see First Nat'l Bank v. National Bank, 667 F2d 708 (8th Cir. 1981).

[23] 12 USC § 30 (1982).

national banks could be sued in federal court only in the district where the bank was "established."[24] The general rule was that "the place specified in a bank's charter as its home office is determinative of the district in which the bank is 'established' for purposes of § 94."[25] This provision also limited the places where a national bank could be sued in a state or local court to the place where the bank was "located."[26] The U.S. Supreme Court has construed the word "located" to mean wherever a branch office of the bank could be found.[27] However, a bank may waive these rights if it so wishes.[28]

With the adoption of the Garn-St Germain Depository Institutions Act, the special venue provision for national banks was eliminated.[29] Under present law, a national bank is subject to suit under the general venue provisions of the procedural law, and parties suing national banks will not be limited to the places where the bank was "established" or "located."

The 1982 act does, however, contain limitations on the places where receivers of national banks may be sued. The act provides that when the FDIC has been appointed as receiver of a national bank, any legal action against that bank or against the FDIC as receiver must be brought in the federal district court in the district where the bank has its principal place of business.[30] When a state or local court has jurisdiction over an action against a national bank, the action must be brought in the county or city where the bank's principal place of business is located.[31]

When a suit is brought against a national bank in a state court or local court, 12 USC § 91 prohibits the state court from entering an "attachment, injunction,

[24] 12 USC § 94 (1976).

[25] Radzanower v. Touche Ross & Co., 426 US 148, 151 n.2 (1976).

[26] 12 USC § 94 (1976).

[27] Citizens & S. Nat'l Bank v. Bougas, 434 US 35 (1977).

[28] International Travellers Cheque Co. v. BankAmerica Corp., 660 F2d 215 (7th Cir. 1981) (bank's appearance before the trademark trial and appeal board does not constitute a waiver of venue); Hamelly Int'l, Inc. v. First Nat'l Bank, 199 Mont. 221, 648 P2d 282 (1982) (Nevada National Bank's relationship with a customer in Montana was not sufficient to constitute a waiver of venue). In First Nat'l Bank v. District Court, 653 P2d 1123 (Colo. 1982), a waiver of venue was found from the bank's prior suit in the same county against the same parties dealing with the same transaction.

[29] Pub. L. No. 97-320, § 406, 96 Stat. 1469 (1982) (amending 12 USC § 94). Board of Managers v. Chase Manhattan Bank, N.A., 116 Ill. App. 3d 690, 452 NE2d 382 (1983), held that the 1982 revisions to the venue provisions of the National Bank Act could be applied retroactively. This issue was clarified in Pub. L. No. 97-457, 20(b), 96 Stat. 2509 (1982), which provided that the 1982 venue changes "shall be deemed to have taken effect upon the enactment . . ." of the law that made the change. The enactment date was October 15, 1982. See generally Wolff, "National Banks and the Vanishing Venue Defense," 97 Banking LJ 245–253 (1980).

[30] Pub. L. No. 97-320, § 406, 96 Stat. 1469 (1982). See discussion of suits against receivers in Chapter 10.

[31] Id.

or execution" against the bank "before final judgment."[32] This section has been interpreted to mean that the state court cannot take action to enforce its judgment until the available appeal process has been completed.[33]

¶ 4.02 The Comptroller of the Currency

The Comptroller of the Currency is the chief officer of the Office of the Comptroller of the Currency, which is located in the Department of the Treasury. The office is charged by law "with the execution of all laws passed by Congress relating to the issue and regulation of a national currency secured by United States bonds and, under the general supervision of the Board of Governors of the Federal Reserve System, of all Federal Reserve notes . . . ."[34] Further regulatory authority is given to the comptroller by specific statutes.

The comptroller is appointed by the president, by and with the advice and consent of the Senate, for a term of five years unless removed sooner by the president.[35] The comptroller serves under the general direction of the Secretary of the Treasury,[36] and is required to make an annual report to Congress.[37]

The comptroller's approval must be obtained before a bank may be organized to do business as a national bank.[38] Before issuing a certificate of approval, the comptroller must conduct an inquiry into the condition of the banking association and determine that it is lawfully entitled to commence the business of banking.[39]

Once the bank becomes a national bank, the comptroller has extensive powers to regulate its activities. Every national bank must make reports of condition to the comptroller in such form and containing such information as

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[32] 12 USC § 91 (1982).

[33] In United States v. Lemaire, 826 F2d 387 (5th Cir. 1987), a Texas state court entered judgment against a national bank on behalf of creditors of the bank. The creditors then served a writ of garnishment on the Federal Reserve Bank of Dallas to collect their judgment. This procedure was available to them under state law. The FDIC and the comptroller then brought suit in federal court to enjoin the creditors from enforcing their judgment. The federal court ruled in favor of the comptroller and the FDIC. The court emphasized the national interest in preventing the "premature, and potentially fatal, seizure of assets of an operational bank . . . ," and indicated the comptroller would be hindered in carrying out his responsibilities as supervisor of national banks if it were possible for creditors to seize the national bank's assets prior to the exhaustion of appeal rights.

[34] 12 USC § 1 (1982).

[35] 12 USC § 2 (1982).

[36] 12 USC § 1 (1982).

[37] 12 USC § 14 (1982).

[38] 12 USC § 26 (1982).

[39] 12 USC § 27 (1982).

TABLE 4-1 Regulations of the Comptroller of the Currency*

12 CFR Pt.	*Regulation*
1	Investment securities regulation
2	Disposition of credit life insurance income
3	Minimum capital ratios; issuance of directives
4	Description of office, procedures, public information
5	Rules, policies, and procedures for corporate activities
6	[Reserved]
7	Interpretive rulings
8	Assessment of fees; national banks; District of Columbia banks
9	Fiduciary powers of national banks and collective investment funds
10	Municipal securities dealers
11	Securities Exchange Act disclosure rules
12	Recordkeeping and confirmation requirements for securities transactions
13–15	[Reserved]
16	Securities offering disclosure rules
18	Annual financial disclosures to shareholders
19	Rules of practice and procedure
20	International operations regulation
21	Minimum security devices and procedures for national and district banks
22	Loans in areas having special flood hazards
23–24	[Reserved]
25	Community Reinvestment Act regulations
26	Management official interlocks
27	Fair housing home loan data system
28	Federal branches and agencies of foreign banks
29	Adjustable-rate mortgages
30	Real estate loans
31	Extensions of credit to national bank insiders
32	Lending limits
33	Disposition of unclaimed property recovered from closed national banks
34	Real estate lending
35–199	[Reserved]

*12 CFR pts. 1–199 (1987). See Fed. Banking L. Rep. (CCH) for unofficial reproduction of regulations.

the comptroller prescribes. The comptroller may call for special reports whenever he or she believes that such reports may be necessary to perform his or her supervisory duties.[40] The comptroller has the further authority to examine national banks and, pursuant to that examination, "to administer oaths and to examine any of the officers and agents thereof under oath" in order to make a "full and detailed report of the condition" of the bank.[41] Examinations may be made as often as the comptroller deems necessary.[42] Any refusal of the bank to permit such an examination or to supply the required information may result in the forfeiture of all rights of the bank.[43] The comptroller is authorized to publish bank examination reports.[44]

The comptroller is also authorized to regulate the conversion and merger of national banks, the establishment of branch banks, and the dissolution of banks. For a discussion of these topics, see Chapters 6, 10, and 13.

The comptroller may grant national banks the authority to engage in trust activities.[45] This authority may be revoked by the comptroller if the national bank "unlawfully and unsoundly" exercises the authority.[46] Finally, the comptroller has authority to issue rules and regulations to carry out the responsibilities of the office.[47]

[1] National Bank Holidays and Emergency Powers

The president of the United States has emergency authority to suspend all or part of the operations of banks that are members of the Federal Reserve System during "such emergency period as the President of the United States by proclamation may prescribe . . . ."[48] The comptroller also has emergency powers to declare legal holidays for national banks. The statute provides that "in the event of national calamity, riot, insurrection, war, or other emergency conditions occurring in any State whether caused by acts of nature or of man, . . ." the comptroller may declare a legal holiday by proclamation for national banks in the state or part of the state that is affected by the emergency.[49]

When a state authority declares a bank holiday for state banks for either emergency or ceremonial reasons, the holiday automatically applies to national

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[40] 12 USC § 161 (1982).

[41] 12 USC § 481 (1982).

[42] Id.

[43] Id.

[44] Id.

[45] 12 USC § 92a(a) (1982).

[46] 12 USC § 92a(k) (1982).

[47] 12 USC § 93a (1982).

[48] 12 USC § 95(a) (1982).

[49] 12 USC § 95(b) (1982).

banks located in the state. However, national banks may choose whether to close or remain open during the holiday unless the comptroller gives specific directions on what to do.[50]

When a bank is closed for a bank holiday, the closing may affect the calculation of the time a bank has to give notice or take other action when checks are collected or returned for nonpayment. The check collection process is discussed in Chapters 20 and 21. To the extent banks observe uniform holidays, these problems are minimized. The Federal Reserve Board has promulgated regulations designating specific dates as dates which are not to be considered "banking days" for the purpose of calculating the time for giving notice of nonpayment of a check, for example.[51]

The president also has broad powers during times of war to suspend various transactions with foreign interests or involving property in which a foreign country or national has an interest.[52] His powers include authority to:

> (A) investigate, regulate, or prohibit, any transactions in foreign exchange, transfers of credit or payments between, by, through, or to any banking institution, and the importing, exporting, hoarding, melting, or earmarking of gold or silver coin or bullion, currency or securities, and
>
> (B) investigate, regulate, direct and compel, nullify, void, prevent or prohibit, any acquisition holding, withholding, use, transfer, withdrawal, transportation, importation or exportation of, or dealing in, or exercising any right, power, or privilege with respect to, or transactions involving, any property in which any foreign country or a national thereof has any interest.[53]

[2] Unclaimed Property

Ordinarily the ownership of unclaimed property in the possession of national banks will be determined according to state law governing escheat of unclaimed property.[54] However, state law may not interfere with the operation of national banks.[55] The Garn-St Germain Depository Institutions Act of 1982 permits state authorities to review the records of a national bank to determine

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[50] Id.

[51] 12 CFR § 210.12(c)(10) (1987). Giving notice of dishonor is discussed at ¶ 21.11.

[52] 12 USC § 95a (1982). Before amendments in 1977, this statute also gave authority to the president to act "during any other period of national emergency declared by the President." Pub. L. No. 95-223, §§ 101(a), 102, 91 Stat. 1625, 1626 (1977).

[53] 12 USC § 95a (1982).

[54] See Clovis Nat'l Bank v. Callaway, 69 NM 119, 364 P2d 748 (1961); Office of the Comptroller of the Currency, Interpretive Letter No. 186, 1981-82 Dec. Vol., Fed. Banking L. Rep. (CCH) ¶ 85,267 (1981).

[55] See State by Lord v. First National Bank, 313 NW2d 390 (Minn. 1981), appeal dismissed, 456 US 967 (1982).

compliance with state unclaimed property laws. The examination must be "at reasonable times and upon reasonable notice" to the bank. It may take place only when the state authority has "reasonable cause to believe that the bank has failed to comply" with the unclaimed property laws.[56] Apart from this limited right to review the records of a national bank, state authorities have no power to conduct examinations of national banks.[57]

When a national bank becomes insolvent and the comptroller succeeds to the custody of property held in safe deposit boxes or other safekeeping arrangements by the bank where the ownership of the property is unknown or disputed, there is a federal procedure for resolving questions of who holds title to the property. The comptroller must give notice and allow time for the submission of claims. If no valid claim is filed, the title vests in the United States. The U.S. Claims Court is given jurisdiction to resolve disputes involving the comptroller's rulings on claims to the property.[58]

¶ 4.03 POWERS OF NATIONAL BANKS

There is no single source to which one can turn to discover the powers and limitations of national banks. There are specific powers conferred by various federal laws. Many important subjects will be covered in other parts of this text as set forth in the following list.

1. Investment and lending limitations. See Chapter 7.
2. Loans to officers and directors. See Chapter 9.
3. Loans to bank affiliates. See Chapter 9.
4. Transactions in securities. See Chapter 8.
5. Branch banking and mergers and acquisitions. See Chapters 6 and 13.
6. Bank holding companies. See Chapter 5.
7. Membership in Federal Reserve System. See Chapter 3.
8. Deposits and deposit insurance. See Chapter 11.
9. Interest and usury limits. See Chapter 26.

This section describes the general authority conferred on national banks under the National Bank Act. These powers may be divided into two groups. The first group comprises powers the act expressly enumerates. The second comprises "incidental" powers not expressly granted but "necessary to carry on the business of banking."[59] All of the powers derive from the constitutional author-

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[56] 12 USC § 484(b) (1982).

[57] 12 USC § 484(a) (1982)

[58] 12 USC §§ 216a, 216b (1982).

[59] 12 USC § 24 Seventh (Supp. III 1985).

ity of Congress to establish national banks. To the extent state law may be inconsistent or in conflict with or may interfere with the exercise of the powers Congress has prescribed, the supremacy clause of the U.S. Constitution makes the federal powers supreme. There are areas, however, where state law does not conflict with the federal scheme, and, to that extent, national banks are also subject to state law.

[1] Express Powers of National Banks

The National Bank Act grants national banks basic corporate powers. These are powers to organize as a corporation, to sue and be sued, to enter into contracts, to conduct business through officers and directors, and to adopt bylaws to govern its operations.[60] Other provisions of the national banking laws specifically grant and limit the powers of national banks. Some of the more important ones are discussed in the following text.

[a] Trust Authority. The comptroller may grant special permission to national banks to engage in trust activities when the laws of the state in which the national bank is located allow "[s]tate banks, trust companies, or other corporations which come into competition with national banks . . ." to function in such fiduciary capacity.[61] The bank must keep its trust activities separate from its other banking activities and must permit the state banking authorities access to reports of examinations made by the comptroller relating to the trust activities. The federal law expressly stipulates that this permission shall not "be construed as authorizing the State banking authorities to examine the books, records, and assets of such bank."[62]

[b] Real Estate Ownership. National banks are limited in the purposes for which they can own real estate to circumstances where the real estate is used for conducting business of the bank, is acquired through a conveyance in satisfaction of debt, or is purchased at a judgment or foreclosure sale or to secure debts due the bank, or where the real estate consists of property in which the bank holds a security interest for loans.[63] The normal holding period allowed for real

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[60] 12 USC § 24 (1982). See generally Dunn, "Expansion of National Bank Powers: Regulatory and Judicial Precedent Under the National Bank Act, Glass-Steagall Act, and Bank Holding Company Act," 36 SWLJ 763–792 (1982); Glidden, "The Regulation of National Banks' Subsidiaries," 40 Bus. Law. 1299–1317 (1985); "Construction and Application of 12 U.S.C. § 214–214c, Authorizing Conversion of National Bank Into, or Its Merger or Consolidation With, State Bank," 15 ALR Fed. 817 (1973).

[61] 12 USC § 92a (1982).

[62] 12 USC § 92a(c) (1982).

[63] 12 USC § 29 (1982).

estate acquired as security for debts is five years, but this may be extended by the comptroller for up to an additional five-year period when there has been a good faith effort to dispose of the property but disposal would be detrimental to the bank.[64]

[c] **Transactions in Coin and Bullion.** Federal law permits national banks to buy and sell "exchange, coin, and bullion . . ."[65] The Comptroller of the Currency has issued general guidelines for national banks to follow in engaging in these activities.[66] The comptroller's guidelines define the term "coin" as "coins held for their metallic value which are minted by a government, or exact restrikes of such coins minted at a later date by or under the authority of the issuing government." Under this definition, "national banks are prohibited from buying or selling coins the value of which is not based upon metallic content." (Banks may acquire such coins as collateral for debts.) The term "bullion", according to the comptroller, refers only to "uncoined gold or silver in bar or ingot form."[67]

The comptroller's guidelines establish policies requiring reporting and accounting for transactions in coin and bullion, procedures assuring the purity of assets acquired, and warnings regarding the possible applicability of Securities Act provisions. (The Glass-Steagall Banking Act of 1933 prohibits banks from investing in or underwriting securities of companies engaged in gold activities.)[68]

The comptroller views future and forward transactions concerning coin and bullion as activities that are incidental to banking and that are permitted to national banks.[69]

[d] **Financing by Leasing Personal Property.** Congress amended the National Bank Act in 1987 to permit national banks to lease personal property for financing purposes. The authority is to invest in "tangible personal property, including, without limitation, vehicles, manufactured homes, machinery, equipment, or furniture . . . ." The investment must be "for lease financing transactions on a net lease basis," and the investment cannot exceed 10 percent of the

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[64] Id.

[65] 12 USC § 24 Seventh (Supp. III 1985).

[66] Comptroller of the Currency, Banking Circular No. 58 (revised) (Nov. 3, 1981).

[67] Id. Consistent with these guidelines, the comptroller has issued an interpretation that national banks may not legally engage in investments in rare coins and currency, although investments that adhere to the guidelines of Banking Circular No. 58 are permissible. Comptroller of the Currency, Interpretive Letter No. 252, reprinted in Fed. Banking L. Rep. (CCH) ¶ 85,416 (Nov. 24, 1982).

[68] 12 USC § 24 Seventh (Supp. III 1985).

[69] Banking Circular No. 58, supra note 66.

bank's assets.[70] Although a federal court interpreted the former version of the National Bank Act to give national banks authority to engage in personal property leasing transactions, the leases had to be the functional equivalent of a loan.[71] The comptroller has applied a test for determining when this functional equivalency exists, which test limits the extent to which the bank may rely on any residual value in the property for recovering the bank's investment in the leased property. The authority conferred by the new amendments permits finance leases on a "net lease" basis without regard to the residual value of the property. (Under a net lease, the bank cannot be responsible for maintenance, repair, or servicing of the leased property.) The amendments are intended as an expansion of the authority of national banks to enter into leasing transactions beyond the scope of the *M & M Leasing Corp.* ruling.[72]

[e] Lotteries. A national bank may not participate in a lottery or permit the use of its offices for a lottery.[73] The term "lottery" is broadly defined and includes any "game, race, or contest" or "random selection" where participants give money or credit with the possibility that some but not all will obtain in exchange more than was given.[74]

[2] The Incidental Powers of National Banks

Defining the scope of national bank's "incidental powers" is complex. The National Bank Act, after enumerating the various general corporate powers national banks enjoy, continues in a separate seventh paragraph to further provide that national banks shall have the power

> to exercise by its board of directors or duly authorized officers or agents, subject to law, *all such incidental powers as shall be necessary to carry on the business of banking;* by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this chapter . . . ."[75] (Emphasis added.)

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[70] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 108, 101 Stat. 551, 579 (1987) (to be codified at 12 USC § 24 Tenth).

[71] M & M Leasing Corp. v. Seattle First Nat'l Bank, 563 F2d 1377 (9th Cir. 1977), cert. denied, 436 US 956 (1978).

[72] H.R. Conf. Rep. No. 261 on H.R. 27, 100th Cong., 1st Sess., reprinted in 1987 U.S. Code Cong. & Admin. News 533.

[73] 12 USC § 25a (1982).

[74] 12 USC § 25a(c) (1982).

[75] 12 USC § 24 Seventh (Supp. III 1985).

Interpretation of this paragraph has been somewhat of a puzzle. The second part of this paragraph lists specific banking functions that Congress obviously intended national banks to have authority to engage in. The first part of the paragraph contains a general provision stating that national banks shall have "all such incidental powers as shall be necessary to carry on the business of banking. . . ." Although when considered alone it appears to be a general grant of authority, this phrase is followed by the enumeration of specific activities in the second part of the paragraph. What relationship do the activities listed after the phrase that begins "by discounting and negotiating" have to the scope of the incidental powers granted by the first part of the paragraph? Do they operate as a limitation, or are they merely illustrative of what constitutes the "business of banking"?[76] The case law in this regard is not conclusive. An unduly restrictive view is difficult to square with the acceptance of many activities, such as safe deposit facilities, that are generally accepted as within the scope of the "business of banking," although not expressly mentioned.

The scope of incidental powers of national banks is a sensitive area, since any enlargement of the authority of national banks affects the competitive relationship between national banks and state banks whose powers are based upon state law. The courts have taken into account the interest in competitive parity between the two banking systems.[77] Defining the scope of the incidental powers remains the subject of much legal controversy and uncertainty.[78] When a bank is part of a bank holding company structure, some of the difficulties presented as a result of the uncertain content of these "incidental powers" may be sidestepped by conducting the activity through a nonbank affiliate of the holding company. (Bank holding companies are discussed in Chapter 5.)

One disputed area has been the provision of travel services by national banks. Although the comptroller sought to authorize such activities by a regulation that would have permitted national banks to operate full-scale travel agencies, a federal court of appeals held that the regulation was not authorized by law.[79] The court said:

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[76] This interpretive problem is addressed and the relevant Supreme Court cases are reviewed in Symons, "The 'Business of Banking' in Historical Perspective," 51 Geo. Wash. L. Rev. 676 – 726 (1983). Professor Symons suggests an intermediate view based on the historical role of banks, a view that would define the "business of banking" as deposit taking, credit granting, and credit exchange.

[77] See First Nat'l Bank v. Walker Bank, 385 US 252 (1966).

[78] See National Retailers Corp. v. Valley Nat'l Bank, 411 F. Supp. (D. Ariz. 1976), aff'd in part and dismissed in part, 604 F2d 32 (9th Cir. 1979) (barring a national bank from marketing a retail information service).

[79] Arnold Tours, Inc. v. Camp, 397 US 315 (1970), on remand, 428 F2d 359 (1st Cir. 1970), rev'd, 400 US 45 (1970), on remand, 338 F. Supp. 721 (D. Mass. 1972), aff'd, 472 F2d 427 (1st Cir. 1972).

> And when one looks at past decisions it becomes apparent that the activities of national banks which have been held to be permissible under the "incidental powers" provision have been those which are directly related to one or another of a national bank's expressed powers. . . . [A] national bank's activity is authorized as an incidental power, "necessary to carry on the business of banking," . . . if it is convenient or useful in connection with the performance of one of the bank's established activities pursuant to its express powers under the National Bank Act. If this connection between an incidental activity and an express power does not exist, the activity is not authorized as an incidental power.[80]

Yet the reasoning supporting the court's decision appears to accept the notion "that there is a normal and traditional range of activities that is permissible to banks and is encompassed within the incidental powers phrase, not as incidental powers, but as powers within the business of banking."[81]

A number of important banking functions rests upon the "incidental powers" grant of authority. Some of these are discussed in the following text.

[a] Borrowing Money. One area of incidental power is the power of national banks to borrow money.[82] As is often the case, the existence of the power may involve an interplay of some specific statutory authority or limitations with the general grant of authority in the incidental powers provisions. As a result of provisions in the Federal Reserve Act, national banks are authorized to engage in transactions involving the discounting of commercial paper and to obtain advances from Federal Reserve banks.[83] In the case of the authority to borrow, for example, there is specific statutory authority for national banks to pledge assets to secure public deposits of various kinds,[84] but there is no authority to pledge assets for private deposits.[85]

[b] Insurance Activities. Engaging in activities as an insurance agency has been an area of controversy that ultimately led to legislative clarification. At one time, the banking laws specifically authorized national banks to act as insurance agents when the banks were located in towns with a population of under 5,000

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[80] 472 F2d at 431–432.

[81] Symons, supra note 76, at 714 (1983).

[82] 2 S. Whitley, W. Schlichting, T. Rice & J. Cooper, Banking Law § 26.03 (1982), citing First Nat'l Bank v. Nat'l Exch. Bank, 92 US 122 (1876); Western Nat'l Bank v. Armstrong, 152 US 346 (1894); Aldrich v. Chemical Nat'l Bank, 176 US 618 (1900); Wyman v. Wallace, 201 US 230 (1906).

[83] 12 USC §§ 342–348 (1982). See discussion of the powers of the Federal Reserve System in Chapter 3.

[84] 12 USC § 90 (1982); 12 CFR § 7.7410 (1987). See the discussion at ¶ 3.04[1][b].

[85] 12 CFR § 7.7410 (1987). See the discussion in 2 S. Whitley, W. Schlichting, T. Rice & J. Cooper, supra note 82, at § 27.03.

persons.[86] Courts construed this provision to deny authority to national banks under their "incidental powers" to conduct an insurance business in larger-sized towns.[87] Congress again addressed the issue and imposed limitations on the conduct of insurance activities in the Bank Holding Company Act.[88] See Chapter 5 for a discussion of authority to engage in insurance related activities.

[c] **Computer Services.** Another area of current interest involves providing computer services and hardware. According to the comptroller, "data processing is a technology rather than a service distinct or different from the underlying services or functions to which the technology is applied." Accordingly, the comptroller's regulations authorize a national bank to "use data processing equipment and technology to perform for itself and others all services expressly or incidentally authorized under the statutes applicable to national banks."[89]

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[86] See the former version of 12 USC § 92 (1946). The provisions of Section 92, which were added as a new paragraph of RS § 5202 by Act of Sept. 7, 1916, ch. 461, 39 Stat. 753, were omitted in the amendment of RS § 5202 by Act of Apr. 5, 1918, ch. 45, 40 Stat. 512, and therefore the authors of the U.S. Code did not include it. It has been referred to by courts as having continued in effect, however. See Saxon v. Georgia Ass'n of Indep. Ins. Agents, Inc., 399 F2d 1010 (5th Cir. 1968).

[87] Saxon v. Georgia Ass'n of Indep. Ins. Agents, Inc., 399 F2d 1010 (5th Cir. 1968). See also Alabama Ass'n of Ins. Agents v. Board of Governors, 533 F2d 224 (5th Cir. 1976), vacated in part, 558 F2d 729 (5th Cir. 1977), cert. denied, 435 US 904 (1978). Banks were permitted to arrange credit life insurance for bank borrowers. See First Nat'l Bank v. Smith, 436 F. Supp. 824 (SD Tex. 1977), aff'd in part and vacated in part, 610 F2d 1258 (5th Cir. 1980). The issue of engaging in insurance activities is now covered by the Bank Holding Company Act in 12 USC § 1843(c)(8) (1982). See the discussion of insurance activities in Chapter 5.

[88] 12 USC § 1843(c)(8) (1982). The Federal Reserve Board refused to approve a Citicorp application to establish a bank to engage in national insurance activities, because the Board believed approval would constitute an evasion of direct limitations on these activities by the Bank Holding Company Act. Application of Citicorp, 71 Fed. Reserve Bull. 789 (1985).

[89] 12 CFR § 7.3500 (1987). The comptroller also has approved the sale of computer hardware as part of a package of correspondent banking services to other banks, because these services are "incidental to banking." Comptroller of the Currency, Letter No. 345 (July 9, 1985), reported in Fed. Banking L. Rep. (CCH) ¶ 85,515 (1985). The comptroller also has approved a bank's providing, through a wholly owned subsidiary that is a general partner in a services partnership, an electronic network to supply information and transaction services relating to commodity transactions. The services were approved because the comptroller saw them as an integrated product offering in cases where "the transactional capability is intimately connected with the information services and financial settlement services and is useful and convenient for the provision of these services. Comptroller of the Currency, Interpretation Letter No. 346 (July 31, 1985), reported in Fed. Banking L. Rep. (CCH) ¶ 85,516 (1985).

[d] Guaranty Agreements. As a general rule, national banks do not have the authority to guarantee the debts of others. When the guarantee is incidental to engaging in banking business, however, national banks may do so.[90] The Comptroller of the Currency has issued rules defining the circumstances under which a national bank may lawfully guarantee the debt of another. Under the comptroller's interpretation, a bank may guarantee notes or obligations it sells for its own account and may guarantee liabilities of its Edge Act subsidiaries and foreign instrumentalities. A national bank also may act as a surety or guarantor in transactions where it has "a substantial interest in the performance of the transaction involved or has a segregated deposit sufficient in amount to cover the bank's total potential liability."[91] For example, a bank's interest in disposing of collateral may justify such an undertaking.[92]

In 1982, the Comptroller of the Currency had occasion to consider whether a transaction was one in which a national bank had a substantial interest. The question presented to the comptroller was whether a national bank could guarantee a loan made by a Federal Reserve bank to a correspondent of the national bank. The comptroller ruled that the correspondent relationship by itself is not a "substantial interest that justifies an irrevocable guarantee."[93] However, a national bank could enter into an agreement to guarantee the debt of its correspondent to the Reserve bank if the agreement was restructured in a manner acceptable to the comptroller.[94]

The comptroller's rules allow a bank to enter into check guarantee plans that represent to the public that the bank will honor checks up to a certain amount drawn by a depositor displaying the guarantee card. This arrangement is one that in essence is an agreement by the bank to give its customer credit, if necessary, to honor the customer's check. As such, it is within the authority of a national bank because it is nothing more than the ordinary bank commitment to lend to a customer.[95]

A potential source of problems in determining whether the prohibition against guaranteeing the debts of others has been violated involves the issuance of letters of credit. Issuing letters of credit is, of course, a common bank transaction. The comptroller's rules recognize that a national bank may issue for its

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[90] See 2 S. Whitley, W. Schlichting, T. Rice & J. Cooper, supra note 82, at § 26.09 (1982), citing Farmers & Miners Bank v. Bluefield Nat'l Bank, 11 F2d 83 (4th Cir.), cert. denied, 271 US 669 (1926); Pinckney v. Wyleie, 86 F2d 541 (5th Cir. 1936).

[91] 12 CFR § 7.7010(a) (1987).

[92] See 2 S. Whitley, W. Schlichting, T. Rice & J. Cooper, supra note 82.

[93] Comptroller of the Currency, Banking Circular No. 168 (Apr. 9, 1982), reported in [Jan.–June] Wash. Fin. Rep. (BNA) No. 17, at A-4 (Apr. 26, 1982).

[94] Id.

[95] 12 CFR § 7.7015 (1981). FDIC regulations permit insured nonmember banks to issue check guarantee cards and to issue credit cards where the bank guarantees the credit of its customers. 12 CFR §§ 332.3, 337.5 (1987).

customers letters of credit that conform to the Uniform Commercial Code or to the Uniform Customs and Practices for Documentary Credits. Expansion of the use of letters of credit as a financing device, however, has led to the use of these instruments in ways that are perilously close to traditional guarantees. These problems are discussed in Chapter 17.

A case involving a question of state law considered what constitutes "a substantial interest in the performance of the transaction involved." Under Georgia law, state banks were empowered to guarantee the debts of others when the bank had such a substantial interest. A customer of the state bank who was indebted to the state bank and had given the state bank a security interest in certain oil and gas leases needed additional funds to finance the oil and gas operation. The state bank was not willing to make the loan itself, but encouraged another bank to do so and expressed its willingness to guarantee the customer's obligation to the other bank because the extension of the additional loan also would improve the security of the state bank. Under these circumstances, the court held that the contract of guarantee given by the state bank to the bank that extended the additional loan was authorized.[96]

[e] **Other Powers.** There are a number of other activities that national banks have been authorized to perform under the authority, at least in part, of the "incidental powers" clause, including the following items:

1. Establishment of bank customer electronic communication devices for instructing banks on funds transfers.[97]
2. Leases of personal property that are entered into as a secured lending transaction.[98]

[f] **Ultra Vires Acts.** When a bank enters into a transaction that it does not have authority to conduct, the bank's lack of authority may be asserted as a defense in a suit to compel performance of the transaction. There is a general body of corporate law dealing with the circumstances under which this defense of ultra vires conduct can be raised.[99] Generally, courts disfavor allowing a person to avoid obligations voluntarily entered into on the ground the contract was ultra

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[96] First Nat'l Bank v. Citizens & S. Bank, 651 F2d 696 (10th Cir. 1981).

[97] Oklahoma v. Bank of Okla., 409 F. Supp. 71 (ND Okla. 1975).

[98] M & M Leasing Corp. v. Seattle First Nat'l Bank, supra note 71. In 1987, Congress gave national banks express authority to engage in leasing of personal property as part of a financing transaction. This authority is discussed in ¶ 4.03[1].

[99] See 7A R. Eickhoff & J. Schneider, Fletcher Cyclopedia of Corporations ch. 40 (1978)

vires.[100] Similar principles have been applied to national banks, and courts have refused to permit banks to raise the ultra vires defense to avoid performance of their own contracts.[101] However, because of the public interest in protecting the solvency of banks, there is a body of case law that allows banks to raise the defense of ultra vires, although most of these cases are from the 1930s or earlier.[102]

When the bank's action is being challenged by one who claims the bank had no authority to act, the challenger's ability to question the lack of authority may be doubtful. The party must have "standing" to challenge the bank's action, and the bank's lack of authority may be a defect that only the proper regulatory authority or party with a particular interest can raise.[103] It is not possible to state an absolute rule in this area, because circumstances may exist where the bank's lack of authority to engage in the transaction is the result of a deliberate legislative policy to benefit or protect the persons with whom the bank has contracted.[104] This is often the case with consumer-oriented legislation.

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[100] Id. at § 3407. Total Automation, Inc. v. Illinois Nat'l Bank & Trust Co., 40 Ill. App. 3d 266, 351 NE2d 879 (1976) ("[T]he defense of ultra vires is not favored by the courts where it is raised by a private party seeking to avoid payment for a benefit received and where there is no matter of public policy involved.") See also Krantz v. City of Hutchinson, 165 Kan. 449, 196 P2d 227 (1948).

[101] See Citizens Union Nat'l Bank v. Phelps, 95 F2d 763 (6th Cir. 1938); McCarthy v. Brockton Nat'l Bank, 314 Mass. 318, 50 NE2d 196 (1943).

[102] Awotin v. Atlas Exch. Nat'l Bank, 295 US 209 (1935); First Nat'l Bank v. Converse, 200 US 425 (1906); Birdsell Mfg. Co. v. Anderson, 104 F2d 340 (6th Cir. 1939).

[103] See e.g., FDIC v. Freudenfeld, 492 F. Supp. 763 (ED Wis. 1980), where the court held, alternatively, that even if a bank violated the prohibition against guaranteeing a debt by issuing a standby letter of credit, only the United States had standing to challenge the bank for its ultra vires action. See also First Nat'l Bank v. Weise, 333 Ill. App. 1, 76 NE2d 538 (1947) (involving a realty trust); Noel Estate, Inc. v. Commercial Nat'l Bank, 232 F2d 483 (5th Cir. 1956).

[104] See Borkus v. Michigan Nat'l Bank, 117 Mich. App. 662, 324 NW2d 123 (1982), where a state court held that a real estate loan made by a bank in 1971, a loan that at that time violated a federal statute requiring real estate loans to be secured by first liens, was an illegal loan, and the debtor could defend a mortgage foreclosure action by the bank on the ground that the loan was made in violation of the statute even though the foreclosure action was brought after 1974 when the federal prohibition on second-mortgage real estate lending was removed.

5

Bank Holding Companies

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¶ 5.01 THE EVOLUTION OF BANK HOLDING COMPANY REGULATION

This chapter considers the regulation of bank holding companies. In the sections that follow, the text discusses the definition of a bank holding company, the history of how the complex web of laws regulating bank holding companies developed, and the limitations these laws place on the activities that bank holding companies may undertake.

[1] Definition of "Bank Holding Company"

The 1970 amendments to the Bank Holding Company Act of 1956[1] define a "bank holding company" as "any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this chapter." Thus, the two major elements of the definition of a bank holding company are (1) that a company have "control" and (2) that such control be over a "bank" or a "bank holding company." The definition of "bank" is considered

[1] Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, 84 Stat. 1760 (codified at 12 USC §§ 1841, 1843, 1849 and at 31 USC §§ 5111, 5112 (1982)).

in later sections of this chapter; the present section considers what constitutes "control."

Preliminarily, it should be noted that a holding company need not have any particular form of organization, and may include corporations, partnerships, business trusts, and other associations.[2] A bank itself may be a holding company. In one case, an employee stock ownership plan was viewed by the court as sufficiently similar in organization and function to be treated as a business trust that needed the approval of the Board of Governors before acquiring control of a bank.[3]

Moreover, a number of companies are exempt from bank holding company status, which companies otherwise fall within the definition. Some of these exemptions reflect "grandfather rights" of companies in existence prior to the time that the various bank holding company restrictions were adopted. Many such companies were created as a result of the Competitive Equality Banking Amendments of 1987, discussed later in this chapter.

In defining "bank holding company," a company has "control" over a bank if it:

1. Directly or indirectly owns, controls, or has power to vote at least 25 percent of any class of voting stock of the bank;
2. Controls the election of a majority of the directors; or
3. Exercises either directly or indirectly a controlling influence over the management or policies of the bank, as determined by the Federal Reserve Board after notice and opportunity for a hearing.[4]

In making a finding under the third statutory standard of "directly or indirectly exercising controlling influence," the Board is aided by a presumption. If a company owns or controls less than 5 percent of the voting shares of a bank, it is presumed that the company does not control the bank.[5] For the first two standards of control, the company may not be held to have control unless it

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[2] See 12 USC § 1841(b) (1982); 12 CFR § 225.2 (1987). See generally Eisen, "Banking Acquisition Procedures by Holding Companies," 101 Banking LJ 681–691 (1984); Golden, "Directors' Duties When Forming a Bank Holding Company," 99 Banking LJ 146–156 (1982); Fischel, Rosenfield & Stillman, "The Regulation of Banks and Bank Holding Companies," 73 Va. L. Rev. 301–338 (1987).

[3] First Nat'l Bank of Blue Island Employee Stock Ownership Plan v. Board of Governors, 802 F2d 291 (7th Cir. 1986). See generally Helfer & Bruemmer, "Interstate Nonvoting Equity Agreements and Control Under the Bank Holding Company Act: The Impact of the Federal Reserve Board's 1982 Policy Statement," 39 Bus. Law. 383–415 (1984); Kadish, "Bank Holding Company Investments in Nonvoting Stock," 100 Banking LJ 580–606 (1983).

[4] 12 USC § 1841(a)(2) (1982).

[5] 12 USC § 1841(a)(3) (1982).

directly or indirectly controls at least 5 percent of a class of voting stock of the bank.[6] For all three standards set forth in the act, there are certain transactions through which the securities of a bank may be obtained, transactions that are not treated as transactions giving rise to control. Examples include ownership of securities in certain fiduciary relationships, securities acquired pursuant to underwriting activities, and securities obtained as a result of collecting a debt.[7]

At the end of 1986, there were 6,456 bank holding companies controlling 9,409 commercial banks, holding approximately 92 percent of the bank assets of all the insured banks in the United States.[8] Comparing these figures with those of fifteen years earlier, a great increase is apparent. In 1971, bank holding companies controlled 2,420 banks, with 13,252 offices holding 55 percent of all bank deposits.[9]

Table 5-1 shows the growth of bank holding companies and the extent to which this form of organization is a characteristic of the domestic commercial banking industry.[10]

TABLE 5-1 **Number and Deposits of Registered Bank Holding Companies—Selected Years, 1957–1983**

		Domestic Deposits of Subsidiary Banks	
End of Year	*Number of Holding Companies*	*Amount (Billions of Dollars)*	*Percentage of All Deposits of U.S. Banks*
1957	50*	15.1	7.5
1960	47*	18.3	7.9
1965	53*	27.6	8.3
1970	121*	78.1	16.2
1971	1,567	297.0	55.3
1975	1,821	527.5	67.1
1980	3,056	840.7	71.0
1981	3,702	937.8	74.1
1982	4,559	1,107.7	79.4
1983	5,409	1,279.4	83.8

*Includes only bank holding companies that control two or more banks.

[6] 12 USC § 1841(a)(4) (1982).

[7] 12 USC § 1841(a)(5) (1982).

[8] 73 Board of Governors, Fed. Reserve Sys. Ann. Rep. 188 (1987).

[9] M. Jessee & S. Seelig, Bank Holding Companies and the Public Interest 38 (1977) (hereinafter cited as Jessee).

[10] Board of Governors, Federal Reserve System, Purposes & Functions 95 (1984).

[2] The History of Bank Holding Company Regulation

The concepts of holding company organization were developed in the early 1800s, but it was not until the latter part of the century that corporate bank holding companies became popular. The growth of bank holding companies occurred primarily as a means by which investors could circumvent restrictive state branching laws.[11] By the 1920s, bank holding companies had evolved into corporate giants with substantial financial power. Expansion continued into the latter part of the decade, as bankers acted defensively to protect their correspondent banking relationships and other sources of business from loss to existing holding companies. Anticipation of a relaxing of the branch banking laws also stimulated interest in the development of bank holding company systems, as investors sought to acquire banks that could ultimately be operated as integrated branches.[12]

The rapid growth of bank holding companies concerned independent bankers' groups as well as federal banking officials, who lacked the authority to regulate such entities. As a result of the stock market crash of 1929, much of the attention directed toward bank holding company regulation was diverted to a general restructuring of the banking industry. The Glass-Steagall Act of 1933 contained few provisions concerning holding company regulation. It did, however, require holding companies to agree to divest any interest acquired in companies "engaged principally" in the securities business before they could vote in the selection of directors of affiliated banks.[13] This did little to restrict holding company movement into nonbanking activities other than the securities business,[14] and, in any event, holding companies could easily evade the requirement by refraining from voting the stock of the bank affiliates.[15]

For the next fifteen years, bank holding company growth was minimal. Even so, at least one bill designed in some way to restrict bank holding companies was introduced at every session of Congress between 1933 and 1955.[16] Anticipation of the eventual passage of regulatory legislation stimulated further bank holding company expansion.[17] Then, in 1956, prompted by a Court of Appeals for the Third Circuit decision against the Federal Reserve Board, which had charged the Transamerica Corporation with violation of the antimonopoly provisions of the Clayton Act because of commercial bank acqui-

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[11] G. Fischer, Bank Holding Companies 138 (1961)

[12] Jessee, supra note 9, at 6.

[13] Banking Act of 1933, ch. 89, § 19(e), 48 Stat. 188. See also Board of Governors v. Investment Co. Inst., 450 US 46 (1981).

[14] Jessee, supra note 9, at 8; Fischer, supra note 11, at 59–62.

[15] See Board of Governors v. Investment Co. Inst., 450 US 46, 70 (1981).

[16] Jessee, supra note 9, at 8.

[17] Id. at 9.

sitions,[18] Congress passed the Bank Holding Company Act of 1956. This legislation empowered the Federal Reserve Board to grant or deny applications of bank holding companies for the acquisition of more than 5 percent of the voting shares of any bank.[19]

The 1956 act defined a bank holding company as a company controlling "25 per centum or more of the voting shares of each of two or more banks,"[20] thereby leaving one-bank holding companies exempt from any regulation. Although the 1956 act controlled further formation of multiple bank networks through holding company organizations, it failed to curb the affiliation of banks with commercial companies through holding company conglomerates. As a result, some large banks began utilizing the one-bank holding company as a vehicle for obtaining new investment outlets. By 1970, one-bank holding companies controlled 38 percent of all commercial bank deposits and had acquired nonbanking firms engaged in mortgage banking, factoring, management consulting, and credit cards.[21] Diverse nonbanking firms, such as Montgomery Ward, Baldwin Piano, and S&H Green Stamps, also began forming one-bank holding companies.[22] The fear that banks, in combination with commerce and industry, might eventually bring about the formation of a few powerful financial centers dominating the U.S. economy led to the enactment of the 1970 amendments to the Bank Holding Company Act of 1956.[23]

The 1970 amendments restricted the previously unregulated ability of one-bank holding companies to engage in nonbank activities. They also explicitly offered bank holding companies the opportunity to expand into nonbanking activities closely related to banking, under the supervision of the Board of Governors of the Federal Reserve System.[24] Following this lead, holding companies expanded aggressively into nonbanking areas. Between 1970 and 1973, the number of bank holding companies owning nonbank subsidiaries increased from 531 to 721, and the number of nonbank subsidiaries increased from 3,632 to 4,812.[25]

During the 1980s, the regulatory scheme for bank holding companies came under new strains. These stresses developed because of the manner in which the

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[18] Transamerica Corp. v. Board of Governors, 206 F2d 163 (3rd Cir. 1953), cert. denied, 346 US 901 (1953).

[19] Bank Holding Company Act of 1956, ch. 240, § 1842, 70 Stat. 133 (12 USC §§ 1841–1850 & 26 USC §§ 1101–1103 (1982)).

[20] 12 U.S.C. § 1841 (1964) (amended 1970).

[21] L. Goldberg & L. White, The Deregulation of the Banking and Securities Industries 222 (1979).

[22] Id.

[23] Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, 84 Stat. 1760 (*codified at* 12 USC §§ 1841, 1843, 1849 *and at* 31 USC §§ 5111, 5112 (1982)).

[24] Jessee, supra note 9, at 38.

[25] Id.

Bank Holding Company Act defined a "bank." In the competition to provide financial services in the 1980s, companies were finding it advantageous to acquire depository institutions that performed specialized financial activities, but that escaped the Bank Holding Company Act restrictions on acquisitions of banks because these institutions did not fall into the act's definition of a bank. After an unsuccessful attempt by the Board of Governors to deal with this problem through a regulatory change in the definition of a bank, Congress adopted significant new amendments to the Bank Holding Company Act in the Competitive Equality Banking Amendments of 1987. These developments are described in the following text.[26]

[3] Nonbank Banks

According to the Bank Holding Company Act, a company becomes a bank holding company when it acquires control over any bank.[27] A definition of "bank" is given for the purposes of the act.[28] The original definition, as enacted in 1956, included all national banks, state banks, and savings banks. In 1966, Congress amended this definition so that it was narrower in scope. It substituted the language "any institution that accepts deposits that the depositor has a legal right to withdraw on demand" for the original reference to specific types of institutions. In 1970, Congress further narrowed this definition by adding the requirement that banks also must be engaged in making commercial loans. Following this change, the basic definition of a "bank," for purposes of the Bank Holding Company Act, was an institution that

> (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans.[29]

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[26] The "nonbank bank" phenomenon is discussed infra ¶ 5.01[3]. The legislative changes that Congress made to deal with this problem are discussed infra ¶ 5.01[4].

[27] See discussion supra ¶ 5.01[1] for the definition of "bank holding company" in the Bank Holding Company Act.

[28] 12 USC § 1841(c) (1982). See generally Felsenfeld, "Nonbank Banks—An Issue in Need of a Policy," 41 Bus. Law. 99–123 (1985); Malloy, "Nonbanks and Nondefinitions: New Challenges in Bank Regulatory Policy," 10 Seton Hall Legis. J. 1–66 (1986); "The Demise of the Bank Non-Bank Distinction: An Argument for Deregulating the Activities of Bank Holding Companies," 98 Harv. L. Rev. 650–668 (1985); "Nonbank Banks: Congressional Options," 38 Vand. L. Rev. 1735–1775 (1986); "Nonbank Banks: A Legitimate Financial Intermediary Emerges from the Bank Holding Company Act Loophole," 14 Pepperdine L. Rev. 107–135 (1986); "Have Nonbank Banks Become a Nonissue?" 38 Hastings LJ 377–411 (1987).

[29] 12 USC § 1841(c) (1982).

This definition remained until the Competitive Equality Banking Amendments of 1987, which enlarged the definition of a bank.[30] Until the 1987 changes, it was possible for a company to have control over a financial institution that performed many of the functions that banks performed and that was chartered as a bank by state or federal chartering authorities, but was not within the restrictions on acquisitions of banks and activities of bank holding companies in the Bank Holding Company Act, because the institution did not constitute a bank under the definition in the act. These financial institutions became known as nonbank banks.

Recognition of nonbank banks had at least three legal consequences. Firstly, control of a nonbank bank did not make the controlling company a bank holding company, and, if it was not otherwise a bank holding company, it would not be subject to the restrictions in the Bank Holding Company Act on nonbanking activities. Thus, it became possible for commercial companies and securities firms to affiliate with nonbank banks. Secondly, the interstate banking restrictions of the Douglas amendment to the Bank Holding Company Act (discussed in Chapter 6) could be avoided because these restrictions applied only to banks. Thus, even regulated bank holding companies might find it advantageous to establish an interstate network of nonbank banks for various purposes. Thirdly, a bank holding company would not have to establish that acquisition of the nonbank bank met the various standards in the act for Board approval of a bank, but the company could use the nonbank bank to perform many banking functions such as consumer lending and credit card operations. To the extent that state-chartered nonbank banks might have authority under state law to engage in activities forbidden to national banks, such as offering insurance products or engaging in securities underwriting, the possibility existed for nonbank banks to enlarge the activities of a bank holding company beyond those contemplated in the Bank Holding Company Act.

The nonbank bank phenomenon underwent a series of legal challenges. The Board of Governors prevailed in some of the early tests. In *Wilshire Oil Co. v. Board of Governors*,[31] the court held that the Board was entitled to prevent evasions of the act by penetrating the form of the transaction and looking to its substance. In this case, an oil company had acquired control of a trust company that clearly was a bank under the definition. To bypass the Bank Holding Company Act, the oil company had the trust company send notices to its depositors that the trust company reserved the right to require fourteen days' notice prior to withdrawal of its transactional accounts, although the notice also said that the trust company had no intention of exercising this right. The oil company took the position that this action meant the trust company did not

[30] The Competitive Equality Banking Amendments of 1987 are discussed infra ¶ 5.01[4].

[31] 668 F2d 732 (3d Cir. 1981), cert. denied, 457 US 1132 (1982).

offer deposits that its customers had "a legal right to withdraw on demand" and so was not a bank. The court rejected this argument, relying on Section 5(b) of the act,[32] which gave the Board authority to act to "prevent evasions" of the act.[33] A similar result was reached by the Court of Appeals for the Eleventh Circuit in a case where U.S. Trust sought permission to expand the activities of a Florida subsidiary to engage in taking deposits, including demand deposits and checking accounts, but not to make commercial loans.[34] Although the Board reluctantly approved the application, with conditions, believing that the literal language of the act must be followed,[35] the court ruled otherwise, stating that "literalism in statutory interpretation, when it is contrary to an express purpose of the act, cannot be a talisman." The court believed that Congress did not intend to allow the creation of interstate deposit-taking networks when it modified the definition of "bank." However, in *First Bancorporation v. Board of Governors*,[36] the Court of Appeals for the Tenth Circuit reversed an order of the Board. The case involved the acquisition of an industrial loan company that offered negotiable order of withdrawal (NOW) accounts. The court held that these accounts were not demand deposits, because a Utah regulation required the loan company to reserve the right to require thirty days' notice before allowing a withdrawal.

The actions of the regulatory agencies in approving the formation and control of nonbank banks set off a storm of controversy. Efforts were made over a four-year period to persuade Congress to adopt legislation to stop the practice. In response to steps taken by Congress to consider legislation, the Comptroller of the Currency established a moratorium on the consideration of new applications for nonbank banks. He subsequently extended the moratorium several times, but, when Congress adjourned without addressing the issue, he ended it. With the end of the moratorium, the Independent Bankers Association brought suit to prevent further chartering of nonbank banks. This litigation ultimately resulted in an injunction against the granting of further approvals. The court reasoned

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[32] 12 USC § 1844(b) (1982).

[33] Compare Oklahoma Bankers Ass'n v. Federal Reserve Board, 766 F2d 1446 (10th Cir. 1985), where the Board ruled that a trust company offering deposits that were restricted by private contract to time deposits was not a bank. The private contracts were enforceable, and so the deposits were not demand deposits.

[34] Florida Dep't of Banking & Fin. v. Board of Governors, 760 F2d 1135 (11th Cir. 1985), vacated, U.S. Trust Corp. v. Board of Governors, 106 S. Ct. 875 (1986). On remand, 800 F2d 1534 (11th Cir. 1986), cert. denied sub nom. Conference of State Bank Supervisors v. Board of Governors, 107 S. Ct. 1887 (1987), the court concluded the application must be approved in light of the Supreme Court decision in Board of Governors v. Dimension Fin. Corp., 474 US 361 (1986).

[35] The Board's conditions are described in its decision. 70 Fed. Reserve Bull. 371 (1984). See also Application of Bankers Trust New York Corp., Fed. Banking L. Rep. (CCH) ¶ 86,095 (1984).

[36] 728 F2d 434 (10th Cir. 1984).

that an institution "is not engaged in the business of banking as contemplated by the National Bank Act" if it cannot both accept demand deposits and make commercial loans. These two functions, in the court's view, are central to the banking business, and the comptroller lacked authority to control institutions that did not engage in them.[37]

The Board of Governors had sought to stem the nonbank bank explosion by revising its regulations to enlarge the definition of a bank. Under the new regulations, a "demand deposit" included NOW accounts and other accounts with checking privileges. Commercial lending included the purchase of commercial paper and retail installment loans. This effort was immediately challenged, and the Board lost in the Court of Appeals for the Tenth Circuit and again in the U.S. Supreme Court.

The Supreme Court's decision in the case, *Board of Governors v. Dimension Financial Corp.*,[38] upheld the validity of nonbank banks.[39] The Supreme Court ruled that the Board had exceeded its authority when it defined the terms used in the statutes, "demand deposit" and "commercial loan" in an expansive fashion. The Court held that the statutory language of the Bank Holding Company Act was not ambiguous. The phrase that a bank must be an institution that "accepts deposits that the depositor has a legal right to withdraw on demand" did not include deposits that "as a matter of practice" are payable on demand. Similarly, the Court rejected the Board's definition of commercial loan as going beyond the commonly accepted definition of commercial loans as well as the Board's own long-standing interpretation.

Within days after the Supreme Court decision in *Dimension Financial Corp.*, the Supreme Court vacated the Court of Appeals for the Eleventh Circuit's decision in the U.S. Trust case.[40] The circuit court then concluded that although the creation of the Florida nonbank subsidiary "clearly frustrates the congressional purpose expressed in the Douglas Amendment" against interstate bank networks, the definition of a bank in 12 USC § 1841(c), which the Supreme Court construed in *Dimension Financial Corp.*, must be the same in the part of the act known as the Douglas amendment, 12 USC § 1842(d)(1). Hence, because the subsidiary would not make commercial loans, it was not a bank.

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[37] See Independent Bankers Ass'n of America v. Conover, 53 USLW 2430 (MD Fla. Feb. 15, 1985). The action subsequently was dismissed.

[38] 474 US 361 (1986), aff'g 744 F2d 1402 (10th Cir. 1984).

[39] Before the Supreme Court decision, there was considerable jockeying to determine whether the Comptroller of the Currency or the Board was entitled to pass upon the application to create a network of nonbank banks. Independent Bankers Ass'n of America v. Conover, 603 F. Supp. 948 (DDC 1985). The court declined to enjoin the comptroller, because it believed that such an order would interfere with the jurisdiction exclusively vested in the federal courts of appeal to review matters involving the Board of Governors of the Federal Reserve System.

[40] U.S. Trust Corp. v. Board of Governors, 106 S. Ct. 875 (1986).

With the decision of the U.S. Supreme Court in *Dimension Financial Corp.*, attention shifted back to Congress. In August of 1987, Congress enacted the Competitive Equality Banking Amendments of 1987. Title I of this act addresses the nonbank bank issue. The provisions of this act are explained in the following text.

[4] Nonbank Banks Under the Competitive Equality Banking Amendments of 1987

Title I of the Competitive Equality Banking Amendments of 1987 addresses the nonbank bank issue. As discussed in the previous section, the 1970 definition of "bank" in the former version of the Bank Holding Company Act required that the institution both make commercial loans and accept demand deposits. As a result, it became possible for institutions chartered as banks by state and federal banking authorities to avoid classification as banks, for purposes of the act, by refraining from making commercial loans or by declining to accept demand deposits.

Title I deals with this problem by expanding the act's definition of bank to include most of the nonbank bank institutions that escaped the old definition. Because these institutions are now classified as banks, the act makes it illegal for a holding company to acquire them without the approval of the Federal Reserve Board. If a holding company makes a nonapproved acquisition, it will be required to divest.[41] Further, since the acquisition or control of such nonbank banks makes the company a bank holding company, its activities are subject to the constraints of the Bank Holding Company Act on nonbanking activities and interstate banking.

Beyond the enlarged definition of "bank," the title contains layers and sublayers of exceptions and qualifications to these exceptions, which the act creates in an effort to recognize acquisitions accomplished before enactment of the 1987 Amendments, without permitting previously established rights to become the source of unreasonable competitive advantage.

According to the new definition of "bank" in the Bank Holding Company Act, an institution is a bank if it is an "insured bank" under the Federal Deposit Insurance Act or it is an institution organized under the laws of the United States, which institution both:

(i) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others; and
(ii) is engaged in the business of making commercial loans.[42]

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[41] Competitive Equality Banking Act of 1987, tit. I, § 101(b), 100 Stat. 554, 557 (amending 12 USC § 1843(a)(2)(1982)) (hereinafter CEBA).

[42] CEBA tit. I, § 101(a)(1), 100 Stat. 554 (amending 12 USC § 1841(c) (1982)).

Under the first part of this definition, an institution is a bank if it is insured by the Federal Deposit Insurance Corporation.[43] Thus, if the comptroller charters a national bank, it will be a bank for purposes of the Bank Holding Company Act even if it limits its activities so that it does not accept demand deposits or make commercial loans. If the institution is a thrift institution that the Federal Savings and Loan Insurance Corporation has insured, this part of the definition will not apply, but the provisions of the law on savings and loan holding companies may apply. This is discussed in greater detail later in this chapter.

Under the second part of this definition, an institution qualifies as a "bank" even if it does not offer what are strictly regarded as demand deposits against which checks can be drawn. As long as it offers a "check-like" deposit account, this prong of the definition will be satisfied. This legislative definition reverses the results reached under the former version of the Bank Holding Company Act, where the Supreme Court interpreted the reference to "demand deposits" in the act to exclude other transaction accounts such as NOW accounts, which offer check-writing services but are not demand accounts.[44] The definition encompasses more than checking arrangements; it is also intended to cover transfer by computer or wire instructions, and automatic sweep arrangements.[45] The second part of the definition requires that the institution both offer accounts from which check-like payments can be made *and* offer commercial loans. The new definition does not enlarge the activities that may be regarded as commercial lending under the interpretation in *Dimension Financial Corp.*

[a] Exceptions to the Definition of "Bank." Although the act adopts a broad general definition of "bank," there are numerous exceptions. The institutions that qualify for these exceptions are not banks for purposes of the Bank Holding Company Act, as per the following guidelines:

1. Foreign banks with U.S. branches are not banks for purposes of the act if the definition would apply to them "solely because such [foreign] bank has an insured or uninsured branch in the United States."[46] Under this language, it would seem that as long as the branch does not engage in the activities that would qualify it as a bank under the act, regardless of whether the branch is FDIC-insured or not, the foreign bank does not come within the act.

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[43] Id.; 12 USC § 1813(h) (1982). Banks insured by the FDIC include all national banks, all member banks of the Federal Reserve System, state banks that elect to apply for FDIC insurance, and others. See ¶ 11.01[1] for a list of banks eligible for FDIC insurance.

[44] See the discussion of the *Dimension* case supra ¶ 5.01[3].

[45] *Conf. Rep.. No. 100-261, on H.R. 27, reprinted as Special Report, Fed. Banking L.* Rep. (CCH) No. 1192 at 122–123 (Aug. 7, 1987) (hereinafter Conf. Rep. No. 100-261).

[46] CEBA tit. I, § 101(a)(1), 100 Stat. 554 (amending 12 USC § 1841(c) (1982)).

2. "Insured institutions" are not banks under the act.[47] Such institutions are those insured by the FSLIC. They include all federal savings and loan associations and other FSLIC-insured institutions, including FSLIC-insured federal savings banks, building and loan associations, savings and loan associations, homestead associations, cooperative banks, and FDIC-insured federal savings banks.[48]

3. An organization such as an Edge corporation, whose business in the United States is only "incidental" to its activities outside the United States, is not a bank within the act.[49]

4. A trust company or fiduciary that "acts solely in a trust or fiduciary capacity . . ." is not a bank.[50] There are four requirements that the trust company must satisfy in order to qualify: (1) substantially all of its deposits must be in trust or a fiduciary capacity; (2) no FDIC-insured deposits may be marketed through an affiliate; (3) the institution may not offer checking services; and (4) the institution may not make use of the Federal Reserve payment services or discount or borrowing facilities.

5. Credit unions are not banks under the act.[51]

6. Credit card banks are exempt if they satisfy the following criteria contained in the act for limiting their activities:[52] They must (1) engage only in credit card operations; (2) not accept demand deposits or similar transaction accounts; (3) not accept savings deposits below $100,000; (4) not make commercial loans; and (5) maintain only one office for accepting deposits. They may, however, have multiple offices for their credit card "back-room activities."[53] The banks' lending powers are limited as explained in the conference report:

> A credit card bank may make loans only through credit cards. Loans made to individuals through credit cards are not commercial loans. The prohibition against commercial loans does not limit a credit

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[47] Id.

[48] Id.; 12 USC § 1730a(a)(1)(A) (1982).

[49] CEBA tit. I, § 101(a)(1), 101 Stat. 554 (amending 12 USC § 1841(c) (1982)).

[50] Id. at 554-555. See generally Silver & Norman, "The Trust Company: A Means of Entering the Financial Services Market or Positioning for Interstate Banking," 101 Bank LJ 216-231 (1984).

[51] CEBA tit. I, § 101(a)(1), 101 Stat. 554, 555 (amending 12 USC § 1841(c) (1982)). The definition of "credit union" is that contained in the Federal Reserve Act. It includes any federally insured credit union and any credit union eligible to become a federally insured credit union. 12 USC § 461(b)(1)(A)(iv) (1982).

[52] CEBA tit. I, 101(a)(1), 100 Stat. 554, 555 (amending 12 USC § 1841(c) (1982)).

[53] Conf. Rep. No. 100-261, supra note 45, at 121.

card bank from purchasing credit card receivables directly from establishments where such credit cards are accepted.[54]

7. Organizations operating under Federal Reserve Act § 25 or § 25a are exempt.[55]

8. Certain industrial loan companies, industrial banks and similar organizations are exempt, notwithstanding that they are insured by the FDIC, as long as they qualify under the limitations on their activities imposed by the act.[56]

9. Exemptions are provided for certain other named institutions, as long as the qualifications on their activities are met.[57]

[b] Immediate Divestiture for "New Bank" Acquisitions Between March 5, 1987 and Date of Enactment. A company must obtain approval to acquire an institution that is within the amended definition of a bank, when that acquisition is otherwise within the terms of the Bank Holding Company Act. For any company that was not a bank holding company under the former provisions of the act, but that became a bank holding company as a result of the new definition in the Competitive Equality Banking Amendments of 1987, that company is required to divest itself immediately of any institution it acquired between March 5, 1987 and the date of enactment of the act (August 10, 1987) if that institution became a bank as a result of these amendments.[58]

[c] Grandfather Rights for Pre-March 5, 1987 Acquisitions. Companies that prior to March 5, 1987, had acquired institutions that at the time were not banks under the Bank Holding Company Act, but that became banks as a result of the new amendments, have a general exemption as long as they were not previously within the definition of a bank holding company. Such companies are not treated as bank holding companies under the new amendments, and so enjoy "grandfather rights" to their former status as nonbank holding companies.[59]

These grandfathered companies, however, are subject to special regulation, and will lose their exemption if (1) they acquired control of a bank or an insured institution (other than certain emergency acquisitions) after March 5, 1987; (2) they obtain control of more than 5 percent of the assets or shares of a bank or insured institution, except as specifically allowed; or (3) any of their bank

[54] Id.

[55] CEBA tit. I, § 101(a)(1), 100 Stat. 554, 555 (amending 12 USC § 1841(c) (1982)); 12 USC §§ 601–605, 611–632 (1982).

[56] CEBA tit. I, § 101(a)(1), 100 Stat. 554, 555 (amending 12 USC § 1841(c)(1982)).

[57] Id. at 555–556.

[58] CEBA tit. I, § 101(b), 100 Stat. 554, 557 (amending 12 USC § 1843(a)(2) (1982)).

[59] CEBA tit. I, § 101(c), 100 Stat. 554, 557–561 (amending 12 USC § 1843 (1982)).

subsidiaries do not restrict their activities as further provided in the amendments.[60]

The grandfathered companies are subject to limitations on the activities of their bank subsidiaries to restrict the possibilities for conflicts of interest and unfair competitive advantages over companies subject to the full restrictions of the Bank Holding Company Act as amended.

The bank subsidiaries cannot engage in activities different from those in which they were engaged on March 5, 1987. They are also restricted on joint marketing of products and services with the other affiliate companies, and may not market products or services of affiliate companies that would not be allowed for bank holding companies under Section 4(c)(8) of the act, limiting holding companies to activities closely related to banking. Further, the bank subsidiaries may not market their products or services through affiliate companies that provide products or services not permissible under Section 4(c)(8) of the act. However, if a previous marketing arrangement had allowed the banks' products or services to be offered through such an affiliate as of March 5, 1987, such an arrangement may continue as long as it is not expanded. Such services or products must be marketed "only in the same manner in which they were being offered or marketed as of [March 5, 1987] . . ."[61] The conference report of Congress on the 1987 amendments notes that there are two categories of restrictions on joint marketing and gives the following examples of how the amendments work:

> In category (1), the restrictions on an affiliate's products and services are such that, for example, a company could not market life insurance or automotive supplies through its bank subsidiary, since those products are not permissible for bank holding companies generally under section 4(c)(8) of the act. Likewise, in category (2), the grandfathered nonbank may not permit its products or services to be offered or marketed through an affiliate that engages in nonbanking activities that are prohibited for bank holding companies generally under section 4 of the Bank Holding Company Act. Thus the life insurance affiliate or the automobile parts retailer could not market the bank's insured deposits or trust accounts.[62]

The subsidiaries are not allowed access to the overdraft facilities of the Federal Reserve System on behalf of any affiliate. This is to prevent an affiliate company from arranging for the bank subsidiary to direct the Federal Reserve

[60] Id. at 558.

[61] Id. at 559.

[62] Conf. Rep. No. 100-261, supra note 45, at 126. The conference report continues and explains. "On the other hand, the grandfathered nonbank bank could offer its customers loans from an affiliated mortgage banking or consumer finance company, and such an affiliate could offer its customers the products or services of the bank, because these activities are permitted under section 4(c)(8) of the Bank Holding Company Act." Id.

System to make payments for the benefit of the affiliate that exceed the creditworthiness of the bank and the affiliate. The following example illustrates this purpose:

> For example, a troubled affiliate of a nonbank bank could direct the nonbank bank to make final, irrevocable funds transfers to pay its creditors far in excess of the balance in the affiliate's account at the nonbank bank or even the nonbank bank's account at the Federal Reserve. Those transfers could precipitate the failure of the nonbank bank, causing loss to the depositors, creditors, and the FDIC.[63]

Finally, the bank subsidiaries cannot increase their assets at any faster a rate than 7 percent per year.[64] The congressional conferees indicated that it would be permissible for a bank to sell assets to meet the target growth rate.[65] As indicated previously, any violation of these limitations on the activities of the bank subsidiaries results in a loss of the company's exemption from being classified as a bank holding company and subjects the company to a requirement of divestiture "of each bank it controls" within 180 days after loss of the exemption.[66]

The grandfathered company can become free of these restrictions on its activities by obtaining approval to be a bank holding company and complying with all of the provisions of the Bank Holding Company Act. But this approach cannot be used to authorize a holding company that has an interstate network of banks in violation of the Bank Holding Company Act's restrictions on interstate banking.[67]

The grandfathered companies must supply information to the Board of Governors, and the Board has authority to examine such companies and to require reports "solely for purposes of assuring compliance" with these restrictions. The Board can exercise its general enforcement authority.[68]

All companies that qualify for grandfather rights from treatment as bank holding companies nevertheless are subject to the antitying restrictions of the Bank Holding Company Act and to the provisions of the act that deal with transactions with affiliates and insiders.[69] The antitying provisions also apply to certain institutions that are exempt from classification as banks.[70]

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[63] Id. at 127.

[64] CEBA tit. I, § 101(c), 100 Stat. 554, 559 (amending 12 USC § 1843 (1982)).

[65] Conf. Rep. No. 100-261, supra note 45, at 125.

[66] CEBA tit. I, § 101(c), 100 Stat. 554, 559 (amending 12 USC § 1843 (1982)).

[67] Id. at 559-560. The interstate banking limitations are discussed in Chapter 6.

[68] Id. at 560. See also 12 USC § 1818 (1982).

[69] CEBA tit. I, § 101(c), 100 Stat. 554, 560 (amending 12 USC § 1843 (1982)). These limitations are discussed in ¶¶ 9.02[3]–9.02.[5]. See also ¶ 5.03[2].

[70] Id. at 561.

[d] Conditions for Retaining Control. According to a general provision in the 1987 amendments, companies are permitted to keep control over the nonbank banks they acquired before the amendments became effective, as long as they limit the activities of the nonbank banks. This grandfather provision applies to companies that acquired control of an institution that became a bank as a result of the Competitive Banking Equality Amendments of 1987. Such a company may retain control of the nonbank bank by adhering to two conditions.[71] Firstly, the nonbank bank may not engage in any activity that would have caused the institution to be classified as a bank under the former definition of a bank in the Bank Holding Company Act. This means that the institution is not allowed both to accept demand deposits and make commercial loans. Secondly, after March 5, 1987, the bank may not increase the number of locations from which it does business. These restrictions end if the nonbank bank is one that meets approval from the Board of Governors for the holding company to acquire.[72]

[e] Exception for Activities of Certain Savings Banks. Savings banks that are chartered under state law and that are subsidiaries of a bank holding company are not subject to the limitations on their activities that other nonbank banks are subject to under the amendments. The savings bank may engage, "directly or through a subsidiary, in any activity in which such savings bank may engage . . . pursuant to express, incidental, or implied powers under any statute or regulation, or under any judicial interpretation . . ." of the law of the state where it is located.[73] There are, however, restrictions for savings banks on insurance activities. Savings banks generally are limited to the same insurance activities allowed for bank holding companies, but special dispensation is given to savings banks in Connecticut, Massachusetts, and New York to sell life insurance if special conditions are met.[74]

[f] Thrift Institutions' Bank. Thrift institutions and savings banks may own a "bank" without becoming a bank holding company.[75] The bank must restrict its deposit taking to deposits from the thrift institution or to those arising out of the business of the thrift institution, or to public deposits.

[g] Restrictions on Member Banks' Transactions With Affiliates. Member banks of the Federal Reserve System and their subsidiaries are subject to new

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[71] Id.

[72] Id.

[73] CEBA tit. I, § 101(d), 100 Stat. 554, 561-562 (amending 12 USC § 1842 (1982)).

[74] Id. at 562.

[75] CEBA tit. I, § 101(e), 100 Stat. 554, 562-563 (amending 12 USC § 1841(a)(5)(E) (1982)).

limitations on their transactions with affiliates. For those transactions covered by the amendments, they must be on terms "substantially the same, or at least as favorable" to the bank or its subsidiary "as those prevailing at the time for comparable transactions" with nonaffiliated companies.[76] The transactions that are subject to this requirement include sales of securities or other assets to an affiliate, payment of money or furnishing of services to an affiliate under contract, lease or otherwise, transactions where the affiliate is a broker or agent or "receives a fee for its services," transactions with third parties where the affiliate has a financial interest, and other transactions covered under existing law.[77]

Member banks and their subsidiaries also are prohibited from using any authority they have as a fiduciary to acquire securities or other assets from an affiliate.[78] Such acquisitions can be made if there is legal authority from a court order or under the controlling trust agreement or other fiduciary instrument. Further, the bank or subsidiary cannot acquire a security if "a principal underwriter of that security is an affiliate of such bank."[79]

Member banks cannot advertise that they are responsible for the obligations of affiliates or enter into an agreement to that effect.[80]

¶ 5.02 REGULATION OF BANK HOLDING COMPANY ACTIVITIES

Bank holding companies are restricted in the activities in which they and their affiliate companies may engage. They are prohibited from engaging in nonbank activities, subject to certain exceptions; these exceptions are discussed in the following text. Further, the Board of Governors may permit bank holding companies to engage in activities that are closely related to banking; these are discussed later in this chapter.[81]

[1] Exemptions to Prohibition of Nonbank Activities

Section 4(a) of the Bank Holding Company Act, as amended, sets forth a general rule that a bank holding company cannot acquire (and after two years from the date on which it became a bank holding company, cannot retain) "direct or indirect ownership or control of any voting shares of any company

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[76] CEBA tit. I, § 102(a), 100 Stat. 554, 564 (amending 12 USC § 371c (1982)).

[77] 12 USC § 371c(b)(7) (1982). See also ¶ 8.01[8] on securities.

[78] CEBA tit. I, § 102(a), 100 Stat. 554, 565 (amending 12 USC § 371c (1982)).

[79] Id. at 565.

[80] Id.

[81] For a discussion of activities closely related to banking, see infra ¶ 5.02[2].

which is not a bank."[82] Congress had two reasons for prohibiting nonbank investments. Firstly, a holding company might use its banks to allocate available credit to customers of its other subsidiaries rather than creditworthy borrowers who are not customers; secondly, the soundness of the holding company's subsidiary bank might be impaired by investment of its funds in nonbanking affiliates, thereby risking the depositors' funds.[83]

The act provides numerous exceptions to the general rule. Section 4(a)(2) of the act establishes grandfather rights for holding companies that, at the time of the 1970 amendments, had continuously engaged in nonbanking activities since June 30, 1968. Such holding companies are allowed to continue these activities indefinitely.[84] However, the Board of Governors had the power to terminate these grandfathered nonbank activities if it determined that these activities would lead to an "undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices."[85] If termination was required, the holding company had ten years to divest its interests.[86]

Section 4(d) authorized the Board to grant exemptions to one-bank holding companies in existence since July 1, 1968, if divesture would cause undue hardship, such as disrupting existing business relationships and thereby adversely affecting the bank or community, or forcing the sale of small locally owned banks to purchasers not representative of community interests.[87] The act also allowed the Board to approve retention of a bank when it was so small in relation to both the holding company's interests and the relevant banking market that the likelihood of its granting or denying credit in furtherance of the holding company's other interests was minimal.[88]

Section 4(c) specifically exempts labor, agricultural, or horticultural organizations and family-owned bank holding companies, as well as thirteen other activities closely related to banking. Of these thirteen exemptions, Section 4(c)(8) is the only one authorizing nonbank businesses.[89] The nonbank activities covered by Section 4(c)(8) are discussed in the following section of this chapter. The remaining exemptions permit a bank holding company to acquire the shares

[82] 12 USC § 1843(a) (1982).

[83] H.R. Rep. No. 609, 84th Cong., 1st Sess. 1 (1955).

[84] 12 USC § 1843(a)(2) (1982). Any holding company not so engaged had until December 31, 1980 to divest. 44 Fed. Reg. 74,920 (1979). See generally Annot., "Construction and Application of 'Grandfather Proviso' of § 4(a)(2) of Bank Holding Company Act (12 U.S.C. § 1843(a)(2))," 35 ALR Fed. 942 (1977).

[85] 12 USC § 1843(a)(2) (1982). The act required the Board to act within two years in the case of companies with bank assets over $60 million.

[86] Id.

[87] 12 USC § 1843(d) (1982).

[88] Id. See also P. Heller, Handbook of Federal Bank Holding Company Law 183 n.76 (1976) (hereinafter Heller).

[89] 12 USC § 1843(c)(8) (1982).

of companies engaged in the exempted activities or to engage in certain of these activities directly. Thus, the prohibition in Section 4(c) against engaging in nonbank activities does not apply to:

1. Shares of service companies for the holding company and its banking subsidiaries; companies engaged in holding or operating properties "used wholly or substantially" in the operations of the banking subsidiary; companies in the safe deposit business; companies engaged in liquidating assets of the holding company.
2. Shares acquired "in satisfaction of a debt previously contracted" if they are disposed of in a timely fashion.
3. Shares that the holding company is required by federal or state law to dispose of, provided the disposal occurs in a timely fashion.
4. Shares held in a fiduciary capacity permitted under the act.
5. Shares that qualify as being eligible for investment by national banks.
6. Shares of a company that "do not include more than 5 per centum of the outstanding voting shares of such company . . ."
7. Shares of an investment company "which is not a bank holding company and which is not engaged in any business other than investing in securities" as long as the securities "do not include more than 5 per centum of the outstanding voting shares of any company . . ."
8. Shares of companies engaged in activities approved by the Board. (See discussion in next subsection.)
9. Shares of foreign corporations whose main business is outside the United States, if approved by the Board.
10. Shares acquired prior to May 9, 1956 by a bank that is a bank holding company or by its subsidiaries.
11. Shares owned by a company covered by the act in 1970, but "which does not engage in any activities other than those" allowed under Section 4(c) of the act.
12. Shares of a company that became a bank holding company as a result of the 1970 amendments, if the company ceases to become a bank holding company, divests control, or follows conditions established by the Board.
13. Shares of a company "which does no business in the United States except as an incident to its international or foreign business . . ." as the Board approves.
14. Shares of a company that qualifies as an export trading company.[90]

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[90] 12 USC § 1843(c) (1982).

[2] Activities Closely Related to Banking

Section 4(c)(8) of the 1970 amendments to the Bank Holding Company Act reflects a compromise between the House and Senate after nearly two years of debate.[91] Prominent in the debate were the criteria to be used for determining permissible nonbank activities. The House bill took a somewhat restrictive approach, including a "laundry list" of prohibited nonbank activities and a public benefits test; the Senate bill took a more liberal approach, rejecting the laundry list and instead leaving the determination of whether activities were "functionally related to banking" up to the Federal Reserve Board.[92] Both House and Senate, however, were in total agreement on the requirement that a bank holding company's entry into a nonbanking activity must result in net public benefits when weighted against any adverse effects, and that the holding company bear the burden of proof.[93]

Under Section 4(c)(8), then, in order for a bank holding company to engage in nonbank activities, the Federal Reserve Board, after due notice and opportunity for hearing, must determine that the activity is "so closely related to banking or managing or controlling banks as to be a proper incident thereto" and that its subsequent performance as a subsidiary "can reasonably be expected to produce benefits to the public . . . that outweigh possible adverse effects."[94]

[a] Activities Allowed Under Board Regulation Y. The Federal Reserve Board implements Section 4(c)(8) of the Bank Holding Company Act with Regulation Y, which contains a list of activities the Board of Governors deems to be "closely related" to banking.[95] With respect to these listed activities, a bank holding company does not have to show that the activity satisfies the "closely related" test, but need only show that the public benefits from engaging in that activity will outweigh any adverse effects. The activities listed in Regulation Y are:

1. Making, acquiring, or servicing loans or other extensions of credit (including issuing letters of credit and accepting drafts) for the account of the bank holding company or for the account of others. Loans made by consumer finance companies, credit card companies, mortgage companies, commercial finance companies, and factoring companies are examples of transactions the bank holding company can handle.

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[91] Jessee, supra note 9, at 48.

[92] H.R. 6778, 91st Cong., 1st Sess., 115 Cong. Rec. 33125 (1969); S. 6778, 91st Cong., 2d Sess., 116 Cong. Rec. 32124 (1970). See Board of Governors v. Investment Co. Inst., 450 US 46 (1981).

[93] Jessee, supra note 9, at 30.

[94] 12 USC § 1843(c)(8) (1982). See generally Wilson, "Separation Between Banking and Commerce Under the Bank Holding Company Act—A Statutory Objective Under Attack," 33 Cath. UL Rev. 163–185 (1983).

[95] 12 CFR § 225.25 (1987).

2. Operating an industrial bank, Morris Plan bank, or industrial loan company, as authorized under state law, so long as the institution does not become a bank by accepting demand deposits and making commercial loans.
3. Performing the functions of a trust company as authorized by federal or state law. These functions may include activities of a fiduciary, agency, or custodial nature. The institution may not be a bank and may not make loans or investments or accept deposits other than as authorized by Regulation Y. The institution may not accept deposits that are used by customers as general purpose checking accounts or interest-bearing accounts.
4. Acting as an investment or financial advisor in providing advice to a mortgage or real estate investment trust or to an investment company registered under the Investment Company Act of 1940.[96] These activities include furnishing general economic information and advice, providing financial advice to governmental units, and providing "portfolio investment advice" to other persons.
5. Leasing personal property (including automobiles) or real property, or acting as agent, broker, or adviser in leasing transactions where the leases are the functional equivalent of an extension of credit.[97]
6. Making equity and debt investments in community welfare projects or corporations engaged in such projects.
7. Providing data-processing and data transmission services, facilities (including data processing and data transmission hardware, software, documentation or operating personnel), data bases or access to such services, facilities, or data bases by any technological means if (1) the data to be processed or furnished are financial, banking, or economic, and the services are limited by written agreement; (2) the facilities are designed, marketed, and operated for the processing and transmission of financial, banking, or economic data; and (3) the hardware provided is offered only with the software designed for use in handling the qualified types of data. (The general purpose hardware may not constitute more than 30 percent of the cost of any packaged offering.)[98]

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[96] See Board of Governors v. Investment Co. Inst., 450 US 46 (1981).

[97] The Competitive Equality Banking Amendments of 1987 expanded the power of national banks to engage in credit leasing transactions. See ¶ 4.03[1][d].

[98] Some of these services may be provided for the internal use of the bank holding company system under the servicing exemption in Section 4(c)(1)(C) of the Bank Holding Company Act without prior Board approval. In addition to the activities previously mentioned, the Board has issued an interpretation that additional activities will be permitted as incidental to carrying on these data processing activities. On this basis, subject to certain limitations, a bank holding company may provide excess capacity without limiting it to the processing or transmission of banking, financial, or economic

8. Acting as an insurance agent, broker, or underwriter, except as prohibited by the act, for insurance that is credit insurance or insurance directly related to the provision of other financial services. Also, the bank holding company may sell insurance without these limitations in a community where the bank holding company has an office if the population of the community does not exceed 5,000.[99]

9. [Reserved]

10. Providing courier services for checks, commercial paper, and similar documents and business records that are exchanged among banks and financial institutions.

11. Providing bank management consulting advice to nonaffiliated bank and nonbank depository institutions.

12. Selling U.S. savings bonds, traveler's checks, money orders, and similar consumer-type payment instruments. (Money orders and similar instruments cannot have a face value exceeding $1,000.)[100]

13. Performing appraisals of real estate and personal property, including securities.

14. Engaging in commercial real estate equity financing as an intermediary for investors by arranging the financing of certain commercial or industrial income-producing real estate projects.

15. Providing securities brokerage services, credit activities related to these securities services, and incidental activities, such as custodial services, individual retirement accounts, and cash management services. These securities brokerage services are restricted activities where the holding company is buying and selling solely as agent for the account of a

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data. 12 CFR § 255.123(e) (1987). See generally Association of Data Processing Serv. Org. v. Board of Governors, 745 F2d 677 (DC Cir 1984); note, "National Banks, Bank Holding Companies and Data Processing Services," 14 Ga. L. Rev. 576 (1980).

[99] The insurance provisions of the Bank Holding Company Act are discussed later in this section. The scope of the Bank Holding Company Act as it relates to insurance activities was litigated in Alabama Ass'n of Ins. Agents v. Board of Governors, 533 F2d 224 (5th Cir. 1976), vacated in part, 558 F2d 729 (5th Cir. 1977), cert. denied, 435 US 904 (1978).

[100] The Board approved an application of Citicorp to issue and sell payment instruments (including money orders and official checks) with a maximum face value of $10,000, because it thought entry by Citicorp into this business would increase competition and encourage deconcentration in the industry. The Board expressed concern that the issuance of these instruments might have an adverse effect on the reserve base, so it required the bank to report weekly on its activity. Application of Citicorp, 71 Fed. Reserve Bull. 58 (1985). The Board had previously decided that the issuance and sale of payment instruments with a face value of up to $10,000 was closely related to banking. 70 Fed. Reserve Bull. 364 (1984).

customer and is not involved in underwriting, dealing, or providing investment advice or research services.[101]

16. Underwriting and dealing in obligations of the United States and other governmental bodies, and in obligations permitted by statute, including banker's acceptances and certificates of deposit.
17. Providing general information and statistical forecasting about foreign exchange markets and providing advisory and transactional services for customers engaged in foreign exchange transactions. These services include arranging for "swaps" among customers and executing foreign exchange transactions, as long as they occur through a separate subsidiary that complies with Board conditions.
18. Acting as a futures commission merchant for nonaffiliated persons in the execution and clearance on major commodity exchanges of future contracts and options on futures contracts for bullion, foreign exchange, government securities, certificates of deposit, and other money market instruments that a bank may buy or sell in the cash market for its own account. The activity must be conducted through a separately incorporated subsidiary.
19. Providing investment advice on financial futures and options on futures as a futures commission merchant or a commodity trading adviser as authorized under the act and by Board regulations.
20. Providing consumer financial counseling, including educational courses and instructional materials, on financial management matters such as debt consolidation, applying for a mortgage or bankruptcy, budget management, tax planning, retirement and estate planning, insurance and general investment management subject to Board conditions.[102]
21. Providing tax advice and tax preparation services.
22. Providing check guaranty services for merchants.
23. Operating a collection agency for collecting overdue retail or commercial accounts.
24. Operating a credit bureau.

The Board is authorized in Section 4(c)(8) to differentiate between activities commenced de novo and activities commenced by the acquisition of a going

[101] The securities activities permitted to banks and bank holding companies are discussed in Chapter 8.

[102] The Board also has permitted a bank holding company to provide consulting services in designing and administering employee benefit plans. Application of Bank Vermont Corp., Board of Governors, Fed. Banking L. Rep. (CCH) ¶ 86,532 (Mar. 6, 1986).

concern.[103] As seen in Regulation Y, the Board favors de novo entry by a bank holding company because it may benefit the public by increasing competition. A bank holding company can engage de novo in any of the listed activities, either directly or through a subsidiary, thirty days after giving its Reserve bank notice of its intentions, unless the Federal Reserve bank acts to delay the proposal.[104] Upon application for the acquisition of shares of a company already engaged in one of the listed activities, the applying holding company must await the Board's determination of whether or not benefits to the public will outweigh any adverse effects.[105]

The Board also reviews applications concerning activities not among those specifically listed in Regulation Y. If a holding company feels that under the surrounding circumstances of the case, an activity is closely related to banking or managing or controlling banks, it may file an application for Board approval.[106]

Activities ruled on favorably by the Board in this manner include the purchase, sale, and arbitrating of gold and silver coins,[107] engaging in the activity of a guaranty savings bank, operating a pool reserve plan for the pooling of loss reserves of banks with respect to their loans to small businesses, and land escrow services.[108]

Nonbank activities not approved by the Board include:

1. Insurance premium funding (combining the sale of mutual funds and insurance)[109]
2. Underwriting life insurance not sold in connection with a credit transaction of a bank holding company or its subsidiary[110]
3. Real estate brokerage[111]
4. Land development[112]

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[103] 12 USC § 1843(c)(8) (1982).

[104] 12 CFR § 225.23(a)(1) (1987). A de novo activity is "presumed to result in benefits to the public through increased competition." 12 CFR § 225.24 (1987).

[105] 12 CFR § 225.23(a)(2) (1987).

[106] 12 CFR § 225.23(a)(3)(1987). The Board has ninety-one days to act on a proposal. Failure of the Board to act results in the application being deemed approved. 12 CFR § 225.23(h) (1987). See BankAmerica Corp. v. Board of Governors, 596 F2d 1368 (9th Cir. 1979). See generally Annot., "Construction and Application of Bank Holding Company Act Provision That Application for Approval to Acquire Control of Bank Shall Be Deemed Granted If Federal Reserve Board Does Not Act on Application Within 91 Days (12 U.S.C.S. § 1842(b))," 38 ALR Fed. 919 (1978).

[107] See 4 Fed. Banking L. Rep. (CCH) ¶¶ 43,086, 97,177 (1983).

[108] Heller, supra note 88, at 257.

[109] See 12 CFR § 225.126 (1987).

[110] Id.

[111] Id.

[112] Id.

5. Real estate syndication[113]
6. Management consulting[114]
7. Property management[115]
8. Operation of savings and loan associations[116]

Although Regulation Y lists the previous activities as those that are not closely related to banking, there have been substantial changes in the law and enlargement of the activities recognized as permissible for bank holding companies since the date of the Board's interpretation. The actions of the Board in approving activities related to those shown previously should be consulted.[117]

[b] Deciding When an Activity Is Closely Related to Banking. In order for the Board to approve an application for a nonbank activity, it must determine that the proposed activity is "closely related" to banking and that any adverse effects are outweighed by benefits to the public. In the case of activities listed in Regulation Y, the "closely related" question is already affirmatively answered. For those activities that are not on the list, the Board must determine whether the proposed activity is "closely related." If the Board's determination is negative, it does not reach the further question of the potential for public benefits.

The congressional intent behind the "closely related" test of the 1970 amendments is by no means clear, as the House and Senate Conferences expressed differing views regarding the expansiveness of the clause.[118] The court in *National Courier Ass'n v. Board of Governors*[119] has interpreted the phrase as being a "substantial relaxation" of the Board's restrictive approach prior to the 1970 amendments.[120] The *Courier* court articulated three connections that would bring an activity within the "closely related" requirement:

1. Banks generally have in fact provided the proposed services;

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[113] Id.

[114] Id.

[115] Id.

[116] This is the policy as contained in the regulation. See Id. The regulation notes that it is under consideration. See 1972 Fed. Reserve Bull. 717 (1972). It also has been modified by Congress in that acquisition of savings and loan associations is permitted in certain emergency situations. See the discussion at ¶ 6.06.

[117] A good source of the Board's actions is the three-volume Board of Governors, Federal Reserve Regulatory Service.

[118] Jessee, supra note 9, at 30.

[119] 516 F2d 1229 (DC Cir. 1975).

[120] For the Supreme Court's interpretation, see Securities Indus. Ass'n v. Board of Governors, 468 US 207 (1984), discussed in this section. Compare Board of Governors v. Investment Co. Inst., 450 US 46 (1981).

2. Banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed services; and
3. Banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form.[121]

The Board successfully argued that the courier services in question, used for transporting banking and financially related data processing materials, met all three of the aforementioned criteria. The court went on to hold, however, that non-financially related courier services are impermissible. The following year the Board applied the *Courier* test in determining that the operation of a travel agency was not an activity closely related to banking.[122]

In *Securities Industry Association v. Board of Governors*,[123] the U.S. Supreme Court reaffirmed the Board's broad discretion to decide what activities are "closely related" to banking. Saying that "the Board's determination of what activities are 'closely related' to banking . . . 'is entitled to the greatest deference,' "[124] the Court upheld the Board's approval of BankAmerica Corp.'s acquisition of Charles Schwab & Co., a discount broker. The Securities Industry Association challenged the Board's decision on the basis that an activity cannot be "closely related" to banking unless it will facilitate other banking operations. Both the Court of Appeals for the Second Circuit and the Supreme Court rejected this argument. The Bank Holding Company Act authorized the Board to consider "a variety of factors" in making its determination.

The Court also rejected as "without merit" the securities association's argument that the Board could not use a "functional" analysis to decide that the activities were closely related to banking. In the Court's view, the 1970 amendments to the Bank Holding Company Act expanded the Board's discretion and gave no indication of a congressional intent to forbid the Board from considering the functional relationship of nonbanking activities to banking.[125] In uphold-

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[121] National Courier Ass'n v. Board of Governors, 516 F2d 1229, 1237 (DC Cir. 1975). See generally "Construction and Application of § 4(c)(8) of Bank Holding Company Act of 1956 (12 U.S.C.S. § 1843(c)(8)), Permitting Bank Holding Companies to Acquire Shares in Companies Whose Activities Are Closely Related to Banking," 31 ALR Fed. 520 (1977); De Santo, "Product Expansion in the Banking Industry: An Analysis and Revision of Section 4(c)(8) of the Bank Holding Company Act," 53 Fordham L. Rev. 1127–1157 (1985).

[122] 62 Fed. Reserve Bull. 148 (1976).

[123] 468 US 207 (1984).

[124] Id. at 212.

[125] Id. at n.12. Compare the Supreme Court's rejection of the Board's "functional" analysis in Securities Indus. Ass'n v. Board of Governors, 468 US 137 (1984), rev'g A.G. Becker, Inc. v. Board of Governors, 693 F2d 136 (DC Cir. 1982) where the legal issue involved the interpretation of the term "securities" in the Glass-Steagall Act. This case is discussed further in Chapter 8.

ing the Board's findings, the Court noted that banks perform in their trust departments functions that are not significantly different from the discount brokerage activities engaged in by Schwab. Schwab was not engaged in underwriting or in giving investment advice, but only in executing sale and purchase transactions and certain related activities for its customers. Banks have offered similar services for their own customers for years under the authority of section 16 of the Glass-Steagall Act, which expressly allows banks to buy and sell securities for the account of their customers.[126]

In *Association of Data Processing Service Organizations, Inc. v. Board of Governors,*[127] the court approved related reasoning by the Board to uphold the provision of data processing services. The court said it was proper for the Board to adopt a data test that would not limit the type of technology that might be used. The affiliate of the bank holding company could provide data-processing services, regardless of the type of technology employed, as long as the data being processed or furnished were "financial, banking or economic" and that the other requirements of the Board were satisfied. The court specifically upheld the decision to allow bank holding companies to provide general economic information and advice and to engage in economic statistical forecasting and industry studies. In addition, the court approved the sale of data-processing hardware, although it noted limitations on the extent of this aspect of the bank holding company's activities.

After finding an activity to be closely related to banking, the Board must determine whether the activity is a "proper incident to banking," that is, whether the performance of the nonbanking affiliate "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices."[128] Resolution of the public benefits test must be determined on a case-by-case basis, with reference to the particular facts surrounding the proposed activity.[129] The adverse and beneficial effects set out in section 4(c)(8) are not intended to be exclusive, but only to serve as examples to be weighed. In the absence of any adverse factors, the Board

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[126] The scope of banks' and bank holding companies' authority to engage in securities transactions is discussed in Chapter 8.

[127] 745 F2d 677 (DC Cir. 1984).

[128] 12 USC § 1843(c)(8) (1982).

[129] See Securities Indus. Ass'n v. Board of Governors, 468 US 207 (1984); Independent Bankers Ass'n v. Board of Governors, 516 F2d 1206, 1216 (DC Cir. 1975). See also Oklahoma Bankers Ass'n v. Board of Governors, 766 F2d 1446 (10th Cir. 1985); Independent Ins. Agents of America v. Board of Governors, 736 F2d 468 (8th Cir. 1984); Independent Ins. Agents of America v. Board of Governors, 658 F2d 571 (8th Cir. 1981).

may approve a proposed acquisition even though no public benefits are expected.[130]

[c] Approval of Nonbank Activities—Hearings and Judicial Review. Section 4(c)(8) provides that the act's prohibitions against nonbank expansion by bank holding companies shall not apply to "shares of any company the activities of which the Board after *due notice and opportunity for hearing has determined (by order or regulation)* to be so closely related to banking or managing or controlling banks as to be a proper incident thereto."[131]

The 1970 amendments added the term "by order or regulation," so that the Board could proceed "either by order in specific cases or by regulation in a general classification or category of cases in order to provide maximum flexibility as a procedural matter in administering this section."[132] The Board has promulgated Regulation Y to designate activities it deems to be "closely related" to banking.[133]

The 1970 amendments replaced the "due notice and hearing" language of the 1956 act with "due notice and opportunity for hearing," so that "the Board would not be required to hold hearings in all cases . . . , but should hold hearings in all cases where a contest is raised."[134] When the Board has previously determined by regulation that an activity is not "closely related" to banking, or when the facts in issue are concerned with general policy matters, no hearing is required.[135] However, when there is a factual dispute as to the "public benefits" of an acquisition, it must be resolved in a trial-type hearing because the resolu-

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[130] Heller, supra note 88, at 263. For a study of Board orders between 1971 and 1976 that evaluated the significance of such factors, see Jessee, supra note 9, at 75.

[131] 12 USC § 1843(c)(8) (1982) (emphasis added).

[132] Conf. Rep. No. 1747, 91st Cong., 2d Sess. 15 (1970) (hereinafter Conf. Rep. No. 1747). Before 1970, the Board had to hold a full adjudicatory hearing. See also Independent Bankers Ass'n v. Board of Governors, supra note 129, at 1213.

[133] The Regulation Y activities are discussed in ¶ 5.02[2][a]. Amendments that clarify or interpret these regulations may be promulgated without prior notice or an opportunity for hearing. See American Bancorp. v. Board of Governors, 509 F2d 29 (8th Cir. 1974), where the court found the Board's amendments regarding the extent to which a bank holding company's subsidiary can provide financial services to state and local governments came within the exemptions to the notice and hearing requirements in the act.

[134] Conf. Rep. No. 1747, supra note 132, at 15-16.

[135] In BankAmerica Corp. v. Board of Governors, 491 F2d 985 (9th Cir. 1974), the court affirmed the Board's denial of BankAmerica's request for a hearing on its application to engage in the "non-full payout" leasing of computer equipment. The court found that BankAmerica had participated fully in the Board's extensive public hearings prior to the adoption of Regulation Y, in which they had urged the Board to include non-full payout leasing in its list of "closely related" activities.

tion depends on the particular "adjudicative facts" peculiar to each application.[136]

A court can review the Board's regulations, even when those regulations were not challenged at the time of promulgation, and can set them aside if they are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance of law."[137]

The Court of Appeals for the District of Columbia, in *Independent Bankers Association v. Board of Governors*,[138] confronted the issue of whether or not the 1970 amendments affected the right of interested parties to obtain a full adjudicative hearing in which to challenge an application's approval or denial. The court concluded: "As a rule a party in interest may not be deprived of his right to have the facts aired and tested in adversary proceedings—unless it is shown that none of the facts material to the ultimate decision are in dispute."[139] The agency carries a heavy burden of justification to show that the parties could gain nothing by a full adjudicatory hearing.

The act provides that "[a]ny party aggrieved by an order of the Board under this chapter may obtain a review of such order in the United States Court of Appeals within any circuit wherein such party has its principal place of business, or in the Court of Appeals in the District of Columbia . . . ."[140] It further provides that "a party who would become a competitor of the applicant or subsidiary thereof by virtue of the applicant's or its subsidiary's acquisition . . . shall have the right to be a party in interest in the proceeding and, in the event of an adverse order of the Board, shall have the right as an aggrieved party to obtain judicial review thereof as provided in Section 1848 . . . ."[141] The purpose of this provision is to guarantee a "properly liberal attitude concerning the right of competitors . . . to have standing" so that "the broadest possible forum [is] allowed for adversary proceedings to take place in order that all issues may be aired completely."[142] To be "aggrieved," a party must first pursue its administrative

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[136] Alabama Ass'n of Ins. Agents v. Board of Governors, 533 F2d 224, 235 (5th Cir. 1976), vacated in part, 558 F2d 729 (5th Cir. 1977), cert. denied, 435 US 904 (1978). See also Oklahoma Bankers Ass'n v. Board of Governors, 766 F2d 1446 (10th Cir. 1985), where the challengers failed to establish that there were material disputed facts, which required a full evidentiary hearing. See generally Helfer & Morse, "Hearings Under Section 4(c)(8) of the Bank Holding Company Act," 101 Banking LJ 50–70 (1984).

[137] *Alabama Ass'n. of Ins. Agents v. Board of Governors*, 533 F2d at 240.

[138] 516 F2d 1206 (DC Cir. 1975).

[139] Id. at 1222.

[140] 12 USC § 1848 (1982). See generally Annot., "Jurisdiction of United States Courts of Appeals to Review Agency Action Under § 9 of Bank Holding Company Act (12 USC § 1848)," 40 ALR Fed. 593 (1978); Annot., "Who Is 'Party Aggrieved' under § 9 of Bank Holding Company Act (12 USCS § 1848), Which Allows Any Party Aggrieved by Federal Reserve Board Order Under Act to Obtain Judicial Review," 36 ALR Fed. 349 (1978).

[141] 12 USC § 1850 (1982).

[142] Conf. Rep. No. 1747, supra note 132, at 29-30.

remedies before the Board. Only after a party has exhausted its remedies can it request judicial review.[143]

[3] Other Authority for and Restrictions on the Activities of Bank Holding Companies

The amendments to the Bank Holding Company Act over the years have also created another layer of federal statutory law that determines which activities by bank holding companies and their affiliates are proper. The major such areas are discussed in the following text. Congress is in the process of conducting a comprehensive examination of the structure of the financial services industry, an examination that could lead to a reevaluation of the activities Congress approves as appropriate for bank holding companies. The Competitive Equality Banking Amendments of 1987 state that Congress intends to review the "need for financial restructuring legislation in the light of today's changing financial environment both domestic and international . . . ."[144] Pending the completion of this review, Congress established a moratorium on certain areas of activity by bank holding companies and other financial institutions. The moratorium affected financial institutions broadly, and was not limited to bank holding companies and their affiliates. The first part of this section explains the terms of this moratorium.

[a] 1987 Moratorium on Certain Nonbanking Activities. Title II of the Competitive Equality Banking Amendments of 1987 established a moratorium on certain nonbanking activities. As described, this moratorium was broad in scope and applied to other financial institutions in addition to bank holding companies and their affiliates. The moratorium expired on March 1, 1988, and Congress stated its intent that the moratorium shall not be extended.[145] The activities subject to the moratorium included nonbanking activities of foreign banks, securities transactions, insurance activities, and real estate dealings. They are listed in the following text.

[i] **Certain activities of foreign banks.** Foreign banks with grandfather rights under the International Banking Act of 1978 are prohibited from expanding activities "under any provision of law which is not applicable to domestic bank holding companies" by acquiring an interest in another firm.[146] Under the law governing foreign banks, some foreign banks enjoyed grandfather rights that allowed them to engage in transactions and activities that domestic banks could

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[143] First Nat'l Bank of St. Charles v. Board of Governors, 509 F2d 1004 (8th Cir. 1975).

[144] CEBA tit. II, § 203(a), 100 Stat. 554, 584 (1987).

[145] CEBA tit. II, §§ 201(a), 203(b), 100 Stat. 554, 581, 584 (1987).

[146] CEBA tit. II, § 201(b), 100 Stat. 554, 582 (1987).

not participate in. This amendment limits foreign banks' abilities to expand the activities allowed under the grandfather provisions of the International Banking Act of 1978.

[ii] Securities transactions of banks and bank holding companies. There is a general moratorium for bank holding companies, affiliates, foreign banks, and insured banks on certain securities transactions.[147] These institutions may not engage in the United States in any of the following:

> (A) in the flotation, underwriting, public sale, dealing in, or distribution of securities if that approval would require the agency to determine that the entity which would conduct such activities would not be engaged principally in such activities,
> (B) in any securities activity not legally authorized in writing prior to March 5, 1987, or
> (C) in the operation of a nondealer marketplace in options.[148]

The prohibition on securities activities discussed in item (B) does not apply to transactions in which the bank is only an agent, and to activities that "had been lawfully engaged in prior to March 5, 1987 . . ."[149]

[iii] Insurance activities of banks and bank holding companies. There are extensive provisions dealing with insurance activities. In general, the amendments prohibit the federal banking agencies from approving any insurance powers beyond the activities specifically allowed in Section 4(c)(8) of the Bank Holding Company Act.[150] In addition, the Board of Governors may not approve the acquisition of a company under the Bank Holding Company Act, including a state-chartered bank, unless there is an agreement to limit the insurance activities of the company to those permitted under Section 4(c)(8). As a result, although the holding company may acquire a bank that is authorized under the laws of the state where it was chartered to engage in insurance activities, the Board will condition the acquisition on an agreement to restrict the insurance activities to those allowed under the Bank Holding Company Act.[151] Finally, national banks and foreign banks cannot expand their insurance activities "into places where it was not conducting such activities as of March 5, 1987."[152] A separate section of the amendments makes clear that the amendments are not

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[147] Id. § 201(b)(2).

[148] Id.

[149] Id.

[150] Id. § 201(b)(3). See generally "Paving the Way in the Financial Services Industry: South Dakota Opens the Insurance Industry to Banks," 29 SDL Rev. 172–180 (1983); "The Merger of Banking and Insurance: Will Congress Close the South Dakota Loophole?", 60 Notre Dame L. Rev. 762–778 (1985); Hemmer, "Insurance Underwriting Activities of BHCs," 100 Banking LJ 700-717 (1983).

[151] CEBA tit. II, § 201(b)(4), 100 Stat. 554, 582 (1987).

[152] Id. § 201(b)(5).

intended either to "increase or reduce the insurance authority" of bank holding companies and national banks under the "current law."[153]

[iv] Powers to engage in real estate transactions. The amendments limit the ability of federal banking regulators to approve new real estate powers for certain regulated financial institutions. The banking agencies may not take action that would increase the real estate powers of any bank, bank holding company, foreign bank, or subsidiary.[154]

Although there was a moratorium on the previously described activities, the federal banking agencies were allowed to continue to consider applications or to adopt rules allowing banks to engage in the suspended activities as long as the effective date of such action was deferred until the moratorium expired.[155]

[b] Securities Activities of Bank Holding Companies. As one of the areas under comprehensive review by Congress, the securities activities of banks and bank holding companies were subject to the constraints of the moratorium imposed by the Competitive Equality Banking Act of 1987.[156] Under the existing provisions of federal law, as discussed in Chapter 8, the Board could approve bank holding company affiliation with affiliates engaged in securities business, under some conditions, as long as the company was not "principally engaged" in such activities. One of the purposes of the 1987 moratorium was to prevent further affiliations with securities firms on this basis.

[c] Insurance Activities. The issue of insurance activities of bank holding companies has been a controversial one for years. A federal court of appeals decision in the mid-1970s determined that the sale of insurance to the holding company and its nonbank subsidiaries and the sale of "convenience" insurance were invalid.[157] This led to a series of Board rulings and regulations[158] and to eventual action by Congress.

The Garn-St Germain Depository Institutions Act of 1982[159] amended the Bank Holding Company Act to provide that acting as an insurance principal,

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[153] CEBA tit. II, § 201(d), 100 Stat. 554, 583 (1987).

[154] CEBA tit. II, § 201(b)(6), 100 Stat. 554, 583 (1987).

[155] CEBA tit. II, § 202, 100 Stat. 554, 584 (1987).

[156] The moratorium imposed by the Competitive Equality Banking Act of 1987 is discussed supra ¶ 5.02[3][a].

[157] Alabama Ass'n of Ins. Agents v. Board of Governors, 533 F2d 224 (5th Cir. 1976), vacated in part 558 F2d 729 (1977), cert. denied, 435 US 904 (1978).

[158] The Board decision on remand in the Alabama Ass'n of Ins. Agents case is at 44 Fed. Reg. 65,051 (1979). See also the current Board version of Regulation Y on insurance activities. 12 CFR § 225.25(8) (1987).

[159] Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified in scattered sections of titles 12, 15, and 18 USC).

agent, or broker is not an activity closely related to banking in which bank holding companies can engage.[160] There are six exceptions to this prohibition:

1. Insurance provided to assure repayment of loans in the event of death, disability, or involuntary unemployment of the borrower.
2. Casualty insurance on property used as collateral for loans extended by finance companies that are subsidiaries of bank holding companies. (The dollar value of loans that qualify is limited to $10,000 or, in case of manufactured homes, $25,000, subject to an adjustment for inflation.)
3. Insurance agent activity in places that have a population not exceeding 5,000 persons, or where the bank holding company can demonstrate that inadequate insurance agency facilities exist.
4. Insurance agency activity that the bank holding company or its subsidiary engaged in on May 1, 1982, or that the Board of Governors had approved by May 1, 1982. (If a bank holding company or subsidiary qualifies under this exception, the company or subsidiary also may engage in sales of insurance at new locations so long as the new locations are in the state where the principal place of business of the bank holding company is located, are in a state immediately adjacent to the state where the principal place of business is located, or are in a state where the holding company or subsidiary had engaged in insurance activities on May 1, 1982. Qualifying companies also may offer new insurance coverage that becomes available after May 1, 1982, so long as the new coverage insures against the same types of risks as those the company was insuring against on May 1, 1982.)[161]
5. Certain insurance activities related to property used in the operation of a bank holding company and insurance protecting employees of the company.
6. Any insurance agency activity engaged in by a bank holding company or subsidiary when the bank holding company has total assets of $50 million or less.

[160] Id. § 601, amending 12 USC § 1843(c)(8). See Application of Citicorp, 71 Fed. Reserve Bull. 789 (1985), where the Federal Reserve Board refused to approve an application of Citicorp to establish a bank to engage in national insurance activities because the Board believed approval would constitute an evasion of direct limitations on these activities by the Bank Holding Company Act.

[161] In commenting on the grandfather rights afforded by the act, the conference committee stated: "The conferees stress that nothing in this Title is intended to prevent the transferring of grandfathered insurance activities of a bank holding company to the parent company or any of its subsidiaries if the transferral is brought about for management or efficiency purposes. Such a reorganization shall have no effect on the application or the restrictions or exemptions contained in this Title." Conf. Rep. on Garn-St Germain Depository Institutions Act of 1982, H.R. Conf. Rep. No. 899, 97th Cong., 2d Sess. 91 (1982).

Special grandfather rights are recognized for bank holding companies registered with the Board of Governors before January 1, 1971.[162] The Competitive Equality Banking Act of 1987 established a moratorium on certain insurance activities, as discussed previously.[163]

[d] **Bank Service Companies.** The Garn-St Germain Depository Institutions Act of 1982[164] allows insured banks to establish bank service corporations.[165] Bank service corporations are defined as corporations "organized to perform services authorized by this Act, all of the capital stock of which is owned by one or more insured banks."[166] An insured bank may not invest more than 10 percent of its capital surplus in any bank service corporation and cannot invest more than 5 percent of its total assets in bank service corporations.[167]

Bank service corporations may provide services related to the collection of checks and undertake accounting functions related to depository activities.[168] Bank service corporations cannot take deposits, and they are limited in the geographical areas they can serve without prior approval from the Federal Reserve Board.[169] The conference committee on the act stated in its conference report that the provisions relating to bank service corporations "do not authorize a bank service corporation to perform any activity that is not authorized for any bank that is a shareholder of the bank service corporation or that is not authorized for bank holding companies" under existing law. Moreover, the conferees said that "the amendments do not authorize any securities activity" that is prohibited under existing federal legislation.[170]

[e] **Bankers' Banks.** The Garn-St Germain Depository Institutions Act of 1982[171] provides for the establishment of bankers' banks, which are organized to provide services for other banks and depository institutions. The Comptroller of the Currency has authority to charter as a national banking association banks

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[162] 12 CFR § 225.25(8)(vii) (1987).

[163] The moratorium imposed on certain insurance activities by the Competitive Equality Banking Act of 1987 is discussed supra ¶ 5.02[3][a].

[164] Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified in scattered sections of titles 12, 15, and 18 USC).

[165] 12 USC § 1861 (1982).

[166] 12 USC § 1861(b)(2) (1982).

[167] 12 USC § 1862 (1982).

[168] 12 USC § 1863 (1982).

[169] 12 USC § 1864 (1982).

[170] Conf. Rep. on Garn-St Germain Depository Institutions Act of 1982, H.R. Conf. Rep. No. 899, 97th Cong., 2d Sess. 92 (1982).

[171] Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of titles 12, 15, and 18 USC).

that will be owned exclusively by other depository institutions and are "organized to engage exclusively in providing services for other depository institutions and their officers, directors, and employees."[172] Alternatively, the bankers' bank may be a bank that is insured by the FDIC. The 1982 act authorizes national banks to invest in a bank insured by the FDIC if the bank is owned exclusively by depository institutions and if the bank and all its subsidiaries are engaged exclusively in providing services to other depository institutions.[173] A bankers' bank is within the definition of "bank" in the Bank Holding Company Act.[174] Therefore, the prohibition against nonbank activities in the act does not apply to it.

[f] Thrift Institutions' Bank. As discussed earlier in this Chapter, thrift institutions and savings banks may own a "bank" without becoming a bank holding company.[175]

[g] Other Bank Holding Company Activities. There are other important activities and aspects of bank holding companies that are discussed in other chapters of this text. The major ones are listed as follows:

1. Securities activities, discussed in Chapter 8;
2. Edge Act and Agreement banks, discussed in Chapter 2;
3. Interstate activities and acquisitions of bank holding companies, discussed in Chapter 6;
4. Antitrust and competitive considerations in the formation and expansion of holding companies, discussed in Chapters 13;
5. Acquisition of thrift institutions, including emergency acquisitions, discussed in Chapters 6 and 10; and
6. The formation of holding companies for savings and loan associations, mutual savings banks, and other thrift institutions, discussed in Chapter 6.

[4] Export Trading Companies

The Export Trading Company Act of 1982 (ETCA) further enlarged the scope of permissible bank holding company investment activities. In general,

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[172] 12 USC § 27(b)(1) (1982).

[173] 12 USC § 24 Seventh (1982).

[174] See 12 USC § 1841(c) (1982).

[175] CEBA tit. I, § 101(e), 100 Stat. 554, 562–563 (amending 12 USC § 1841(a)(5)(E) (1982)). For a discussion of restrictions on the banks' deposit-taking activities, see supra ¶ 5.01[4][f].

the ETCA allows bank holding companies to invest limited amounts of capital in export trading companies (ETCs) and provides antitrust immunity to ETCs that comply with certain certification procedures.

The purpose of the ETCA is to provide for meaningful and effective participation by bank holding companies, bankers' banks, and Edge Act corporations in the financing and development of ETCs in the United States.[176] To accomplish the stated purpose, the Board of Governors of the Federal Reserve System is to provide regulations allowing for the establishment of ETCs that will be competitive with similar foreign-owned trading companies in the United States and abroad. This legislation is designed specifically to aid small and medium-sized firms in the export of their goods and services.[177] The drafters felt that bank holding companies in general could provide communication, financing, marketing, technological, and management capabilities, which would otherwise be unavailable to smaller and medium-sized firms.[178] With such resources, the drafters projected that ETCs would contribute to the elimination of the increasing trade deficits the United States has faced in the recent past.[179]

The ETCA defines an ETC as a company that is "organized and operated principally for purposes of (A) exporting goods or services produced in the United States; or (B) facilitating the exportation of goods or services produced in the United States by unaffiliated persons by providing . . . export trade services."[180] The definition is narrower for purposes of investment in ETCs by bank holding companies. The ETC must be "exclusively engaged in activities relating to international trade."[181] ETCs may provide a variety of services including consulting, international marketing research, advertising, marketing product

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[176] Export Trading Company Act of 1982, Pub. L. No. 97-290, 96 Stat. 1233 (15 USC §§ 4001–4003 (1982)). See 15 USC § 4001(b) (1982). See generally Reinsch, "The Export Trading Company Act of 1981," 14 JL & Pol'y Int'l Bus. 47–127 (1982); Norton, "The Efficacy of Export Trading Companies and Related Legislation and Regulations," 50 J. Air L. & Com. 865–905 (1985); Ferchill, "Banks and Export Trading Company," 6 Fordham Int'l LJ 265–287 (1982-83); Golden & Kolb, "The Export Trading Company Act of 1982: an American Response to Foreign Competition," 58 Notre Dame L. Rev. 743–792 (1983); Seberger, "The Banking Provisions of the Export Trading Company Act of 1982," 39 Bus. Law. 475–494 (1984).

[177] 15 USC § 4001(a)(4) (1982).

[178] S. Rep. No. 27, 97th Cong., 1st Sess. 4 (1981)

[179] Export Trading Company Act of 1981: Hearing on S. 144 Before the Subcomm. on International Finance and Monetary Policy of the Senate Comm. on Banking, Housing and Urban Affairs, 97th Cong., 1st Sess. 58-59 (1981) (statement of John Heinz, Senator from Pennsylvania)

[180] 15 USC § 4002(a)(4) (1982). There is a narrower definition in the act for purposes of investment by bank holding companies and their subsidiaries in ETCs. 12 USC §§ 1843(c)(14)(F)(i), 1843(c)(14)(C), 1843(c)(14)(D) (1982).

[181] 12 USC § 1843(c)(14)(F)(i) (1982).

research, common legal assistance, and more.[182] The definition of an ETC limits the provision of services to "facilitating" the export of domestically produced goods and services that persons not affiliated with ETCs have produced.[183]

The ETCA amends the Bank Holding Company Act to allow bank holding companies to invest up to a maximum of 5 percent of the bank holding company's consolidated capital and surplus in the shares of an export trading company.[184] Such investments are, however, subject to the disapproval of the Board of Governors of the Federal Reserve. Before investing in an ETC, bank holding companies must give the Board sixty days' prior written notice of the proposed investment.[185]

The Board may disapprove of a bank holding company's investment in an export trading company only upon three findings. Firstly, disapproval may be based upon a Board determination that the disapproval is necessary to prevent "unsafe or unsound banking practices, undue concentration of resources, decreased or unfair competition, or conflicts of interest."[186] Secondly, the Board may disapprove when it finds that investment in an export trading company would affect the financial or managerial resources of the bank holding company to the extent that it adversely affects the "safety and soundness" of a subsidiary bank.[187] Thirdly, investment may be disapproved upon the failure of the bank holding company to provide information required by regulation.[188]

Under the terms of the ETCA, both banks and bank holding companies are permitted to extend credit to ETCs. The extension of credit by bank holding companies, including extensions of credit by their subsidiaries, is limited to 10 percent of the bank holding company's consolidated capital and surplus.[189] Such amount does not include any amount invested by a bank holding company in the shares of the ETC itself.[190] Extensions of credit are further limited by the terms of Section 23A of the Federal Reserve Act as amended in 1966.[191] Thus, extensions

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[182] 12 USC § 1843(c)(14)(F)(ii) (1982).

[183] Although ETCs may "engage in or hold shares" of a company engaged in the business of selling, distributing, or underwriting securities in the United States, they may only do so to the same extent that bank holding companies are allowed to do so under state and federal laws. In addition, ETCs are forbidden to engage in any agricultural or manufacturing production processes. They may, however, perform packaging and processing transactions that are incidental to the exportation of goods. 12 USC § 1843(c)(14)(C) (1982).

[184] 12 USC § 1843(c)(14) (1982).

[185] 12 USC § 1843(c)(14)(A)(i) (1982).

[186] 12 USC § 1843(c)(14)(A)(iv)(I) (1982).

[187] 12 USC § 1843(c)(14)(A)(iv)(II) (1982).

[188] 12 USC § 1843(c)(14)(A)(iv)(III) (1982).

[189] 12 USC § 1843(c)(14)(B)(i) (1982).

[190] Id.

[191] 12 USC § 1843(c)(14)(F)(iv) (1982).

of credit include any purchase of securities, assets, or other obligations under a repurchase agreement and the discounting of promissory notes, bills, and so forth.[192]

In addition, bank holding companies are forbidden to extend credit to ETCs on terms more favorable than those available to other similar borrowers under similar circumstances.[193] One exception to this rule, however, is that collateral requirements otherwise applicable to bank holding companies do not apply to extension of credit to ETCs in which the bank holding company has an interest.[194]

The Board may require a bank holding company to terminate its investment in an ETC at any time.[195] Alternatively, the Board may impose limitations or conditions on the continued investment in an ETC.[196] Termination, limitation of activities, or the imposition of conditions on the continued investment in ETCs is dependent on a Board determination that the ETC "has taken positions in commodities or commodity contracts, in securities, or in foreign exchange, other than as may be necessary in the course of export trading company's business or operations."[197]

In addition to bank holding companies, other institutions are allowed to participate in the overall exporting activities of ETCs. Under the ETCA, Edge corporations, which are subsidiaries of a bank holding company, or agreement corporations, which are also subsidiaries of a bank holding company, may invest, directly or indirectly, up to 5 percent of their consolidated capital and surplus.[198] When a corporation is not engaged in banking activities, it may invest up to 25 percent of its consolidated capital and surplus in the voting stock or other evidences of ownership in one or more ETCs.[199]

In addition to Edge Act corporation participation mentioned above, the Export-Import Bank of the United States is authorized by the act to provide loan guarantees on loans extended by financial institutions, public creditors, or private creditors to ETCs.[200] These loans must be secured by export account receivables on inventories of exportable goods.[201] The Export-Import Bank may guarantee loans only when its board of directors believes the private credit

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[192] 12 USC § 371c (1982).

[193] 12 USC § 1843(c)(14)(B)(iii) (1982).

[194] 12 USC §§ 1843(c)(14)(B)(i), 1843(c)(14)(B)(ii) (1982).

[195] 12 USC § 1843(c)(14)(D) (1982).

[196] Id.

[197] Id.

[198] 12 USC § 1843(c)(14)(E) (1982).

[199] Id.

[200] 12 USC § 635a-4 (1982). See generally, "The Bank Export Services Act: Deregulation Floundering in Compromise," 34 Emory LJ 455–505 (1985); Wilson, "The Bank Export Services Act of 1982: How Can It Be Fixed?", 102 Banking LJ 569–593 (1985).

[201] 12 USC § 635a-4 (1982).

market is not providing adequate financing to creditworthy export trading companies and where guarantees would facilitate expansion of exports that would not occur without such guarantees.[202] Under this provision, the board of directors is required to ensure that a major share of any loan guarantee is for the ultimate benefit of small, medium-sized, and minority businesses or agricultural concerns.[203]

A major purpose of the act was to provide antitrust immunity to ETCs. Under Section 303(a) of the ETCA, the Secretary of Commerce is required to issue a certificate of review to an ETC applicant that can establish that its export trade activities meet four criteria. The ETC must demonstrate that its activities (1) will not result in a substantial lessening of competition or a restraint of trade in the United States; (2) will not unreasonably enhance, stabilize, or depress prices within the United States of the goods or services exported; (3) will not constitute an unfair method of competition against competitors engaged in the export of similar goods and services; and (4) will not reasonably be expected to result in the sale for consumption or resale within the United States of the goods exported by the applicant.[204] Upon issuance of a certificate of review, there are substantial limitations on the ability of any person to bring an action against the ETC under the antitrust laws.[205]

¶ 5.03 SAVINGS AND LOAN HOLDING COMPANIES

[1] Regulation of Savings and Loan Holding Companies in General

Savings and loan holding companies, like bank holding companies, are subject to regulation. They must register with the FSLIC and must provide such information as the FSLIC deems necessary.[206] They must file reports with the FSLIC, maintain such records as it may prescribe, and submit to examinations as the FSLIC deems appropriate.[207]

A savings and loan holding company is defined simply to be "any company which directly or indirectly controls an insured institution or controls any other company which is a savings and loan holding company . . . ."[208] The law has

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[202] Id.

[203] Id.

[204] 15 USC § 4013(a) (1982). For a discussion of some of the antitrust problems arising under the Export Trading Company Act, including a discussion of the extent the act affords benefits to banks establishing such affiliates, see 40 Wash. Fin. Rep. (BNA) at 733 (Apr. 4, 1983).

[205] 15 USC § 4016 (1982).

[206] 12 USC § 1730a(b)(1) (1982).

[207] 12 USC § 1730a(b) (1982).

[208] 12 USC § 1730a(a)(1)(D) (1982). An "insured institution" is defined to mean a "Federal savings and loan association, a Federal savings bank, a building and loan,

distinguished between "multiple savings and loan holding companies," which are holding companies that control at least two insured institutions, and unitary savings and loan holding companies, which control no more than one insured institution.[209] The distinction is relevant to the activities allowed for the holding company. Until the enactment of amendments in 1987, as a general rule, the law restricted the activities of multiple savings and loan holding companies but not unitary holding companies.[210] Similarly, the prohibition on interstate location of insured institution subsidiaries has applied only to multiple savings and loan holding companies.[211] See Chapter 6 for a discussion of interstate activities.

Savings and loan holding companies cannot acquire control of or merge with other insured or uninsured institutions without obtaining prior approval from the FSLIC.[212] Similarly, any other company cannot acquire control of one or more insured institutions without the approval of the FSLIC.[213] The statute directs the FSLIC to consider, in deciding whether to give approval, "the financial and managerial resources and future prospects of the company and institution involved, and the convenience and needs of the community to be served . . . ."[214] It forbids the FSLIC from approving an acquisition that would result in a monopoly or have other serious anticompetitive effects that are not outweighed by other public interest considerations.[215]

The insured institutions that are subsidiaries of a savings and loan holding company are also subject to special prohibitions.[216] They may not invest in the securities or obligations of an affiliate company except for certain allowed service companies. They may not engage in transactions with affiliates that involve making a loan or extending credit to an affiliate, except for limited circumstances permitted by the statute and as authorized by the FSLIC. There are limitations on the purchase of securities of an affiliate, use of securities of the

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savings and loan or homestead association or a cooperative bank, the accounts of which are insured by the Federal Savings and Loan Insurance Corporation, and shall include a Federal savings bank the deposits of which are insured by the Federal Deposit Insurance Corporation . . . ." Id. at § 1730a(a)(1)(A). Alternatively, the term "uninsured institutions," by definition, refers to institutions that are "insured institutions," except that they are not insured by the FSLIC and are not a federal savings bank insured by the FDIC. Id. at § 1730a(a)(1)(B).

[209] 12 USC § 1730a(a)(1)(E) (1982).

[210] 12 USC § 1730a(c)(2) (1982).

[211] 12 USC § 1730a(e)(3) (1982).

[212] 12 USC § 1730a(e)(1) (1982).

[213] 12 USC § 1730a(e)(1)(B) (1982).

[214] 12 USC § 1730a(e)(2) (1982).

[215] Id.

[216] 12 USC § 1730a(d) (1982).

affiliate as collateral, and guarantees of the affiliate's debt.[217] Some of these limitations have been affected by the 1987 amendments, as discussed later.

The FSLIC has general regulatory authority over savings and loan holding companies. It may promulgate rules and regulations.[218] It may conduct investigations, take testimony under oath, issue subpoenas, and compel the attendance of witnesses in order to carry out its investigatory responsibilities.[219]

[2] Effect of the Competitive Equality Banking Act of 1987 on Regulation

The 1987 amendments contained in the Competitive Equality Banking Act of 1987 change the scheme for regulating the activities of savings and loan holding companies in important ways. As in the former law, there is a general prohibition against the holding company engaging in an activity or providing a service for an insured institution subsidiary for the purpose or with the effect of evading the laws that apply to the insured thrift subsidiary.[220] There are changes, however, in the types of activities permitted to holding companies.

[a] Regulation of Business Activities of Savings and Loan Holding Companies and Their Noninsured Institution Subsidiaries. The Competitive Equality Banking Act amendments allow savings and loan holding companies and their noninsured thrift institution subsidiaries to engage in the following activities, termed "exempt activities" by the statute. These activities are as follows:[221]

1. Furnishing or performing management services for an insured institution subsidiary;
2. Conducting an insurance agency or escrow business;
3. Holding, managing, or liquidating assets owned or acquired from an insured institution subsidiary;
4. Holding or managing properties used or occupied by an insured institution subsidiary;
5. Acting as trustee under a deed of trust;
6. Activities allowed by the regulations of the FSLIC for multiple savings and loan holding companies to engage in directly as of March 5, 1987;[222] and

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[217] Id.

[218] 12 USC § 1730a(h)(1) (1982).

[219] 12 USC § 1730a(h)(2) (1982).

[220] CEBA § 104, 101 Stat. 552, 567-568 (to be codified at 12 USC § 1730a(c)(1)(A)).

[221] Id. (to be codified at 12 USC § 1730a(c)(2)).

[222] Under the law before the 1987 amendments, the exempt activities listed in the statute included the first five categories shown in the text, as well as other services

7. Other activities that the Board of Governors of the Federal Reserve System has approved by regulation for bank holding companies, subject to any limitation imposed on them by the FSLIC by regulation.

The activities on the Federal Reserve Board's list for bank holding companies are allowed for savings and loan holding companies and their noninsured institution subsidiaries, but only when the FSLIC has given prior approval.[223] Thus, the amendments allow savings and loan holding companies to engage in activities that the Board of Governors allows bank holding companies to engage in, unless the FSLIC determines that the activity should be prohibited or limited for savings and loan holding companies. In deciding whether to grant approval to the savings and loan holding company to engage in the bank holding company approved activities, the FSLIC must apply a test that weighs the costs against the benefits of providing the service. It must consider the following factors:

(i) [W]hether the performance of the activity described in such application by the company or the subsidiary can reasonably be expected to produce benefits to the public (such as greater convenience, increased competition, or gains in efficiency) that outweigh possible adverse effects of such activity (such as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound financial practices);
(ii) the managerial resources of the companies involved; and
(iii) the adequacy of the financial resources, including capital, of the companies involved.[224]

The FSLIC is expressly authorized to distinguish between activities a holding company enters de novo and those it begins by acquiring another firm.[225]

Before the 1987 amendments, the prohibitions on activities of savings and loan holding companies and their subsidiaries applied only to multiple savings and loan holding companies. Following the 1987 changes, the prohibitions apply to all savings and loan holding companies, subject to some major exceptions discussed later. Before turning to the scope of these exceptions, the general prohibitions need to be set forth. Firstly, as indicated previously, there is a general prohibition against using a savings and loan holding company to evade the law pertaining to insured institutions. Secondly, a savings and loan holding company is not allowed to "commence" any activity other than those permitted as "exempt" activities, which are described previously, after the date of the

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approved by the FSLIC as a proper incident to the operations of insured institutions. The FSLIC, by regulation, provided that the holding company and its noninsured institution subsidiaries could engage in those activities allowed for service corporations. 12 CFR §§ 545.74, 584.2(c) (1987).

[223] CEBA § 104 (to be codified at 12 USC § 1730a(c)(4)).

[224] CEBA § 104 (to be codified at 12 USC § 1730a(c)(4)(B)).

[225] CEBA § 104 (to be codified at 12 USC § 1730a(c)(4)(C)).

enactment of the 1987 act, namely, August 10, 1987.[226] Thirdly, the holding company cannot "continue" any activity, other than those qualifying as "exempt," for more than a two-year grace period from the date of enactment of the 1987 act.[227]

These prohibitions are subject to certain qualifications. The 1987 amendments introduce a concept of a qualified thrift lender (QTL). This is an insured thrift institution whose investments in specified housing and related assets equal at least 60 percent of the total tangible assets of the institution.[228] When the savings and loan holding company is a unitary holding company whose thrift institution is a QTL, the prohibitions on commencing or continuing activities, other than those that are "exempt," do not apply.[229] Similarly, when the savings and loan holding company has more than one insured thrift institution subsidiary, but all (or all but one) of those insured institution subsidiaries were acquired pursuant to the emergency acquisition procedures authorized by the statute, the prohibitions on commencing or continuing activities other than the "exempt" activities do not apply as long as all of the insured institution subsidiaries meet the QTL test.[230] Thus, a unitary savings and loan holding company remains free from the restrictions on its business activities as long as its insured thrift subsidiary meets the QTL test, and it can have even more than one insured thrift subsidiary as long as they are acquired under the emergency procedures and they all satisfy the QTL test.[231]

Additionally, there are significant grandfather rights recognized by the 1987 amendments. As mentioned previously, the general rule is that activities other than those qualifying as "exempt" may be continued for a two-year grace period. This grace period does not apply in the case of a company that received approval to control an insured institution between March 5, 1987, and the date of enactment of the 1987 amendments.[232] However, for companies that did acquire control of insured institutions approved before March 5, 1987, those companies may continue to engage in any activity in which the company was lawfully engaged on March 5, 1987.[233] This grandfather privilege, however, can be lost if (1) the company acquires control of a bank or an additional insured institution

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[226] CEBA § 104 (to be codified at 12 USC § 1730a(c)(1)(B)).

[227] CEBA § 104 (to be codified at 12 USC § 1730a(c)(1)(C)). Alternatively, if later in time than the two-year grace period, the activity cannot be continued beyond the date when the company was approved as a savings and loan holding company. Id.

[228] CEBA § 104 (to be codified at 12 USC § 1730a(o)(1)).

[229] CEBA § 104 (to be codified at 12 USC § 1730a(c)(3)(A)).

[230] CEBA § 104 (to be codified at 12 USC § 1730(a)(c)(3)(B)).

[231] See H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess. 135, reprinted in 1987 U.S. Code Cong. & Ad. News 604 (hereinafter H.R. Conf. Rep. No. 261).

[232] CEBA § 104 (to be codified at 12 USC § 1730a(c)(6)(A)).

[233] CEBA § 104 (to be codified at 12 USC § 1730a(c)(6)(B)).

(other than through the emergency acquisition procedures); (2) any of its insured institution subsidiaries fail to qualify as a domestic building and loan association under the Internal Revenue Code; (3) the company engages in activities not permitted as "exempt," other than those in which it was engaged on March 5, 1987; (4) any of its insured institution subsidiaries increase the locations from which they conduct business after March 5, 1987 (other than increases under the emergency acquisition procedures); or (5) any insured institution subsidiary allows an overdraft in its Federal Reserve account on behalf of an affiliate.[234] Additionally, the FSLIC has a general authority to order the termination of an activity to prevent "conflicts of interest or unsound practices" or to protect the public interest.[235]

[b] Regulation of Relationships Between Insured Institution Subsidiaries and Affiliate Companies. The 1987 amendments to the Bank Holding Company Act revise the regulatory scheme governing the relationship between insured thrift subsidiaries of savings and loan holding companies and affiliate companies. As long as the subsidiary of the holding company engages only in those "exempt" activities that are permissible for bank holding companies, the restrictions on transactions between insured institution subsidiaries and affiliates, with respect to loans, credit transactions, investment in securities, and so forth, which restrictions were discussed previously, will not apply, and the applicable rules will be those governing transactions between bank subsidiaries of a bank holding company and affiliate companies.[236] The purpose of this measure is to create a parity between bank holding companies and savings and loan holding companies as to activities between their insured institution subsidiaries and affiliate companies.[237]

The 1987 amendments also establish cross-marketing restrictions, similar to those imposed on bank holding companies, to foreclose use of an insured institution to market products or services of an affiliate that is engaged in business activities other than those allowed under the act. Likewise, the insured institution cannot market its services through the affiliate if the latter is engaged in business activities other than those allowed under the act. As with the bank holding company provision, there is an exception for savings and loan holding companies that allows them to continue marketing arrangements that were in effect on March 5, 1987, as long as such arrangements are continued in the same manner as they were conducted on that date.[238] The cross-marketing restrictions

[234] CEBA § 104 (to be codified at 12 USC § 1730a(c)(6)(C)).

[235] CEBA § 104 (to be codified at 12 USC § 1730a(c)(6)(D)).

[236] CEBA § 104 (to be codified at 12 USC § 1730a(p)(1)).

[237] H.R. Conf. Rep. No. 261, supra note 231, at 138.

[238] CEBA § 104 (to be codified at 12 USC § 1730a(p)(2)).

apply to the insured institution subsidiaries of a "diversified savings and loan holding company."[239]

[c] Extension of Tying Prohibitions to State-Chartered Insured Institutions. The 1987 amendments extend the prohibitions on tying arrangements to state-chartered insured institutions that are subsidiaries of savings and loan holding companies.[240] Formerly, these restrictions applied only to federal thrift institutions. The restrictions on "tying" extend only "with respect to products and services offered by the thrift subsidiary."[241]

[d] Interstate Activities. The 1987 changes also affect the provisions dealing with interstate activities of savings and loan holding companies. The amendments conform these restrictions more closely to those applicable to bank holding companies. The FSLIC may not approve an acquisition by a savings and loan holding company if it will result in "a multiple savings and loan holding company controlling insured institutions in more than one State . . ."[242] There are three exceptions to these restrictions; there may be interstate combinations when (1) the acquisition is pursuant to the emergency acquisition powers of the Act; (2) the holding company controls an insured institution subsidiary that has its home office or a branch office in the state as of March 5, 1987; or (3) the laws of the state governing state-chartered institutions "specifically authorize such an acquisition (for state institutions) by language to that effect and not merely by implication."[243] Thus, the laws on interstate activities of savings and loan holding companies are similar to the restrictions on bank holding companies under the Douglas amendment to the Bank Holding Company Act. The interstate banking limitations are discussed in Chapter 6.

[e] Affiliations With Securities Firms. Further, the 1987 amendments affect the regulation of affiliations between securities firms and insured institutions. They extend the prohibitions in Sections 20 and 32 of the Glass-Steagall Act against affiliations between member banks and firms "engaged principally" in securities activities and against certain interlocking management arrangements so that they now also prohibit such relationships between insured institutions

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[239] Id. A diversified savings and loan holding company is one whose insured institution and related activities comprise less than 50 percent of its consolidated net worth and its consolidated net earnings. 12 USC § 1730a(1)(F) (1982).

[240] CEBA § 104 (to be codified at 12 USC § 1730a(1)).

[241] H.R. Conf. Rep. No. 261, supra note 231, at 139. The tying provisions are discussed at ¶ 9.02.

[242] CEBA § 104 (to be codified at 12 USC § 1730a(e)(3)).

[243] Id.

and securities firms.[244] As with the provisions for bank holding companies, this measure was set to expire on March 1, 1988. Special exemptions exist for activities involving insured institutions in certain specified real estate related securities or partnerships and insurance activities.[245]

[f] Treatment of FDIC-Insured State Savings Banks as Insured Institutions for Regulation as Subsidiaries of a Savings and Loan Holding Company. State savings banks and cooperative banks are entitled to be treated as insured institutions under the savings and loan holding company provisions, whether they are uninsured or insured by the FDIC.[246] They must apply to the FSLIC for this recognition. To qualify, institutions must meet the standards established for QTLs. By qualifying for this treatment, the savings and loan holding company rules will apply to these institutions when they are part of a holding company structure, rather than the bank holding company rules.[247]

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[244] CEBA § 106 (to be codified at 12 USC § 1730a(r)).

[245] Id. The moratorium is discussed at ¶¶ 5.02[3][a], 5.02[3][b].

[246] CEBA § 104 (amending 12 USC § 1730a(n)).

[247] See H.R. Conf. Rep. No. 261, supra note 231. Of course, for treatment as a savings and loan holding company, the holding company must not otherwise fall within the bank holding company rules by controlling a bank as defined in the Bank Holding Company Act.

6

Regulation of Bank Expansion Through Branching and Interstate Banking

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¶ 6.01 BRANCH BANKING

Although a complex set of legal restrictions has inhibited the ability of banks to expand their operations territorially by establishing multiple offices in different locations, the barriers have proven ineffective. Large networks of banks operate across state boundaries, through affiliates and subsidiaries, as a result of gaps and exceptions in the laws. Additionally, the advent of electronic technology has allowed banking to occur through banking communication terminals, enabling customers to conduct banking transactions at locations far removed from customers' home bank offices. This chapter discusses the body of federal law that regulates the territorial expansion of banking activities. Because this legal framework has become out of step with the realities of the marketplace, there have been numerous calls for reform.[1] Substantial changes in the law can be expected in the future.

"Branch banking" is defined as a single bank's conducting its business at a number of different offices located in the same or different cities, states, or nations. "Branch banking" generally refers to arrangements for the creation of different offices of a bank that is one legal entity. It does not usually refer to arrangements by which separate bank organizations are affiliated through stock ownership or other control devices. Such arrangements create bank holding companies.[2] Under federal law, the basic constraints on bank expansion are those limiting the establishment of bank branches, both intrastate and interstate, and restrictions on bank holding company acquisitions across state lines.[3] These topics are addressed in the following text.

[1] Definition of "Branch"

Federal law defines a bank "branch" to include "any branch bank, branch office, branch agency, additional office, or any branch place of business located

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[1] In 1981, a report prepared by the Carter administration concluded, "Whatever their benefits in an earlier era, the administration regards existing geographic limitations [on banking] as anachronistic in the competitive marketplace of the 1980s." "Geographic Restriction On Commercial Banking in the United States: The Report of the President" (Jan. 1981). See generally Conover, "Interstate Banking: Bring Down the Walls," 4 Ann. Rev. Banking 115–121 (1985).

[2] The ability of bank holding companies to operate multistate affiliates is discussed infra ¶ 6.02.

[3] See generally Collins, "Interstate Banking: Where the Law Stands Now," 4 Ann. Rev. Banking L. 95–102 (1985); Friedli, "Changing Times in Interstate Banking Law," 1986 Colum. Bus. L. Rev. 97–113 (1986); Ginsburg, "The Future of Interstate Banking," 1984–1985 Corp. Prac. Commentator 469–486; Glidden, "Legal Constraints on Bank Expansion: Can They Be Removed Without Destroying the Dual Banking System?", 1980 U. Ill. LF 369; Gray, "The Interstate Banking Diversion: Are More Serious Issues Being Ignored?", 4 Ann. Rev. Banking L. 123–133 (1985); Note, "Banking Law; Developments in Interstate Branching," 1985 Ann. Surv. Am. L. 113–136 (1985).

in any state or territory of the United States or in the District of Columbia *at which deposits are received, or checks paid, or money lent*."[4] If a bank office is designated a "branch," the extent to which national banks and Federal Reserve member banks may establish such an office is restricted by federal law.[5] If the office escapes classification as a "branch," the locational limitations and approval requirements for bank "branches" do not apply.

The U.S. Supreme Court has held that the primary purpose of the branch banking law is to promote competitive equality between state banks and national banks.[6] In recognition of this purpose, the courts have liberally construed the definition of "branch." For example, notwithstanding the explicit statutory language classifying a branch according to its deposit-lending or check-paying activities, it has been held that an off-premises trust operation involving neither of these activities is a branch and as such is forbidden to national banks unless authorized by state law.[7]

In another case, the Supreme Court held that an armored car picking up customers' deposits was a branch.[8] Drive-in facilities also have provoked con-

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[4] 12 USC § 36(f) (1982) (emphasis added). This definition applies to national banks. Under 12 USC § 321 (1982), state banks that are members of the Federal Reserve System are subject to the same branching controls as national banks. A similar definition of "branch" exists for the purposes of regulating state nonmember banks insured by the Federal Deposit Insurance Corporation. 12 USC § 1813(o) (1982).

[5] The restrictions by federal law on the extent to which national banks and member banks may branch are discussed infra ¶ 6.01[2].

[6] First Nat'l Bank v. Dickinson, 396 US 122 (1969); First Nat'l Bank v. Walker Bank & Trust Co., 385 US 252 (1966).

[7] St. Louis County Nat'l Bank v. Mercantile Trust Co., 548 F2d 716 (8th Cir. 1976), cert. denied, 433 US 909 (1977). The comptroller has indicated disapproval of the *St. Louis County Nat'l Bank* case. See Clarke v. Securities Indus. Ass'n, 107 S. Ct. 750 (1987). Loan offices have been problems. See State ex rel. Leonard v. American Nat'l Bank & Trust Co., No. CIV-78-0304-E, slip op. (WD Okla., July 28, 1978) (an office that took loan applications but did not lend funds was held to constitute a branch). A comptroller interpretation states that a loan production office may not both originate and approve loans at its office without being a "branch." Further, the office cannot escape classification as a branch by forwarding loans to the bank's main office for perfunctory approval and disbursement of funds after the lending decision has already been made by the loan production office. Comptroller of the Currency, Banking Circular No. 199 (May 23, 1985) (clarifying Ruling 7.7380, 12 CFR § 7.7380), reprinted in 1 Fed. Banking L. Rep. (CCH) ¶ 3168A (1985). However, a loan production office is not to be classified as a bank "branch" when the following four factors are present: (1) customers have no direct contact with the loan production office, but obtain information, file loan applications, and receive loan funds from the regular offices of the bank; (2) loan disbursement occurs from the bank's regular branch and main offices; (3) loans are originated and solicited by the regular offices of the bank; and (4) the loan production office exists mainly to improve the efficiency of bank loan operations and not to compete for customers. Comptroller of the Currency, Interpretive Letter No. 343 (May 24, 1985), 4 Quarterly J. No. 4 at 47 (1985).

[8] First Nat'l Bank v. Dickinson, 396 US 122 (1969). See generally Annotation, "What Is a 'Branch' Under 12 U.S.C.S. § 36(f) Which a National Banking Association May

siderable litigation.[9] Another area of controversy has been the customer bank communications terminals (CBCTs) located off bank premises. At one point, the Comptroller of the Currency ruled that a terminal established in accordance with his regulations did not constitute a branch.[10] This ruling provoked a number of lawsuits and led to a court decision that national banks must comply with the branch banking laws in establishing computer-linked terminals that allow bank customers to withdraw cash from their accounts, transfer funds, and make credit purchases.[11]

The Supreme Court revisited the question of what constitutes a "branch" in *Clarke v. Securities Industry Association.*[12] The Comptroller of the Currency authorized Union Planters National Bank and Security Pacific National Bank to open offices to conduct discount brokerage services. These offices were not to be limited to the main offices and branch offices of the banks, but, rather, would be located at places both inside and outside of the home states of the two banks. The comptroller took a narrow view of the definition of "branch." He ruled that the discount brokerage offices were not in violation of the federal branch banking prohibitions, because they would not be engaging in any one of the three functions specifically enumerated in 12 USC § 36(f). The Securities Industry Association challenged the comptroller's action, contending that federal legislation requires national banks to engage in their discount brokerage activities only at their main offices or at authorized branches, because legislation stipulates that "the general business of each national banking association shall be transacted in the place specified in its organization certificate and in the branch or branches, if

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Establish, or Operate," 52 ALR Fed. 649 (1981); Annot., "What Is a 'Branch Bank' Within Statutes Regulating the Establishment of Branch Banks," 23 ALR3d 683 (1969).

[9] See Virginia ex rel. State Corp. Comm'n v. Farmers & Merchants Nat'l Bank, 515 F2d 154 (4th Cir.) cert. denied, 423 US 869 (1975) (drive-in facility, physically separated from branch bank, not a "branch"); Dakota Nat'l Bank & Trust Co. v. First Nat'l Bank & Trust Co., 554 F2d 345 (8th Cir.), cert. denied, 434 US 877 (1977) (freestanding auto bank, located two blocks from main bank, is a "branch").

[10] See 40 Fed. Reg. 21,700, 21,704 (1975) (amending 12 CFR § 7.7491).

[11] Independent Bankers Ass'n of America v. Smith, 534 F2d 921 (DC Cir.) aff'g 402 F. Supp. 207 (DDC 1975); cert. denied, 429 US 862 (1976). See also Illinois ex rel. Lignoul v. Continental Ill. Bank & Trust Co., 409 F. Supp. 1167 (ND Ill. 1975), aff'd in part and rev'd in part, 536 F2d 176 (7th Cir.), cert. denied, 429 US 871 (1976); Missouri ex rel. Kostman v. First Nat'l Bank, 405 F. Supp. 733 (ED Mo. 1975), aff'd per curiam, 538 F2d 219 (8th Cir.) cert. denied, 429 US 941 (1976). Other decisions holding that an off-premises ATM constitutes a branch are Colorado ex rel. State Banking Bd. v. First Nat'l Bank, 540 F2d 497 (10th Cir. 1976), cert. denied, 429 US 1091 (1977); but see Oklahoma ex rel. State Banking Bd. v. Bank of Okla., 409 F. Supp. 71 (ND Okla. 1975). For an extensive discussion of the issue, see *N. Penney & D. Baker, The Law of Electronic Fund* Transfer Systems ¶ 22.01 (1980 & Supp. 1987). See the discussion of ATM activities in ¶ 6.03 of this chapter.

[12] 107 S. Ct. 750 (1987).

any, established" in accordance with federal bank branching law.[13] The court of appeals agreed.

The Supreme Court held that the brokerage offices were not branches of the banks. Relying on the legislative history of the McFadden Act (discussed in the following text) the Court unanimously concluded (Justice Scalia not participating) that the phrase "general business of each national banking association" did not "encompass all the business in which the bank engages, but . . . can plausibly be read to cover only those activities that are part of the bank's core banking functions." Although federal legislation specifically authorizes national banks to engage in securities activities, subject to restrictions, the Court declined to interpret the "general business" of the national banks as necessarily including all the activities specifically authorized to national banks when the issue at hand was the locational constraints imposed on such activities by the McFadden Act.[14]

The Court then turned to its prior decision in *First National Bank v. Dickinson*,[15] in which it had interpreted the McFadden Act as establishing a policy of competitive equality between state and national banks, and so found that its decision freeing discount brokerage operations from the constraints of the branching limitations did not offend the "competitive equality principle." As the Court said:

> The Comptroller reasonably interprets the statute as requiring 'competitive equality' only in core banking functions, and not in all incidental services in which national banks are authorized to engage. We are not faced today with the need to decide whether there are core banking functions beyond those explicitly enumerated in § 36(f); it suffices, to decide this case, to hold that the operation of a discount brokerage service is not a core banking function.[16]

Thus, the definition of "core banking function" is left for another day. Neither the specific authorization of an activity in the statute nor the absence of its enumeration will be conclusive as to whether that activity is a core banking function. The Court was invited by the comptroller to define "branch" as an office in which one of the statutory activities of receiving deposits, paying checks, or lending money took place, but the Court studiously avoided any opportunity to embrace or reject the comptroller's interpretation.[17]

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[13] 12 USC § 81 (1982).

[14] 107 S. Ct. at 760.

[15] 396 US 122 (1969).

[16] 107 S. Ct. at 762 (footnotes omitted).

[17] Violation of the prohibition in the National Bank Act against conducting the business of a national bank at places outside the bank's authorized locations will not necessarily make such transactions void. See Rainier Nat'l Bank v. Schnurr, [1981–1982] Fed. Banking L. Rep. (CCH) ¶ 99,015 (Wash. Super. Ct., Apr. 9, 1981), holding that

[2] Establishing New Branches—The McFadden Act

To promote competitive equality between federal and state banks, federal law generally permits a bank to establish a branch only when it would be expressly permitted for state banks by state law.[18] The comptroller regulates the establishment of branches by national banks.[19] The Board of Governors controls the establishment of branches by state member banks.[20] The Federal Deposit Insurance Corporation approves the creation of branch offices by state non-member insured banks.[21] If a branch is created by merger or consolidation of one bank with another, the law on who is the approving authority and when approval may be given is more complex. In general, the philosophy of the federal law is to defer to the state law in order to maintain competitive equality in the banking system.

The basic federal law restricting the establishment of branches of national banks dates back to the McFadden Act of 1927.[22] Under this law, special provisions exist to govern the continuation of branch offices after banks have been converted or consolidated into a national bank. Grandfather rights exist for certain branches in existence in 1927 when the McFadden Act was enacted. Also provided for in the law are certain other special circumstances, such as the establishment of seasonal banking agencies and other situations. The basic provision of the McFadden Act is as follows:

> A national banking association may, with the approval of the Comptroller of the Currency, establish and operate new branches: (1) Within the limits of the City, town or village in which said association is situated, if such establishment and operation are at the time expressly authorized to State banks by the law of the State in question; and (2) at any point within the State in which said association is situated, if such establishment and operation are at the time authorized to State banks by the Statute law of the State in question by language specifically granting such authority affirmatively and not merely by implication or recognition, and subject to the restrictions as to location imposed by the law of the State on State banks.[23]

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persons who were obligated to a national bank under promissory notes and security documents prepared and executed at an unauthorized location did not have a private right of action to rescind the transaction.

[18] 12 USC §§ 36(c), 321, 1828(d)(1) (1982).

[19] Id.

[20] Id. It also has authority over the creation of branches in foreign countries. See generally ¶ 3.03.

[21] 12 USC § 1828(d)(1) (1982).

[22] Act of Feb. 25, 1927, 44 Stat. 1224. See generally Regan, "Circumventing the McFadden Act: The Comptroller of the Currency's Efforts to Broaden the Branching Capabilities of National Banks," 72 Ky. LJ. 707–726 (1983–1984); Note, "Interstate Banking Restrictions Under the McFadden Act," 72 Va. L. Rev. 1119–1153 (1986).

[23] 12 USC § 36(c) (1982).

Thus, the statute produces an interplay of federal and state law. Federal law determines when an office of a bank constitutes a branch, as discussed previously. However, once federal law recognizes the existence of a branch, state policies on branching control.

The provisions of the McFadden Act contain two parts. Firstly, the act permits branching within the limits of the city in which the national bank is "situated," if the law of the State "expressly authorizes" state banks to establish and operate[24] such branches.[25] Secondly, a national bank is permitted to branch throughout the state in which it is situated when "such establishment and operation are at the time authorized to State banks by the statute law of the State in question by language specifically granting such authority affirmatively and not merely by implication or recognition . . . ." This second situation requires determinations that (1) state banks have such authority and (2) the state statute law specifically grants the authority.[26] For the purposes of the act, the term "state bank" encompasses "trust companies, savings banks, or other such corporations or institutions carrying on the banking business under the authority of State laws."[27] Given this federal definition, the question as to which depository institutions within a state are to be regarded as "banks" cannot be decided by state law. National banks are entitled to branch to the extent that the state expressly allows its state banks to branch, regardless of the name the state uses to identify its banks. Under this provision of federal law, the Fifth Circuit upheld a decision by the Comptroller of the Currency allowing national banks in Mississippi to operate branches statewide, because the state law permitted state savings

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[24] This law also has been applied to the acquisition of an existing branch of another bank through an exchange of branches (Washington ex rel. Edwards v. Heiman, 633 F2d 886 (9th Cir. 1980)) and to the relocation of an old branch to a new location (Mutschler v. Peoples Nat'l Bank, 607 F2d 274 (9th Cir. 1979)). See also Marion Nat'l Bank v. Van Buren Bank, 418 F2d 121 (7th Cir. 1969); cf. Ramapo Bank v. Camp, 425 F2d 333 (3d Cir.), cert. denied, 400 US 828 (1970).

[25] See American Fidelity Bank & Trust Co. v. Heimann, 683 F2d 999 (6th Cir. 1982), where the comptroller authorized the establishment of a branch in the city where the bank was situated, although the area of the city where the branch would be placed was in a different county than the county where the main bank was located. The court declined to follow a state administrative opinion interpreting the state branching law, because it did not represent a consistently applied administrative opinion. For the recognition given to state administrative interpretation, also see Washington ex rel. Edwards v. Heimann, 633 F2d 886 (9th Cir. 1980), where the court made clear that interpretations of the state law by the state banking agency or administrator did not bind the comptroller; First Nat'l Bank of Fairbanks v. Camp, 465 F2d 586 (DC Cir. 1972), cert. denied, 409 US 1124 (1973).

[26] This requires the federal court as a matter of federal law to decide when the state statute is sufficiently explicit. See also the cases on the role of state administrative interpretations cited supra note 25.

[27] 12 USC § 36(h) (1982).

associations to branch to this extent although it denied such branching powers to state banks.[28]

Also, under the act, national banks that establish branches must satisfy capital requirements. Except for certain seasonal banking agencies, a national bank that establishes a branch outside of its home city must have a "combined capital stock and surplus equal to the combined amount of capital stock and surplus" required by the law of the state in which the national bank is situated for branches of state banks, or a minimum capital stock equal to that required for the establishment of branches by state banks if the state law requires a minimum amount.[29]

The federal act does not permit national banks to establish branches outside of the state in which the national bank is located.[30] However, the bank may be able to operate in common control with an affiliate institution under a holding company structure.[31]

State banks that become members of the Federal Reserve System are subject to similar constraints as those imposed by the McFadden Act. The federal statutes applicable to state member banks provide that no state bank may hold stock in a Federal Reserve bank (as required for membership) "except upon relinquishment of any branch or branches established after February 25, 1927, beyond the limits of the city, town, or village in which the parent bank is situated . . . ."[32] However, as the statute continues, this shall not prevent "any State member bank from establishing and operating branches . . . on the same terms and conditions and subject to the same limitations and restrictions as are applicable to the establishment of branches by national banks . . . ," except that the Board of Governors rather than the comptroller must give approval.[33] When a state nonmember bank that is insured by the FDIC is involved, the FDIC by statute must approve the relocation of branches or the establishment of new branches.[34] In doing so, the FDIC is required to consider the same factors that it must weigh in approving the applications of state banks for federal deposit insurance,[35] but the statute that applies to the FDIC's approval does not contain the locational constraints of the federal laws on national banks and state mem-

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[28] Department of Banking and Consumer Fin. v. Clarke, 809 F2d 266 (5th Cir.), cert. denied, 107 US 3240 (1987). The types of state laws regulating branching and interstate banking are discussed at ¶ 6.01[3].

[29] 12 USC § 36(c) (1982).

[30] 12 USC § 36 (1982).

[31] Interstate expansion by bank holding companies is discussed infra ¶ 6.02.

[32] 12 USC § 321 (1982).

[33] Id. It also provides that the Board of Governors must give approval to the establishment of any new branch within the limits of the city, town, or village where the parent bank is situated. Id.

[34] 12 USC § 1828(d) (1982).

[35] 12 USC §§ 1816, 1828(d) (1982).

ber banks. In the case of state nonmember FDIC-insured banks, however, the state chartering authority controls the extent to which the bank may establish new branches, so there is no concern, as there is with national banks, of a competitive advantage being obtained by national banks engaging in branching to a greater extent than state law allows their state bank counterparts.

Because branch banking is regarded as the creation of multiple offices by a single legal entity, it is not generally viewed as "chain banking." The comptroller has defined "chain banking" as "the form of banking structure in which two or more independently chartered banks are controlled either directly or indirectly by the same individual, family or group of individuals closely associated in their business dealings." Bank holding companies too are not usually thought of as being part of a chain banking structure, unless they are "linked to other banking organizations through common control."[36] Just as the branching restrictions of the McFadden Act do not necessarily reach chain banking arrangements, neither do the similar restrictions of the Douglas amendment to the Bank Holding Company Act apply to chain banking structures that do not qualify as holding companies. However, the comptroller has indicated that he will monitor chain banking arrangements involving a national bank, because such arrangements have the "potential for unsafe and unsound banking practices to impact more than one institution in the chain group."[37]

[3] State Regulation of Bank Branching

A great variety of regulatory schemes exist for branch banking among the states. While some states permit statewide branch banking,[38] others permit branching only within designated areas. Still others prohibit branching entirely.[39] Many states have special legislation addressing automated teller

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[36] Comptroller of the Currency, Examining Circular No. 233 (July 22, 1985), reprinted in 1 Fed. Banking L. Rep. (CCH) ¶ 3197 (1986).

[37] Id. It has been reported that few state laws limit the use of chain banking arrangements. 1 Fed. Banking L. Rep. (CCH) ¶ 3103 (1987).

[38] The various state laws are thoroughly surveyed in N. Penney & D. Baker, The Law of Electronic Fund Transfer Systems ¶ 22.01[2] (1980 & D. Baker & R. Brandel Supp. 1987). See generally Hawke, Jr., "Can Interstate Banking Be Left to the States?", 4 Ann. Rev. Banking L. 103–113 (1985).

[39] One authority reports the following breakdown among the states in these three categories. It lists twenty-four states that permit statewide branching: Alaska, Arizona, California, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Idaho, Maine, Maryland, New Jersey, Nevada, New York, North Carolina, Oregon, Rhode Island, South Carolina, South Dakota, Utah, Vermont, Virginia, Washington, and West Virginia. It lists seventeen states that allow branching within limited areas; Arkansas, Georgia, Indiana, Iowa, Kentucky, Louisiana, Massachusetts, Michigan, Minnesota, Nebraska, New Hampshire, New Mexico, Ohio, Oklahoma, Pennsylvania, Tennessee, and Wisconsin. It lists eight states that prohibit branching: Colorado, Illinois, Kansas, Missouri, Montana,

machines and other electronic fund transfer facilities. This legislation may or may not treat such facilities as branches. Often the state law governing the placement of electronic terminals by banks and other depository institutions authorizes their location over a broader geographic area than allowed within the same state for traditional bank branches. A number of states specifically authorize banks in their states to establish interstate terminals, and some authorize banks outside of their states to locate terminals within the states.[40] Thus, the laws of the states on this subject are varied and complex. In determining the law of a particular state, careful attention must be paid to the specific provisions of that state's law. In addition, administrative interpretations as well as judicial opinions must be reviewed.

State law has become even more complex as states have enacted special legislation in anticipation of large-scale interstate banking. With the approval by the U.S. Supreme Court of state laws allowing interstate banking on a regional basis, a number of states have adopted laws allowing limited interstate banking in designated regions. Additionally, some of these statutes provide expiration or "trigger" dates for the regional limitations, after which time the state will be open to interstate banking on a national scale. Moreover, states vary as to whether de novo entry by out-of-state banking enterprises is allowed or only the acquisition of existing depository institutions. Some states have laws allowing greater than normal authority for out-of-state banking companies to acquire failing or weak financial institutions within the state.[41]

¶ 6.02 INTERSTATE BANK EXPANSION BY BANK HOLDING COMPANIES

[1] The Douglas Amendment

Under the McFadden Act, discussed in the previous section, national banks and Federal Reserve member banks may establish branches only to the extent that state banks are permitted to branch, and they may not establish branches beyond the boundaries of the state in which they are located.[42] The Douglas amendment to the Bank Holding Company Act was enacted by Congress to prevent evasion of the McFadden Act by national and Federal Reserve member banks, who might seek to escape the provisions of the act by organizing in the form of a bank holding company with affiliates in different states. Under the

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North Dakota, Texas, and West Virginia. N. Penney & D. Baker, supra n. 38 at ¶ 22.01[2] (D. Baker & R. Brandel Supp. 1987).

[40] The authoritative treatment of this subject is N. Penney & D. Baker, supra note 38.

[41] See generally Victor L. Saulsbury, "Interstate Banking—An Update," Regulatory Rev. (July 1986), summarized in 1 Fed. Banking L. Rep. (CCH) ¶ 3106 (1986).

[42] 12 USC § 36 (1982).

Douglas amendment,[43] a bank holding company is constrained from acquiring a bank in a state beyond the holding company's home state unless state law (of the state in which the bank to be acquired is located) permits it. Under this law, the Board of Governors of the Federal Reserve System may not approve a bank holding company application for the acquisition of control of

> any additional bank located outside of the State in which the operations of such bank holding company's banking subsidiaries were principally conducted on July 1, 1966, or the date on which such company became a bank holding company, whichever is later, unless the acquisition of such shares or assets of a State bank by an out-of-State bank holding company is specifically authorized by the statute laws of the State in which such bank is located, by language to that effect and not merely by implication. For the purposes of this section, the State in which the operations of a bank holding company's subsidiaries are principally conducted is that State in which total deposits of all such banking subsidiaries are largest.[44]

As with the McFadden Act, the Douglas amendment requires that the state law in question specifically authorize interstate expansion by "language to that effect and not merely by implication."[45] The Douglas amendment applies to any application of a bank holding company or subsidiary "to acquire, directly or indirectly, any voting shares of, interest in, or all or substantially all of the assets of any additional bank . . . ."[46] It does not apply to the acquisition of *nonvoting* shares of other bank holding companies or banks, although the Federal Reserve Board has issued a policy statement cautioning against some types of arrangements, which, in the Board's view, would violate the Bank Holding Company Act.[47]

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[43] 12 USC § 1842(d) (1982).

[44] 12 USC § 1842(d) (1982).

[45] See Girard Bank v. Board of Governors, 748 F2d 838 (3d Cir. 1984), where the court concluded that the statutory language was too "ambiguous" to find specific authorization therein. 748 F2d at 844. See also Application of First Bank Sys., Inc., 70 Fed. Reserve Bull. 771 (1984), where the Federal Reserve Board decided this requirement was not met. A holding company whose principal operations were in Minnesota proposed to acquire a Utah bank through the formation of an intermediary holding company called Montana First. Under Utah law, the Utah bank commissioner could approve acquisitions involving bank holding companies within a region consisting of eleven western states. The Minnesota holding company was not within the region, but the Montana First company would have been. The Board ruled that the language of the Utah statute did not specifically authorize the acquisition.

[46] 12 USC § 1842(d) (1982). In Independent Community Bankers Ass'n v. Board of Governors, 820 F2d 428 (DC Cir. 1987), the court rejected an argument that a bank holding company had no authority under this provision to acquire an out-of-state *national* bank.

[47] 12 CFR § 225.143 (1987).

The Douglas amendment, as worded, places a limitation on the Board of Governors' authority to approve applications to acquire banks under the provisions of Section 3 of the Bank Holding Company Act.[48] This is significant substantively as well as procedurally, because it leads to the conclusion that transactions not requiring Board approval under Section 3 of the act are not within the prohibitions contained in the Douglas amendment against interstate banking activity. For example, acquisition of less than 5 percent of the voting shares of a bank does not require Board approval.[49] Similarly, because Section 3 of the act does not expressly require Board approval when a bank subsidiary of a holding company merges with another bank by acquiring the assets of the other bank, it has been said that the Douglas amendment principles will not apply.[50]

Neither does the Douglas amendment state whether the relocation of the main office of a bank holding company subsidiary bank to another state is subject to its restrictions. However, the Federal Reserve Board has interpreted the statute to apply in such circumstances.[51] Reasoning that since its approval is required for a bank holding company to acquire a subsidiary bank located in a state outside of the holding company's home state (a requirement established by Congress to make national banks adhere to state policies on interstate banking), the Board takes the position that it would be contrary to the purpose of the Douglas amendment to allow a bank holding company to evade the statute's

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[48] 12 USC § 1842(d) (1982) states "no application . . . shall be approved under this section. . . ."

[49] 12 USC § 1842(a) (1982). See generally the discussion of bank holding company regulation in Chapter 5.

[50] 12 USC § 1842(a)(4) (1982) says Board approval is needed "for any bank holding company or subsidiary thereof, *other than a bank*, to acquire all or substantially all of the assets of a bank . . . ." (emphasis added.) When a bank subsidiary makes an acquisition of the assets of another bank, the section does not apply, although other provisions of law regulating mergers may require approval by the other appropriate banking regulatory agency. The Board concluded in 1958 that this undermined the purposes of the Douglas amendment, but the Board's recommended amendment to delete the words "other than a bank" from the statute was not implemented by Congress. 44 Fed. Reserve Bull. 776, 787–789 (1958). In Girard Bank v. Board of Governors, 748 F2d 838 (3d Cir. 1984), the court acknowledged the existence of a "bank merger" exception in Section 1842(a)(4). Because the court held that the Board had jurisdiction over the merger under Section 1842(a)(3), the case did not have to address the possible nonapplicability of the Douglas Amendment Section 1842(d).

[51] 12 CFR § 225.144 (1987). The regulation states:

> The retention by a bank holding company of control of a bank after its relocation outside of the holding company's home state, while simultaneously controlling a bank in its home state, creates a multi-state bank holding company, and, in the Board's view, is inconsistent with, and constitutes an evasion of, the terms and intent of the BHC Act that a bank holding company not expand its banking operations outside its home state without the express approval of the other state.

Id. § 225.144(a).

limitations so easily by acquiring a bank in the holding company's home state and then moving its main office to a new location in another state without Board approval.

In *Girard Bank v. Board of Governors*,[52] the court was called upon to consider where a bank holding company was located. Mellon owned Girard, a Pennsylvania bank. The comptroller approved the merger of Girard with Heritage Bank of New Jersey. Heritage had ninety branches in New Jersey and one in Pennsylvania, but was exempt from the restrictions of the McFadden Act because of grandfather rights. The merger plan called for Mellon to end up with control of Heritage Bank. The Board blocked the consolidation, ruling that Heritage was located outside of Pennsylvania, notwithstanding its one branch in Pennsylvania, and therefore the limitations of the Douglas amendment applied. The court upheld the Board's ruling, reasoning that in light of Heritage's substantial activities in New Jersey, it clearly was located in New Jersey. Furthermore, even if Heritage might be viewed as being located in both New Jersey and Pennsylvania because of its single branch in Pennsylvania, the Board was correct in interpreting the Douglas amendment to mean that the bank was "located outside" of Pennsylvania, and therefore the Douglas amendment required that the state laws of New Jersey had to specifically authorize the transaction. The result left a curious juxtaposition of the McFadden Act and the Douglas amendment. The comptroller had given approval to the merger under the McFadden Act but the Board found a violation of the Douglas amendment. The court concluded that even if the two provisions were to be construed in harmony, it would still be persuaded by the Board's interpretation.[53]

According to a 1986 Federal Reserve Board decision, application of the Douglas amendment to mergers may depend on which of the merger partners is the surviving corporation. In the case at hand, the Board approved a merger of two bank holding companies located in Missouri. General Banc Shares was a holding company with two Missouri banks, nine Illinois banks, and one Tennessee bank. General was authorized to retain the Illinois and Tennessee banks because of grandfather rights under the Douglas amendment and specific legislation in Illinois and Tennessee. The other holding company, Boatmen's Banc Shares, was the larger organization but had banks located only in Missouri. The Douglas amendment forbade Boatmen's from acquiring General, because that would result in Boatmen's acquisition of subsidiary banks in Illinois and Tennessee. To avoid this, the merger was structured as an acquisition by General of Boatmen's. The Board approved this arrangement, notwithstanding its prior decision that substance rather than the form of the transaction would control when a violation of the Douglas amendment occurred. Illinois and Tennessee regulatory officials had advised the Board that the proposed acquisition did not

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[52] 748 F2d 838 (3d Cir. 1984).

[53] Id. at 843.

conflict with their state laws, which permitted out-of-state bank holding companies to retain banks in their states and to expand through the acquisition of additional banks.[54]

[2] Expansion Through Nonbank Subsidiaries—The Douglas Amendment, the Commerce Clause, and Other Constitutional Considerations

Under the Bank Holding Company Act, the states' authority to regulate with respect to banks and bank holding companies is specifically preserved. The act states, "The enactment by the Congress of this chapter shall not be construed as preventing any state from exercising such powers and jurisdiction which it now has or may hereafter have with respect to banks, bank holding companies, and subsidiaries thereof."[55] The act also states that a bank holding company may not control a bank outside of the state of its principal operations unless the acquisition of such control is "specifically authorized by the statute laws of the state in which such bank is located, by language to that effect and not merely by implication."[56]

When a state legislates with respect to businesses that operate in interstate commerce, the federal constitution forbids the state from legislating in a manner that discriminates against interstate commerce. The interplay between the federal constitutional prohibition against discrimination and the provisions of the Bank Holding Company Act that deal with state authority over interstate banking became the subject of Supreme Court attention in a 1980 case.

[a] *Lewis v. B.T. Investment Managers, Inc.* The case was *Lewis v. B.T. Investment Managers, Inc.*,[57] and it involved Bankers Trust, a New York bank holding company, which sought to provide investment advisory services in the state of Florida through a subsidiary, Bankers Trust Investment Managers (BTIM). When Bankers Trust sought the approval of the Board of Governors for this operation, opposition developed, and Florida enacted a statute prohibiting *out-of-state* bank holding companies from owning or controlling subsidiaries in Florida that performed investment advisory services. The board regarded the Bankers Trust application as promoting competition in Florida, but it denied the proposal because of the Florida statute. The board read the Bank Holding

[54] Application of General Banc Shares Corp., 72 Fed. Reserve Bull. 268 (1986). The Board said: "As far as either state is concerned, there continues to be only a single Missouri bank holding company that is authorized to operate in these states and that Missouri bank holding company has no greater rights after the merger than before the merger."

[55] 12 USC § 1846 (1982).

[56] 12 USC § 1842(d)(1) (1982).

[57] 447 US 27 (1980).

Company Act as requiring it to defer to state law. Under the board's view of the act, states enjoyed considerable scope in regulating bank holding companies and their activities.

The Supreme Court rejected the board's interpretation. Although it acknowledged that "banking and related financial activities are of profound local concern. . ." and that "sound financial institutions and honest financial practices are essential to the health of any State's economy and to the well-being of its people . . . ,"[58] traditional constitutional principles led to the conclusion that the Florida statute constituted a discrimination against banks and bank holding companies whose principal operations were outside of Florida, in violation of the commerce clause of the U.S. Constitution. Recognizing the state's legitimate interest in preventing fraud and undue economic concentration in companies supplying financial services, the Court concluded that such interests did not justify "the heavily disproportionate burden" the statute placed on bank holding companies that operated principally out of state.[59]

The Supreme Court then turned to the argument that the Bank Holding Company Act expressly conferred on the states the power to engage in regulation of bank holding companies. Congress may, if it desires, regulate interstate commerce by giving the states "an ability to restrict the flow of interstate commerce that they [the states] would not otherwise enjoy."[60] Two parts of the Bank Holding Company Act were in issue. Firstly, the Florida opponents claimed that the Douglas amendment (Section 3(d) of the act), by prohibiting a holding company from obtaining control of a bank outside its home state unless the state law permits it, gave states the authority to regulate the activities of bank holding companies. The Court firmly rejected this argument, stating that this part of the act simply did not apply to the nonbank activities of bank holding companies. As the court said, "The structure of the Act reveals that § 3(d) applies only to holding company acquisitions of banks. Non-banking activities are regulated separately in § 4."[61] Secondly, the Florida interests claimed that the part of the Bank Holding Company Act that preserved general state power to regulate bank holding companies (Section 7) gave Florida the authority to legislate as it did. The Court rejected this argument as well, on the ground that the said section of the act merely preserved to the states the authority that they had prior to enactment of the act: namely, the power to legislate, constrained by the limits of the commerce clause.[62] This part of the act contained "nothing in its

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[58] Id. at 43.

[59] Id. at 50.

[60] Id. at 51

[61] Id. at 53.

[62] Id. at 55. "Far from creating a new state power to discriminate between foreign and local bank holding companies, the legislative history evinces an intent to forestall such a broad interpretation. We therefore conclude that § 7 applies only to state legislation that operates within the boundaries marked by the Commerce Clause." Id.

language or legislative history to support the contention that it also was intended to extend to the states new powers to regulate banking that they would not have possessed absent the Federal legislation."[63]

The result of the *Lewis* decision is, thus, twofold. Firstly, notwithstanding legitimate local interests in regulating finance, discriminatory treatment designed to favor local interests will be invalid under the commerce clause. Secondly, neither the Douglas amendment nor the general provisions of the Bank Holding Company Act can be read as a broad grant of power to the states to regulate bank holding company activities.[64]

[b] ***Northeast Bancorp, Inc. v. Board of Governors.*** In *Northeast Bancorp, Inc. v. Board of Governors*, the Supreme Court was called upon to give further consideration to the commerce clause issue in litigation challenging the validity of state regional banking schemes.[65] The case involved a challenge to the New England regional banking scheme. The Board approved applications for two bank holding companies located in the New England region to acquire banks in other New England states. This was permissible under the Douglas amendment, because the states involved had enacted legislation allowing out-of-state holding companies located in the New England region to acquire banks in their state so long as reciprocity was extended by the other state. As the Court noted, a "predictable effect of the regionally restrictive statutes will apparently be to allow the growth of regional multistate bank holding companies which can compete with the established banking giants in New York, California, Illinois, and Texas."[66] The petitioners who opposed the acquisitions in the Supreme Court included Citicorp, a national bank holding company that was located outside the New England region, and that could not qualify under the state laws in question for acquiring banks within those states, and another bank holding company, Northeast, that was located within the region, and that sought to

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[63] Id. at 55.

[64] The Depository Institutions Deregulation and Monetary Control Act of 1980 briefly extended the prohibitions of Section 3(d) on interstate acquisitions to certain trust companies, but this provision expired automatically on October 1, 1981. Pub. L. No. 96-221, Tit. VII, § 712(c), 94 Stat. 132, 189–190 (1980).

[65] 472 US 159 (1985). See generally Gray, "Regional Reciprocal Banking Laws: Constitutional, But What Next?", 14 Fla. St. UL Rev. 267–300 (1986); Miller, "Interstate Branching and the Constitution," 41 Bus. Law. 337–346 (1986); Note, "The Constitutionality of the New England Interstate Banking Experiment," 4 Ann. Rev. Banking L. 213–235 (1985); Note, "Regional Banking Statutes and the Equal Protection Clause," 84 Colum. L. Rev. 2025–2044 (1984); Note, "Regional Banking—A Viable Alternative? An Empirical Study," 9 J. Corp. L. 815–899 (1984); Note, "Regional Banking Laws: An Analysis of Constitutionality under the Commerce Clause," 60 Notre Dame L. Rev. 548–565 (1985).

[66] 472 US at 165.

affiliate with a bank holding company outside the region.[67] They raised both statutory and constitutional challenges.

The challengers first contended that the Douglas amendment did not permit a state to approve bank acquisitions that were restricted to a particular region. Describing the Board as an "authoritative voice on the meaning of a federal banking statute," the Court agreed with the Board that the Douglas amendment allowed the state regional banking laws. Reasoning that Congress intended the Douglas amendment to be a parallel, for bank holding companies, to the McFadden Act's treatment of banks, the Court said that "Congress contemplated that some States might partially lift the ban on interstate banking without opening themselves up to interstate banking from everywhere in the Nation."[68] Having determined that Congress, when it passed the Douglas amendment, specifically intended for the states to have the freedom to impose partial restraints on interstate commerce such as the regional legislation involved, it was an easy step for the Court to conclude no violation of the commerce clause existed. Although such legislation would indeed have been invalid absent the action by Congress in the Douglas amendment, here Congress had acted.[69] As stated by the Court:

> Here the commerce power of Congress is not dormant, but has been exercised by that body when it enacted the Bank Holding Company Act and the Douglas Amendment to the Act. Congress has authorized by the latter Amendment the Massachusetts and Connecticut statutes which petitioners challenge as violative of the Commerce Clause. When Congress so chooses, state actions which it plainly authorizes are invulnerable to constitutional attack under the Commerce Clause.[70]

The Court made clear that other federal banking legislation, such as the provision allowing the FDIC to arrange for the acquisition of failing banks by out-of-state bank holding companies, would preempt state law if a conflict arose.[71]

The Court further held that no problem existed under the compact clause of the Constitution, because, given the Douglas amendment, the state laws could

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[67] The legality of the regional arrangements was also litigated in a case in which Northeast Bancorp sought to merge with the Bank of New York. This merger could not occur without violating the Connecticut regional banking law, because it involved a banking institution from outside the New England region recognized under Connecticut law. Under the Connecticut statute, if a bank outside the region acquired the parent New England banking institution, the banking organization would have to divest its Connecticut banks. The court held that Northeast Bancorp lacked standing to challenge the Connecticut legislation. Northeast Bancorp v. Woolf, 576 F. Supp. 1225 (D. Conn. 1983), aff'd mem., 742 F2d 1439 (2d Cir. 1984).

[68] 472 US at 172.

[69] Id. at 174.

[70] Id.

[71] Id. at 176.

not be viewed as an infringement of federal sovereignty; further, it was doubtful that the regional arrangement amounted to a compact. As stated by the court:

> [S]everal of the classic indicia of a compact are missing. No joint organization or body has been established to regulate regional banking or for any other purpose. Neither statute is conditioned on action by the other State, and each State is free to modify or repeal its law unilaterally. Most importantly, neither statute requires a reciprocation of the regional limitation.[72]

Finally, the Court rejected arguments that the state laws denied equal protection because they discriminated against banking institutions outside the region. In an earlier case,[73] the Court had held that a state violated the equal protection rights of out-of-state insurance corporations, notwithstanding the state's interests in encouraging the formation of instate insurance firms and in promoting investment in local assets. However, in the instant case, the Court said that although the state obviously was favoring regional banking institutions over those outside the region, in matters involving banking "we do not write on a clean slate."[74] The Court had previously concluded that "banking and related financial activities are of profound local concern."[75] This statement, the Court said, "is a recognition of the historical fact that our country traditionally has favored widely dispersed control of banking."[76] The Court explained the interests at stake in maintaining a decentralized banking system:

> While many other western nations are now dominated by a handful of centralized banks, we have some 15,000 commercial banks attached to a greater or lesser degree to the communities in which they are located. The Connecticut legislative commission that recommended adoption of the Connecticut statute in question considered interstate banking on a regional basis to combine the beneficial effect of increasing the number of banking competitors with the need to preserve a close relationship between those in the community who need credit and those who provide credit. . . . The debates in the Connecticut legislature preceding the enactment of the Connecticut law evince concern that immediate acquisition of Connecticut banks by holding companies headquartered outside the New England region would threaten the independence of local banking institutions.[77]

These interests satisfied the traditional rational basis test of equal protection for the validity of state economic legislation.

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[72] Id. at 175.

[73] Metropolitan Life Ins. Co. v. Ward, 470 US 869 (1985).

[74] Id. at 177.

[75] Id., quoting from Lewis v. B.T. Investment Managers, Inc., 447 US 27, 38 (1980).

[76] 472 US at 177.

[77] *Northeast*, 472 US at 177–178.

[c] ***Sears, Roebuck & Co. v. Brown.*** A result favorable to state interests was reached in a case before the Court of Appeals for the Second Circuit, a case involving financial activities of the Sears financial network.[78] In this case, a Connecticut statute limited bank holding companies from establishing offices in the state to engage in banking. The holding companies could only establish banking offices if they were grandfathered under the act or if the subsidiaries opening the offices were organized under Connecticut banking laws. Sears wished to operate places of business containing its Sears Financial Network Centers, at which affiliate financial, insurance, and brokerage organizations provided services. These services included the processing of loans from the Sears Savings Bank (a California thrift institution) and the brokering of certificates of deposit from the Sears Savings Bank and others. The Connecticut commissioner determined that the banking services provided at the centers were within the statute, and involved receiving deposits and permitting withdrawals. Since Sears came within the definition of a holding company under Connecticut law, but did not qualify for grandfather rights or as an entity organized under Connecticut laws, Sears was allowed to establish only two offices per year to conduct banking activities, as long as those offices did not engage in taking deposits or allowing withdrawals.

Sears challenged the statute as unconstitutionally discriminatory against interstate commerce, and in violation of the supremacy clause because of congressional preemption of the field by the Federal Savings and Loan Holding Company Act. The court concluded that the Connecticut regulation was in response to a "substantial legitimate local concern in the regulation of banking services within the state" and did not violate the commerce clause. Although Sears claimed that the legislative history reflected a protectionist intent, the court disagreed, viewing the statute as an answer to the problem of "how the state could effectively deal with the regulation of banking . . . during a volatile period of nationwide transition in the banking industry."[79] Legislators were responding to the problems posed by the entrance of nonregulated banking entities into the banking arena. The Douglas amendment gave the state the power to adopt regional banking legislation. As there was no protectionist intent, the issue became the extent to which the Connecticut laws had a discriminatory effect on interstate commerce. Although the Connecticut act discriminated between Connecticut banks and thrifts and out-of-state banks and thrifts, this distinction was not challenged, and could be supported under the McFadden Act and the Douglas amendment as interpreted in *Northeast Bancorp, Inc.* There was no discrimination, in the court's view, with respect to holding companies, as the statute applied to all holding companies without regard to geography.[80] The

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[78] Sears, Roebuck & Co. v. Brown, 806 F2d 399 (2d Cir. 1986).

[79] Id. at 407–408.

[80] Id. at 408.

court finally concluded that "any burden upon interstate commerce cannot be characterized as excessive in relation to the local concern found herein."[81]

[3] Interstate Expansion Through Nonbank Subsidiaries

In light of the Supreme Court's decision in *Lewis v. B.T. Investment Managers, Inc.*[82] and other cases that have interpreted the Douglas amendment to the Bank Holding Company Act as allowing bank holding companies to locate nonbank subsidiaries on an interstate basis, bank holding companies have created a vast national network of financial services, including trust operations, investment advisory services, loan processing centers, and credit card operations.[83] A 1981 report showed that Citicorp, for example, had 229 consumer finance offices and mortgage outlets in fifty-five cities, and when loan production offices and Edge Act subsidiaries were added, the offices totalled about 400 in thirty-eight states.[84]

Also significant is the Court of Appeals for the Eleventh Circuit's decision in a case involving the United States Trust Corporation and the Florida Department of Banking and Finance.[85] In this case, the United States Trust Corporation asked the Federal Reserve Board to approve the expansion of the activities of its Florida subsidiary to allow the subsidiary to engage in accepting time and demand deposits, establishing checking accounts, and making consumer loans. The Comptroller of the Currency had previously approved conversion of the

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[81] Id. at 409.

[82] 447 US 27 (1980). See also the decision of the Supreme Court in Clarke v. Securities Indus. Ass'n, 107 S. Ct. 750 (1987), discussed in ¶ 6.01[1], holding the McFadden Act definition of "branch" did not cover discount brokerage offices, because the activity was not a "core banking function."

[83] See generally "Survey of International Banking," The Economist, Mar. 14, 1981, at 24; ABA Banking J. 102 (June 1981). See generally Malloy, "Nonbank and Nondefinitions: New Challenges in Bank Regulatory Policy," 10 Seton Hall Legis. J. 1–66 (1986); Moffitt & Rigsby, "Loan Production Offices: The Beginning of the End for the McFadden Act?" 10 Stetson L. Rev. 427 (1981); Silver & Norman, "The Trust Company: A Means of Entering the Financial Services Market or Positioning for Interstate Banking," 101 Banking LJ 216–231 (1984); Note, "The Nonbank-Bank Conundrum," 4 Ann. Rev. Banking L. 187–212 (1985).

[84] The Economist, Mar. 14, 1981, at 24. The same report showed Bank of America with 350 offices in forty-one states and Manufacturers Hanover with 190 offices in eighteen states. Id.

Although the prohibitions on interstate activities of the Act do not apply to these nonbank activities, the Bank Holding Company Act contains other standards a bank holding company must satisfy in order to engage in nonbanking activities. The Board of Governors must determine that the activities are "closely related to banking," for example. These matters are discussed in Chapter 5.

[85] Florida Dep't of Banking v. Board of Governors, 760 F2d 1135 (11th Cir. 1985), vacated, 474 US 1098 (1986), on remand, 800 F2d 1534 (11th Cir. 1986).

subsidiary from its former status as a state-chartered trust company to that of a national bank, on the condition that it refrain from commercial lending. Because the subsidiary did not plan to engage in commercial lending, it did not fall within the definition of a bank under the Bank Holding Company Act and the Board's Regulation Y, and thus the Board approved the application with conditions.

When the case reached the federal Court of Appeals for the Eleventh Circuit, the court ruled against the Board. In the circuit court's view, the Douglas amendment to the Bank Holding Company Act prohibited banks from expanding interstate, in the absence of specific statutory approval by the state concerned. Although the Florida subsidiary would not be engaging in commercial lending, the court believed it was a bank within the contemplation of Congress when it passed the Bank Holding Company Act. It did not feel that the act's restrictions on interstate expansion of banking should be evaded so easily.[86]

The Supreme Court did not agree with the circuit court's reasoning. The Supreme Court vacated the opinion and remanded it back to the circuit court for reconsideration in light of the Supreme Court's opinion in *Board of Governors v. Dimension Financial Corp.*[87] In *Dimension*, the Supreme Court held that the Board could not enlarge the definition of "bank" contained in 12 USC § 1841, which required that the institution both accept deposits that the depositor had a legal right to withdraw on demand and make commercial loans. Although the United States Trust application involved the Douglas amendment, 12 USC § 1842(d)(1), which was a different part of the Bank Holding Company Act than was at issue in the *Dimension* case, the Eleventh Circuit concluded after the remand from the Supreme Court that the definition of "bank" must be the same in both parts of the act. Because the Florida subsidiary would not make commercial loans, it was not a bank under the act.[88] As the court stated, "If, as *Dimension* holds, the Federal Reserve Board is without regulatory jurisdiction to regulate nonbank banks as 'banks' under the Act, then it is without regulatory jurisdiction to prevent the interstate proliferation of nonbank banks under the Douglas Amendment."[89]

Under the *Florida Department of Banking & Finance* decision, the Douglas amendment restraints on interstate banking do not apply to so-called nonbank banks. Bank holding companies may expand interstate, free of the restrictions of the Douglas Amendment, by establishing financial institutions that are chartered as banks but that escape regulation as such because they neither accept demand deposits nor engage in commercial lending.[90]

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[86] Id.

[87] 474 US 361 (1986). The *Dimension Fin. Corp.* case is discussed at ¶ 5.01[3].

[88] Florida Dep't of Banking v. Board of Governors, 800 F2d 1534 (11th Cir. 1986), cert. denied, 107 S. Ct. 1887 (1987).

[89] Id. at 1536–1537.

[90] For a discussion of nonbank banks generally, see ¶ 5.01[3].

The nonbank bank rubric has also provided an opportunity for bank holding companies to establish multistate subsidiaries of other types of financial institutions. The Federal Reserve Board has approved applications for acquisitions of a savings and loan institution,[91] an industrial bank,[92] and a bank for credit card operations.[93]

In 1987, in response to the explosion of nonbank banks, Congress was prompted to enact the Competitive Equality Banking Act. This act, discussed in Chapter 5, restricts bank holding company use of the nonbank bank to avoid the prohibition on interstate banking. This is discussed in the following section.

[4] Effects of the Competitive Equality Banking Act of 1987 on Nonbank Bank Interstate Expansion

The 1987 Competitive Equality Banking Act provisions on nonbank banks affect the ability of bank holding companies to establish interstate banking networks through establishment of nonbank banks. With the new, expanded definition of what qualifies as a "bank" under the Bank Holding Company Act, the Douglas amendment rules on interstate acquisitions become applicable to many institutions that formerly were not subject to those rules.

The act contains key exemptions from its definition of a bank.[94] These exemptions have particular significance in the interstate banking context. Firstly, there is an exemption for bona fide trust companies.[95] Such companies are not within the definition of a bank if they limit their activities. Consequently, under the principles of the *Lewis* case,[96] bank holding companies may establish and operate them free from interstate banking restrictions. Secondly,

[91] Application of United States Trust Corp., 70 Fed. Reserve Bull. 371 (1984), reprinted in 42 Wash. Fin. Rep. (BNA) 554 (1984).

[92] Application of Citicorp, 70 Fed. Reserve Bull. 231 (1984) [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,853 (Feb. 17, 1984).

[93] Application of Citizens Fidelity Corp., 69 Fed. Reserve Bull. 556 (1983); see also, 41 Wash. Fin. Rep. (BNA) 813 (1983). In Independent Community Bankers Ass'n v. Board of Governors, 820 F2d 428 (DC Cir. 1987) petition for cert. filed, 56 USLW 3185 (US Sept. 22, 1987) (No. 87-397), the court upheld First City Bancorp's plan to acquire a national bank in South Dakota to conduct First City's credit card operations. The opponents of the acquisition contended that the transaction violated the Douglas amendment, and argued that the amendment did not allow the acquisition of a *national* bank by an out-of-state holding company, but the appellate court disagreed. Although South Dakota law also restricted the activities the national bank could conduct, the court concluded these restrictions did not conflict with federal banking legislation.

[94] The exemptions to the definition of "bank" in the Bank Holding Company Act are discussed at ¶ 5.01[4].

[95] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 101, 101 Stat. 552, 554–555 (hereinafter CEBA).

[96] *Lewis v. B. T. Investment Managers, Inc.* is discussed supra ¶ 6.02[2][a].

the 1987 amendments allow operation of a credit card bank, as long as it (1) does not make commercial loans or accept demand deposits; (2) limits its general deposit-taking activities; and (3) maintains only one office where deposits are accepted.[97] Thus, the practice of establishing a bank in a state with favorable laws on interest rates and controls to serve as the basis for national credit card operations may continue. Thirdly, the act exempts industrial loan companies from the definition of a bank.[98] This is in keeping with the previous approach, in which such institutions, although eligible for FDIC deposit insurance,[99] are not regarded as banks under the Bank Holding Company Act.[100]

The grandfather rights established under the 1987 amendments have particular reference to interstate banking activities. The grandfathered company can free itself of the restrictions imposed on its activities by the act by obtaining approval to be a bank holding company and by complying with all of the provisions of the Bank Holding Company Act as amended. However, this approach cannot be used to authorize a holding company that has an interstate network of banks in violation of the Bank Holding Company Act's restrictions on interstate banking.[101]

Companies that acquired control of a nonbank bank institution that became a bank as a result of the Competitive Equality Banking Amendments of 1987 may retain control of the nonbank bank by satisfying two conditions.[102] Firstly, the nonbank bank may not engage in any activity that would have caused it to be classified as a bank under the former definition of a bank in the Bank Holding Company Act. This means that the institution is not allowed both to accept demand deposits and to make commercial loans. Secondly, the nonbank bank may not increase the number of locations from which it does business after March 5, 1987. These restrictions end if the nonbank bank meets approval from the Board of Governors as a bank that it would allow the holding company to acquire.[103] Thus, in order for the subsidiary nonbank bank to increase its locations, the Douglas amendment would have to allow it.[104]

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[97] Id.

[98] Id.

[99] Id.

[100] Although the Board once contended that an industrial loan company that offered negotiable order of withdrawal (NOW) accounts and made commercial loans was a bank, the Board's view was overturned by the Court of Appeals for the Tenth Circuit. First Bancorp v. Board of Governors, 728 F2d 434 (10th Cir. 1984). See Hawke, "Can Interstate Banking Be Left To the States?" 4 Ann. Rev. Banking L. 103, 111 (1985).

[101] CEBA § 101 (amending 12 USC § 1843(f)(5)). The interstate banking limitations are discussed in ¶ 5.01[4][d].

[102] CEBA § 101 (amending 12 USC § 1843(g)).

[103] Id.

[104] See H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess. 129, reprinted in 1987 U.S. Code Cong. & Admin. News 598–599.

¶ 6.03 ATM NETWORKS AND THE RESTRICTIONS ON INTERSTATE BANKING

Rapid growth has occurred in both interstate and intrastate ATM networks,[105] with a substantial percentage of the machines belonging to networks through which ATM use is available to customers of multiple banks. The great majority of states have laws that deal specifically with ATM operations.[106] Some of these laws define an ATM as a branch of a bank; others specify that it is not.[107]

As noted previously, whether and under what circumstances an ATM may be a "branch" under the federal definition in the McFadden Act has been the subject of considerable litigation. Since the decision in *Independent Bankers Association v. Smith*,[108] it has been clear that ATMs can meet the test in 12 USC § 36(f) of what constitutes a bank branch. However, in accordance with the McFadden Act, a national bank may establish and operate ATM branches within a particular state if the state law specifically allows it. As indicated in *Independent Bankers Association v. Smith*, a national bank may be allowed to establish ATMs consistent with the act—even in a state that, as a general rule, prohibits bank branching—if that state does not treat ATMs as branches subject to the general state law prohibition against bank branching.[109]

The ability of banks and bank holding companies to use ATM systems was significantly advanced in a 1985 decision by the U.S. Court of Appeals for the Second Circuit in *Independent Bankers Association v. Marine Midland Bank, N.A.*[110] Although prior decisions, such as *Independent Bankers Association v. Smith*, had established that CBCTs that accepted deposits and dispensed funds were "branches" within the meaning of the McFadden Act, the comptroller excluded from the definition of "branch" those terminals that were not *owned* or *rented* by a national bank. The case involved a terminal owned by Wegman's, a

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[105] These developments are thoroughly reviewed in N. Penney & D. Baker, *The Law of Electronic Fund Transfer Systems* ¶ 6.02[5] (1980 & Supp. 1987).

[106] There are forty-one states with legislation specially authorizing "one or more types of state-chartered depository institutions to deploy electronic terminals." Id. at ¶ 22.01[2] n.41.

[107] Id. at ¶ 22.01[2] ns. 41–44.

[108] 534 F2d 921 (DC Cir. 1976), aff'g 402 F. Supp. 207 (DDC 1975), cert. denied, 429 US 862 (1976). See cases cited supra ¶ 6.01[1].

[109] 534 F2d at 948–949. See N. Penney & D. Baker, supra note 105, at ¶ 22.01[2]. See generally Felsenfeld, "Electronic Banking and Its Effect on Interstate Branching Restrictions—An Analytic Approach," 54 Fordham L. Rev. 1019–1062 (1986); Langevoort, "Interpreting the McFadden Act: the Politics and Economies of Shared ATMs and Discount Brokerage Houses," 41 Bus. Law. 1265–1280 (1986).

[110] 757 F2d 453 (2d Cir. 1985), rev'g 583 F. Supp. 1042 (WDNY 1984), cert. denied, 106 S. Ct. 2926 (1986).

supermarket, which terminal was linked to an interbank network through a contract with Marine Midland Bank, a national bank. Wegman's placed the terminal in its store to enable customers to access their bank accounts for deposits, withdrawals, cash advances, and account information. While Wegman's loaded the terminal with cash, it was not responsible for emptying the deposit container or reconciling the deposits; this Marine Midland did. Further, customer transactions through the terminal required electronic approval by Marine Midland before cash was dispensed.

A federal district court in New York held that the ATM constituted a "branch." The fact that Wegman's owned the terminal, rather than the bank, was irrelevant, because Marine Midland customers could use the terminal to deposit or withdraw money to or from their Marine Midland accounts, as well as to engage in other transactions, "with the same force and effect as if they appeared personally at a Marine Midland 'brick and mortar' branch and made the same transactions."[111]

Following the Supreme Court's lead in the *Plant City*[112] case, that "form" should not control "substance," the court held that the terminal was a branch of Marine Midland, one that gave Marine Midland a competitive advantage "by allowing the bank to provide the service to customers of depositing money at a place away from the bank's main office."[113] Furthermore, the court held the ATM constituted a "branch" prohibited by federal law, even though the state law of New York might permit a state bank to utilize the same terminal. The court rejected a contention that Wegman's violated state law by engaging in banking without a charter.

On appeal, the Court of Appeals for the Second Circuit reversed. It upheld the comptroller's view that an ATM that is neither owned nor rented by a bank does not constitute a branch under the McFadden Act. The court relied on the language used in the *Smith* case (on which the comptroller's interpretation was based). After commenting on the difficulty of categorizing the various ways that modern banking transactions are conducted, the circuit court concluded that the comptroller had a reasonable basis for distinguishing in his regulations between transactions conducted at facilities owned or rented and other types of transactions. In so holding, the court rejected the argument that Marine Midland rented the ATM because it charged the user a transaction fee. The court considered this charge as a per unit cost, like the charge at a pay telephone for making a telephone call.[114]

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[111] 583 F. Supp. at 1047.

[112] First Nat'l Bank v. Dickinson, 396 US 122 (1969).

[113] 583 F. Supp. at 1047

[114] Id. The court also held that the state courts should determine whether Wegman's violated state banking law by operating an ATM.

¶ 6.04 REGULATION OF BRANCHING BY SAVINGS AND LOAN ASSOCIATIONS

Savings and loan associations are not subject to the same rules on branch banking and interstate banking that govern banks. The Federal Home Loan Bank Board in the past has administratively followed rules for federal savings and loan association branching that were similar to the McFadden Act provisions for national banks. The FHLBB regulations now provide: "As a general policy, the Board permits a Federal association to branch within the state in which its home office is located."[115] FHLBB policy on interstate branching allows federal associations to establish branches outside of their home state (1) when this is allowed by the state law in which the association's home office is located and (2) if the state in which the branch is to be located "would permit" the establishment of such a branch for a state-chartered institution.[116] An exception to this policy allows branching to occur as a result of the acquisition of failing institutions, under transactions arranged as an alternative to payment of FSLIC insurance benefits, or to prevent failure of the insured institutions.[117]

The rules for interstate activities of savings and loan holding companies have differed from those for bank holding companies. Until the 1980s, federal statutes prohibited multistate savings and loan holding companies.[118] In 1982, this prohibition was relaxed to allow emergency acquisitions of failing institutions.[119] In 1987, further changes were introduced by the Competitive Equality Banking Act.

The general policy of the federal statute dealing with savings and loan holding companies is that the FSLIC may not approve an acquisition by a savings and loan holding company if it will result in "a multiple savings and loan holding company controlling insured institutions in more than one State . . . ."[120] There are three exceptions to this rule; interstate combinations may occur when (1) the acquisition is pursuant to the emergency acquisition powers of the act; (2) the holding company controls an insured institution subsidiary that enjoys grandfather rights, because the combination predates the cutoff date in the act of March 5, 1987; or (3) the laws of the state governing state-chartered institutions "specifically authorize such an acquisition [for state institutions] by language to that effect and not merely by implication."[121] With these exceptions, the laws on

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[115] 12 CFR § 556.5(a)(2) (1987).

[116] 12 CFR § 556.5(a)(3) (1987).

[117] 12 CFR § 556.5(3)(ii)(a) (1987).

[118] See Hawke, "Can Interstate Banking Be Left to the States?" 4 Ann. Rev. of Banking L. 103–113 (1985); 12 USC § 1730a(e)(3) (1982).

[119] Provisions regarding emergency acquisitions of financially weak institutions are discussed infra ¶ 6.05.

[120] 12 USC § 1730a(e)(3) (1982).

[121] 12 USCA § 1730a(e)(3)(c) (West Supp. 1988).

interstate activities of savings and loan holding companies become similar to the restrictions on bank holding companies under the Douglas amendment to the Bank Holding Company Act.

¶ 6.05 EMERGENCY ACQUISITIONS OF FINANCIALLY WEAK BANKS

[1] Emergency Acquisition Authority

The Garn-St Germain Depository Institutions Act of 1982[122] gave the FDIC and Federal Savings and Loan Insurance Corporation special authority to arrange mergers or acquisitions of certain banks and savings institutions that had failed or were in precarious financial condition. This authority includes the power to bypass the usual restrictions against interstate banking. It also includes the power to approve acquisitions across traditional industry lines, so that banks, for example, might acquire failed thrift institutions.[123]

Under the 1982 act, the FDIC may give financial assistance to facilitate mergers or asset acquisitions of insured banks that are in financial jeopardy. The assistance may take the form of loans, contributions, guarantees, or assumptions of liabilities, and may be given directly to the acquiring entity.[124] This assistance is authorized only when the insured bank involved is either closed, "in the judgment of the Board of Directors [of the FDIC], is in danger of closing," or is in need of assistance to prevent risk to the FDIC as a result of circumstances in which "severe financial conditions exist which threaten the stability of a significant number of insured banks or of insured banks possessing significant financial resources . . . ."[125] The 1982 act gave similar authority to the FSLIC to assist the mergers of financially threatened insured thrift institutions.[126] Both the FDIC and FSLIC are limited in the amount of financial aid they can provide to no more than what would have been "reasonably necessary to save the cost of liquidating" the institution, except in cases where the continued operation of the institution is "essential" to provide adequate financial services to the community.[127]

The 1982 act also gave the FDIC and FSLIC authority to approve "extraordinary acquisitions" by out-of-state financial institutions in certain

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[122] Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of titles 12, 15, and 18 USC) (hereinafter Garn-St Germain Act).

[123] 12 USC § 1823(c), (f) (FDIC); 12 USC §§ 1729(b), 1730a(m) (FSLIC) (1982).

[124] 12 USC § 1823(c)(2) (1982).

[125] 12 USC § 1823(c)(2)(B) (1982). The determination of the need for assistance is to be at the "sole discretion" of the FDIC. Id.

[126] 12 USC § 1729(f) (1982).

[127] 12 USC §§ 1729(f)(4), 1823(c)(4) (1982).

circumstances.[128] The FDIC could exercise this authority when there was an insured bank with total assets of $500 million or more that was *closed*.[129] The power of the FSLIC was broader in scope.[130] The act also gave both agencies authority to approve acquisitions by certain acquiring institutions that are of a different type than the failing institution, under stated circumstances.[131] Thus, since 1982, the two banking agencies may approve not only interstate acquisitions but also some interindustry combinations as a means of rescuing foundering depository institutions.

The emergency acquisition powers of the FDIC cannot be exercised in disregard of the impact on competition. The law prohibits acquisitions "which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States."[132] It also prohibits the approval of acquisitions whose effect may be to substantially lessen competition, unless there is a finding that the "anticompetitive effects of the proposed transactions are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served."[133] These provisions on the preservation of competition apply only to acquisitions and sales of insured banks approved by the FDIC. There is no comparable provision relating to thrift institutions regulated by the FSLIC.[134] The law also authorizes mergers of financially weak federal credit unions with other federally insured depository institutions when a merger with another insured credit union is not possible.[135]

In a case involving the acquisition of First Federal Savings and Loan Association by a subsidiary of Citicorp, the merger provision of the Garn-St Germain Act came under consideration. The plaintiffs in the case launched a broad challenge against the FSLIC's decision about which of the competing offers for restructuring the association to accept. In response, the court first held

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[128] 12 USC § 1823(f) (FDIC); 12 USC § 1730a(m) (FSLIC).

[129] 12 USC § 1823(f)(2) (1982). Similar authority existed when the bank was "in danger of closing" if it was an insured bank organized in mutual form with $500 million or more in total assets. Id., § 1823(f)(3).

[130] 12 USC § 1730a(m)(1)(A)(i) (1982). In the case of the FSLIC, the insured institution must be eligible for merger assistance under 12 USC § 1729(f), discussed previously, and the FSLIC must determine "that severe financial conditions exist which threaten the stability of a significant number of insured institutions, or of insured institutions possessing significant financial resources . . . " and that exercising authority to approve the emergency acquisition would "lessen the risk" to the FSLIC. *Id.*

[131] 12 USC § 1823(f) (FDIC); 12 USC § 1730a(m) (FSLIC).

[132] 12 USC § 1823(f)(7)(A) (1982).

[133] 12 USC § 1823(f)(7)(B) (1982).

[134] Compare 12 USC § 1823(f)(7) (1982), referring to FDIC and banking concerns, with 12 USC § 1730a(m) (1982), referring to FSLIC and thrift institutions.

[135] 12 USC § 1785(b) (1982).

that while judicial review of the agency decision was proper under the act, the decision itself as to which bid or emergency arrangements to accept was a matter for the discretion of the agency that the court could review only for abuse by the FSLIC in exercising its discretion. A rejected bidder argued that the court should require the FSLIC to augment the record before the court so that the court could examine the manner in which the agency evaluated the various alternatives, but the court refused, stating that, in the court's opinion, the FSLIC should be able to deal with the emergency presented by a financial institution failure without having to subject its complicated calculations for evaluating alternative arrangements to a protracted dispute on review. In addition, as the FSLIC needed to deal with financial institutions in a confidential manner in order to encourage and evaluate proposals, the preservation of the confidentiality of the information submitted to it, on which it based its judgment, also justified denying the request to force the agency to spread its information on the record.[136]

In another Citicorp acquisition, an opportunity was provided for judicial review of the acquisition provisions. In *Getty v. FSLIC*,[137] the FSLIC solicited bids from both Citicorp and Getty for National Permanent Bank (NPB), a federally chartered mutual savings bank, under the emergency thrift acquisition provisions of the act. After a series of rebidding, the FSLIC accepted Citicorp's bid. Getty then launched a challenge to the FSLIC action. After initially losing its request for a stay, and after procedural disputes to obtain access to interagency memoranda involved in the FSLIC decision process, Getty's appeal was heard. The court ruled for Getty on two issues. Firstly, 12 USC § 1730a(m)(3)(B) enumerates priorities for the FSLIC to consider in making its decision, based upon geographical considerations and the nature of the institutions. The FSLIC erred by not providing an explanation of how it considered these statutory priorities.[138] Secondly, when the FSLIC decides to request a rebid, the law permits other bidders who were within a defined range of the "initial lowest acceptable offer" to submit a new offer as well.[139] The FSLIC had refused to allow Getty to submit a further modified bid after the last Citicorp bid. The court held that Getty was entitled to rebid because it was within the prescribed range of "the offer FSLIC would accept *but* for the rebidding requirement of subsection (3)(A)."[140]

Having ruled for Getty, the court then faced the issue of determining appropriate relief in view of the consummation of the acquisition by Citicorp. The court said that it would be inappropriate for the FSLIC to go through a

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[136] Hartigan v. FHLBB, 746 F2d 1300 (7th Cir. 1984).

[137] Getty v. FSLIC, 805 F2d 1050 (DC Cir. 1986). The *Getty* litigation (No. 86-1387, DC Cir.) was eventually settled out of court, according to 48 Banking Rep. (BNA) 1080 (June 22, 1987).

[138] 805 F2d at 1055. These priorities are discussed infra ¶ 6.05[2].

[139] 12 USC § 1730a(m)(3)(a) (1982).

[140] 805 F2d at 1060.

process of rebidding only to reject a better offer from Getty because it favored the management abilities of Citicorp. In the court's opinion, the FSLIC could not reopen the issue of the qualifications of the bidders, after having determined those qualifications to have been adequate at the outset, when it solicited the bids. The court also ruled that fairness required allowing Citicorp, as well as Getty, to submit a new bid.[141]

In 1987, Congress made the emergency acquisition authority permanent and substantially expanded it. The 1987 legislation also modified some of the emergency powers and procedures contained in the 1982 act, which have been discussed in this section. The changes are explained in the following section.

[2] Effects of the Competitive Equality Banking Act of 1987 on Emergency Acquisition Powers

The Competitive Equality Banking Act of 1987 expands the authority of the FDIC to approve interstate acquisitions of financially weak institutions. It repeals the 1986 expiration of and permanently extends the authority contained in the Garn-St Germain Act of 1982 on extraordinary acquisitions.[142] It also enlarges that authority in significant respects.

Initially, it should be noted that the substantive amendments to the emergency acquisition authority primarily affect the FDIC. The 1987 act does not make as substantial a change in the emergency acquisition authority of the FSLIC, perhaps because this is already reasonably broad. The act extends the 1982 emergency acquisition powers of the FSLIC[143] and also adds a requirement that the qualified thrift lender (QTL) rules be satisfied.[144] The conference report

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[141] Id. at 1062.

[142] The extraordinary acquisition authority expired in 1986 after having been extended previously. Pub. L. No. 99-120, 1985 U.S. Code Cong. & Admin. News (99 Stat.) 504. CEBA § 509(a), 101 Stat. 552, 635, amended the Garn-St Germain Depository Institutions Act of 1982 by repealing Part D of Title I. This part of the act contained the provisions calling for the sunset of the emergency acquisitions authority. Title II of the act was extended for only five years until October 13, 1991, however. CEBA § 509(b). This contains the authority to issue net worth certificates, discussed in Chapter 10.

[143] CEBA Title V, 101 Stat. 552. Other provisions of the 1987 act, as discussed at ¶¶ 5.03[2][d], 6.04, give savings and loan holding companies authority to operate interstate savings and loans subject to policies similar to the Douglas amendment. These provisions recognize the FSLIC's authority to make emergency acquisitions and provide that such authority is free from the other restraints of the savings and loan holding company laws on interstate activities. Id., § 104(g) (amending 12 USC § 1730(e)(3)); see 12 USC § 1730(a)(m)(1)(A)(i) (1982), saying that no other provisions of federal or state law except the specific provisions mentioned limit the FSLIC authority. See also H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess. 139–140, reprinted in 1987 U.S. Code Cong. & Admin. News 608–609.

[144] CEBA § 104(h), 101 Stat. 552, 575, amending 12 USC § 1730a(m)(1)(A)(i) by making the emergency acquisition authority also subject to Section 408(c) of the National

makes clear that the preemption provisions in the emergency acquisition authority reach broadly. The FSLIC's authority to approve emergency acquisitions includes the power to authorize "any company to acquire control" of the insured institution, not just acquiring firms that also are insured institutions or banks.[145] The conference report explains:

> [I]f a life insurance company invested in or acquired a thrift institution under section 408(m), that section would preempt any State law that would prevent the company from continuing to engage in the life insurance business because of that investment or acquisition. That section would not, however, preempt State restrictions on the percentage of an insurance company's assets that may be invested in any one subsidiary, or similar type safeguards.[146]

As under the 1982 law, any acquisition of a thrift by a bank holding company requires the approval of the Federal Reserve Board. In cases involving a merger party other than another insured savings and loan association, if the law generally requires approval from the federal regulator of that party (such as the Federal Reserve Board), approval must be obtained.[147] The 1987 amendment also maintains the requirement that if a bank holding company or bank is involved in a merger with a savings and loan, the savings and loan may keep existing branches, but otherwise must conform to the branching rules that apply to national banks.[148]

[a] Enlarged Emergency Acquisition Powers of the FDIC. With respect to the FDIC, the 1987 act amends the previous provisions regarding the FDIC's authority to exercise its emergency interstate acquisition powers. Under the new provisions, these powers are limited to circumstances in which the FDIC uses its general merger assistance powers to help an out-of-state bank or bank holding company make an acquisition.[149]

Although the Senate version of the bill that became the 1987 act contained a provision upholding the FDIC's authority under state law to arrange interstate mergers and acquisitions, there is no such statement in the final legislation. The conference report makes clear, however, that the conferees regarded such a statement as unnecessary, saying: "The emergency acquisition provisions are

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Housing Act, which, as amended by the 1987 amendments, contains the qualified thrift lender rules. See H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess. 140, reprinted in 1987 U.S. Code Cong. & Admin. News 608–609.

[145] 12 USC § 1730a(m)(1)(A)(i) (1982).

[146] H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess. 140–141, reprinted in 1987 U.S. Code Cong. & Admin. News 609–610.

[147] 12 USC § 1830a(m)(1)(A)(iii) (1982).

[148] 12 USC § 1830a(m)(5) (1982).

[149] 12 USC § 1823(f)(3)(1) (1982).

intended to provide the FDIC with greater flexibility in handling closed or failing banks. The conferees recognize that alternatively the FDIC may use applicable state laws for an interstate acquisition, where it determines such laws are more advantageous toward resolving an existing problem."[150]

Under the former provisions of the law, the emergency procedures could be used to acquire stock institutions only if they were closed. The 1987 act permits acquisition of such institutions when they are "in danger of closing."[151] The act also enlarges the scope of the acquisition. Under the new provision, the acquisition may be made by one or more out-of-state banks or by one or more out-of-state bank holding companies. They may acquire "an insured bank in danger of closing which has total assets of $500,000,000 or more" or two or more "affiliated banks in danger of closing which have aggregate total assets of $500,000,000 or more," but, in this latter situation, the total assets of the banks must be "equal to or greater than 33 percent of the aggregate total assets of all affiliated insured banks."[152] When one or more insured banks that are part of a holding company system of affiliated institutions are acquired, the acquiring out-of-state bank or banks or holding companies may acquire the entire holding company, or they may acquire other insured banks affiliated with the banks in danger of closing. The acquiring companies may have the opportunity to acquire the larger holding system if the banks in danger of closing have "aggregate total assets . . . equal to or greater than 33 percent of the aggregate total assets of all affiliated insured banks . . . ."[153]

[b] Acquisition of a Bank in Danger of Closing. A bank that is in danger of closing is defined by the act according to two standards. Both standards require certification by the state or federal chartering authority. One standard requires an evaluation of the bank's ability to continue to meet obligations of depositors and creditors in the normal course of business. The other standard involves an evaluation of the capital position of the institution. Thus, to find a bank in danger of closing, the chartering authority must certify that either (1) the bank is not likely to be able to meet the demands of depositors or to pay its obligations in the normal course of business, and "there is no reasonable prospect" of the bank's meeting depositors' demands or paying obligations without federal assistance; or (2) the bank "has incurred or is likely to incur losses that will deplete all or substantially all of the capital of the bank," and there is no reasonable prospect for replenishment of the capital without federal assist-

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[150] H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess. 170, reprinted in 1987 U.S. Code Cong. & Admin. News 638–639.

[151] CEBA § 502, 101 Stat. 552, 623–629 (amending 12 USC § 1823(f)(3)).

[152] Id.

[153] Id.

ance.[154] Before an acquisition can be made under this authority, the board of directors of the insured bank in danger of closing must request in writing that the FDIC assist the acquisition.[155] In addition, the state bank supervisor of the state in which the bank is located must approve it.[156]

Once the FDIC provides assistance to such a bank under its general assistance powers in 12 USC § 1823(f)(c) to a bank that is eligible for an interstate acquisition under the act, the bank remains eligible for such an acquisition for as long as the FDIC's assistance to the bank remains outstanding.[157] This permits the FDIC to strengthen a failing bank financially, so that it becomes more attractive as a merger partner.

Once an out-of-state bank or bank holding company acquires a bank under the emergency interstate acquisition rules, that bank or bank holding company is allowed to expand in the state in which the acquired bank is located. Subject to conditions in the act that may limit the timing of the acquisition, it may "acquire any other insured bank and establish branches in such State to the same extent as a bank holding company whose insured bank subsidiaries operations are principally conducted in such State may acquire any other insured bank or establish branches."[158] Thus, so far as branching and acquisition of additional insured bank subsidiaries is concerned, the acquiring bank holding company may expand to the same extent that bank holding companies operating primarily within the state of the acquired failing bank may expand.

The act also specifies that state laws on regional banking that limit the territory in which bank holding companies may operate are not effective against acquisitions under this emergency authority. Such state laws cannot require divestiture of any other insured bank or prevent the acquisition of any other bank or holding company.[159]

The 1987 act establishes a procedure by which the FDIC may solicit offers from prospective purchasers or merger partners in approving interstate emergency acquisitions.[160] The FDIC is given "sole discretion" to determine the

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[154] CEBA § 502 (amending 12 USC § 1823(f)(8)(D)).

[155] CEBA § 502 (amending 12 USC § 1823(f)(3)(D)).

[156] CEBA § 502 (amending 12 USC § 1823(f)(3)(E)). Note that there is no provision for override of the state chartering authority's disapproval. This is unlike the FDIC authority under 12 USC § 1823(f)(2), with respect to *closed* banks, where, by unanimous vote, the FDIC can override the state objections. The emergency acquisition powers of the FSLIC also specify notice to the state official having jurisdiction of the acquired institution with the power to override the objection of the state official by a unanimous vote. Id. (amending 12 USC § 1830a(m)(1)(B)).

[157] CEBA § 502 (amending 12 USC § 1823(f)).

[158] Id.

[159] Id.

[160] CEBA § 502 (amending 12 USC § 1823(f)(6)). There is a comparable procedure for the FSLIC. 12 USC § 1730a(m)(2) (1982).

buyers it deems "qualified and capable."[161] Further, in deciding which offers to accept, the FDIC must consider a list of statutory priorities. These priorities are based on the types of depository institutions involved in the proposed acquisition or merger and the states in which they are located. The statute assigns priority to mergers between depository institutions as follows:

1. Depository institutions of the same type within the same state.
2. Depository institutions of the same type in different states that "by statute specifically authorize such acquisitions" or, in cases where there is no such statutory authorization, in contiguous states;
3. Depository institutions of the same type in states other than those in the second priority;
4. Depository institutions of different types in the same state;
5. Depository institutions of different types in different states that "by statute specifically authorize such acquisitions" or, in cases where there is no such statutory authorization, in contiguous states; and
6. Depository institutions of different types in different states other than the states described in the fifth priority.[162]

In the case of a minority-controlled bank, the highest priority is to continue the minority-controlled status. In this situation, the FDIC must seek offers from other minority-controlled banks before following the priorities listed previously.[163]

The emergency assistance provisions may not be used by the FDIC to provide assistance to a bank holding company subsidiary that is not an insured bank, unless the subsidiary is designed as a conduit for channeling help to an insured bank.[164] Further, the Board of Governors has authority to expedite the approval process of the acquisition of banks in danger of closing.[165] The approval process may be streamlined by dispensing with certain notice and hearing requirements. The Board also may obtain expedited antitrust review of an emergency acquisition.[166] Additionally, the 1987 act provides for the use of "bridge banks" in the acquisition of closed banks.[167] Detailed provisions are contained within the act relating to the establishment of such banks.

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[161] CEBA § 502 (amending 12 USC § 1823(f)(5)).

[162] CEBA § 502(c)(2) (amending 12 USC § 1823(f)(6)(B)). The priorities provided for the FSLIC are slightly different. 12 USC § 1730a(m)(3)(B) (1982).

[163] CEBA § 502(c)(2) (amending 12 USC § 1823(f)(6)(C)).

[164] CEBA § 502 (amending 12 USC § 1823(f)(9)).

[165] CEBA § 502(h).

[166] Id.

[167] CEBA § 503. See ¶ 10.04 on the use of bridge banks.

¶ 6.06 BANK HOLDING COMPANY ACQUISITION OF THRIFT INSTITUTIONS

Apart from the emergency acquisition procedures discussed in the previous section, bank holding companies have had limited ability to acquire savings and loan associations. The Federal Reserve Board has applied the Bank Holding Company Act in a manner that denies approval of healthy thrift acquisitions. In a 1982 case in which the Board did approve a bank holding company acquisition of a failing thrift institution,[168] it also applied conditions to its approval, limiting transactions between the thrift and the holding company. These conditions included restrictions on activities that otherwise would enable the bank holding company to avoid restrictions on its interstate activities.

The Board's general policy on acquisition of healthy thrift institutions was set in 1977 in its opinion in *D.H. Baldwin*.[169] In this case, the Board concluded that the operation of a savings and loan association was an activity "closely related to banking," as required by the Bank Holding Company Act, but it was not to be regarded as a proper incident to banking, because the benefits of such an affiliation did not outweigh the adverse effects.[170] The Board later said it based its determination on three factors:

> (1) the perception of a competing and conflicting regulatory framework governing banks and S&Ls; (2) the possibility that cross-industry acquisitions would undermine the perceived rivalry between the banking and thrift industries; and (3) the possibility that such acquisitions could undermine the interstate banking restrictions of the Douglas Amendment to the Bank Holding Company Act . . . "[171]

In September 1987, the Board solicited public comment as to whether it should modify its policy on acquisition of healthy thrift institutions. Citing a changed economic and regulatory environment, in which thrifts engage in expanded activities and have increasingly formed interstate affiliations, the

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[168] Application of Interstate Financial Corp., 68 Fed. Reserve Bull. 316 (1982); Application of Citicorp, 68 Fed. Reserve Bull. 656 (1982).

[169] 63 Fed. Reserve Bull. 280 (1977).

[170] For a discussion of the provisions of the Bank Holding Company Act, see Chapter 5. See also the statement of the Board's general counsel at 35 Wash. Fin. Rep. (BNA) 771 (1982). Although federal legislation had so substantially expanded the powers of savings and loan associations that they arguably could be included within the definition of bank in the Bank Holding Company Act, the Board would take its policy direction from the guidelines for acquisitions of thrifts in the emergency procedures of the Garn-St Germain Act. Id.

[171] Board of Governors, Fed. Reserve Sys., Solicitation of Public Comment, "Board Policy Regarding the Acquisition and Operation of Thrift Institutions by Bank Holding Companies," 52 Fed. Reg. 36,041 (1987).

Board specifically requested commentators to address the implications of a modified policy on the interstate banking rules of the Douglas amendment.[172]

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[172] Id.

7

Bank Examination and Supervision and Restrictions on Loans and Investments

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¶ 7.01 EXAMINATION AND SUPERVISION GENERALLY

Congress has given the primary federal banking regulators the power to conduct examinations and require reports of the depository institutions under each regulator's jurisdiction. This section discusses the general authority of these regulators; subsequent sections examine particular aspects of regulation by these agencies.

[1] Federal Bank Examination

The three principal federal bank regulatory agencies—the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation—conduct the examination of banks under their jurisdiction. The Comptroller of the Currency has primary responsibility for national banks.[1] The Federal Reserve System exercises supervisory responsibility over state banks that are members of the Federal Reserve System.[2] The FDIC has authority to examine all insured banks, but concentrates especially on state nonmember insured banks.[3] The Federal Home Loan Bank Board has supervisory authority and conducts examinations of insured savings and loan associations.[4] The National Credit Union Administration exercises responsibility with respect to insured credit unions.[5]

In 1978, the Financial Institutions Regulatory and Interest Rate Control Act established a Financial Institutions Examination Council to prescribe uniform standards for the examination of depository institutions that are subject to federal examination.[6] The council consists of the Comptroller of the Currency, the chairman of the board of directors of the FDIC, a governor of the Board of Governors of the Federal Reserve System as designated by the chairman, the chairman of the FHLBB, and the chairman of the National Credit Union Administration Board.[7] The chairmanship of the council rotates among the members every two years.[8]

The council is responsible for establishing uniform principles and standards and report forms for the examination of financial institutions, to be applied by the federal financial institutions regulatory agencies.[9] The council also makes recommendations with respect to other supervisory matters. The council develops uniform reporting systems for federally supervised financial institutions and their holding companies and nonfinancial subsidiaries, and also is directed by Congress to conduct schools for examiners.[10] To carry out its duties, the council

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[1] See ¶¶ 2.03 and 4.02. See also 12 USC §§ 161, 481 (1982).

[2] See ¶¶ 2.03 and 3.01. See also 12 USC §§ 325, 326 (1982).

[3] See ¶¶ 2.03 and 11.01[4]. See also 12 USC § 1815(a) (1982).

[4] See ¶¶ 2.03 and 11.02. See also 12 USC § 1440 (1982).

[5] See ¶¶ 2.03 and 11.03. See also 12 USC § 1756 (1982).

[6] 12 USC § 3301 (1982). Congress has considered legislation to improve the training of federal bank examiners and to establish a system for accepting state examinations of federally insured institutions when minimum standards are satisfied, but the legislation has not passed. H.R. 4917, 99th Cong., 2d Sess., 132 Cong. Rec. H3297 (daily ed. June 3, 1986); H.R. Rep. No. 809, 99th Cong., 2d Sess. (1986); S. 288, 100th Cong., 1st Sess., 133 Cong. Rec. S627–S633 (Jan. 12, 1987).

[7] 12 USC § 3303(a) (1982).

[8] 12 USC §§ 3303(b), 3303(c) (1982).

[9] 12 USC § 3305(a) (1982).

[10] 12 USC §§ 3305(b), 3305(c), 3305(d) (1982).

has legal access to all reports and records of the five regulatory agencies that are members of the council, including reports the agencies have made in examining financial institutions under their jurisdiction.[11]

Although a federal banking agency may be negligent in conducting an examination of an institution under its jurisdiction, stockholders and others with interests in the financial institution concerned have not been successful in efforts to hold the examining authorities liable for failing to discover improprieties that subsequently proved injurious to their institutions.[12] Further, state banking regulators do not have the power to examine national banks absent federal legislation granting them this authority.[13] The Garn-St Germain Depository Institutions Act of 1982[14] gives state regulatory authorities limited power to examine national banks. The act specifies that state examiners may review a national bank's records to determine compliance with state unclaimed property or escheat laws, when the authorities have "reasonable cause to believe that the bank has failed to comply with such laws."[15]

With the International Lending Supervision Act of 1983,[16] federal banking regulatory agencies were given enlarged supervisory and examination powers. The act authorizes the banking agencies to require banks to set up special reserves, when appropriate, to guard against poor-quality loans to borrowers in foreign countries.[17] It also establishes reporting and information requirements for banks engaged in foreign lending,[18] as well as provisions on fees charged for restructuring foreign loans that require the amortization of such bank fees over the life of the loan if the fee exceeds the administrative cost of the loan,[19] a requirement for special evaluation of the financing of certain foreign mining and mineral-processing projects,[20] and additional authority in other areas for the banking agencies.

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[11] 12 USC § 3308 (1982).

[12] Gary Sheet & Tin Employees Fed. Credit Union v. United States, 605 F. Supp. 916 (ND Ind. 1985) (National Credit Union Board did not owe a duty to owners of credit union under Federal Tort Claims Act). See also In re Franklin Nat'l Bank Sec. Litig., 445 F. Supp. 723 (EDNY 1978); Social Sec. Admin. Baltimore Fed. Credit Union v. United States, 138 F. Supp. 639 (D. Md. 1956).

[13] For a discussion of the limited grant of authority to the states in this area under the federal banking laws, see ¶ 4.02[2].

[14] Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of 12, 15, and 18 USC).

[15] 12 USC § 484(b) (1982).

[16] Pub. L. No. 98-181, 97 Stat. 1278 (codified at 12 USC §§ 3901–3912 (Supp. IV 1986)).

[17] 12 USC § 3904 (Supp. IV 1986).

[18] 12 USC § 3906 (Supp. IV 1986).

[19] 12 USC § 3905 (Supp. IV 1986).

[20] 12 USC § 3908 (Supp. IV 1986).

The International Lending Supervision Act also grants important powers to the federal banking regulatory agencies in order to establish capital adequacy requirements for all banks under their jurisdiction. This authority is not limited to transactions with foreign parties.[21] The act directs the federal banking agencies to "cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions and by using such other methods as the appropriate Federal banking agency deems appropriate."[22] It gives the banking agencies discretionary authority to set minimum capital levels for institutions as the agency "deems necessary or appropriate in light of the particular circumstances of the banking institution."[23] Failure of the banking institution to maintain a capital level, as required, can be treated by the banking agency as an unsafe and unsound banking practice.[24] The federal banking agency also may require a bank that does not meet the minimum capital standards to adopt a plan acceptable to the agency to bring itself into compliance with the standards, and then may consider the bank's progress in following that plan, in passing on a proposal from the bank that "would divert earnings, diminish capital, or otherwise impede such banking institution's progress in achieving its minimum capital level."[25]

The authority of the Federal Savings and Loan Insurance Corporation to deal with the adequacy of the capital of savings and loan institutions was enlarged by Congress in 1987.[26]

The Comptroller of the Currency and the Federal Reserve Board have adopted regulations on the adequacy of the capital of the financial institutions they supervise.[27] Additionally, the federal banking regulatory agencies have engaged in international discussions leading to a proposal for a uniform set of guidelines on capital adequacy for banks.[28] This proposal uses a system for

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[21] As explained by M. Cobb & H. Birmingham, Federal Regulation of Depository Institutions, Enforcement Powers and Procedures ¶ 2.04[2][c][ii] (Supp. 1986), this measure was added to the act during its consideration by Congress in order to reverse the decision of the court in First Nat'l Bank of Bellaire v. Comptroller of the Currency, 697 F2d 674 (5th Cir. 1983), which took an unsympathetic position on the comptroller's efforts to enforce minimum capital adequacy standards.

[22] 12 USC § 3907 (a)(1) (Supp. IV 1986).

[23] 12 USC § 3907 (a)(2) (Supp. IV 1986).

[24] 12 USC § 3907 (b)(1) (Supp. IV 1986).

[25] 12 USC § 3907(b)(3)(A) (Supp. IV 1986).

[26] The expanded authority of the FSLIC to deal with the capital adequacy of saving and loan institutions is discussed at ¶ 11.02[3].

[27] 12 CFR §§ 3.1–3.21 (1987) (comptroller); 12 CFR Pt. 225, App. A (1987) (Board of Governors).

[28] The proposal is contained in a joint news release issued by the Federal Reserve Board, Comptroller of the Currency, and FDIC. The text is contained in Comptroller of the Currency, Banking Bull. 87-30, "Risk-Based Capital" (Dec. 10, 1987). In addition to defining "capital," the proposal suggests a method of weighting based upon risk in

determining adequate capital levels, a system that weighs the capital needs of a bank according to the degree of risk reflected in the bank's lending and other operations.

In conducting examinations of banks, the comptroller, the FDIC, and the Board of Governors follow a uniform rating system.[29] Under this system, the agencies rate the financial condition and operating soundness of a bank, based on evaluation of five aspects of the bank's operations: (1) capital adequacy; (2) asset quality; (3) management/administration; (4) earnings; and (5) liquidity. The agency assigns the bank a composite rating on a scale of one to five, with one representing the highest rating and five the lowest rating. The statement of the banking agencies on the rating system defines these five composite rating categories as follows:

> *Composite 1.* Banks in this group are sound institutions in almost every respect; any critical findings are basically of a minor nature and can be handled in a routine manner. Such banks are resistant to external economic and financial disturbances and capable of withstanding the vagaries of business conditions more ably than banks with lower composite ratings.
>
> *Composite 2.* Banks in this group are also fundamentally sound institutions but may reflect modest weaknesses correctable in the normal course of business. Such banks are stable and also able to withstand business fluctuations quite well; however, areas of weakness could develop into conditions of greater concern. If the minor adjustments are handled in the normal course of business, the supervisor response is limited.
>
> *Composite 3.* Banks in this group exhibit a combination of weaknesses ranging from moderately severe to unsatisfactory. Such banks are only nominally resistant to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting the areas of weakness. Consequently, such banks are vulnerable and require more than normal supervision. Overall strength and financial capacity, however, are still such as to make failure only a remote possibility.
>
> *Composite 4.* Banks in this group have an immoderate volume of asset weaknesses, or a combination of other conditions that are less than satisfactory. Unless prompt action is taken to correct these conditions, they could

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determining the proper capital level for a bank. Risk-Based Capital Requirements for Banks and Bank Holding Companies: Hearings Before the Subcomm. on General Oversight and Investigations, 100th Cong., 1st Sess. (Apr. 30. 1987). For prior views on capital adequacy expressed by the Federal Reserve Board, see Application of National City Corp., [1984–1985 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 86,068 (Aug. 10, 1984); Application of Chase Manhattan Corp., 70 Fed. Reserve Bull. 529 (1984); Bank of Mid-America, Inc., 70 Fed. Reserve Bull. 460 (1984); Manufacturers Hanover Corp., 70 Fed. Reserve Bull. 452 (1984); NCNB Corp., 69 Fed. Reserve Bull. 49 (1983); proposed rule, 51 Fed. Reg. 3976 (1986).

[29] Uniform Interagency Bank Rating System, 1 Fed. Reserve Reg. Serv. ¶ 3-1575 (1978).

reasonably develop into a situation that could impair future viability. A potential for failure is present but is not pronounced. Banks in this category require close supervisor attention and financial surveillance.

Composite 5. This category is reserved for banks whose conditions are worse than defined under number 4. The volume and character of weaknesses are such as to require urgent aid from the shareholders or other sources. Such banks require immediate corrective action and constant supervisory attention. The probability of failure is high for these banks.[30]

The banking agencies have issued many circulars and policy statements on bank examination issues. The following publications are some of those issued by the Federal Reserve Board that may be of special interest with regard to examination

- "Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks";[31]
- "Capital Adequacy Guidelines for Bank Holding Companies and State Member Banks";[32]
- "Country Risk—Uniform Interagency Examination Procedures";[33]
- "Examinations and Inspections of State Member Banks and Bank Holding Companies";[34]

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[30] Id.

[31] Joint Statement by the Board of Governors, Office of the Comptroller, FDIC, and the Conference of State Bank Supervisors, 1 Fed. Reserve Reg. Serv. ¶ 3-1501 (1979). Under this statement, the agencies use the following classification system when it is necessary to classify assets: substandard, doubtful, and loss. They define these terms as follows:

> A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. An asset classified doubtful has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

Id.

[32] 1 Fed. Reserve Reg. Serv. ¶ 3-1506 (1986) (Board of Governors).

[33] 1 Fed. Reserve Reg. Serv. ¶ 3-1510 (1979).

[34] 1 Fed. Reserve Reg. Serv. ¶ 3-1531 (1985). This statement of policy covers the frequency and scope of examinations of state member banks and bank holding companies.

- "Communicating Problems to Management and Boards of Directors";[35] and
- "Trust Rating System."[36]

[2] Portfolio Regulation

Traditionally, the statutes governing depository institutions and the actions of the banking regulators have imposed rigid limitations on the types and amounts of investments that banks and other depository institutions may make.[37] Among others, these limitations have included restrictions on the maximum amount that banks could loan to a single borrower, restrictions on the amount that could be lent against particular collateral, qualifications for collateral, and restrictions on amounts that could be lent to particular individuals such as officers and directors of the bank. This handbook cannot examine all such regulations in detail. They are too numerous, too varied, and too complex. Some of the more important of these restrictions are discussed in this chapter. Other such restrictions have already been referred to in the chapters discussing the powers of different types of financial institutions (Chapters 2, 3, 4, and 5).

It is important to note that since the beginning of the 1980s, there has been a liberalization of the rules limiting depository institutions' activities. On the federal level, passage of the Garn-St Germain Depository Institutions Act of 1982 marked a distinct loosening of the bonds that circumscribed the actions of national banks as well as of thrift institutions.

[a] Loans and Extensions of Credit. Under the Garn-St Germain Depository Institutions Act of 1982,[38] the amount a national bank may lend to a single borrower is determined by a percentage formula.[39] A national bank may loan up to fifteen percent of its unimpaired capital and surplus to a single borrower; the bank may loan an additional ten percent when the additional loans are fully secured. These two limits are cumulative. To implement these limitations, the

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[35] 1 Fed. Reserve Reg. Serv. ¶ 3-1532 (1985).

[36] 1 Fed. Reserve Reg. Serv. ¶ 3-1576 (1981). There also are statements on the rating systems to be used for Edge corporations, id. at ¶ 3-1576.1 (1986); transfer agents, id. at ¶ 3-1577 (1986); and data-processing centers, id. at ¶¶ 3-1515 (1978), 3-1516 (1979).

[37] For a thorough review of the lending limits of national banks after passage of the Garn-St Germain Depository Institutions Act of 1982 and the regulations of the comptroller pursuant to this legislation, see Norton, "Lending Limits and National Banks Under the 1982 Banking Act," 101 Banking LJ 122–154 (1984); Rojc, "National Bank Lending Limits—A New Framework," 40 Bus. Law. 903–931 (1985).

[38] Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of 12, 15, and 18 USC).

[39] 12 USC § 84(a) (1982).

act provides a broad statutory definition of what constitutes a loan or extension of credit subject to the limitations and defines to whom the limits apply.[40] The Comptroller of the Currency enjoys broad authority under the federal statute to adopt rules, regulations, and definitions as well as "to establish limits or requirements other than those specified in [the statute] . . . for particular classes or categories of loans or extensions of credit."[41] The comptroller also may decide when a loan that putatively has been made to one person shall be attributed to another person for the purposes of applying the loan limitations of the federal law.[42]

Determining what constitutes a loan or extension of credit is not always a simple task. Under the comptroller's regulations, an extension of credit includes a "contractual commitment to advance funds,"[43] Examples of commitments that fall within this definition are obligations on the part of the bank to guarantee or serve as surety for the benefit of a third party. A standby letter of credit for which the bank undertakes an obligation to the beneficiary either to repay money borrowed by its customer, to make payment on account of indebtedness undertaken by its customer, or to make payment in the event of a default by its customer in performing an obligation should be treated as an extension of credit subject to the loan limits of the federal law.[44] A bank does not extend credit, on the other hand, by issuing a commercial letter of credit that does not involve a guarantee by the bank to pay a money obligation and does not provide for the bank to pay in the event of a default by the customer.[45]

Occasionally, loans that a bank ostensibly makes to separate parties may be treated as loans to a single person for the purpose of applying the bank's lending limitation. In *del Junco v. Conover*,[46] the court found that three loans made separately to a company and two of its officers, respectively, should be aggregated. Moreover, the directors of the bank had personal liability because they had knowledge of the violation.[47] The facts were clear that the company used the

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[40] 12 USC § 84(b) (1982).

[41] 12 USC § 84(d)(1) (1982). See also Glidden, "National Bank Lending Limits and the Comptroller's Regs: A Clarification," 101 Banking LJ 430–468 (1984).

[42] 12 USC § 84(d)(2) (1982).

[43] 12 CFR § 32.2 (1987).

[44] 12 CFR § 32.2(d), (e) (1987). The comptroller has stated that a direct-pay letter of credit will also be subject to a bank's lending limitations and should be treated the same as a standby letter of credit. Office of the Comptroller of the Currency, Interpretative Letter No. 361 (June 1986), reported in 47 Wash. Fin. Rep. (BNA) No. 2, at 57 (July 14, 1986).

[45] 12 CFR § 32.2(d) (1987).

[46] 682 F2d 1338 (9th Cir. 1982), cert. denied, 459 US 1146 (1983).

[47] The enforcement proceeding was brought under 12 USC § 1818(b)(1) (1982) rather than under 12 USC § 93 (1982), which expressly imposes liability only for knowing violations. The Court said it was not required to decide whether Section 1818(b)(1) also required the violation to be a knowing one, because the directors in fact had knowledge. Id. at 1342.

proceeds of the loan, and the bank had known that to be the purpose of the loan. Although the bank directors against whom the comptroller imposed liability claimed to have acted without knowledge of the violation, the court held that the violation was a knowing one, because the directors "had knowledge of the identity of the borrowers, knowledge that all the loan proceeds were to be used by one company, and knowledge of the loan amounts and the bank's loan limits."[48] The law was violated even though the directors did not know that the three separate loans must be aggregated, as a matter of law. Moreover, the court upheld the comptroller's remedial action against the directors. The directors would remain liable for the total amount of the loans until they were fully satisfied, and not just until the loans were brought within the bank's legal lending limit.[49]

The comptroller's regulation also includes detailed rules as to when loans should be combined to be attributed to a single person. Under these regulations, a loan to one person should be attributed to another person when the proceeds of the loan are to be used "for the direct benefit of the other person" or when "a common enterprise is deemed to exist between the persons."[50] The regulations define what constitutes a common enterprise.[51]

[b] Exceptions to the Limitations on Loans to a Single Borrower. There are ten exceptions to the limitation on loans by a national bank to a single borrower. These exceptions are stated as follows:

> (1) Loans or extensions of credit arising from the discount of commercial or business paper evidencing an obligation to the person negotiating it with recourse shall not be subject to any limitation based on capital and surplus.
>
> (2) The purchase of bankers' acceptances of the kind described in section 372 of this title and issued by other banks shall not be subject to any limitation based on capital and surplus.
>
> (3) Loans and extensions of credit secured by bills of lading, warehouse receipts, or similar documents transferring or securing title to readily marketable staples shall be subject to a limitation of 35 per centum of capital and surplus in addition to the general limitations if the market value of the staples securing each additional loan or extension of credit at all times equals or exceeds 115 per centum of the outstanding amount of such loan or extension of credit. The staples shall be fully covered by insurance whenever it is customary to insure such staples.

[48] Id.

[49] For further discussion of the liability of bank officers and directors, including liability for breach of lending limits, see the discussion at ¶¶ 9.01[3], 9.01[4], 9.02.

[50] 12 CFR § 32.5(a)(1) (1987).

[51] 12 CFR § 32.5(a)(2) (1987).

(4) Loans or extensions of credit secured by bonds, notes, certificates of indebtedness, or Treasury bills of the United States or by other such obligations fully guaranteed as to principal and interest by the United States shall not be subject to any limitation based on capital and surplus.

(5) Loans or extensions of credit to or secured by unconditional takeout commitments or guarantees of any department, agency, bureau, board, commission, or establishment of the United States or any corporation wholly owned directly or indirectly by the United States shall not be subject to any limitation based on capital and surplus.

(6) Loans or extensions of credit secured by a segregated deposit account in the lending bank shall not be subject to any limitation based on capital and surplus.

(7) Loans or extensions of credit to any financial institution or to any receiver, conservator, superintendent of banks, or other agent in charge of the business and property of such financial institution, when such loans or extensions of credit are approved by the Comptroller of the Currency, shall not be subject to any limitation based on capital and surplus.

(8)(A) Loans and extensions of credit arising from the discount of negotiable or nonnegotiable installment consumer paper which carries a full recourse endorsement or unconditional guarantee by the person transferring the paper shall be subject under this section to a maximum limitation equal to 25 per centum of such capital and surplus, notwithstanding the collateral requirements set forth in subsection (a)(2) of this section.

(B) If the bank's files or the knowledge of its officers of the financial condition of each maker of such consumer paper is reasonably adequate, and an officer of the bank designated for that purpose by the board of directors of the bank certifies in writing that the bank is relying primarily upon the responsibility of each maker for payment of such loans or extensions of credit and not upon any full or partial recourse endorsement or guarantee by the transferor, the limitations of this section as to the loans or extensions of credit of each such maker shall be the sole applicable loan limitations.

(9)(A) Loans and extensions of credit secured by shipping documents or instruments transferring or securing title covering livestock or giving a lien on livestock when the market value of the livestock securing the obligation is not at any time less than 115 per centum of the face amount of the note covered, shall be subject under this section, notwithstanding the collateral requirements set forth in subsection (a)(2) of this section, to a maximum limitation equal to 25 per centum of such capital and surplus.

(B) Loans and extensions of credit which arise from the discount by dealers in dairy cattle of paper given in payment for dairy cattle, which paper carries a full recourse endorsement or unconditional guarantee of the seller, and which are secured by the cattle being sold, shall be subject under this section, notwithstanding the collateral requirements set forth in subsection (a)(2) of this section, to a limitation of 25 per centum of such capital and surplus.

(10) Loans or extensions of credit to the Student Loan Marketing Association shall not be subject to any limitation based on capital and surplus.[52]

[i] Bank acceptances. Exception (2) in the previous list, for bank acceptances, applies to the purchase of bank acceptances created by other banks where the other bank is the acceptor. This exception should not be confused with the limitation on the extent to which a national bank may engage in accepting drafts. As the comptroller's regulations point out, the limits that apply to a national bank's acceptance of eligible drafts are contained in other statutes. Moreover, if the bank acceptances are not drafts eligible under the standards referred to in the exception, the national bank may acquire such "ineligible" drafts only within the limitations of the federal law on loans to a single borrower.[53]

The Export Trading Company Act of 1982,[54] expanded the ability of banks that are members of the Federal Reserve System to invest in bankers' acceptances.[55] Under this statute, a member bank can invest up to 150 percent of its paid-up and unimpaired capital stock and surplus by accepting "drafts . . . drawn upon it having not more than six months' sight to run, exclusive of days of grace," that relate to three types of transactions: (1) "transactions involving the importation or exportation of goods;" (2) "transactions involving the domestic shipment of goods;" or (3) transactions where the bank is "secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples."[56] By permission of the Board of Governors of the Federal Reserve System, an institution may increase the amount of its acceptances to an aggregate amount of up to 200 percent of its capital stock and surplus as previously defined.[57]

The statute also distinguishes between acceptances arising in domestic transactions and those arising in international transactions. The bank may not accept an aggregate amount of acceptances arising in domestic transactions in excess of 50 percent of the total amount of acceptances authorized under the statute.[58] No bank can accept paper or be obligated to any one person for an aggregate amount of more than 10 percent of its capital and surplus for transactions involving bank acceptances unless the bank is secured "either by attached documents or by some other actual security growing out of the same transaction

[52] 12 USC § 84(c) (1982).

[53] 12 CFR § 32.6(b) (1987).

[54] Pub. L. No. 97-290, 96 Stat. 1233. Title II of this act is known as the Bank Export Services Act. See ¶ 5.02[4].

[55] 12 USC § 372 (1982). There is an excellent description of bankers' acceptances and how they are used in Jensen & Parkinson, "Recent Developments in the Bankers' Acceptance Market," 72 Fed. Reserve Bull. 1–12 (1986).

[56] 12 USC § 372(a) (1982).

[57] 12 USC § 372(c) (1982).

[58] 12 USC § 372(d) (1982).

as the acceptance."[59] Further, banks may participate in acceptances that have been made by another primary accepting bank.[60]

[ii] Real estate loans. At one time, the authority of a national bank to make real estate loans was subject to detailed requirements on the nature of the security for the loan and on other criteria. Since the 1982 amendments made by the Garn-St Germain Act, the Comptroller of the Currency may issue rules or orders prescribing the terms and conditions under which national banks may make loans secured by interests in real estate.[61]

[iii] Other investments. Other provisions of the National Bank Act specify additional activities in which a national bank may engage, and impose limitations on them. One part of the act deals with a national bank's ability to invest in securities.[62] Although a national bank may both purchase securities from a single borrower and make loans to the same entity, the comptroller will not treat the securities as within the loan limitations of 12 USC § 84 (1982) as long as the investments meet the limits and eligibility requirements of 12 USC § 24 (1982).[63]

The comptroller also has considered when purchase of securities or other paper under a repurchase agreement should be treated as a loan or an extension of credit.[64] Under the comptroller's interpretation, a repurchase agreement involving certain eligible securities is not to be treated as a loan or an extension of credit, but a repurchase agreement of other securities will be treated as a loan and not as "an obligation of the underlying obligor of the security."[65] When a bank purchases third-party paper under a repurchase agreement, the transaction is one that falls within the limitations on loans to a single borrower. The obligation of the seller of the paper to repurchase it from the bank should be regarded as an extension of credit to be measured "by the total amount of paper

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[59] 12 USC § 372(e) (1982). The former version of the statute contained a detailed enumeration of the type of collateral that would be acceptable security.

[60] Letter from J. Charles Partee, Chairman, Federal Financial Institutions Examination Council, reprinted in 4 Fed. Banking L. Rep. (CCH) ¶ 43,690 (1983).

[61] 12 USC § 371(a) (1982). See Borkus v. Michigan Nat'l Bank, 117 Mich. App. 662, 324 NW2d 123 (1982), where the court held that a real estate loan made by a bank in 1971, which violated a statute requiring that it be secured by a first lien, was an illegal loan. The court ruled that the debtor could defend a mortgage foreclosure action brought by the bank, on the grounds that the bank violated the statute, even though the foreclosure action was brought after 1974, when the federal prohibition on second mortgage real estate lending had been removed.

[62] A national bank's ability to invest and deal in securities is discussed at ¶ 8.01.

[63] 12 CFR § 32.111 (1987).

[64] 12 CFR §§ 32.102, 32.103, 32.104 (1987).

[65] 12 CFR § 32.103 (1987).

the seller may ultimately be obligated to repurchase."[66] Also, under the regulations, the sale of a participation in a loan does not necessarily remove that loan from the selling bank's own loan limitation. The participation must be sold on a nonrecourse basis, and "must result in a prorata sharing of credit risk proportionate to the respective interests of the originating and participating lenders," in order to be removed from the bank's lending limit.[67] An overdraft other than an "intra-day" or "daylight" overdraft is an extension of credit.[68] While the sale of federal funds for one business day is not an extension of credit, a sale with a maturity of more than one business day is subject to the lending limit.[69]

Although a guarantor will be liable on the obligation of guarantee to the bank, the obligation need not be included in the loan limitations applicable to that person if the guarantor "does not receive any of the proceeds, or the benefit of the proceeds, of the loan or extension of credit," and the rules on attributing loans to other persons do not apply.[70]

[c] State Banks and Savings and Loan Associations. With regard to loans and investments, state-chartered banks operate under restrictions similar to those on national banks. It would be too complex to review here the various details of each state law and regulation. The differences between states in this area are considerable, and some states have enacted banking laws that grant significant freedom to state-chartered institutions to engage in activities that traditionally had been severely curtailed or prohibited. Real estate transactions, insurance activities, and securities dealings are areas in which such changes have been especially notable.

The ability of savings and loan associations to engage in broader investment and lending activities has been especially dramatic. Title III of the Garn-St Germain Act of 1982[71] expanded the powers of federal savings and loan associations and federal savings banks in a number of important ways, as detailed in the following paragraphs.

Accounts. The act increases the investment opportunities for federal savings and loan institutions and federal savings banks. The types of accounts these institutions may offer to raise capital, include not only savings accounts for "fixed, minimum or indefinite periods of time," but also demand accounts when the person or organization has a business loan relationship with the institution

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[66] 12 CFR § 32.104 (1987).

[67] 12 CFR § 32.107 (1987).

[68] 12 CFR § 32.105 (1987).

[69] 12 CFR § 32.102 (1987).

[70] 12 CFR § 32.101 (1987).

[71] Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of 12, 15, and 18 USC).

or the account will assist the thrift institution to collect payments from a nonbusiness customer.[72] The act makes clear that accounts established by the institution may be subject to check or transfer under a negotiable order of withdrawal, according to regulations established by the FHLBB.

Remote service units. The act authorizes the FHLBB to establish regulations allowing institutions to utilize remote service units for the purpose of crediting or debiting accounts of the institution.[73]

Stock, security, and borrowing powers. The FHLBB is empowered to authorize federal savings institutions to borrow money, give security, act as sureties, and issue securities, including capital stock.[74]

Conversion to federal charters. The act authorizes institutions to convert to federal institutions and to change from a mutual to a stock form of organization.[75]

Investments. The act enlarges the power of federal savings and loan associations to make real estate loans on nonresidential property, to invest in government securities, and to make commercial and other loans.[76]

Elimination of interest rate differentials. The act orders the abolition of interest rate differentials between federally insured banks and federally insured savings institutions. It required the Depository Institutions Deregulation Committee to end all differentials by January 1, 1984.[77]

Money market account. The act directs the Depository Institutions Deregulation Committee to establish a new deposit account, within sixty days from the enactment of this legislation, that will be competitive with money market mutual funds offered under the Investment Company Act of 1940.[78] No maximum interest rate limitation may be established for these accounts.[79] This new account will not be subject to reserve requirements of the Board of Governors of the Federal Reserve System, so long as it is not a transaction account and does not permit more than three authorized or automatic transfers and three other transfers to third parties monthly.[80]

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[72] 12 USC § 1464(b)(1)(A) (1982).

[73] 12 USC § 1464(b)(1)(F) (1982).

[74] 12 USC § 1464(b)(2) (1982).

[75] 12 USC § 1464(i) (1982).

[76] 12 USC § 1464(c)(1)(A), (B), (G), (H), (R) (1982).

[77] Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, tit. III, § 326, 96 Stat. 1500 (codified at 12 USC § 3503).

[78] 12 USC § 3503(c)(1) (1982).

[79] 12 USC § 3503(c)(2) (1982).

[80] 12 USC § 3503(c)(3) (1982).

Antitying provisions. The act prohibits federal institutions from tying the extension of credit or other services to requirements that customers obtain other services or conduct other business with that institution.[81] These measures are similar to the antitying provisions applicable to banks.[82]

Service corporations. Although the act gives thrift institutions expanded authority, the conference report on the legislation stresses that the legislation does not authorize the FHLBB to permit service corporations to engage in any new activities not previously authorized.[83]

¶ 7.02 SECURITIES ACTIVITIES

Banks engage in many transactions that bring them within the ambit of federal securities laws. These laws and the regulations implementing them are complex. The complexity becomes even greater in the case of banks, because banks receive special treatment under these laws. This handbook cannot survey the extensive body of federal securities laws. Instead, the present section sketches only some of the salient features of the general body of federal securities law, as it relates to banks, with primary emphasis on the provisions of the federal banking statutes that control the extent to which banks and other depository institutions may engage in securities activities. These latter federal controls are often popularly referred to as the Glass-Steagall Act. (See Chapter 8.)

The federal securities laws are relevant to banks in at least three ways. Firstly, there is extensive regulation of securities issuers and others by the Securities and Exchange Commission (SEC), which, among other requirements, imposes duties of disclosure of information and registration related to transactions within the purview of the statutes. Although banks enjoy an exclusion from many of these requirements, to the extent that they are not excluded, or to the extent that they engage in activities subject to such regulation, there are serious consequences. Secondly, the securities laws contain provisions establishing liability when parties who are covered by the acts engage in certain securities transactions in a fraudulent manner. Banks generally are subject to the antifraud provisions of the securities laws. They also are able to assert rights based on the securities laws against other parties. Thirdly, since the legislation passed by Congress in the aftermath of the Great Depression. federal law has attempted to restrict the extent to which banks may engage in securities activities by requiring a separation between commercial banks, which engage in deposit taking

[81] 12 USC § 1464(q) (1982).

[82] See ¶ 9.02[5].

[83] Conf. Rep. on Garn-St Germain Depository Institutions Act of 1982, H.R. Rep. No. 899, 97th Cong., 2d Sess. 88 (1982).

and commercial lending, and investment banks and securities brokers and dealers, who engage in issuing, underwriting, and dealing in securities. The line that marks the distinction between commercial banks and investment banking has blurred if not entirely dissolved in the face of market developments in the mid-1980s accentuating deficiencies in the federal regulatory scheme. In 1988, Congress was considering significant changes in the powers that banks may exercise in this area and concommittant adjustments in the manner in which the federal government would regulate such new activities. Given the extreme complexity, technicality, and fast-developing nature of federal securities law, timely consultation with legal counsel is indispensable.

[1] Scope of Federal Securities Laws Generally, as Applied to Banks

The major federal securities statutes[84] are the Securities Act of 1933,[85] the Securities Exchange Act of 1934,[86] the Trust Indenture Act of 1939,[87] the Investment Company Act of 1940[88] the Investment Advisers Act of 1940,[89] the Securities Investor Protection Act of 1970[90] (not discussed here), and the Government Securities Act of 1986.[91] The Securities Act of 1933 imposes registration and information disclosure requirements on issuers of securities. It also contains provisions prohibiting misrepresentations and fraudulent practices. Securities issued by a bank are exempt from the *registration* requirements of the 1933 Act.[92] Exemptions also exist for certain trust funds held by the bank as a

[84] Good general references are H. Bloomenthal, Securities Law Handbook (1987–1988); V. DiLorenzo, W. Schlichting, J. Cooper, 5 Banking Law (1987); L. Loss, Fundamentals of Securities Regulation (1983); L. Soderquist, Understanding the Securities Laws (1987). See also Fischer, Gram, Kaufman & Mote, "The Securities Activities of Commercial Banks: Life Beyond Lending," 14 Sec. Reg. LJ 315–342 (1987); Note, "Regulation of Bank Securities Activities," 41 Wash. & Lee L. Rev. 1187–1213 (1984).

[85] 15 USC §§ 77a–77aa (1982 & Supp. IV 1986).

[86] 15 USC §§ 78a–78kk (1982 & Supp. IV 1986).

[87] 15 USC §§ 77aaa–77bbbb (1982).

[88] 15 USC §§ 80a-1–80a-64 (1982 & Supp. IV 1986).

[89] 15 USC §§ 80b-1–80b-21 (1982 & Supp. IV 1986).

[90] 15 USC §§ 78aaa–78lll (1982).

[91] Pub. L. No. 99-571, 100 Stat. 3208 (codified at 12 USC § 78o-5 and 31 USC § 9110, and amending 12 USC §§ 78c, 78o, 78o-3, 78q, 78w, 78y, 80a-9, 80b-3 and 31 USC § 3121).

[92] The exemption is stated as follows:

> Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities . . . or any security issued or guaranteed by any bank; or any security issued by or representing an interest in or a

fiduciary or under a qualified pension plan arrangement.[93] These exemption provisions apply to both national and state banks.[94] Certain other exemptions in the act, which are not specifically directed at banks, may apply in particular transactions, such as the exemption for "private offerings."[95]

The Securities Exchange Act of 1934 requires the disclosure of information, through registration and periodic reports, by companies that issue securities listed on the national exchanges or by companies that are of a certain size. It also regulates proxy solicitation, deals with disclosure of insider information, authorizes regulation of margin requirements,[96] and establishes liability for false statements and fraudulent practices. As amended in 1964, the act applies to companies that have 500 or more stockholders or that have assets in excess of $1 million.[97] Generally, the SEC is responsible for administering the act; but, in the case of banks, the federal banking regulatory agencies have authority. National banks make their reports to the comptroller; state member banks, to the Federal Reserve Board; and state-insured nonmember banks, to the FDIC. These federal banking agencies have regulations that deal with the application of these laws to the banks under their jurisdictions.[98]

The Trust Indenture Act of 1939 applies to debt securities, such as bonds, and contains various exemptions, including an exemption similar to that of the 1933 Securities Act for securities issued by banks.[99] The Investment Advisers Act of 1940 and the Investment Company Act of 1940 regulate persons who serve as investment advisers and the activities of companies that engage in trading or investing in securities. The definitions in the Investment Advisers Act

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direct obligation of a Federal Reserve bank; or any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian;

15 USC § 77c(a)(2) (1982).

[93] Id.

[94] "For purposes of this paragraph, . . . the term "bank" means any national bank, or banking institution organized under the laws of any State, territory or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official." Id.

[95] 15 USC § 77d(2) (1982).

[96] The margin regulations are discussed at ¶ 3.04[6][a]. See also 15 USC § 78g (1982 & Supp. IV 1986).

[97] 15 USC § 78l(g)(1) (1982).

[98] 12 USC § 78q (1982 & Supp. IV 1986). The regulations are at 12 CFR §§ 11.101, 11.201, 11.301 (1987) (national banks); 12 CFR § 206.4 (1987) (state member banks); and 12 CFR §§ 335.01, 335.301, 335.310 (1987) (nonmember FDIC insured banks).

[99] 15 USC § 77ddd (1982).

do not encompass banks.[100] Under the Investment Company Act, banks[101] are excluded from the definition of "investment company," as are thrifts[102] and certain bank trust funds.[103] It is possible for a bank to be subject to the act, however, if it acts as an "investment adviser" to an investment company.[104]

The United States Government Securities Act of 1986[105] was passed after the dramatic failure of a number of firms that specialized in dealing in U.S. securities. The act directs the Secretary of the Treasury to adopt regulations to implement its provisions.[106]

The exemption for banks in the securities laws was tested on July 1, 1985, when the SEC adopted a rule requiring banks engaged in securities brokerage activities for profit to submit to regulation by the SEC as a broker-dealer. The rule was prompted by actions on the part of the comptroller and the courts allowing national banks to engage in discount brokerage operations. A challenge to the rule by the Bankers' Association produced a decision invalidating the rule.[107] The SEC argued in favor of a functional division of regulatory responsibility between the banking supervisory agencies and the SEC. The court rejected this approach, holding that the Securities Exchange Act of 1934 exempts national banks from regulation by the SEC.[108] In addition, the court read the

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[100] 15 USC §§ 80b-2(a)(3), 80b-2(a)(7), 80b-2(a)(11), 80b-2(a)(12) (1982). A bank is defined for purposes of the act as

> (A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve system, (C) any other banking institution or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this subchapter, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

15 USC § 80b-2(a)(2) (1982).

[101] 15 USC § 80a-3(c)(3) (1982). A bank is defined the same as in the Investment Advisers Act. 15 USC § 80a-2(a)(5) (1982). See also Annot., "What is an 'Investment Company' Under § 3 of Investment Company Act of 1940 (15 U.S.C.S. § 80a(3))," 64 ALR Fed. 337 (1983).

[102] 15 USC § 80a-3(c)(3) (1982).

[103] 15 USC § 80a-3(c)(3), (11) (1982).

[104] 15 USC § 80a-2(a)(20) (1982).

[105] Pub. L. No. 99-571, 100 Stat. 3208 (codified at 15 USC § 78o-5 (Supp. IV 1986)). This act is discussed at ¶ 8.02.

[106] 15 USC § 78o-5(b)(1) (Supp. IV 1986). The Treasury regulations are reported at 52 Fed. Reg. 27,910, 27,926–27,959 (1987) (to be codified at 17 CFR Ch. IV).

[107] American Bankers Ass'n v. SEC, 804 F2d 739 (DC Cir. 1986).

[108] Id. at 743. Section 3 of the 1934 Act defines both "broker" and "dealer" as a person engaged in certain securities activities "but does not include a bank." 15 USC

legislative history of the 1975 amendment to the 1934 Act as indicating that Congress was specifically aware of the controversy over the scope of the SEC's regulation of banks' securities activities and that Congress not only declined to revise the definitions that kept banks from being classified as broker-dealers but also directed the SEC to provide Congress with recommendations for legislative change, if that was thought to be appropriate. The court held that the plain meaning of the statute, regarding the exemption of banks, "reflects a basic decision by Congress on how to allocate responsibility among different federal agencies for regulating financial institutions and markets."[109]

[2] Antifraud Provisions of the Federal Securities Laws

There are a number of provisions in the federal securities laws that establish liability for misrepresentations, fraudulent practices, and other violations of the acts. The 1933 Act creates liability for misstatements in registration statements,[110] for securities sold in violation of the registration requirements of the act,[111] and for misstatements by a person who offers or sells securities in interstate commerce.[112] Under the 1934 Act, there is liability to a person who purchases or sells in reliance on misstatements in a report filed under the act.[113]

The provision most often at issue is Section 10(b) of the 1934 Act. This provision states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange— . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[114]

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§§ 78c(a)(4), 78c(a)(5) (1982). The definition of "bank" in the act, 15 USC § 78(c)(a)(6) (1982), also reveals no intent to carve an exception to the exemption from regulation afforded banks.

[109] American Bankers Ass'n v. SEC, 804 F2d at 755.

[110] 15 USC § 77K (1982). See Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (SDNY 1968).

[111] 15 USC § 771 (1982). See also Annot., "Necessity of Privity Between Purchaser and Issuer of Security in Action Against Issuer Under § 12 of Securities Act of 1933 (15 U.S.C.S. § 771)," 56 ALR Fed. 659 (1982).

[112] 15 USC § 771 (1982).

[113] 15 USC § 78r (1982).

[114] 15 USC § 78j(b) (1982). See also Annot., "Purchase or Sale Requirement as to Defendant or Victim in Criminal Prosecution for Violation of § 10(b) of Securities

The SEC has implemented Section 10(b) with a regulation known as Rule 10b-5. This rule has been the basis for broad liability, and reads as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[115]

Although the statute does not expressly give a person who has been injured by violation of Section 10(b) the right to bring a private action for damages, the Supreme Court has ruled that such actions may be maintained.[116] In order for a violation of Section 10(b) and Rule 10b-5 to exist, the violator must have acted with a certain degree of intent or "scienter."[117]

Exchange Act," 66 ALR Fed. 848 (1984); Annot., "Who is 'Forced Seller' for Purposes of Maintenance of Civil Action Under § 10(b) of Securities Exchange Act of 1934 (15 U.S.C.S. § 78(b) and SEC Rule 10b-5," 59 ALR Fed. 10 (1982).

[115] 17 CFR § 240.10b-5 (1987). The rule is similar to the antifraud provisions of Section 17(a) of the 1933 Act, 15 USC § 77q(a) (1982). This section states:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

See also Thompson, "The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages," 37 Vand. L. Rev. 349–398 (1984).

[116] Ernst & Ernst v. Hochfelder, 425 US 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 US 723 (1975). Not all of the provisions of the securities laws may be privately enforced. Courts have held, for example, that individuals who borrow from lenders in order to purchase securities do not have a private right of action against the investment lenders under Regulation U. Bassler v. Central Nat'l Bank, 715 F2d 308 (7th Cir. 1983). See generally Annot., "What Constitutes Violation of Margin Requirements for Banks Under § 7 of Securities Exchange Act of 1934 (15 U.S.C.S. § 78(g)) and Regulation U Promulgated Thereunder (12 CFR § 221.1 et seq.)," 34 ALR Fed. 332 (1977).

[117] Aaron v. SEC, 446 US 680 (1980); Santa Fe Indus. v. Green, 430 US 462 (1977); Ernst & Ernst v. Hochfelder, supra note 116. See also Note, "Prying Open Swiss Vaults:

Rule 10b-5 reaches a variety of practices and conduct. Among the most significant is its impact on insider trading. The liability under the rule for use of insider information has developed in a series of Supreme Court decisions. It is now well established that this liability is much broader than the simple situation in which an officer of a company with special information about that company buys or sells company stock.[118] As bankers may have ready access to much insider information from serving on boards of directors of companies and in the course of dealing with credit files, loan applications, and other transactions involving their customers, the possibility of liability as a result of access to inside information must be carefully considered. With banks increasingly engaged in securities tradings, not only in their trust departments but also in other areas, this is a problem that needs to be carefully reviewed by experienced legal counsel for the bank.

[3] Definition of "Security" Under the Securities Act of 1933 and the Securities Exchange Act of 1934

The issue of determining what constitutes a security is an important one for banks, since, as discussed earlier in this chapter,[119] the antifraud provisions of the securities laws do apply to banks when they are involved in a transaction involving a security, and may be the source of both rights and liabilities.[120] The

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The SEC's Investigation of Insider Trading in the Santa Fe Case," 1 Am. UJ Int'l L. & Pol'y 259–289 (1986).

The scienter requirement is not the same for all of the antifraud provisions of the securities laws. See Herman & MacLean v. Huddleston, 459 US 375 (1983), which discusses the differences between Section 10(b) and Section 11 of the 1933 Act. The precise requirements of the scienter element are matters that have occupied considerable scholarly and judicial attention. For a thorough discussion see Milich, "Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense," 11 J. Corp. L. 179 (1986).

[118] See Chiarella v. U.S., 445 US 222 (1980); SEC v. Texas Gulf Sulphur Co., 401 F2d 833 (2d Cir. 1968), cert. denied, 394 US 976 (1969). See also Goelzer, et al., "Symposium on Insider Trading," 13 Hofstra L. Rev. 1–146 (1984).

[119] The scope of federal securities laws as they apply to banks is discussed supra at ¶ 7.02[1].

[120] For an excellent brief discussion, see D. Ratner, Securities Regulation (2d ed. 1982). For a more extended treatment, see V. DiLorenzo, W. Schlichting, J. Copper, 5 Banking Law Ch. 96–105 (1987). See also Annot., "Commodity Futures Contract or Account as Included in Meaning of 'Security' as Defined in § 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C.S. § 78c(a)(10))," 58 ALR Fed. 616 (1982); Annot., "Partnership and Joint Venture Interests as Securities Within Meaning of Federal Securities Act of 1933 (15 U.S.C.S. § 77a et seq.) and Securities Exchange Act of 1934 (15 U.S.C.S. § 78a et seq.)," 58 ALR Fed. 408 (1982); Annot., "What Interests in Real Estate Are 'Securities' Within the Meaning of § 3(a)(10) of Securities Exchange Act of 1934 (15 U.S.C.S. § 78c(a)(10))," 52 ALR Fed. 146 (1981).

starting point for determining what constitutes a security is with the federal securities statutes themselves. Preliminarily, it is important to note that each of the various federal securities laws affecting banks usually contains its own definition of "security." Care must be taken to be alert to differences between these laws. It has not been decided, for example, that a security for purposes of the 1933 and 1934 securities acts is also a security for purposes of the Glass-Steagall Act.[121] There are other important differences as well.

Under the Securities Act of 1933, a security includes:

> any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, . . . or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[122]

The 1934 Act has a similar definition.[123] There is a vast body of law on what constitutes a security. In light of this, the present section briefly reviews some of the leading cases that discuss what may constitute a "security" under this and similar definitions, and also describes some of the circumstances in which transactions with securities may fall within the antifraud measures of the securities laws.

[a] Transactions in Stocks, Bonds, and Similar Securities. Although the U.S. Supreme Court has held that shares of stock in a specially regulated cooperative housing corporation were not "securities" for the purpose of the federal securities laws,[124] in most cases stock will be issued with an investment or profit motivation and thus will not fit within the limited circumstances present in the housing case. Therefore, as a leading commentator has said, "A share of stock will almost always be deemed to be a 'security.' "[125]

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[121] The definition of "security" with regard to the Glass-Steagall Act is discussed at ¶ 8.01[3].

[122] 15 USC § 77b(1) (1982).

[123] 15 USC § 78c(a)(10) (1982). This definition of "security" adds the following to the definition set out in the 1933 Act (15 USC § 77b(1) (1982)): "but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

[124] United Hous. Found. v. Forman, 421 US 837 (1975).

[125] D. Ratner, Securities Regulation 23 (2d ed. 1982).

When a bank takes stocks and bonds as collateral, there may be a transaction within the securities laws. In *Rubin v. United States,*[126] the Supreme Court held that a pledge of securities constituted an "offer or sale" within the Securities Act of 1933, because it was the disposition of an interest in a security for value. As a result, the Court upheld a bank customer's conviction for violating the antifraud provisions of the act by, among other things, submitting a false financial report to the bank and representing that worthless stock used as collateral was valuable. Similarly, there is a transaction within the federal securities laws where the antifraud provisions also will apply when the sale of a closely controlled business is accomplished through a transfer of stock.[127]

[b] Certificates of Deposit and Other Bank Deposits. Often there is a dispute over how to characterize various types of bank instruments or interests. The Supreme Court has held that certain shares issued by savings and loan associations are securities for the purposes of the 1934 Act.[128] However, in a 1982 case involving a certificate of deposit, *Marine Bank v. Weaver*, the Court ruled that a certificate of deposit was not a security under the 1934 Act.[129] This case is important for its suggestion that the protections afforded bank customers through the provisions of the federal banking laws may serve as the basis for distinguishing some bank instruments from those that otherwise might be securities under the federal securities laws.

In *Marine Bank v. Weaver*, Marine Bank had issued a certificate of deposit, insured by the FDIC, to the Weavers, who had then pledged the certificate to the bank to guarantee a loan by the bank to another party. The primary debtor under this transaction had entered into an agreement with the Weavers that gave them a percentage of the debtor's net profits and that limited the debtor's ability to make further borrowings. The primary debtor then became bankrupt, and the Weavers sued the bank for violations of Section 10(b) of the Securities Exchange

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[126] 449 US 424 (1981).

[127] Landreth Timber Co. v. Landreth, 471 US 681 (1985); Gould v. Ruefenacht, 471 US 701 (1985). *Landreth* raised the issue of whether the sale of 100 percent of a company's stock would be subject to the federal securities laws. *Gould* presented the issue of whether the sale of 50 percent of a company's stock to purchasers who subsequently were to participate in management of the company would be subject to the federal securities laws. The Supreme Court held that both transactions were covered. See also St. Philip Towing & Transp. Co. v. Pavers, Inc., 768 F2d 1233 (11th Cir. 1985).

[128] Tcherepnin v. Knight, 389 US 332 (1967). See also SEC v. Variable Annuity Life Ins. Co., 359 US 65 (1959); SEC v. United Benefit Life Ins. Co., 387 US 202 (1967), which treated variable annuities as securities.

[129] Marine Bank v. Weaver, 455 US 551 (1982). See also Annot., "Certificate of Deposit as 'Security' Under Federal Securities Laws," 82 ALR Fed. 553 (1987); Klein, "Certificates of Deposit as Securities: State Law Considerations," 5 Ann. Rev. Banking L. 55–89 (1986).

Act of 1934.[130] They claimed that the bank's officers violated the securities law by failing to disclose the financial plight of the debtor. They argued that the securities laws applied to the transaction because the certificate of deposit and the agreement between the Weavers and the primary debtor constituted securities.

A unanimous Supreme Court held that the Securities Act did not apply, because neither the certificate of deposit nor the agreement constituted a security. Noting that Congress did not intend by enacting the securities laws to provide a broad federal remedy for all fraud, the Court said that there were important differences between a certificate of deposit purchased from a federally regulated bank and other long-term debt obligations that do constitute securities. Unlike the holder of an ordinary long-term debt obligation, who assumes the risk of borrower insolvency, the purchaser of a certificate of deposit "is virtually guaranteed payment in full" because of the existence of federal deposit insurance. In the view of the Court, "it is unnecessary to subject users of bank certificates of deposit to liability under the anti-fraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under the federal banking laws.[131]

The Court then considered whether the agreement between the Weavers and the primary debtor constituted a security. The Court held that this agreement was not an instrument of the type "ordinarily and commonly considered to be securities in the commercial world" because it was a "unique agreement, negotiated one-on-one," which was not offered to other potential investors and which was not designed to be traded publicly. Moreover, the provision giving the Weavers control over future borrowings of the debtor was a characteristic not common to ordinary securities.[132]

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[130] 15 USC § 78j(b) (1982).

[131] *Marine Bank*, 455 US at 559. See also Note, "Certificates of Deposit and the Securities Laws: The Limited Precedent of *Marine Bank v. Weaver*," 4 Ann. Rev. Banking L. 453–482 (1985).

[132] Although a bank certificate of deposit may not be a security when issued by a bank, the certificate may be marketed in an investment program in a manner that makes the certificate a security under the federal securities laws. The U.S. Court of Appeals for the Second Circuit distinguished *Marine Bank v. Weaver* when it considered whether a certificate of deposit in an investment program operated by a brokerage firm constituted a security, under the federal Securities Acts (Sections 5(a) and 17 of the 1933 Act, and Section 10(b) of the 1934 Act). The brokerage firm, Merrill Lynch, sold its customers special certificates issued by banks, certificates that were not otherwise available to the public. In the court's opinion, Merrill Lynch engaged in an activity beyond that of acting simply as a broker or sales agent; it used its economic power to negotiate with banks to issue certificates of deposit on favorable terms, it provided a secondary market to its customers for the certificates, its customers relied upon the firm's skill and financial stability, and it provided marketing efforts and monitored the issuing banks for its customers. In view of these factors, the court concluded: "Here investors are buying something more than an individual certificate of deposit. They are buying an opportunity

Another federal court followed *Marine Bank v. Weaver*, in a case in which a Mexican bank issued a certificate of deposit whose payment was determined in accordance with a floating currency exchange rate. The court reasoned that the certificates of deposit should not be treated as securities, because they were issued by a bank that was extensively regulated by Mexico to prevent insolvency, a regulation that the court thought was the equivalent to the protection relied upon in *Weaver*. Because this regulation meant that there was "virtually no risk that insolvency will prevent [the bank] from repaying" the holder of the certificates, the court ruled that the certificates should not be treated as securities.[133]

[c] Promissory Notes and Commercial Loan Agreements. In other cases, an area of frequent litigation has involved lending transactions in which the use of promissory notes has been claimed to bring the transactions within the ambit of the federal securities laws. In some cases, the courts have reasoned that such notes should not be treated as securities when a bank takes them as a lender in a commercial transaction rather than as an investor.[134] In one other case, a federal court held a lender liable for making negligent misrepresentations to a customer

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to participate in the CD program and its secondary market." Unlike the purchaser in *Marine Bank*, who relied on the solvency of the issuing bank, a risk protected by federal deposit insurance, the purchaser from Merrill Lynch relied not only on the solvency of the issuing banks, but "also on the future solvency of Merrill Lynch to enjoy the unique benefits of this investment opportunity." Thus, federal deposit insurance did not eliminate the risk with respect to Merrill Lynch. Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F2d 230 (2d Cir. 1985).

In Brockton Sav. Bank v. Peat, Marwick, Mitchell & Co., 577 F. Supp. 1281, 1285 (D. Mass. 1983), the court held that a certificate of deposit did not constitute a security for purposes of the antifraud provisions.

[133] Although this case was based on the Securities Act of 1933 rather than on the Securities Exchange Act of 1934, which was involved in *Weaver*, the court held that the two acts should be treated similarly. Wolf v. Banco Nacional de Mex. (Banamex), 739 F2d 1458 (9th Cir. 1984), cert. denied, 469 US 1108 (1985). See also Note, "Foreign Certificates of Deposit: Securities or Banking Transactions after *Wolf v. Banco Nacional de Mexico*," 7 Hastings Int'l & Comp. L. Rev. 435–457 (1984).

[134] American Bank & Trust Co. v. Wallace, 702 F2d 93 (6th Cir. 1983). The court held that a bank was not entitled to sue under the 1933 and 1934 Acts for fraudulent misstatements made by the borrower in connection with a thirty-day promissory note. See also Great W. Bank & Trust Co. v. Kotz, 532 F2d 1252 (9th Cir. 1976), on which the court relied. A similar result was reached in Chemical Bank v. Arthur Andersen & Co., 726 F2d 930 (2d Cir.), cert. denied, 469 US 884 (1984), where the court held that the federal securities laws could not provide the basis for an action in a transaction in which a loan was secured by a pledge of promissory notes and notes were issued to replace prior indebtedness because the transaction was a commercial loan. In Kansas State Bank v. Citizens Bank, 737 F2d 1490 (8th Cir. 1984), the court held that a loan participation purchased by one bank from another was not a security within the 1934 Act. See also Vargo, "Equity Participation by the Institutional Lender: The Security Status Issue," 26 S. Tex. LJ 225–241 (1985).

relating to the soundness of an investment for which the lender was encouraging its customer to borrow money. The court held that a violation could be found if the lender's acts were "both necessary to and a substantial factor in the sales transaction."[135]

For an extensive analysis of the factors involved in deciding whether a note purchased by a bank is a security subject to the antifraud provisions of the Federal Securities Act, see the opinion of Judge Friendly in Exchange Nat'l Bank v. Touche Ross & Co., 544 F2d 1126 (2d Cir. 1976). The court took the position that if the note is within the plain terms of the securities law, it ought to be viewed as a security unless the party asserting to the contrary meets the burden of showing that the context requires otherwise. Examples given by the court of cases where the context would require regarding the note as other than a security included:

> the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of a customer of a broker, it is collateralized). When a note does not bear a strong family resemblance to these examples and has a maturity exceeding nine months, § 10(b) of the 1934 Act should generally be held to apply.

544 F2d at 1138. This analysis, however, has not won general acceptance. Certain circuit courts follow an "investment-commercial" test, where the court reviews the transaction to determine if it "more closely resembles typical investment situations or typical mercantile or commercial transactions." Other circuit courts apply a "risk capital" analysis that tries to determine "whether the transaction more closely resembles a 'loan' or has the risk factors associated with 'risk capital.' " Futura Dev. Corp. v. Centex Corp., 761 F2d 33, 40 (1st Cir.) cert. denied, 474 US 850 (1985). Accord Kansas State Bank v. Citizens Bank, 737 F2d 1490, 1494–1495 (8th Cir. 1984). See also Annot., " 'Risk Capital' Test for Determination of Whether Transaction Involves Security, Within Meaning of Federal Securities Act of 1933 (15 U.S.C.S. §§ 77a et seq.) and Securities Exchange Act of 1934 (15 U.S.C.S. §§ 78a et seq.)," 68 ALR Fed. 89 (1984).

In Equitable Life Assurance Soc'y v. Arthur Andersen & Co., 655 F. Supp. 1225 (SDNY 1987), long-term promissory notes were not treated as securities under the 1934 Act, because they strongly resembled commercial loans. See also Glidden, "When are Loans Security Transactions? A Proposed Test," 13 Sec. Leg. LJ 212–238 (1985).

[135] Davis v. Avco Fin. Servs., Inc., 739 F2d 1057 (6th Cir. 1984), cert. denied, 470 US 1005 (1985). When a bank was heavily involved in financing a company that it allegedly knew to have engaged in securities law violations and to be in financial difficulty, a claim against the bank, charging the bank as an aider and abettor to the securities law violations, could not be dismissed. Metge v. Baehler, 762 F2d 621 (8th Cir. 1985), cert. denied, 474 US 1057 (1986). The appeals court applied a three-pronged test in ruling on the aiding and abetting liability. The elements of the test were (1) existence of a securities law violation by the primary party; (2) knowledge by the aider and abettor of the violation; and (3) substantial assistance by the aider and abettor in the achievement of the primary violation. 762 F2d at 624. In the case at hand, the bank's involvement "amounted to inaction rather than positive deeds of manipulation or deception," but the appeals court said liability could still be established if the defendant owed the plaintiff "an independent duty to act or to disclose," or if the "aider-abettor *consciously* intended to assist in the perpetration of the wrongful act." 762 F2d at 624–625 (emphasis in original).

[d] Investment Contracts. Given that the definition of security includes an "investment contract" as well as a "certificate of interest" or "participation in" something that qualifies as a security, this part of the definition is frequently litigated because it is so broad in its potential application. A transaction may be one that gives rise to such an interest, although there is no formal instrument resembling a traditional security. The leading case on this subject is a 1946 Supreme Court decision entitled *SEC v. W.J. Howey Co.*[136] The transaction involved the sale of orange trees that were to be harvested and sold under a service contract with the seller. The Court ruled that there was an investment contract, which should be classified as a "security" under the federal securities laws, when a "person invests his money in a common enterprise and is led to

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> Simply put, in the absence of a duty to act or disclose, an aider-abettor case predicated on inaction of the secondary party must meet a high standard of intent. As applied here, *Woodward* [Woodward v. Metro Bank, 522 F2d 84 (5th Cir. 1975)] and *Monsen* [Monsen v. Consolidated Dressed Beef Co., 579 F2d 793 (3d Cir. 1978), cert. denied, 439 US 930 (1979)] require that the aider-abettor's inaction be accompanied by actual knowledge of the underlying fraud and intent to aid and abet a wrongful act. The requisite intent and knowledge may be shown by circumstantial evidence.

762 F2d at 625. In ruling that the district court erred in granting summary judgment on the aiding and abetting issue, the appeals court noted there was "an unusually favorable banking relationship between the two parties at a time when BTC [the bank] knew of IEI's precarious financial position." There was evidence of the bank's knowledge of the existence and importance of the securities program that gave rise to the violation, and, although the bank made no profit on its loans, it had acted to "lever itself into a more favorable position" than the holders of the securities. 762 F2d at 630.

The second aspect of the case concerned the bank's liability as a "controlling person" under 15 USC § 770, which makes a person who controls someone who violates the securities laws liable jointly and severally with the controlled person "unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." The appeals court affirmed the district court's grant of summary judgment for the bank. In approving the district court's analysis, the appeals court said that the standard to be applied was a two-part test. To prevail against the bank, the plaintiff must show, firstly, that the lender had "actually participated in (i.e., *exercised* control over) the operations of the corporation in general; [secondly,] he must prove that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he need not prove that this later power was exercised." 762 F2d at 631 (emphasis in original). The more restrictive test used in other circuits, requiring actual participation by the lender in the alleged violation, was rejected. The appeals court then concluded that the facts showed no "actual control." At most, there was the "*potential* for influence over some of IEI's business decisions," but this was not enough to show that the bank "actually exercised control over the operation of the corporation in general." 762 F2d at 632. See also Annot., "What is 'Control' Purpose Which Requires Acquiring Entity to File With Securities and Exchange Commission Statement of Intent of Such Purpose Pursuant to § 13(d) of Securities Exchange Act of 1934 (15 U.S.C.S. § 78m(d))," 57 ALR Fed. 806 (1982).

[136] 328 US 293 (1946).

expect profits solely from the efforts of the promoter or a third party."[137] Each of the elements of this test has been the subject of considerable elaboration by the courts in numerous decisions.

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[137] Id. at 299.

8

The Restrictions Against Banks Engaging in Certain Securities Activities

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¶ 8.01 THE PROHIBITION AGAINST DEALING IN SECURITIES—THE GLASS-STEAGALL ACT

Following the widespread bank closings of the Great Depression, Congress concluded that at least in part, responsibility for these failures could be traced to the involvement of banks in securities transactions that were unduly speculative or dangerous to the financial reliability of the banks. Through affiliations with securities firms and in other ways, banks became embroiled in underwriting stock issues and participating in other securities transactions. To deal with these perceived abuses, Congress enacted a series of statutes designed to regulate transactions in securities. Among them was the Glass-Steagall Act of 1933,[1] which was intended to remove banks from the securities business.

The so-called Glass-Steagall wall[2] is a major characteristic of U.S. banking. It attempts to create a permanent separation between the businesses of investment and commercial banking. This attempted separation has come under attack in recent years as banks have sought to expand their securities-related activities to attract new business and to respond to competition from other financial institutions. As a result, litigation has been frequent, and there are numerous court decisions and regulatory rulings interpreting the scope of the Glass-Steagall prohibitions. These interpretations have opened some large cracks in the Glass-Steagall wall. Congress has considered making changes to the Glass-Steagall framework, and the Competitive Equality Banking Act of 1987 addressed some of the issues in its provisions on nonbank banks and in those establishing a moratorium on certain banking activities. These are discussed in a subsequent section. At the outset, however, it is necessary to examine the basic Glass-Steagall provisions.

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[1] For excellent treatment of this area, see V. DiLorenzo, W. Schlichting, J. Cooper, 5 Banking Law (1987); Norton, "Up Against 'the Wall': Glass-Steagall and the Dilemma of a Deregulated ('Reregulated') Banking Environment," 42 Bus. Law. 327–368 (1987). See also Willin, "Commercial Banks and the Glass-Steagall Act: A Survey of New Products and Activities," 104 Banking LJ 5–35 (1987); Notes, "Banks and Bank Holding Companies: Going For Brokerage Under Glass-Steagall." 4 Ann. Rev. Banking L. 315–336 (1985); "Federal Regulation of Bank Securities Activities: Will Congress Allow Glass-Steagall to be Shattered?", 12 J. Contemp. L. 99–135 (1986); "Security Under the Glass-Steagall Act: Analyzing the Supreme Court's Framework for Determining Permissible Bank Activity," 70 Cornell LR 1194–1212 (1985); "Securities Activities Under the Glass-Steagall Act," 35 Emory LJ 463–505 (1986); "Avoiding the Glass-Steagall and Bank Holding Acts: An Option for Bank Product Expansion." 59 Ind. LJ 89–111 (1983-1984).

[2] The Glass-Steagall Act is the name given to Sections 16, 20, 21, and 32 of the Banking Act of 1933, Ch. 89, 48 Stat. 162 (distributed throughout Chs. 2, 3, and 6 of 12 USC).

[1] Basic Provisions of the Act

There are four provisions that customarily are regarded as the Glass-Steagall prohibitions. These are Sections 21, 16, 20 and 32 of the act.[3] Section 21 prohibits, under criminal sanction, "any person" or firm in the securities business (which includes the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities) from engaging "at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment under presentation of a passbook certificate of deposit, or other evidence of debt, or upon request of the depositor."[4]

Section 16 of the act limits national banks and state member banks "to purchasing and selling . . . securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account," except "under such limitations and restrictions" as the comptroller may prescribe.[5] The comptroller may adopt regulations allowing national banks to invest

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[3] 12 USC §§ 24, 78, 377, 378 (1982). See id. § 335, which extends Section 24 to state member banks.

[4] 12 USC § 378(a)(1) (1982). The section reads in full as follows:

> For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor: *Provided*, That the provisions of this paragraph shall not prohibit national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities, to the extent permitted to national banking associations by the provisions of section 24 of this title: *Provided further*, That nothing in this paragraph shall be construed as affecting in any way such right as any bank, banking association, savings bank, trust company, or other banking institution, may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate.

[5] 12 USC §§ 24 Seventh, 335 (1982) states:

> The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock; *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. In no event shall the total amount of the investment securities of any one obligor or maker, held by the association for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund, except that this limitation shall not require any association to dispose of any securities lawfully held by it on August 23, 1935. As used in this section the term "investment securities" shall mean marketable obligations, evidenc-

for their own accounts in securities.[6] These must be "investment securities," which the act defines as "marketable obligations, evidencing indebtedness of any person . . . in the form of bonds, notes and/or debentures . . . " as further defined by the comptroller. However, the restrictions against underwriting or purchasing for the bank's own account do not apply to certain U.S. government agency securities (which are enumerated in the statute), and to the "general obligations" of a state or its political subdivisions. Except for these government securities, the bank cannot hold for its own account investment securities of any one obligor or maker that exceed at any time ten percent of the bank's capital and surplus.[7] Therefore, under Section 16 of the Glass-Steagall Act, national banks and state member banks may (1) purchase securities for the accounts of their customers; (2) purchase investment securities for their own account as authorized by regulation of the comptroller; and (3) deal in the governmental securities specified in the statute.

Section 20 of the act, which applies to member banks of the Federal Reserve System, is discussed in the next section of this chapter. Sections 20 and 32 of the act restrict affiliations between securities firms and certain banks through stock-holding arrangements or interlocking personnel structures. Section 20 prohibits a member bank from affiliating with any organization "engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities . . . ."[8] Section 32 of the act forbids officers and other employees of firms "primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities . . . " from serving at the same time as an officer, director, or employee of a member bank.[9]

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ing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency. Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation. The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof.

[6] The limitations of 12 USC § 24 Seventh (1982), including the provision relating to investment securities, also apply to state member banks by virtue of 12 USC § 335.

[7] 12 USC § 24 Seventh (1982).

[8] 12 USC § 377 (1982). There is an exception for organizations in the process of liquidation. Id.

[9] 12 USC § 78 (1982). The Federal Reserve Board is allowed to make exceptions by general regulation when it believes that there would not be an undue influence on the investment policies of the bank or the advice it gives customers. Id.

Additionally, a national bank is authorized to engage in activities for its customers as a trustee or other fiduciary when state law permits this for state banks or trust organizations.[10] This authority allows banks as trustees to invest in securities for its trust customers.[11]

Even the prohibitions of the Glass-Steagall Act are not absolute. Banks cannot avoid all dealings with securities. Commercial banks traditionally have taken securities as collateral for loans and sometimes are called upon to sell them as part of the process of foreclosing on the collateral when default occurs. In addition, banks have long provided trust services for their customers, including managing investment accounts involving the purchase and sale of securities for their customers. Banks also have invested in government securities for their own accounts. Glass-Steagall recognizes these activities, and the Supreme Court has held that they are not prohibited.[12] On the other hand, the Glass-Steagall provisions contemplate that banks' securities activities should not be unlimited. Defining where the act draws the line between what activities are permissible and what ones are not is a difficult problem that, if anything, has become even more complex as the types of securities and their importance in personal and corporate finance have grown.

[2] Scope of the Glass-Steagall Act

[a] Application of the Act to National Banks, Member Banks, Insured Banks, and Savings and Loan Associations. There are significant differences between the four sections that make up the Glass-Steagall prohibitions not only in the substance of the limitations but also in the scope of their application. Section 16 of the act applies to national banks; it is part of the description of the powers of national banking associations and does not mention what powers subsidiaries or affiliates of national banks may have.[13] The terms of Section 16 also apply to state banks that are members of the Federal Reserve System (state member banks).[14] Section 20 of the act applies to banks that are members of the Federal Reserve System,[15] and it forbids their affiliation with "any corporation, association, business trust, or other similar organization engaged principally . . . " in

[10] 12 USC § 92a(a) (1982).

[11] 12 CFR § 9.11 (1987).

[12] Board of Governors v. Investment Co. Inst., 450 US 46, 63 n.32 (1981.)

[13] 12 USC § 24 Seventh (1982).

[14] 12 USC § 335 (1982). "State member banks shall be subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as are applicable in the case of national banks under paragraph "Seventh" of section 24 of this title." Id.

[15] 12 USC § 377 (1982). It reads "no member bank shall be affiliated . . . " Id.

certain securities activities. It prohibits an affiliation "in any manner" described in the definitional sections of the National Bank Act.[16]

Section 21 of the act applies to "any person, firm, corporation, association, business trust or other similar organization . . . ," and forbids such persons when they are engaged in the specified securities activities from also taking deposits.[17] They may not "engage at the same time to any extent whatever in the business of receiving deposits . . . "[18] Section 32 of the act applies to officers, directors, and other agents of "any corporation or unincorporated association," a "partner or employee of a partnership," and any "individual" who is "primarily engaged" in certain securities activities.[19] They are prohibited from serving as an officer of "any member bank" unless permitted by the Federal Reserve Board. In view of these differences as to the persons to whom the prohibitions apply, careful analysis is necessary in interpreting them.

Based on these differences, the Federal Deposit Insurance Corporation has established a policy permitting nonmember FDIC-insured banks to establish an affiliate relationship with, or a subsidiary corporation to engage in underwriting, selling or participating in, syndications involving securities. This policy was upheld in a 1987 decision.[20] Although Section 21 prohibits banks that are engaged in taking deposits from dealing in securities, the court reasoned that this section applies only to the direct activities of banks and not to their subsidiaries and affiliates. The Section 20 prohibition against affiliation with securities firms applies only to member banks of the Federal Reserve System. Section 32 also applies only to member banks, and Section 16 applies only to national banks (or state member banks). Thus, the FDIC was free to permit the activities.[21]

Similar issues arise when a savings and loan institution engages in securities activities. The Federal Home Loan Bank Board has approved savings and loan associations to engage in brokerage and investment advisory services through a subsidiary.[22]

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[16] The term affiliate is defined in the act to include "direct or indirect control" through stock ownership or control of voting for directors. 12 USC § 221a (1982).

[17] 12 USC § 378(a)(1) (1982).

[18] Id.

[19] 12 USC § 78 (1982).

[20] Investment Co. Inst. v. FDIC, 815 F2d 1540 (DC Cir. 1987), cert. denied 108 S. Ct. 143 (1987). The FDIC regulations were published at 49 Fed. Reg. 46,709 (1984), codified at 12 CFR § 337.4 (1987). See generally Saba, "Regulation of State Non-Member Insured Banks' Securities Activities: A Model for the Repeal of Glass-Steagall?", 23 Harv. J. Legis. 211–265 (1986).

[21] The court said that the FDIC's authority to curb unsafe and unsound practices was a basis for regulation of the securities activities but was not of itself a bar to nonmember banks engaging in them. *Investment Co. Inst.*, 815 F2d at 1549–1550.

[22] 39 Wash. Fin. Rep. (BNA) A-20 (1982). See also 40 Wash. Fin. Rep. (BNA) 451 (1983). A federal court has upheld the authority of the FHLBB to approve such applica-

[b] Application of the Act to Bank Holding Companies and Their Affiliates. When bank holding companies are involved in securities activities, the activities must meet the tests of the Bank Holding Company Act and be closely related to banking.[23] The Supreme Court has upheld the Board's use of a "functional" analysis to decide when proposed securities activities are closely related to banking. In *Securities Industry Association v. Board of Governors*,[24] the Court declined to adopt a narrow reading of "closely related," which would limit its activities to those that would facilitate other banking operations. In exercising its discretion, the Board is entitled to consider a variety of factors, and it was proper in the instant case to recognize that the discount brokerage activities at issue were not significantly different from activities routinely performed by bank trust departments.

Some of the Glass-Steagall Act prohibitions may apply to bank holding company affiliates. However, the impact may be limited. As Section 16 applies only to national banks and state member banks, but not to subsidiaries or affiliates, its restrictions would not affect nonbank holding company affiliates. Both Sections 20 and 32 apply only to member banks. "In the view of Section 21 given previously, as applying only to activities of the bank itself, there is no prohibition on the activities of a nonbank holding company subsidiary as a result of Section 21 either. Such a view would leave the principal limitations on securities activities of bank holding companies to the "closely related to banking" test under the Bank Holding Company Act and, in cases where the holding company includes a member bank, to the Section 20 prohibition against affiliation with companies "engaged principally" in securities activities and the Section 32 prohibition against interlocking personnel arrangements.

In *Board of Governors v. Investment Co. Institute*,[25] the Supreme Court provided some guidance as to how far the policies against engaging in securities activities extend to bank holding companies. The Court of Appeals had concluded that the policies of the Glass-Steagall Act should be read into the Bank Holding Company Act to enforce a rigid separation between the securities

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tions. Securities Indus. Ass'n v. FHLBB, 588 F. Supp. 749 (DDC 1984), Fed. Sec. L. Rep. (CCH) ¶ 91,471 (Mar. 9, 1984).

The investment powers of savings and loan associations are outlined in 12 USC § 1464(c) (1982 & Supp. IV 1986). Subsection S specifically provides authority to thrifts for investments in mortgage-related securities. 12 USC § 1464(c)(2)(S) (Supp. IV 1986). The FHLBB regulations regarding securities include 12 CFR §§ 523–524, 541, 545, 555, 561, 563, and 570 (1987). For a thorough discussion of investment powers of thrift institutions, see Zaitzeff v. Metter, "Investment Powers of Federal Savings & Loan Associations after Garn-St Germain," 36 U. Fla. L. Rev. 591–673 (1984).

[23] The requirements relating to bank holding company involvement in securities activities are discussed at ¶ 5.02[2].

[24] 468 US 207 (1984).

[25] 450 US 46 (1981).

business and commercial banking. The Supreme Court took a contrary view, indicating that the activity in question, the provision of investment advisory services to a closed-end investment company, would not constitute a violation of the Glass-Steagall Act, even if it were engaged in by a bank. The Supreme Court also made important comments about the scope of the Bank Holding Company Act. In the view of the Court, even if a bank would be in violation of Glass-Steagall by engaging in these services, it would not necessarily follow that a bank holding company would also be in violation.[26]

The Court reviewed the legislative history of the Bank Holding Company Act and concluded that Congress did not intend that Section 4(c)(8) of the act should be read "[a]s totally prohibiting Bank Holding Companies from being 'engaged' in any securities-related activities; . . . "[27] The Court then concluded that the Board had the discretion to determine, in light of its expertise, what securities-related activities are closely related to banking and, thus, are permitted under Section 4(c)(8).[28]

Additionally, to the extent that state banks may enjoy powers under their state charters to engage in securities transactions that are not permitted to national banks or member banks, such a bank may not be subject to the "closely related to banking" test of the Bank Holding Company Act, although the bank is part of a holding company structure, because the closely related test applies to nonbank subsidiaries.[29]

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[26] According to the Court:

> Even if we were to assume that a bank would violate the Glass-Steagall Act by engaging in certain investment advisory services, it would not follow that a bank holding company could never perform such services. In both the Glass-Steagall Act itself and in the Bank Holding Company Act, Congress indicated that a bank affiliate may engage in activities that would be impermissible for the bank itself. Thus, § 21 of Glass-Steagall entirely prohibits the same firm from engaging in banking and in the underwriting business, whereas § 20 does not prohibit bank affiliation with a securities firm unless that firm is "engaged principally" in activities such as underwriting. Further, § 4(c)(7) of the Bank Holding Company Act, which authorizes holding companies to purchase and own shares of investment companies, permits investment activity by a holding company that is impermissible for a bank itself. Finally, inasmuch as the Bank Holding Company Act requires divestment only of the bank's nonbanking interests, the § 4(c)(8) exception would be unnecessary if it applied only to services that a bank could legally perform. Thus, even if the Glass-Steagall Act did prohibit banks from acting as investment advisors, that prohibition would not necessarily preclude the Board from determining that such advisory services would be permissible under § 4(c)(8). Id. at 63-64.

[27] Id. at 71.

[28] See DeSanto, "Product Expansion in the Banking Industry: An Analysis and Revision of Section 4(c)(8) of the Bank Holding Company Act," 53 Fordham L. Rev. 1127-1157 (1985).

[29] For a discussion of activities closely related to banking, see ¶ 5.02[2].

The Federal Reserve Board has identified activities related to securities that it will treat as "closely related to banking."[30] The Board has approved applications to establish subsidiaries to offer investment advice and to buy and sell government securities, certificates of deposits, and bankers' acceptances.[31] Further, it has approved an application by a foreign bank to participate in a joint venture with a U.S. securities firm through a subsidiary of the bank to provide investment advice and portfolio management services for foreign customers interested in U.S. investments.[32] It also approved an application to acquire a subsidiary mortgage banking firm that would engage in arranging equity financing for commercial and industrial income producing property.[33] Finally, it has authorized financial futures contracts activities.[34] There is a high degree of uncertainty over the legality of many of the securities-related activities sought by bank holding companies, because each new step will likely face extended litigation.

[3] Interpretation of the Glass-Steagall Act

[a] The Subtle Hazards Analysis of the *Camp* Decision. One of the leading cases interpreting the Glass-Steagall provisions is *Investment Co. Institute v. Camp*.[35] In this case, the Supreme Court held that national banks could not operate an open-end collective investment fund or mutual fund. In the Court's view, the bank's operation of and sale of units of participation in the investment fund amounted to the underwriting and sale of securities within the meaning of Sections 16 and 21 of the act. In reaching this conclusion, the Court distinguished the commingling of assets received for "a true fiduciary purpose rather than for investment."[36] Moreover, it noted that historically, banks had both pooled trust assets and served as a managing agent for individual customers.[37] But the combination of functions in the mutual fund form, in the words of the

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[30] See Regulation Y, 12 CFR § 225.25 (1987), and the discussion at ¶ 5.02[2][ii].

[31] Application of Manufacturers Hanover Corp., 70 Fed. Reserve Bull. 661 (1984).

[32] Application of Amsterdam-Rotterdam Bank, 70 Fed. Reserve Bull. 835 (1984).

[33] Application of BancOhio Corp., 69 Fed. Reserve Bull. 34 (1983). See also 41 Wash. Fin. Rep. (BNA) 669 (1983); id. at 606; 12 CFR § 225.25(14) (1987).

[34] Application of J.P. Morgan & Co., Inc., 68 Fed. Reserve Bull. 514 (1982). See also 41 Wash. Fin. Rep. (BNA) 668 (1983); 40 Wash. Fin. Rep. (BNA) 395 (1983). The Board announced in 1982 its willingness to consider applications to engage in futures commission merchant activities. 47 Fed. Reg. 30,872 (1982). The Board has since amended Regulation Y to include such activities. 12 CFR § 225.25 (18) (1987).

[35] 401 US 617 (1971).

[36] 401 US at 638.

[37] 401 US at 624–625.

Court, "gives birth to an investment fund whose activities are of a different character."[38]

In concluding that the act forbade operation of the open-end mutual fund, the Court reviewed the purpose of the Glass-Steagall legislation. In now famous language, it pointed to the "subtle hazards" that Congress tried to prevent by separating commercial banking and investment banking. The Court spoke in these words:

> The hazards that Congress had in mind were not limited to the obvious danger that a bank might invest its own assets in frozen or otherwise imprudent stock or security investments. For often securities affiliates had operated without direct access to the assets of the bank. This was because securities affiliates had frequently been established with capital paid in by the bank's stockholders, or by the public, or through the allocation of a legal dividend on bank stock for this purpose. The legislative history of the Glass-Steagall Act shows that Congress also had in mind and repeatedly focused on the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments. This course places new promotional and other pressures on the bank which in turn create new temptations. For example, pressures are created because the bank and the affiliate are closely associated in the public mind, and should the affiliate fare badly, public confidence in the bank might be impaired. And since public confidence is essential to the solvency of a bank, there might exist a natural temptation to shore up the affiliate through unsound loans or other aid. Moreover, the pressure to sell a particular investment and to make the affiliate successful might create a risk that the bank would make its credit facilities more freely available to those companies in whose stock or securities the affiliate has invested or become otherwise involved. Congress feared that banks might even go so far as to make unsound loans to such companies. In any event, it was thought that the bank's salesman's interest might impair its ability to function as an impartial source of credit.
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> Congress was also concerned that bank depositors might suffer losses on investments that they purchased in reliance on the relationship between the bank and its affiliate. This loss of customer good will might "become an important handicap to a bank during a major period of security market deflation." More broadly, Congress feared that the promotional needs of investment banking might lead commercial banks to lend their reputation for prudence and restraint to the enterprise of selling particular stocks and securities, and that this could not be done without that reputation being undercut by the risks necessarily incident to the investment banking business. There was also perceived the danger that when commercial banks were subject to the promotional demands of investment banking, they might be tempted to make loans to customers with the expectation that the loan

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[38] Id.

> would facilitate the purchase of stocks and securities. There was evidence before Congress that loans for investment written by commercial banks had done much to feed the speculative fever of the late 1920's. Senator Glass made it plain that it was "the fixed purpose of Congress" not to see the facilities of commercial banking diverted into speculative operations by the aggressive and promotional character of the investment banking business.
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> Another potential hazard that very much concerned Congress arose from the plain conflict between the promotional interest of the investment banker and the obligation of the commercial banker to render disinterested investment advice. . . . Congress had before it evidence that security affiliates might be driven to unload excessive holdings through the trust department of the sponsor bank. . . .
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> In sum, Congress acted to keep commercial banks out of the investment banking business largely because it believed that the promotional incentives of investment banking and the investment banker's pecuniary stake in the success of particular investment opportunities was destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system.[39]

The significance of these hazards in interpreting the act is not clear. Subsequent decisions have not indicated whether activities that otherwise might fall within the scope of the prohibitions would be permissible if these hazards were minimal or nonexistent.

Subsequent to the *Camp* decision, the Court held that a bank holding company could control an affiliate that served as an investment advisor to a closed-end investment company. In *Board of Governors v. Investment Co. Institute*,[40] the regulations of the Federal Reserve Board prohibited the holding company from issuing, underwriting, selling, or purchasing any securities. It could only provide advice. The Court reasoned that these arrangements did not violate the act and did not present the "subtle hazards" that existed in the *Camp* situation. The Court also suggested that bank holding companies have greater freedom to engage in securities-related activities than do banks.[41]

[b] Defining a Security for Purposes of the Act. The distinction between commercial banking and securities transactions received further attention in *Securities Industries Association v. Board of Governors*.[42] The Court held that short-term commercial notes constituted securities within the Glass-Steagall Act so that banks could not engage in activities that would amount to "underwriting" that paper. In reaching this result, the Court interpreted the legislative history of the act as intending to apply the ordinary meaning to the term

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[39] 401 US at 630–634.

[40] 450 US 46 (1981).

[41] Id. at 63-64. See id. at 64, n.34

[42] 468 US 137 (1984).

"securities," which would encompass "notes," in the absence of any compelling textual reason to adopt a narrower definition.

The Supreme Court's conclusion contrasted sharply with the approach taken by both the Federal Reserve Board and the appellate court below,[43] both of which ruled that the short-term commercial notes should not be treated as securities. When a "functional analysis" based on examination of the commercial paper market was applied, the bank's activities were more like a traditional commercial banking operation than an investment transaction. The Supreme Court rejected this approach and found the legislative intent conclusive.[44] Although the Court did not directly address the question of whether the use of the term "securities" in the various federal securities laws was intended to have the same meaning in all contexts, it squarely rejected the analysis of the Board and the court below which proceeded on the assumption that a "security" under Glass-Steagall was different than the definition in the federal securities laws.

There have been a number of problem areas involving bank products and services where the question arises whether the service is a "security" within the Glass-Steagall Act. Sweep accounts, where a bank transfers access deposits on a regular basis, often daily, from deposit accounts into a mutual fund (and in reverse from the mutual fund into the account to cover deficits) met a stumbling block when the general counsel of the Federal Reserve Board indicated that such sweep arrangements, depending on the circumstances, might involve the distribution and underwriting of securities in violation of the act.[45]

Another area in dispute is the technique of issuing certificates representing interests in a pool of more traditional interests such as mortgages. The Comptroller of the Currency has issued a legal opinion that a national bank may issue certificates representing interests in a pool of construction and commercial mortgage loans.[46] The Federal Reserve Board has similarly authorized subsidiaries to deal in securities backed by consumer receivables, reasoning that these activities were closely related to banking because they involved credit evaluation and loan management functions similar to those involved in handling the

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[43] A.G. Becker, Inc. v. Board of Governors, 693 F2d 136 (D.C. Cir. 1982), rev'd, 468 US 137 (1984).

[44] The Court remanded the case for determination of whether the methods used in placing the commercial paper amounted to selling and underwriting. 468 US at 160.

Similar difficulties in determining whether a "security" exists are presented in recent litigation over whether banks may deal in mortgage-backed pass through certificates. Securities Indus. Ass'n v. Clarke, No. 87 Civ. 450 (SDNY June 25, 1987). The Comptroller has taken the position that the transaction is equivalent to the sale of loan participations and so should not be regarded as either a security or underwriting or dealing in securities. Letter of the Comptroller of the Currency, 48 Banking Rep. (BNA) 1120 (1987).

[45] Letter to the Security Indus. Ass'n, 43 Wash. Fin. Rep. (BNA) 743 (1984).

[46] Comptroller of the Currency Opinion Letter No. 251, 39 Wash. Fin. Rep. (BNA) 804 (1982).

mortgage related government securities permitted by Section 16 of the Glass-Steagall Act.[47]

[4] The *Bankers Trust* Case: Placement of Commercial Paper and the Ban on Underwriting

The scope of Section 16 was explored further in the *Bankers Trust* commercial paper case after it came back to the Federal Reserve Board.[48] The Board determined that Bankers Trust's proposal to engage in the private placement of commercial paper for commercial customers did not violate the Section 16 prohibitions against selling and underwriting securities. A federal district court disagreed. On appeal to the District of Columbia Circuit, the decision of the Board of Governors was upheld.[49] The court first concluded that if the activities of Bankers Trust were permissible under Section 16, 12 USC § 24 Seventh, they would not violate Section 21, 12 USC § 378(a)(1). Accordingly, its opinion focused on the interpretation of Section 16 that states that the "business of dealing in securities and stock by [a commercial bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of customers, and in no case for its own account, and the [bank] shall not underwrite any issue of securities or stock."[50]

The Securities Industries Association contended that the bank's placement of commercial paper violated these provisions in a number of ways. It claimed that

1. Bankers Trust was not engaged in the "business of dealing in securities and stock" as permitted in Section 16 because such "business" is limited to dealing in the "secondary" securities market and does not include participation in the initial issue of securities;[51]
2. The restriction in Section 16 to securities activities "upon the order, and for the account of customers . . . " meant the bank could offer securities services only to accommodate its existing bank customers;[52]

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[47] Application of Citicorp., 49 Banking Rep. (BNA) 88 (1987). The Board stayed the effective date of its approval pending resolution of a court case dealing with related issues.

[48] Securities Indus. Ass'n v. Board of Governors, 807 F2d 1052 (DC Cir. 1986), cert. denied, 107 S. Ct. 3228 (1987) (hereinafter *Bankers Trust*).

[49] Securities Indus. Ass'n v. Board of Governors, 807 F2d 1052 (DC Cir. 1986), cert. denied 107 S. Ct. 3228 (1987). See generally Glidden, "Bank Sales of Commercial Paper under the Glass-Steagall Act: The Hazards of the Bankers Trust Decisions," 42 Bus. L. 1–28 (1986); Jennings, "Corporate Commercial Paper Issued Through Banks: The Banks' Hidden Liability," 103 Banking LJ 563–576 (1986).

[50] 12 USC § 24 Seventh (1982).

[51] 807 F2d at 1058–1059.

[52] The court held that the bank could serve customers other than its regular banking customers. Securities Indus. Ass'n v. Board of Governors, 807 F2d at 1059.

3. Because Bankers Trust actively solicited the business, it was not acting "solely upon the order" of its customers;[53]
4. The solicitation of buyers for the commercial paper violated Section 16's limitation on the "purchasing of securities" to purchases made "solely upon the order" of the bank's customers;[54]
5. The activities undertaken by Bankers Trust constituted "underwriting" in violation of the express prohibition of Section 16;[55] and
6. Permitting commercial banks to engage in the activities Bankers Trust proposed would expose commercial banks to the "subtle hazards" the Congress intended the Glass-Steagall Act to eliminate.[56]

The District of Columbia Circuit rejected all of these arguments. In addressing what constituted "underwriting," the court acknowledged the uncertainty as to the nature of this definition but said the Securities Act of 1933 indicated that it was reasonable for the Board to conclude the private placement of securities did not constitute underwriting.[57] In addition, the purpose of the Glass-Steagall prohibition against underwriting was not offended by the private placement activities proposed by Bankers Trust. The court read the history of the enactment of the Glass-Steagall Act as indicating congressional concern with the form of economic organization created by the commercial banks that engaged in investment banking operations. In the court's opinion, these commercial banks had created an elaborate structure to sell and distribute securities, which placed heavy fixed costs on the banks. The burden of maintaining this costly distribution network, in turn, was responsible for creating the "subtle hazards" to which the act was addressed. The court quoted from the congressional debates on the act to make its point:

> In order to be efficient a securities department had to be developed; it had to have salesmen; and it had to have correspondent connections with smaller banks throughout the territory tributary to the great bank. Organizations were developed with great enthusiasm and efficiency. The distribution of the great security issues needed for the development of the country was facilitated, and the country developed. But the sales departments were

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[53] 807 F2d at 1061–1062.

[54] Id.

[55] Id. at 1062–1066.

[56] Id. at 1066–1070.

[57] The court rejected Bankers Trust's contention that if the bank confined its activities to those of an agent, without acquiring an interest of its own in the transaction, the activities would not constitute underwriting prohibited by Section 16. Although noting that some had argued "best efforts underwriting, performed solely on an agency basis," should not constitute underwriting, the court specifically declined to adopt the argument, saying that it made "little sense" in view of the common understanding in the securities industry and the approach of the Securities Act of 1933. 807 F2d at 1062, n.3.

> subject to fixed expenses which could not be reduced without the danger of so disrupting the organization as to put the institution at a disadvantage in competition with rival institutions. These expenses would turn the operation very quickly from a profit to a loss if there was not sufficient originations and underwritings to keep the sales department busy.
>
> It was necessary in some cases to seek for customers to become makers of issues of securities when the needs of those customers for long-term money were not very pressing. Can any banker, imbued with consciousness that his bond-sales department is, because of lack of securities for sale, losing money and at the same time losing its morale, be a fair and impartial judge as to the necessity and soundness for a new security issue which he knows he can readily distribute through channels which have been expensive to develop but which presently stand ready to absorb the proposed security issue and yield a handsome profit on the transaction?
>
> It is easy to see why the security business was overdeveloped and why the bankers' clients and country bank correspondents were overloaded with a mass of investments many of which have proved most unfortunate.

From this history, the court concluded it was "highly plausible" that in Section 16 of the act, Congress intended to distinguish between public and private offerings of securities on the theory that private offerings involved "relatively minor expenses," which were acceptable, as compared to "the much heavier fixed burden of having a far-flung retail network to distribute securities to the public."[58] Although recognizing that such a distinction did not eliminate all of the subtle hazards, the court agreed that the Board had reasonably assessed the risks in determining that a distinction between public and private offerings would minimize the problems that Section 16 was intended to eliminate. The court then approved the Board's conclusion that the activities proposed by Bankers Trust would involve private placement.[59] The court then addressed the specific "subtle hazards" identified by the Supreme Court. Although expressing

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[58] 807 F2d at 1066.

[59] The court described the Board's analysis of the private nature of the activities in the following terms:

> (1) the bank "places commercial paper by separately contracting large financial and non-financial institutions," (2) the bank "does not place commercial paper with any individuals." (3) "the maximum number of offerees and purchasers of commercial paper placed by the bank in any given case is relatively limited," (4) the bank "makes no general solicitation or advertisement to the public" with respect to the placement of particular paper (though it does advertise its activities in business publications to publicize its availability as an agent to issuers), and (5) "the commercial paper placed with the bank's assistance is issued in very large average minimum denominations, which are not a likely investment of the general public." . . . Such considerations properly determine what distinguishes a private from a public offering of securities. . . .

807 F2d at 1064–1065 (citations omitted).

doubt as to whether it should find an activity impermissible because it implicated a bank in the "subtle hazards" condemned by the Supreme Court when the "language and history of the specific provisions support the reasonableness of the Board's construction of those provisions," the court concluded that the Board acted reasonably in assessing the risks posed.

[5] Discount Brokerage

[a] National Banks. In an application from Security National Bank in California, the Comptroller of the Currency approved the bank's proposal to establish a subsidiary that would engage in securities brokerage services to the bank's customers.[60] The subsidiary would buy and sell all types of securities as agent for its customers, and it would provide margin loans to its customers and pay interest on credit balances in customers' accounts. The services were to be offered to the public throughout California and eventually other states at both branch and non-branch bank locations. The subsidiary would register as a broker-dealer under the Securities Exchange Act of 1934.

The comptroller, in granting the application, held that the Glass-Steagall Act did not prohibit the bank from establishing a subsidiary to perform these functions. "On its face, the Glass-Steagall Act permits those securities purchases and sales for customers in which the bank acts in the capacity of agent (i.e., brokerage transactions), while generally prohibiting purchases and sales by the banks acting as principal. This constitutes clear authorization for banks and, hence, their operating subsidiaries (See 12 C.F.R. § 7.7376) to engage in the activities contemplated for Discount Brokerage."[61]

The Securities Industry Association challenged the action of the comptroller. It argued that Section 16, of the Glass-Steagall Act (12 USC § 24 Seventh) permits the bank to perform brokerage services only for customers whose relationship with the bank exists independently of the securities transaction. The court rejected this argument. Section 16, in the court's view, limited bank securities transactions to those made "for the account of customers," thus preventing the bank from acting as a principal in securities transactions, but was not intended to limit the transactions to preexisting customers of the bank.

The court also rejected the argument that the application violated Section 21 of the act, which prohibits any organization "engaged in the business of issuing, underwriting, selling, or distributing at wholesale or retail . . . securities . . . " from engaging at the same time in banking. In the court's view, "the prohibition of Section 21 is clearly aimed at the investment banking

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[60] Comptroller of the Currency, Application of Sec. Pac. Nat'l Bank, Aug. 26, 1982, rev'd, Securities Indus. Ass'n v. Comptroller of the Currency, 577 F. Supp. 252 (DDC 1983), aff'd, 758 F2d 739 (DC Cir. 1985), rev'd 107 S. Ct. 750 (1987).

[61] Id. For a description of the Comptroller's decision, see 39 Wash. Fin. Rep. (BNA) 378 (1982).

business by which large blocks of securities newly issued by corporations are bought by investment banks for resale to the public." The court also rejected the argument that engaging in such transactions amounted to dealing in securities "with recourse," in violation of Section 16.[62] That prohibition is not violated by the possibility that a securities transaction might fall through because a customer failed to pay for securities and thereby created liability for the bank. Although approving the comptroller's treatment of the Glass-Steagall issues, the court was of the view that the McFadden Act prohibition against interstate banking by national banks would be violated. Ultimately, the Supreme Court reversed the McFadden Act ruling.[63] (This aspect of the case is discussed in Chapter 6).

The comptroller's approval of the acquisition of discount brokerage subsidiaries did not involve approval of giving investment advice. However, on September 6, 1983, the comptroller approved an application from the American National Bank of Austin, Texas to set up a separate investment advisory subsidiary. The comptroller ruled such approval could be given without violating the Glass-Steagall Act.[64] The FDIC also has issued a legal opinion that state nonmember banks may offer discount brokerage services to their customers through an unrelated broker and share commissions without violating the Glass-Steagall Act.[65]

[b] Bank Holding Companies. The U.S. Supreme Court considered the application of the Bank Holding Company Act to discount brokerage in 1984 when it upheld the Federal Reserve Board's approval of BankAmerica Corp.'s acquisition of a retail discount brokerage firm, Charles Schwab & Company.[66] The Court held that the handling of purchase and sale transactions for third parties,

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[62] 577 F. Supp. at 256–257.

[63] Securities Indus. Ass'n v. Comptroller of the Currency, 577 F. Supp. 252 (DDC 1983), aff'd, 758 F2d 739 (DC Cir. 1985), rev'd 107 S. Ct. 750 (1987). The Supreme Court denied the Securities Industry Association's petition for review of the part of the court's order allowing national banks to engage in discount brokerage operations. Securities Indus. Ass'n v. Comptroller of the Currency, 474 US 1054 (1986).

[64] 41 Wash. Fin. Rep. (BNA) 355 (1983). The legality of combining discount brokerage services and investment advice was tested in the NatWest case. The Federal Reserve Board's approval for a bank holding company to offer both discount brokerage services and investment advice through a single subsidiary was upheld by Judge Bork in Securities Indus. Ass'n v. Board of Governors, 821 F2d 810 (DC Cir. 1987) cert. denied 56 USLW 3459 (US Jan. 11, 1988) (No. 87-562). The subsidiary would act only as agent for customers and would not act as an underwriter or a principal. The court upheld the Board's determination that such activities did not constitute a "public sale" of securities forbidden by Section 20 of the Glass-Steagall Act. The court stated that substantial deference should be given to the Board's interpretation of the statute. See ¶ 8.01[5][b].

[65] FDIC, General Counsel's Opinion No. 6, 48 Fed. Reg. 22989 (1983).

[66] Securities Indus. Ass'n v. Board of Governors, 468 US 207 (1984).

without providing investment advice, was "closely related" to banking within the meaning of Section 4(c)(8) of the Bank Holding Company Act, because banks performed the same functions in their trust departments. Also, the Court concluded the acquisition did not violate Section 20 of the Glass-Steagall Act.

Section 20 prohibits member banks from affiliating with organizations that are "engaged principally" in the "issue, flotation, underwriting, public sale, or distribution" of securities. Schwab's activities did not involve underwriting or issuing securities. Although the securities industry argued that Schwab's discount brokerage activities constituted a "public sale," the Court held "the term 'public sale' in § 20 should be read to refer to the underwriting activity described by the terms that surround it, and to exclude the type of retail brokerage business in which Schwab principally is engaged." The Court read the legislative history of the act as revealing a congressional concern directed to banks engaging in underwriting activities because underwriting could put bank funds at risk in speculative investments and might create other "subtle hazards" as a result of promotional pressures from affiliates engaged in buying and selling securities for their own accounts.

In approving the Schwab affiliation, the Court pointed out that Section 16 of the Glass-Steagall Act allowed banks to buy and sell securities directly for their customers. Congressional willingness to allow banks to perform these activities for their customers indicated a disinclination to regard the types of brokerage activities performed by Schwab as presenting untoward hazards to commercial banks. Although Section 16 permits banks to engage in securities transactions for the account of the bank's "customers," the Court held an affiliate organization that was not a bank, such as Schwab, could provide the approved services to the public generally and not just to bank customers. Section 16 applied only to banks; Section 20 applied to affiliates and subsidiaries, and Section 20 contained no limiting reference to "customers." The court reserved the issue whether a bank could directly buy and sell securities for persons who were not otherwise customers of the bank.[67]

The ability of bank holding companies to provide investment services to customers received a large boost in the 1987 NatWest decision. In this case, entitled *Securities Industry Association v. Board of Governors*,[68] the court reviewed a decision by the Federal Reserve Board approving an application by National Westminster Bank PLC and its subsidiary, NatWest, under the Bank Holding Company Act to operate a subsidiary named CSC that would provide both investment advice and securities brokerage services to institutional customers. The Securities Industry Association attacked the Board's action on the

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[67] 468 US at 219 n.20. This question was answered by a lower court in the *Bankers Trust* case, which ruled that a bank should not be limited to its existing customers. 807 F2d at 1059. See ¶ 8.01[4].

[68] 821 F2d 810 (DC Cir. 1987), cert. denied, 56 USLW 3459 (US Jan. 11, 1988) (No. 87-562). The Board's action is reported at 72 Fed. Reserve Bull. 584 (1986).

ground that when the subsidiary coupled investment advice with brokerage services it would be engaged in the "public sale" of securities. This would create a violation of the prohibition against a member bank affiliating with a company "engaged principally in the . . . public sale" of securities in Section 20 of the Glass-Steagall Act.

The court rejected the argument of the Securities Industry Association, relying on the Supreme Court decisions in the *Schwab* case[69] and *Board of Governors v. Investment Co. Institute.*[70] The court reasoned that the provision of brokerage services, as discussed in *Investment Co. Institute*, did not constitute a public sale, because, in the context of Section 20 of the Glass-Steagall Act, that term referred to activities of underwriting and distribution. These are functions "distinctly different from that of a securities broker" because an underwriter normally acts as a principal while a broker executes orders as an agent for others.[71] Acting as an agent in providing brokerage services for the account of others does not violate Section 20. As in *Schwab*, the NatWest subsidiary would have no relationship with the issuer of securities other than that needed to execute customer orders. Although the firm would provide investment advice, it would not be an underwriter under the *Schwab* test because it would not purchase securities from the issuer or act as the agent of the issuer.[72] The Court then went on to conclude that the proposed activities did not pose any problem under the subtle hazards analysis of the *Camp* case.[73]

[6] Collective Investment Funds

A series of cases have examined the application of the Glass-Steagall Act to collective investment funds utilized to invest assets of individual retirement accounts.[74] Although the federal district courts that initially ruled on the cases took varying positions, the federal Circuit Court of Appeals upheld the banks' offering such accounts.

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[69] *Schwab* is Securities Indus. Ass'n v. Board of Governors, 468 US 207 (1984).

[70] 450 US 46 (1981).

[71] 821 F2d at 813.

[72] Id. at 814.

[73] Id. at 816–818.

[74] See generally Lybecker, "Bank Collective Investment Management Activities," 15 Inst. On Sec. Reg. 347–376 (1984); Notes, "Bank Sponsorship of a Money Market Mutual Fund: Can It Survive Glass-Steagall?," 3 Ann. Rev. Banking L. 194–224 (1984); "Units of Participation in IRA Common Trust Funds Offered by Commercial Banks: A Violation of the Glass-Steagall Act?," 60 Notre Dame L. Rev. 745–761 (1985); "Glass-Steagall and Collective Investment Trusts for Individual Retirement Accounts: Fiduciary Purpose or Investment?", 42 Wash. & Lee L. Rev. 961–999 (1985).

[a] The Comptroller's *Citibank* Decision. On October 21, 1982, the Comptroller of the Currency approved an application by Citibank to invest assets from individual retirement accounts (IRAs) collectively in a common trust fund maintained by the bank.[75] The comptroller considered the application under regulations of the Comptroller of the Currency, the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), the Glass-Steagall Act, and the federal securities laws.

The comptroller's regulations permit national banks to invest funds collectively in a common trust fund when the bank acts as a trustee or fiduciary, and also permits such investment when the fund consists solely of assets of retirement or similar trusts exempt from federal income taxation.[76] Because the national bank would be receiving the assets in a trust capacity and because the retirement account funds are from retirement plans exempt from federal income tax, the comptroller concluded that both alternatives of the regulation were satisfied. This was consistent with what the comptroller determined was the "overwhelming conclusion" to be drawn from the legislative history of ERISA, "that Congress believed it to be within the power of banks to serve as trustees for IRA trusts and to collectively invest the assets of these trusts in common trust funds or in collective investment funds for retirement plan assets."[77]

Relying upon *Investment Co. Institute v. Camp*,[78] the comptroller concluded the IRA trust account proposed in the application did not constitute the type of investment fund prohibited by the Glass-Steagall Act. There were similarities between the fund proposed in the Citibank application and the fund struck down in *Camp*, but there was a decisive difference—Citibank proposed "the receipt by the bank of assets in trust" rather than receipt "in a managing agent capacity."[79]

The comptroller believed that *Camp* did not disturb long-standing banking practice of serving as a managing agent for investments while acting as a fiduciary in a traditional bank trust department service. The comptroller noted that the meaning of the term "securities" under the Glass-Steagall Act is not necessarily the same as its definition for purposes of federal securities laws. "In particular, when, in the present case, the 'securities' merely represent the formal manifestation of a traditional banking service, it is the Office's opinion that the prohibitions of the Glass-Steagall Act are not applicable."[80] The comptroller went on to consider the possible hazards and potential abuses identified in the

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[75] 39 Wash. Fin. Rep. (BNA) 816 (1982). The subsequent litigation over the comptroller's action is described later in this section.

[76] 12 CFR §§ 9.18(a)(1), 9.18(2) (1987).

[77] 39 Wash. Fin. Rep. (BNA) 816–817 (1982).

[78] 401 US 617 (1971).

[79] 39 Wash. Fin. Rep. (BNA) 816–817 (1982).

[80] Id.

Camp decision and their possible presence in the Citibank proposal. Finding that the abuses referred to were no more present in the collective investment of IRA trust assets proposed by Citibank than in the ordinary fiduciary function banks engage in, the comptroller concluded it would be inappropriate to treat the participation in the IRA funds offered by the bank as securities even though those interests would be registered pursuant to securities laws.

The comptroller also expressed reservations as to whether it was necessary for the bank to register under the Investment Company Act and the federal securities laws. In his view, the exemption for common trust funds maintained by banks and the exemption for collective investment funds for certain tax-exempt pension plans should apply.

[b] Judicial Reaction. Three circuit courts have addressed the question of whether a pooled investment fund for assets held in trust in individual retirement accounts violates the Glass-Steagall Act. Although the district courts have taken contrary positions, the three circuit courts have upheld the comptroller's position.

In the first case, a federal district court in California held that a national bank could not establish funds for the investment of assets in IRAs, because the funds were being established and promoted for investment purposes rather than for fiduciary purposes as a trustee.[81] The district court noted that the Supreme Court decision in *Camp* allowed the commingling of trust assets in a common pool, as long as the assets were "received for a true fiduciary purpose rather than for investment." The comptroller had classified the bank's purpose as fiduciary because the provisions of ERISA limit the funds an investor can place in an IRA each year and impose a penalty on early distributions from the accounts. He also noted that the accounts cannot be transferred to other individuals, cannot serve as security for loans, and that the banks have strict fiduciary obligations imposed as a matter of law to manage the accounts.

But the district court rejected the comptroller's reasoning. Under *Camp*, "the validity of an investment fund under the Glass-Steagall Act does not hinge on its trust form *vel non*."[82] After analyzing the hazards that the Glass-Steagall Act was directed to curb and the manner in which the funds were promoted, the court concluded the funds were investment funds and that the adoption of ERISA, although it conferred permission to commingle assets in certain types of common funds, was not intended to give banks authority beyond the powers associated with their traditional fiduciary roles.

Although the U.S. District Court in California was the first to rule on the question, the Ninth Circuit did not decide the appeal in that case until after

[81] Investment Co. Inst. v. Conover, 593 F. Supp. 846 (ND Cal. 1984), rev'd 793 F2d 220 (9th Cir. 1986), cert. denied 107 S. Ct. 422 (1987).

[82] 593 F. Supp. at 854.

decisions in two similar cases by the District of Columbia Circuit and the Second Circuit.[83] The District of Columbia Circuit case became the lead case on the issue. (The Second Circuit and Ninth Circuit cases are discussed in note 83.) In an opinion that closely tracked the analysis used by the comptroller, the District of Columbia Circuit Court ruled in the *Citibank* case that the Supreme Court's *Camp* decision did not prohibit the commingled trust fund proposed by Citibank.[84] The District of Columbia Circuit declined to read *Camp* broadly, stating: "In our view, however, *Camp* cannot fairly be read to prohibit any financial service that some actors in the marketplace view as functionally similar to a mutual fund. *Camp* nowhere states that all such services are prohibited."[85]

The court agreed with the comptroller's distinction. Citibank was offering a fiduciary service, not the sale of a security. In serving as a "trustee of its IRA

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[83] The California district court was reversed by a three-judge panel of the Ninth Circuit, 793 F2d 220 (9th Cir. 1986), cert. denied 107 S. Ct. 422 (1987). One judge thought the Comptroller's approval was consistent with *Camp* and the Glass-Steagall Act; another thought it was in error; the author of the opinion sided with the Comptroller, but saw the question as "a close one, and certainly not free from doubt. . . ." He expressed his doubts as follows:

> The Comptroller's analysis appears to be superficial, and in some respects to come perilously close to disregarding the spirit of *Camp* while purporting to adhere to its letter. It also comes perilously close to rejecting the division between commercial banking and investment banking that Congress sought to mandate in Glass-Steagall. Nevertheless, in the end, the Comptroller did apply, however inadequately, the *Camp* test.

Id. at 221.

Similar legal issues were presented by the application of Connecticut Bank and Trust Company to market a collective investment fund consisting of individual retirement accounts. A federal district court in Connecticut followed the lead of the District of Columbia, and upheld the bank's proposal. Investment Co. Inst. v. Clarke, 630 F. Supp. 593 (D. Conn. 1986), aff'd mem., 789 F2d 175 (2d Cir.) cert. denied, 107 S. Ct. 422 (1986). Reading the Supreme Court decision in *Camp* as intending to distinguish between "activities motivated solely by an investment purpose and activities motivated, in significant part, by a purpose other than merely to secure income or profit," the district court found that Connecticut Bank's fund constituted a sale of fiduciary services rather than a sale of investments and therefore was permissible. Both the Comptroller and the court placed some importance on the manner in which Connecticut Bank advertised the fund:

> The fiduciary nature of the Fund is also evidenced by CBT's intent to "offer the Trust to IRA customers as part of a total IRA program" and to "advertise the Trust as being merely one of several IRA alternatives. . . . CBT's representations to the Comptroller that the Fund will not be marketed as a separate investment service independent of the other IRA options being offered," . . . further indicate that CBT is offering a package of "fiduciary services" rather than a mere investment vehicle.

Id., 630 F. Supp at 596.

[84] Investment Co. Inst. v. Conover, 790 F2d 925 (DC Cir. 1985), cert. denied 107 S. Ct. 421 (1986).

[85] 790 F2d at 930.

funds rather than as managing agent," the bank was acting in a capacity quite different than that condemned in *Camp*. Moreover, because of the limitations on IRA investments, which restrict the size of the investment, the transferability of units, and the use of the units as collateral, and impose penalties on early withdrawal, the court believed the risks associated with the Citibank arrangement were substantially less than those in *Camp*.[86]

The Investment Institute had argued that the investment units of Citibank's trust should be viewed as securities for purposes of the Glass-Steagall Act. The institute position was that any "undivided and redeemable interest in the assets of a common trust fund" constituted a security. The court rejected this theory. Under the institute's argument, "all commingling of trust funds by national banks would be effectively prohibited. . . . but such commingling, as we have seen, has historically been permitted and is clearly sanctioned by *Camp*."[87] When the court examined the legislative intent of Congress, it concluded that congressional intent did not precisely cover units in a commingled trust fund. The court said:

> . . . as we see it, the statutory language is of limited help in defining congressional intent in this case. The term "security" clearly encompasses instruments like stock, bonds, notes, and mutual fund shares, which have traditionally been unwritten and marketed by members of the securities industry. As *Camp* teaches, moreover, the term may include other financial interests that are functionally equivalent to these traditional kinds of securities. But, as we have also seen, the term cannot be interpreted to include *all* financial interests in assets or in a business venture, lest traditional common trust funds be rendered invalid. Although interests in Citibank's trust share some of the features of traditional mutual fund shares—for example, they permit diversification of risk and can be widely marketed—they are, as we have seen, quite different from traditional mutual fund shares in several important respects. Obviously, interests in IRA trust funds did not exist in 1933 when Congress passed Glass-Steagall; the term Congress employed to identify the financial interests it had in mind, moreover, is not sufficiently precise as to clearly encompass such interests.[88]

Since the court was not able to find a clear direction from the legislative history, it examined the comptroller's analysis and concluded that deference to that decision was required.

The institute argued that the form of Citibank's promotion of the fund indicated that the bank was selling an investment similar to a mutual fund. The court agreed that the marketplace might regard the Citibank fund as "function-

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[86] Id. at 930–931.

[87] Id. at 931.

[88] Id. at 934.

ally similar to a mutual fund" and that the bank's own marketing and advertising departments seemed to view the fund in this manner as well. But for the reasons stated in the quoted material, the court concluded "on close analysis" that the Citibank fund was "quite distinct from the fund at issue in *Camp.*" Although Citibank's aggressive marketing strategy "might provide one indication that its Trust falls on the wrong side of the line between investments and bona fide fiduciary services," this was not dispositive in view of the comptroller's evaluation that such promotional measures were not "sufficiently strong to warrant concern.[89] The court then stated that Citibank's characterization of the trust as an "investment opportunity" should not be dispositive of whether the trust should be regarded as a "fiduciary service," because customers of a bank's trust department expect not only safekeeping services but also to earn a return on the funds held in trust. In the court's view, the proper inquiry was "whether the bank is offering a genuine fiduciary service in addition to an opportunity to earn a return."[90]

[7] Affiliations Between Banks and Securities Firms—Determining When a Firm is "Engaged Principally" in Securities Activities

Section 20 of the Glass-Steagall Act prohibits a member bank from being affiliated with a company that is "engaged principally" in securities underwriting and brokerage activities. Additionally Section 32 forbids interlocking personnel relationships between a member bank and firms "primarily engaged" in securities dealing.[91] What amounts to being "engaged principally" and "primarily engaged" has been the critical interpretive issue in a number of important transactions.[92]

When the *Bankers Trust* commercial paper case came back to the Board after it was determined the private placement activities would not constitute "underwriting", the Board considered if there would be a violation of Section 20 because the activities would be conducted through a subsidiary. The Board concluded that the activity did not necessarily have to amount to more than fifty percent of the company's business in order to be an activity in which the affiliate was "engaged principally." The Board said that "the term 'engaged principally' in section 20 denotes an activity of the affiliate that is substantial, even if the activity does not represent more than 50 percent of the affiliate's total business activity or its single largest or most important activity." The Board then

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[89] Id. at 937.

[90] 790 F2d at 937.

[91] See Board of Governors v. Agnew, 329 US 441 (1947).

[92] See generally Note, "Banking Law-Defining 'Security' Under Glass-Steagall; and Securities Affiliate Relationships," 1984 Ann. Surv. Am. L. 987–1005 (1985).

declined to set a fixed percentage for what would amount to being "engaged principally" and approved the application on the facts presented.[93]

Soon after the Board's decision in the *Bankers Trust* commercial paper case, the Board decided a series of applications for approval of certain securities activities to be conducted through affiliates of the applicant bank holding companies. These applications became the occasion for the Board to develop the views it expressed in *Bankers Trust* and to give specific guidelines for the interpretation of when a holding company affiliate should be regarded as being "engaged primarily" in securities activities for purposes of the prohibition in Section 20 of the Glass-Steagall Act. The applicant companies sought approval to use wholly-owned subsidiaries that were or would be engaged in underwriting and dealing in U.S. government and agency securities and state and municipal government securities to also engage in activities in certain other types of securities.[94] The other types of securities for which the applicants sought approval were municipal revenue bonds, mortgage related securities, securities backed by consumer receivables, and commercial paper.

In a decision that has great significance for the future development of the banking industry, the U.S. Court of Appeals for the Second Circuit upheld the orders of the Federal Reserve Board granting the applications to engage in the proposed securities activities subject to certain restrictions, and the Supreme Court declined to review the case further.[95] The two main issues in the case both concerned the interpretation of Section 20 of the Glass-Steagall Act.

The first issue concerned the interpretation of "securities" in Section 20. Because Section 16 of the Glass-Steagall Act expressly allows Federal Reserve member banks to underwrite and deal in U.S. government and agency securities and certain general obligations of state and local governments, without utilizing affiliate firms,[96] there is a distinction for the purposes of Section 16 between "bank eligible" securities, which the banks may deal in and underwrite, and all other "bank ineligible" securities, which Section 16 prohibits the banks from dealing in or underwriting. The express wording of Section 20 does not contain a similar distinction between bank eligible and bank ineligible securities, however. The first issue for the court was whether this distinction should be read into

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[93] 73 Fed. Reserve Bull. 138, 141 (1987).

[94] The applicants and the Board's orders in the matters were Citicorp, J.P. Morgan & Co., Inc., Bankers Trust New York Corp., 73 Fed. Reserve Bull. 473 (1987); Chase Manhattan Corp., Chemical New York Corp., Manufacturers Hanover Corp., Security Pac. Corp., 73 Fed. Reserve Bull. 607 (1987); id. at 616; id. at 620; id. at 622.

[95] Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 839 F2d 47 (2d Cir.), cert. denied, 108 S.Ct. 2830 (1988). The Board did not pass on the applications relating to securities backed by consumer receivables because of the state of the record. 839 F2d at 50.

[96] See the discussion at ¶ 8.01[1] of Section 16 and the securities activities permitted by that provision.

Section 20. Section 20 prohibits Federal Reserve member banks from having an affiliate that is "engaged principally" in underwriting or dealing in securities. If "securities" in this section means all types of securities, then Section 20 prohibits affiliation regardless of the type of securities the affiliate underwrites and deals in, so that even affiliation with firms engaged in activities involving only bank *eligible* securities is barred. On the other hand, if "securities" means only the types of bank ineligible securities described in Section 16, the prohibition will apply only when the affiliate's activities involve bank *ineligible* securities. The court concluded, as had the Board, that the bar against affiliation in Section 20 applied only when the affiliate was engaged primarily in activities in "bank ineligible" securities. The court reasoned that if Congress saw no harm in allowing banks to deal directly in "bank eligible" securities, there could be no harm in permitting these same activities to bank affiliates.[97] As a result, if the affiliate engaged in underwriting and dealing in the United States, state, and local government obligations permitted by Section 16, then Section 20 would not prohibit a member bank from affiliation with such firm in a bank holding company as long as the securities firm did not engage in activities in "ineligible" securities to the extent that these activities made the firm "engaged principally" in such "ineligible" securities business.

The second main issue was the standard to apply in deciding when an affiliate is "engaged principally" in the prohibited activities for purposes of Section 20. The Board took the view that any substantial activity in ineligible securities was enough to raise the bar against affiliation, and then the Board defined what it meant by substantial using two quantitative measures. One measure was a gross revenues test. In the Board's view, the affiliate's prohibited activities could not exceed a range of 5 to 10 percent of the affiliate's total gross revenues. The other measure was a market share test, which limited the affiliate to no more than from 5 to 10 percent of the market for the particular security involved. The Board took a conservative view, adopted limits of 5 percent for both measures, and provided for subsequent review and possible adjustment.[98] Deferring to the Board, the court found that the Board's interpretation of "engaged principally" as meaning " any substantial activity" was reasonable. The court agreed that the concerns that prompted Congress to limit bank affiliation with securities firms are not eliminated simply by keeping the affiliate's securities activities below 50 percent of the firm's total activities.[99] The court then upheld the quantitative gross revenue measure used by the Board, but ruled the market share test was not within the scope of the act.[100]

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[97] 839 F2d at 62.

[98] Id. at 63.

[99] Id. at 64, 66.

[100] Id. at 67-68. The court and the Board expressed disapproval of combining the gross incomes of two or more affiliates to determine whether the affiliates were engaged principally in ineligible activity. The court explained: "The reason is plain. The provi-

[8] Restrictions on Securities Activities Imposed by the Competitive Equality Banking Act of 1987

A number of changes were made by the Competitive Equality Banking Act of 1987 to the laws governing the ability of depository institutions to participate in securities activities. Some of these changes are permanent; others were temporary.

[a] Bank Holding Companies. As discussed in Chapter 5 on bank holding companies, the 1987 act gives grandfather rights to companies that were not previously bank holding companies and which controlled nonbank banks as of March 5, 1987.[101] In order to retain these rights, such companies must abide by restrictions against marketing products or services of affiliates through the nonbank bank when the products are ones which would not have been permissible for bank holding companies as "closely related to banking."[102]

A similar prohibition exists against marketing the products or services of the nonbank bank through an affiliate who is not engaged "only in activities permissible for bank holding companies" under the closely related to banking provisions.[103] This precludes offering securities products (if they are not authorized as "closely related to banking") of an affiliate through the nonbank bank.[104] It also prevents bank services from being marketed through a securities affiliate that did not qualify as one that meets the test of engaging only in activities permitted as "closely related to banking." Permission is given to continue activities in which the nonbank bank was engaged on March 5, 1987, if done "in

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sions of § 20 apply to each individual company affiliated with a member bank." 839 F2d at 63. This approach contrasts with that of the Comptroller of the Currency in an application by the Dreyfus National Bank and Trust Company to establish a nonbank bank. The Comptroller concluded that the proposed bank would not be affiliated with firms that were "engaged primarily" in securities underwriting and distribution because the affiliate securities firms of Dreyfus should be regarded as a "single-entity." Decision of the Comptroller of the Currency, Application of Dreyfus Nat'l Bank and Trust Co., 40 Wash. Fin. Rep. (BNA) 308, 313 (1983). For a matter raising similar issues under Section 32 of the Glass-Steagall Act prohibiting interlocking management relationships between a bank and a firm "primarily engaged" in securities activities see Decision of the Comptroller of the Currency, Application of J.W. Seligman Trust Co., N.A., 40 Wash. Fin. Rep. (BNA) 262–265 (1983). The Comptroller's action in the *Dreyfus* and *Seligman* cases prompted the Federal Reserve Board to warn the applicants of the Board's contrary views of the legality of the proposals under Sections 20 and 32. Current Developments, Fed. Banking L. Rep. (CCH) ¶ 99,531 (Apr. 22, 1983); 40 Wash. Fin. Rep. (BNA) 758 (1983).

[101] For a discussion of grandfather rights to companies that became bank holding companies as a result of the act, see supra at ¶ 5.01[4][c].

[102] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 101(c), 101 Stat. 552, 559 (1987) (to be codified at 12 USC § 1843(f)(3)(B) (hereinafter CEBA).

[103] Id.

[104] See H.R. Conf. Rep. 261, 100th Cong., 1st Sess. 126, reprinted in 1987 U.S. Code Cong. & Ad. News 489, 595–596.

the same manner in which they were being offered or marketed as of that date."[105] The restrictions on companies with grandfather rights also include prohibitions on overdrafts on the nonbank bank's account at a Federal Reserve bank, except as allowed by the act.[106]

The 1987 amendments prohibit certain transactions involving securities between banks and their affiliates. These amendments apply to transactions in which a member bank engages involving the sale of securities to an affiliate, transactions where the affiliate acts as an agent or broker for a fee, and other transactions with the affiliate or with third parties where the affiliate participates. In these transactions, the member bank and its subsidiaries must do business "on terms . . . including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies . . . "[107] Alternatively, when there are no comparable standards to use for the purpose of determining if the terms are as favorable as those used in such transactions, the amendments require the transactions to be "on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies."[108] The drafters explained this means, for example, "underwriting standards may not be relaxed in comparision to underwriting standards for transactions with nonaffiliated companies."[109]

There are further restrictions on a member bank's purchasing (or a subsidiary of the bank purchasing) as a fiduciary securities of an affiliate. It is permitted only when the instrument creating the trust or other fiduciary relationship allows the purchase; when the purchase is permitted by court order; or when the applicable law of the jurisdiction would allow the purchase.[110] There is an absolute prohibition on member banks and their subsidiaries against knowingly acquiring a security, as a fiduciary or otherwise, during the period of an underwriting or selling syndicate where the principal underwriter of the security is an affiliate of the bank. This ban can be lifted by obtaining, before the securities are initially offered for sale to the public, approval in advance by a majority of the outside directors of the bank who are not officers or employees of the bank or the affiliate.[111] These restrictions on transactions between member banks and affili-

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[105] CEBA § 101(c) (to be codified at 12 USC § 1843(f)(3)).

[106] Id.

[107] CEBA. § 102(a). (to be codified at 12 USC § 371c-1).

[108] Id.

[109] H.R. Conf. Rep. 261, supra note 104, at 133.

[110] CEBA § 102(a) (to be codified at 12 USC § 371c-1).

[111] Id. The legislators said:

This requirement could be satisfied either by prior approval of the specific acquisition or by the establishment in advance of specific standards by the outside directors

ates also apply to FDIC-insured nonmember banks and to Federal Savings and Loan Insurance Corporation–insured thrift institutions.[112]

Additionally, the amendments apply the provisions of the Glass-Steagall Act in Sections 20 and 32 to nonmember insured banks for a period of time from March 6, 1987, until March 1, 1988.[113] (Glass-Steagall Section 20 deals with affiliations between member banks and securities firms; Section 32 deals with interlocking management relationships between member banks and securities firms.[114] A similar amendment extends these provisions to FSLIC-insured institutions also until March 1, 1988.[115] In the case of FSLIC-insured institutions, however, there are statutory exemptions from the Glass-Steagall prohibitions for affiliations by FSLIC-insured institutions with firms that do business in certain real estate related securities or insurance products.[116]

The temporary ban on affiliations between FDIC-insured nonmember banks and securities firms is on *new* affiliations. Moreover, as explained by Congress, it is not intended to prohibit firms that already have an affiliation from continuing to provide new products or organize new investment vehicles in the ordinary course of their business.[117]

[b] Savings and Loan Holding Companies. Savings and loan holding companies will be regulated in a manner similar to bank holding companies under the 1987 amendments. Unless the holding company qualifies for special treatment, as discussed below, the activities in which the holding company and its noninsured subsidiaries may engage are limited.[118] The amendments list the activities permitted to savings and loan holding companies and to their subsidiaries which are not insured institutions. This list includes activities which are now permitted to multiple savings and loan holding companies. Also, the holding company may engage in a business activity which the Federal Reserve Board has determined is

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> for such acquisitions. If the outside directors establish such standards, they must regularly review acquisitions to assure that the standards have been followed, and they must periodically review the standards to assure that they continue to be appropriate in light of market and other conditions.

H.R. Conf. Rep. 261, supra note 104, at 133.

[112] CEBA § 102(b) (amending 12 USC § 1828(j)(1)). FSLIC insured institutions are covered by § 104(d)(1) (amending 12 USC § 1730a(p)).

[113] CEBA § 103(a) (amending 12 USC § 1818(j)). The restrictions in the Glass-Steagall provisions do not apply to trust companies or credit card banks because of exceptions created in the amendments. Id.

[114] For a discussion of Sections 20 and 32 of the Glass-Steagall Act, see supra at ¶ 8.01.

[115] CEBA § 106(a) (to be codified at 12 USC § 1730a(r)).

[116] Id. (to be codified at 12 USC § 1730a(r)(4)).

[117] H.R. Conf. Rep. 261, supra note 104, at 134.

[118] CEBA § 104(b) (amending 12 USC § 1730a(c)(1)).

permissible for bank holding companies subject to possible additional limitation or regulation by the FSLIC.[119] But the holding company must obtain the prior approval of the FSLIC in order to begin engaging in an activity approved for bank holding companies.[120] These restrictions do not apply, however, to a unitary savings and loan holding company whose thrift institution meets a test established in the amendments known as the "qualified thrift lender" test.[121] There also are additional exemptions permitting a savings and loan holding company to continue activities previously approved (before March 5, 1987) so long as the holding company does not engage in certain specified activities. The FSLIC can end this exemption by determining that the activity poses conflicts of interest or unsound practices or should be prevented to protect the public interest.[122]

[c] Moratorium on Certain Nonbanking Activities. Finally, Title II of the Competitive Equality Banking Act of 1987 imposes a moratorium on some nonbanking activities. This moratorium lasted from March 6, 1987, until March 1, 1988. It covers some securities activities. An insured bank, a bank holding company, their subsidiaries and affiliates cannot engage in the following activities:

> (A) in the flotation, underwriting, public sale, dealing in, or distribution of securities if that approval would require the agency to determine that the entity which would conduct such activities would not be engaged principally in such activities,
> (B) in any securities activity not legally authorized in writing prior to March 5, 1987, or
> (C) in the operation of a nondealer marketplace in options.[123]

The prohibition in item (A) curbs the developments under Section 20 of the Glass-Steagall Act, discussed previously, where affiliations between member banks and securities firms have been permitted because the securities firm has not been "engaged principally" in securities activities.

There are exceptions to the moratorium. The prohibition in item (B) does not apply when the bank is acting as an agent or where the bank was lawfully engaged in those activities before March 5, 1987, or the transaction closed before June 30, 1987. Further, the moratorium does not prevent one of the federal banking agencies from issuing orders or regulations expanding securities

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[119] Id. (amending 12 USC § 1730a(c)(2)(F)).

[120] Id. (amending 12 USC § 1730a(c)(4)).

[121] Id. (amending 12 USC § 1730a(c)(3)). See H.R. Conf. Rep., supra note 104, at 135.

[122] Id. (amending 12 USC § 1730a(c)(6)(D)).

[123] CEBA, § 201.

powers of banks as long as the effective date of the regulatory action is delayed until the end of the moratorium.[124]

¶ 8.02 THE GOVERNMENT SECURITIES ACT OF 1986

[1] U.S. Government Securities Market

With the enactment of the Government Securities Act of 1986,[125] Congress put in place a system for regulation of persons who act as brokers and dealers in U.S. government securities. Prior to this act, the provisions of the existing federal securities laws generally did not reach the activities of brokers and dealers in U.S. government securities because the securities laws treated U.S. government securities as exempted securities.[126] As a result, brokers and dealers in government securities were largely free from regulation, except to the extent that those persons might come under the supervision of a federal regulatory agency, such as the Securities and Exchange Commission (SEC) or one of the banking agencies.

The U.S. government securities market has been described as "the world's largest, most efficient and liquid securities market."[127] Tens of billions of dollars of securities are traded daily. In 1985, the U.S. Treasury raised almost $1.2 trillion from this market to finance the budget deficit and to refinance debt.[128] The Federal Reserve System and the Federal Reserve banks, particularly the Federal Reserve Bank of New York, play a critical role in the operation of this market. It is a highly specialized and sophisticated market with transactions in large dollar amounts that must be executed rapidly. The market operates in a way that involves a complex web of interrelationships between the U.S. Treasury, the Federal Reserve System, commercial banks, government securities dealers, and others. The Senate report on the Government Securities Act gives a description of how this market operates that is helpful in understanding the role of the banking regulatory agencies in these activities:[129]

> The government securities market is the cornerstone of the U.S. capital market system. It serves as a means through which the Department of the Treasury [Treasury] finances the national debt and provides the ability for

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[124] Id.

[125] Pub. L. No. 99-571, title I, § 101, 100 Stat. 3208 (codified at 15 USC § 78o-5 (Supp. IV 1986)).

[126] 15 USC § 78c(a)(12) (Supp. IV 1986). See also 15 USC § 78c(a)(42) (Supp. IV 1986).

[127] S. Rep. No. 426, 99th Cong., 2d Sess. 5, reprinted in 1986 U.S. Code Cong. & Admin. News 5395, 5399.

[128] Id.

[129] S. Rep. No. 426, supra note 127, at 2–4.

the Government to meet seasonal shortfalls between its receipts and expenditures.

The market in government securities consists of several broad categories of participants including the U.S. Government as the issuer of the securities through its fiscal agents, the 12 Federal Reserve Banks. In addition to the Treasury, issuer participants also include Government-sponsored corporations and Government agency issuers of securities guaranteed by those entities.[130]

To sell marketable Treasury debt, the Treasury, through the 12 Federal Reserve district banks and their branches, sells securities to the public through a competitive auction process. In addition, the Federal Reserve Bank of New York, acting on behalf of the Federal Open Market Committee, uses the day-to-day purchases and sales of government securities as the primary instrument for the conduct of monetary policy.

Private participants in the government securities market include the so-called primary dealers in Treasury securities. The Federal Reserve Bank of New York has recognized a group of securities dealers and commercial banks as primary dealers. These are dealers with whom the Federal Reserve Bank of New York has a business relationship. They are required to demonstrate market-making capacity, creditworthiness and other factors that indicate fitness for this business relationship.

Ten years ago there were 25 primary dealers. This number has grown to the present level of 35. Fourteen of the primary dealers are banks or bank subsidiaries, 12 are broker-dealers subject to Commission regulation and 9 are otherwise "unregulated" at the Federal level. The primary dealers are the core group of underwriters for Treasury securities in that they participate directly and actively in auctions of new Government debt. They are also active in making markets in the over-the-counter secondary markets for Treasury and Federal agency securities. As market makers, primary dealers stand ready to buy and sell securities at the quoted bid and offered prices. They serve as the essential bridge between the Treasury and the vast domestic and international network of institutions and individuals who are the ultimate holders of Government debt.[131]

In addition to the primary dealers, there are a large number of non-primary or secondary dealers in government securities. The secondary

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[130] In addition to Treasury securities, the term 'government securities' generally includes securities issued or guaranteed by government agencies, such as the Government National Mortgage Association [GNMA], or government-sponsored corporations, such as the Federal Home Loan Mortgage Corporation [FHLMC], the Federal National Mortgage Association [FNMA], and the Student Loan Marketing Association [SLMA]. Id. at 2, n.2.

[131] As demonstrated by the figures below, the ownership of U.S. Treasury securities has been changing over the last 15 years. The primary change in the ownership of federal debt has been a shift of approximately 29 percentage points from federal government and individual accounts to foreign, state, local government and miscellaneous accounts which include savings and loans, credit unions and corporate pension trust funds. Id. at 3, n.3.

dealers market new issues of government securities and act as market makers in government securities. There is considerable variation in the regulatory status of secondary dealers. Some are commercial banks, some are institutions regulated by the Commission, and some are specialized firms or separate subsidiaries of regulated firms that operate outside of the federal regulatory structure.

Secondary dealers are not subject to Federal Reserve Bank of New York oversight. They are not required to submit trading or financial data to the Federal Reserve Bank of New York (as primary dealers do daily) and are not subject to Federal Reserve Bank of New York dealer surveillance visits. However, in early 1984, the Federal Reserve Bank of New York requested that non-primary dealers voluntarily submit position, transaction, and financing data on a monthly basis in order to improve monitoring of the market. By June 1, 1984, only 26 dealers were reporting monthly and 7 daily.[132]

While the exact number of secondary dealers is not known, in part because there is no consensus definition of a dealer and in part because a number of these dealers are not registered with a Federal agency, published and other sources would suggest that there may be as many as 400 to 500 firms.[133] The Federal Reserve Bank of New York estimates that the majority of these secondary dealers are "regulated" in the sense that their government securities dealers operations probably take place within an otherwise regulated banking organization or within a Commission-registered broker or dealer. However, even with some of these regulated firms, the government securities activities may, in fact, take place in an affiliate or subsidiary which is not subject to Federal regulation. In addition, perhaps 100 or more government securities dealers are wholly unregulated at the Federal level.

The Treasury Securities market performs four essential functions for the Federal Government. First, the market is the means through which the government finances current deficits. The Treasury sells securities to make up for any shortfall between revenues and outlays that occur as a result of actions taken by Congress and the administration. Second, the market enables the Government to refinance maturing debt. Third, the market is the principal means through which the Federal Reserve System carries out

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[132] "Report on U.S. Treasury Securities—The Markets' Structure, Risks and Regulations," a briefing report prepared by the General Accounting Office for the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, 99th Cong. 2d sess., Aug. 1986, p. 27 (GAO report). Id. at 4, n.4.

[133] "Statement of E. Gerald Corrigan before the Subcommittee on Securities, May 9, 1985. See also, "Survey on the Federal Reserve System's Supervision of the Treasury Securities Market: A Discussion Paper" prepared by the General Accounting Office for the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, 99th Cong. 1st sess. (GAO Survey), May 1985, pp. 12-13 (estimated 300 secondary dealers) and SEC Release No. 34-21959 (Apr. 23, 1985), 50 Federal Register 15905 (SEC Release) (estimating 200 secondary dealers)." Id. at 4, n.5.

monetary policy. With the buying and selling of Treasury securities, the Board of Governors of the Federal Reserve System (Federal Reserve Board) is able to influence the growth of the money supply and/or change in the market interest rates and thus to influence the direction of economic activity. Fourth, the Federal Government uses the market to raise short-term funds (cash management bills) so that it can carry out its day-to-day cash management activities.

The much-publicized failures of a number of unregistered government securities dealers in the period from 1975 to 1985 led to substantial losses by some banks, thrifts, and municipal investors, as well as to one case of a depositors' run on certain thrift institutions.[134] This prompted Congress to take legislative action. The Senate report on the legislation describes the problems that led to these failures in the following way:

> In a number of failures, the firm in question had issued apparently false and misleading financial statements. In others, problems in one company were masked by relationships, and at times complex transactions, with affiliated companies. Indeed, in some instances it would appear that investors may not have fully understood which entity was the counterparty to transactions. In yet other instances, it appears that the dealers in question used working capital generated by matched-book operations to engage in trading for their own account and in the process incurred losses because the customers failed both to know their counterparty and to secure control of the securities underlying a repurchase transaction with the problem dealer. The failure to know the financial status and management of the counterparty, and the failure to secure control of underlying securities not only ultimately resulted in the loss to the customer, but also had the effect of providing funds to the problem dealer, thereby permitting the dealer to continue operations in a way that may have disguised its true financial condition.[135]

[2] Congressional Response—The Government Securities Act of 1986

The Government Securities Act of 1986 addresses the congressional concerns in the following ways. The act does not change the status of U.S. government securities as exempted securities under the federal securities laws, but it establishes a special system of registration. Persons who are not already registered as brokers and dealers under the federal securities laws but who act as government securities brokers or dealers now must register with the SEC as a government securities broker or a government securities dealer.[136] Financial

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[134] These problems are reported in S. Rep. No. 426, supra note 127, at 7-8.

[135] Id. at 6-7

[136] 15 USC § 78o-5(a)(1)(A) (Supp. IV 1986). There are definitions for both "government securities broker" and "government securities dealer". 15 USC § 78c(43), (44) (Supp. IV 1986). The "broker" definition refers to a person "regularly engaged in the

institutions (which include banks and insured institutions)[137] and *registered* brokers and dealers must give written notice to their appropriate regulatory agency that they are acting as a government securities broker or a government securities dealer.[138] Thus, under this scheme, a bank that qualified as either a government securities broker or a government securities dealer under the act and the Secretary's regulations would give notice to its customary federal banking regulatory agency of its activities.

The act gives the Secretary of the Treasury broad rulemaking authority to provide "safeguards with respect to the financial responsibility and related practices" of government securities brokers and dealers which may include "capital adequacy standards," rules with respect to "custody and use of customers' securities," and measures to deal with "the transfer and control of government securities subject to repurchase agreements and in similar transactions."[139] Except when an emergency exists, the Secretary is required to consult with the Federal Reserve Board and the SEC.[140] The SEC exercises enforcement authority over those government securities brokers and dealers who register with it, and the banking regulatory agencies have authority under the law to exercise the enforcement responsibility with respect to the government securities brokers and dealers under their respective jurisdictions.[141] This gives the power to the comptroller, the Board of Governors, the FDIC, the FHLBB and the FSLIC to enforce the act against the institutions for which they have supervisory responsibility.[142] The Senate Committee said:

> This regulatory structure is intended to preserve the existing enforcement, inspection and supervisory authority of the bank regulatory agencies over the banking and nonbanking operations for which they are responsible

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business of effecting transactions in government securities for the account of others . . . " with exclusions. The "dealer" definition refers to a person "engaged in the business of buying and selling government securities for his own account, through a broker or otherwise, . . . " subject to exclusions. The term "government securities" is defined at 15 USC § 78c(42) (Supp. IV 1986) and includes "securities which are direct obligations of, or obligations guaranteed as to principal or interest by the United States" as well as certain other categories of securities in which the United States has an interest or which are specified by statute. See also Bloomental, "SEC Regulation of Banks as Broker-Dealers," 7 Sec. & Fed. Corp. L. Rev. 81-88 (1985); Kulka & Keating, "Regulation of Banks as Brokers Under the Securities Exchange Act of 1934," 10 Seton Hall Legis. J. 67-92 (1986).

[137] See definitions at 15 USC § 78c(46) (Supp. IV 1986).

[138] 15 USC § 78o-5(a)(1)(B)(i) (Supp. IV 1986).

[139] 15 USC § 78o-5(b)(1)(A) (Supp. IV 1986). See S. Rep. No. 426, supra note 127, at 15-16.

[140] 15 USC § 78o-5(b)(3)(D) (Supp. IV 1986).

[141] 15 USC § 78o-5(c)(2)(A) (Supp. IV 1986).

[142] See definition of appropriate regulatory agency in 15 USC § 78c(a)(34) (1982 & Supp. IV 1986).

> under current law. For example, the Federal Reserve Board would have its current jurisdiction over bank holding company nonbank subsidiaries that act as government securities brokers or dealers, and the Comptroller of the Currency would have its jurisdiction over national bank operating subsidiaries that act as government securities brokers or dealers. The Commission retains its current enforcement authority over financial institution-government securities brokers and dealers with regard to provisions of the Exchange Act other than section 15C [the Government Securities Act amendments].[143]

The act also gives the Secretary of the Treasury authority to adopt regulations for depository institutions that are not government securities brokers or dealers to set safeguards for U.S. government securities that the institution holds "as fiduciary, custodian, or otherwise for the account of a customer and not for its own account . . . "[144] The regulations are to "provide for the adequate segregation of . . . [the securities held by the institution], including obligations which are purchased or sold subject to resale or repurchase."[145] This section is directed at problems that had been reported to Congress of institutions failing to follow proper procedures in the custody of government securities of their customers.[146] There is a procedure that allows the Secretary of the Treasury to defer to the rules of the banking regulatory agency when the Secretary finds those rules are adequate.[147]

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[143] S. Rep. No. 426, supra note 127, at 18.

[144] Pub. L. No. 99-571, title II, § 201, 100 Stat. 3222 (1986) (amending 31 USC §§ 3121(h)(1), 9110).

[145] Id.

[146] S. Rep. No. 426, supra note 127, at 22.

[147] 31 USC § 3121(h)(4) (Supp. IV 1986). See S. Rep. No. 426, supra note 127, at 22.

9

Enforcement Powers of the Banking Regulatory Agencies Under Federal Banking Laws

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¶ 9.01 REGULATING UNSAFE AND UNSOUND BANKING PRACTICES

[1] Cease and Desist Orders

The power to issue cease and desist orders was granted to the federal supervisory agencies[1] by the Financial Institutions Supervisory Act of 1966

[1] These regulatory bodies include the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation,

(FISA), and that power was expanded by the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA).[2] The appropriate regulatory agency may issue a cease and desist order against an institution, or against an officer or director thereof, when, in the opinion of the appropriate federal banking agency, the institution or the officer or director has engaged in, is engaging in, or is about to engage in an unsafe or unsound practice.[3] Unsafe and unsound banking practices are practices that are generally viewed as contrary to accepted standards of banking operations, which practices might result in abnormal risk or loss to the financial institution.[4] The discretionary authority of the federal regulations agency to define and eliminate unsafe and unsound conduct is liberally construed.[5] The courts, in interpreting the banking acts, have held that Congress intended to commit the definition of these practices to the expertise of the appropriate regulatory agencies.[6]

Unsafe or unsound banking practices include renewing loans without collecting the interest already due,[7] securing loans inadequately,[8] extending unsecured credit without first obtaining adequate financial information,[9] having unwritten, if any, repayment and amortization schedules[10] or failing to establish and enforce programs for repayment of loans,[11] failing to maintain adequate capital reserves,[12] and failing to make adequate provisions for liquid-

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the Federal Savings and Loan Insurance Corporation, the Federal Home Loan Bank Board, and the National Credit Union Association (NCUA).

[2] For a more in-depth history of federal enforcement regulations, see S. Huber, Bank Officer's Handbook of Government Regulation, ch. 22 (Supp. 1988).

[3] 12 USC §§ 1464(d)(2)(A) (FHLBB), 1730(e)(1) (FSLIC), 1786(e)(1) (NCUA), 1818(b)(1) (Federal Reserve Board (FRB) and the Office of the Comptroller of the Currency (OCC)) (1982).

[4] See First Nat'l Bank v. Comptroller of the Currency, 697 F2d 674, 685 (5th Cir. 1983).

[5] Independent Bankers Ass'n of Am. v. Heimann, 613 F2d 1164 (DC Cir. 1979), cert. denied 449 US 823 (1980).

[6] See First Nat'l Bank v. Smith, 610 F2d 1258 (5th Cir. 1980); Groos Nat'l Bank v. Comptroller of the Currency, 573 F2d 889 (5th Cir. 1978); First Nat'l Bank v. Department of Treasury, 568 F2d 610 (8th Cir. 1978).

[7] Bank of Dixie v. FDIC, 766 F2d 175 (5th Cir. 1985).

[8] Id.; First State Bank v. FDIC, 770 F2d 81 (6th Cir. 1985).

[9] First State Bank v. FDIC, supra note 8.

[10] Bank of Dixie v. FDIC, supra note 7.

[11] First State Bank v. FDIC, supra note 8.

[12] See International Lending Supervision Act of 1983, at 12 USC §§ 3901–3912 (1982 & Supp. IV 1986). This act reversed a U.S. Court of Appeals for the Fifth Circuit decision, First Nat'l Bank v. Comptroller of the Currency, supra note 4, which held that the comptroller's finding that the bank had inadequate capital reserves, contrary to safe and sound banking practices, could not support a cease and desist order requiring that the bank maintain its equity capital at a level of not less than 7 percent of its total assets. The act authorizes the Comptroller, the FDIC, and the Federal Reserve Board to establish and

ity.[13] The agency may also issue a cease and desist order for a violation of any banking laws, rules, or regulations, or for any written agreement between the agency and the institution or an officer or director.[14]

Although a subsequent amendment to a statute may correct a violation, the amendment does not annul the violation that has occurred, and the agency may still issue a cease and desist order if necessary.[15] Similarly, a regulatory agency may issue a cease and desist order even when the institution voluntarily stops engaging in the unsound practices that the order was directed against, because it is generally possible for the institution to resume those practices.[16]

Once the agency determines that there is cause for a cease and desist order, it must serve notice on the institution or the officer or director containing a statement of the facts and providing for a hearing within thirty to sixty days of the date of the notice.[17] If the financial institution consents or if the administrative law judge finds that a violation or an unsafe and unsound condition exists, the agency may issue a cease and desist order.[18] A cease and desist order generally requires the institution or the officer or director to terminate a policy or practice, but it may also require that the institution take affirmative action to correct the conditions resulting from any such violation or practice.[19]

A supervisory agency may issue a temporary cease and desist order, which takes effect immediately, if it determines that the charges making up the cease and desist order are likely to cause insolvency, to weaken seriously the condition of the institution, or otherwise to prejudice seriously the interests of its depositors prior to completion of the normal proceedings.[20] Temporary cease and

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enforce mandatory capital adequacy standards. See ¶ 7.01[1] for a discussion of capital reserves.

[13] Bank of Dixie v. FDIC, supra note 7.

[14] 12 USC §§ 1464(d)(2)(A) (FHLBB), 1730(e)(1) (FSLIC), 1786(e)(1) (NCUA), 1818(b) (FRB and OCC) (1982). Cease and desist authority may be expressly incorporated into other banking laws and regulations. For example, the Money Laundering Control Act of 1986, 99 Pub. L. No. 99-570, § 1359, 100 Stat. 3207–3227 (1986) (amending 12 USC §§ 1464(d), 1730, 1786, 1811(i)(2)(i), 1818(s)), specifically provides that regulatory agencies should use their authority to issue cease and desist orders to enforce the monetary transaction reporting requirements (See ¶ 12.01).

[15] First Nat'l Bank v. Comptroller of the Currency, supra note 4.

[16] First State Bank v. FDIC, supra note 8; FSLIC v. Glen Ellyn Sav. & Loan Ass'n, 606 F. Supp. 91 (ND Ill. 1984).

[17] 12 USC §§ 1464(d)(2)(A) (FHLBB), 1730(e)(1) (FSLIC), 1786(e)(1) (NCUA), 1818(b)(1) (FRB and OCC) (1982).

[18] Id.

[19] Id. The order generally becomes effective thirty days after service of the order upon the bank or officer or director. If the order is by consent, it becomes effective on the date outlined in the order. Id. at §§ 1464(d)(2)(B), 1730(e)(2), 1786(e)(2), 1818(b)(2) (1982).

[20] 12 USC §§ 1464(d)(3)(A) (FHLBB), 1730(f)(1) (FSLIC), 1786(f)(1) (NCUA), 1818(c)(1) (FRB and OCC) (1982).

desist orders remain effective pending completion of the administrative proceedings and until the agency dismisses the charges, or until the temporary order is replaced with a permanent order.[21]

Within ten days after service with a temporary cease and desist order, the bank or officer or director may apply to the U.S. District Court for an injunction setting aside, limiting, or suspending the order pending the completion of the administrative proceedings.[22] Similarly, the district court may enforce a temporary cease and desist order against the named party who is violating or threatening to violate its terms.[23]

[2] Suspension and Removal of Officers and Directors

[a] Authority of the Federal Supervisory Agencies. The federal supervisory agencies have the power to remove or suspend officers or directors of financial institutions they supervise. Three substantive findings must be made before an officer or director may be removed:

1. The first finding is that in the agency's opinion, the officer or director has:

- **a.** Committed a violation of law, rule, or regulation or of a cease and desist order;
- **b.** Engaged or participated in any unsafe or unsound practice in connection with the institution; or
- **c.** Committed or engaged in any act, omission, or practice that constitutes a breach of the officer's fiduciary duty.[24]

2. The agency must then determine that:

- **a.** The bank has suffered or will probably suffer substantial financial loss or other damage;
- **b.** The interests of its depositors could be seriously prejudiced by reason of such violation or practice or breach of fiduciary duty; or
- **c.** The director or officer has received financial gain by his or her violation or practice or breach of fiduciary duty.[25]

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[21] 12 USC §§ 1464(d)(3)(B) (FHLBB), 1730(f)(2) (FSLIC), 1786(f)(2) (NCUA), 1818(c)(2) (FRB and OCC) (1982).

[22] Id.

[23] Id.

[24] 12 USC §§ 1464(d)(4)(A) (FHLBB), 1730(g)(1) (FSLIC), 1786(g)(1) (NCUA), 1818(e)(1) (FRB and OCC) (1982).

[25] Id.

3. The third finding is that the violation or practice or breach of fiduciary duty is one that involves personal dishonesty or is one that demonstrates a willful or continuing disregard for the safety or soundness of the institution.[26]

The authority of the supervisory agencies to prohibit an officer from involvement in the affairs of the depository institution is not limited to the institution at which the improper conduct took place. The supervisory agencies may prohibit an officer or director from participating in the affairs of an institution if it finds that the officer or director has, with respect to another institution, by conduct or practice, evidenced either the officer's personal dishonesty or a willful or continuing disregard for that institution's safety and soundness, with resulting substantial financial loss or other damage.[27]

The authority of the federal agencies to remove or suspend officers or directors has generally been upheld.[28] While this authority is broad, it is not unlimited. In a case involving the Federal Deposit Insurance Corporation, *Anonymous v. FDIC*,[29] the U.S. district court of the District of Columbia found that the FDIC had exceeded its statutory authority when it issued an order that removed an individual from his office and also prohibited him from participating in the conduct of any federally insured bank. (At the time, he had held positions in several small banks.) Following an examination, the FDIC found that the individual was associated to various degrees with several problem loans. The FDIC later amended its order to prohibit the individual from further participating in the examined bank and to require him to secure prior written approval before serving or acting as a director, officer, or employee of any federally insured bank or voting for a director of any such bank.[30]

The court found that the statute granted authority to the FDIC to remove a bank officer for misconduct or mismanagement as an official for a particular bank under 12 USC § 1818(e)(1), but that the FDIC could not remove an officer under this section for misconduct at another bank.[31] The court found that Section 1818(e)(2) would allow the FDIC to remove an officer as a result of misconduct with respect to another insured bank, but that this power could be

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[26] Id.

[27] 12 USC §§ 1464(d)(4)(B) (FHLBB), 1730(g)(2) (FSLIC), 1786(g)(2) (NCUA), 1818(e)(2) (FRB and OCC) (1982).

[28] See Brickner v. FDIC, 747 F2d 1198 (8th Cir. 1984) (removal of two officers and directors for breach of their fiduciary duties upheld where the FDIC had told the individuals that a cashier and fellow director had been making loans above the legal lending limit, and, although they confronted the cashier and told him to stop, they took no further steps and failed to inform the banking regulatory agencies); Sunshine State Bank v. FDIC, 783 F2d 1580 (11th Cir. 1986) (removal of three officers upheld because board's finding was supported by substantial evidence, and remedies were not arbitrary or capricious).

[29] 619 F. Supp. 866 (DDC 1985).

[30] Id. at 867.

[31] Id. at 869.

exercised only if the other requirements for removal under Section 1818 (e)(2) were met.[32] These requirements include a finding by the FDIC of personal dishonesty or a willful or continuing disregard for a bank's safety and soundness.[33]

[b] Procedure for Removal or Suspension. The procedure to remove or suspend an officer or director is very similar to that for cease and desist orders. A notice of intent to remove must be served on the officer or director, which notice contains a statement of the facts constituting the grounds for removal and fixes a date for a hearing within thirty to sixty days after the date of service.[34] An earlier or a later date may be set by the agency upon request of the officer or director, or other person, for good cause shown, or by request of the Attorney General of the United States.[35] If the facts in the notice are established at the hearing, the agency may issue an order of suspension or removal on the officer or director.

Temporary suspension or prohibition orders are available to the supervisory agencies when they deem it necessary for the protection of the institution or for the interests of depositors. These orders are effective upon service, and remain in effect until the administrative suspension or removal proceeding is completed, the charges are dismissed, or the order is stayed by a federal district court.[36] The financial institution must also be served with a copy of the temporary order.[37] Within ten days after any director or officer has been suspended from office and/or prohibited from participating in the conduct of the affairs of a financial institution, such person may apply to the U.S. District Court for a stay of the suspension or prohibition, pending completion of the administrative proceedings.[38] A removal from office during the pendency of administrative proceedings is significant as a practical matter, since such hearings commonly last a year or longer.[39]

Federal supervisory agencies may also suspend or remove any official charged with a felony involving dishonesty or breach of trust if the agency determines that the official's continued service or participation in the conduct of

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[32] Id. at 869–870.

[33] Id. See supra note 27.

[34] 12 USC §§ 1464(d)(4)(E) (FHLBB), 1730(g)(5) (FSLIC), 1786(e)(5) (NCUA), 1818(e)(5) (FRB and OCC) (1982).

[35] Id.

[36] 12 USC §§ 1464(d)(4)(D) (FHLBB), 1730(g)(4) (FSLIC), 1786(g)(4) (NCUA), 1818(e)(4) (FRB and OCC) (1982).

[37] Id.

[38] 12 USC §§ 1464(d)(4)(F) (FHLBB), 1730(g)(6) (FSLIC), 1786(g)(6) (NCUA), 1818(f) (FRB and OCC) (1982).

[39] S. Huber, Bank Officer's Handbook of Government Regulation, § 22.04[2][b] (Supp. 1988) (citing Anonymous v. FDIC, 619 F. Supp. 866, 873 n.27 (DDC 1985)).

the financial institution threatens the interests of the institution's depositors or may threaten to impair public confidence in the institution.[40] The agency may suspend or prohibit the official from further participation in the affairs of the institution by written notice, a copy of which must also be served on the financial institution.[41] The suspension or prohibition remains in effect until the charge is finally disposed of, or until the agency terminates the order.[42] Conviction is sufficient grounds for permanent removal, but an acquittal or other disposition of the charge does not necessarily reinstate the individual or preclude the agency from removing or suspending the officer under the general removal powers outlined previously.[43]

Within thirty days after the officer is served with notice of suspension or removal, the person concerned may request in writing an opportunity to appear before the agency to show that his or her continued service to or participation in the conduct of the affairs of the institution does not, or is not likely to, pose a threat to the interests of the bank's depositors or threaten to impair public confidence in the institution.[44] The agency must provide for a hearing within thirty days, at which the individual charged may appear, with counsel, to present written materials and oral argument supporting his or her position.[45] Within sixty days after the hearing, the agency must notify the official as to whether the suspension or prohibition will be continued, terminated, or otherwise modified.[46]

After the final order suspending or removing an officer or director itself becomes final, violation of the order by participation in the conduct of the affairs of the bank or by exercising any voting rights in such bank is a criminal offense, which upon conviction may result in a fine of $5,000 or imprisonment for up to one year, or both.[47] The original provisions regarding suspension for felonies in FISA did not provide for a hearing. This subsection was amended by FIRA after the U.S. District Court for the District of Columbia held that removal of an officer charged with a felony without a hearing either prior to or promptly after the removal deprived an individual of due process.[48] The amended procedures give a suspended bank officer a right to a post-

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[40] 12 USC §§ 1464(d)(5)(A) (FHLBB), 1730(h)(1) (FSLIC), 1786(i)(1) (NCUA), 1818(g)(1) (FRB and OCC) (1982).

[41] Id.

[42] Id.

[43] Id.

[44] Id.

[45] Id.

[46] Id.

[47] 12 USC §§ 1464(d)(12)(A) (FHLBB), 1730(p)(1) (FSLIC), 1786(1) (NCUA), 1818(j) (FRB and OCC) (1982).

[48] Feinberg v. FDIC, 420 F. Supp. 109 (DDC 1976).

suspension hearing to demonstrate that the continuation of the officer's employment would not pose a threat to the bank or impair public confidence in the bank. At the request of the officer, a hearing must be held within ninety days of the suspension. These amended procedures were upheld in a 1988 Supreme Court decision.[49]

In *Mallen v. FDIC*,[50] a banker who served as president and director of Farmers State Bank was indicted on two felony counts of making false statements to both the bank and the FDIC. The FDIC suspended him by written notice according to 12 USC § 1818(g) after making findings that continued service by the bank officer would impair public confidence in the bank. The officer brought suit in federal court to challenge the suspension without completing the process for a hearing and review before an administrative law judge. The federal district court concluded that the suspension violated the officer's due process rights because the procedures did not give the officer the opportunity for a prompt hearing on the validity of the suspension, and the hearing provided for would not be one where the officer could present oral evidence.[51]

The Supreme Court reversed this decision and upheld the constitutionality of the suspension procedures on both grounds.[52] Although the statutory procedures contemplated that a hearing might not be held until as long as ninety days after the suspension, the court believed that this period was not necessarily a denial of due process, in light of both the public interest in allowing the agency sufficient time to prepare for a hearing and to reach a correct decision on the suspension, and the likelihood that a basis for the suspension existed because of the action of the grand jury in deciding that there was probable cause to issue an indictment.[53] The court also concluded that the form of the hearing did not violate the bank officer's right to due process. Even if there were cases where due process required consideration of oral testimony, the FDIC procedures allowed the hearing officer to permit such evidence to be introduced. In this case, the bank officer had made no request to present such testimony. Consequently, the bank officer could not complain that he had been deprived of the opportunity to present it.[54] In reaching these conclusions, the court expressly noted that all parties, including the court, agreed that due process did not require the FDIC to conduct a hearing *before* the suspension, in light of the important public interest in swift action by the FDIC to preserve the integrity of banking institutions.[55]

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[49] Mallen v. FDIC, 108 S. Ct. 1780 (1988).

[50] Id.

[51] 667 F. Supp. 652 (ND Iowa 1987).

[52] Mallen v. FDIC, 108 S.Ct. 1780 (1988).

[53] 56 USLW at 4468.

[54] 56 USLW at 4469.

[55] 56 USLW at 4467–4468.

[3] Civil Money Penalties

Supervisory agencies may assess civil money penalties against institutions and their officers, directors, employees, and agents who violate specified federal banking laws or regulations promulgated[56] or the terms of any final cease and desist order.[57] Civil money penalties may be assessed for violations of limitations of loans by insured banks to executive officers and directors or to affiliates,[58] for failure to meet reserve requirements,[59] or for violations of the Bank Holding Company Act of 1956 (as amended)[60] and the Change of Bank Control Act of 1978.[61]

Penalties for most violations are not to exceed $1,000 per day for each day during which such violation continues.[62] Civil money penalties are not mandatory; they are subject to the discretion of the federal supervisory agency.[63] To determine the amount of the penalty, the agency must take into account the size of financial resources and the good faith of the institution or person charged, the gravity of the violation, the history of previous violations, and such other matters as justice may require.[64]

After determining that a penalty is appropriate and is within the statutory maximums, the agency must issue a notice of assessment to the person or institution charged.[65] The institution or person assessed has ten days in which to make a request for an administrative hearing. If no hearing is requested, the assessment becomes a final and unappealable order.[66] If the allegations are established at the hearing, the agency issues an order of assessment. The institution or person assessed may then make an appeal to the U.S. Court of Appeals

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[56] 12 USC § 93(b) (1982). For a more detailed analysis of civil money penalties and director liability, see L. Nicholas, "FIRA: Emerging Patterns of Director Liability," 103 Banking LJ 151 (1986).

[57] 12 USC §§ 1464(d)(8)(B)(i) (FHLBB), 1730(k)(3)(A) (FSLIC), 1786(k)(2)(A) (NCUA), 1818(i)(2)(i) (FRB and OCC) (1982).

[58] See 12 USC §§ 375(b) and 371c (1982). See Fitzpatrick v. FDIC, 765 F2d 569 (6th Cir. 1985) (civil penalty of $1,000 against a director was proper for his breach of legal and fiduciary duties in approving insider loans over lending limits and with insufficient security). See also ¶ 9.02.

[59] 12 USC § 461 (1982). See ¶¶ 3.04[2], 7.01.

[60] 12 USC §§ 1841–1850 (1982). See ¶ 5.02.

[61] 12 USC § 1817(j) (Supp. IV 1986). See ¶ 13.03[4].

[62] 12 USC §§ 93(b); 1464(d)(8)(B)(i) (FHLBB), 1730(k)(3)(A) (FSLIC), 1786(k)(2)(A) (NCUA), 1818(i)(2)(i) (FRB and OCC) (1982).

[63] Id.

[64] 12 USC §§ 1464(d)(8)(B) (FHLBB), 1730(k)(3) (FSLIC), 1786(k)(2) (NCUA), 1818(i)(2) (FRB and OCC) (1982).

[65] Id. The rules implementing civil money penalty procedures are codified at 12 CFR §§ 19.22–19.25, 263.30–263.33, 308.64–308.72 and 747.401–747.408 (1987).

[66] 12 USC §§ 1464(d)(8)(B) (FHLBB), 1730(k)(3) (FSLIC), 1786(k)(2) (NCUA), 1818(i)(2) (FRB and OCC) (1982).

within twenty days of service of the final assessment order.[67] If an institution or person fails to pay an assessment after it has become a final and unappealable order, or after the appeals court has entered final judgment in favor of the agency, the agency must then refer the matter to the U.S. Attorney General, who is authorized to sue on behalf of the agency to recover the penalty in U.S. District Court.[68]

[4] Special Liabilities of Officers and Directors

Officers and directors may be personally liable under several statutory provisions.[69] Section 93(a) of the National Bank Act holds directors personally liable upon a showing (in a district court) that they knowingly violated any of the provisions of the chapter.[70] Civil money penalties are also available against officers and directors, making them personally liable for violations of banking laws or of cease and desist orders.[71] A third method of holding officers and directors personally liable, subject to more controversy than the first two methods, involves the broad authority of the supervisory agencies to issue cease and desist orders.

Regulators have issued cease and desist orders requiring that officers or directors personally indemnify the bank for loans made that exceed legal lending limitations. Because cease and desist authority allows supervisory agencies to order affirmative action to correct the conditions resulting from violations, at least one court has upheld such personal liability.[72] In *Del Junco v. Conover*,[73] a bank made a series of loans to insiders. During a routine examination, the examiner decided that the loans should be aggregated. When they were aggregated, the loans exceeded the bank's lending limits. The court confirmed the Comptroller of the Currency's authority to order indemnification by the direc-

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[67] Id.

[68] Id. In this collection proceeding, the validity and appropriateness of the final order imposing the penalty is not subject to review. Id.

[69] See generally Banks & Hoskins, "Liability and Responsibility of Bank Directors: Being Alert to Troubled Times," 72 Ky. LJ 639–670 (1983–1984); Hawke, "The Limited Role of Directors in Assuring the Soundness of Banks," 6 Ann. Rev. Banking L. 285–290 (1987); Searle, "Director Liability and the Relationship Between Bankers and Regulators," 6 Ann. Rev. Banking L. 291–297 (1987); Vartanian & Schley, "Bank Officer and Director Liability—Regulatory Actions," 39 Bus. Law. 1021–1031 (1983–1984); Notes, "Imposition of Personal Liability on Bank Directors for Violation of Lending Limits Under Section 1818(b)(1) Enforcement Proceedings: Triso Del Junco v. Conover," 3 Ann. Rev. Banking L. 355–367 (1984); "Banking Regulations/Excessive Loans/Director's Liability," 75 Ill. BJ 514–517 (1987).

[70] 12 USC § 93(a).(1982).

[71] For a discussion of civil money penalties, see supra ¶ 9.01[3].

[72] See Del Junco v. Conover, 682 F2d 1338 (9th Cir. 1982), cert. denied, 459 U.S. 1146 (1983).

[73] 682 F2d at 1338.

tors.[74] The circuit court did not, however, reach the question of what standard is required for liability under cease and desist authority. The court noted that "on its face Section 1818(b)(1) requires no knowledge on the part of the wrongdoer."[75] The bank directors argued that Section 1818(b) imports the scienter requirement of Section 93, requiring a knowing violation. However, the court avoided the issue because it found that even if a "knowing" standard was required, it was met in this case.[76]

In *Larimore v. Clarke*,[77] however, U.S. Court of Appeals for the Seventh Circuit, en banc, reversed an earlier panel decision and found that the comptroller's power to issue cease and desist orders to prevent unsafe and unsound banking practices does not include the authority to impose personal monetary liability on directors for knowingly approving bank loans that violate the loan limitations of the National Bank Act.[78] Although the powers granted to the comptroller include the power to require affirmative action to correct the conditions that result from unsafe and unsound practices, the affirmative action contemplated by these provisions does not include the power to require directors to reimburse the bank for loans made in excess of the bank's lending limitations. To establish personal liability of directors, the specific provisions of Section 93 of the National Bank Act, which provisions provide for director liability for knowing violations of the act, must be followed. Under Section 93, a federal district court must determine the liability of the director. In concluding that the comptroller lacked authority to impose monetary liability on the directors, the court distinguished the situation in which a director had been personally enriched as a result of the improper banking practices. Personal enrichment, the court said, might be a basis for requiring reimbursement.[79]

[5] Judicial Review of Agency Actions

The U.S. District Courts have jurisdiction over temporary cease and desist orders and removal or suspension orders. For permanent orders, the officer, director, or financial institution must appeal to the U.S. Court of Appeals for the circuit in which the home office of the institution is located.[80] An appeal from a

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[74] Id.

[75] Id. at 1342.

[76] Id. The court did not discuss the fact that under Section 93, it is a district court that determines that the director knowingly violated a federal banking law, not the regulatory agency, as is the case with cease and desist orders.

[77] 789 F2d 1244 (7th Cir. 1986) (en banc).

[78] Id.

[79] See First Nat'l Bank v. Department of the Treasury, supra note 6 (upholding Comptroller's order requiring bank officers to reimburse the bank for bonuses improperly paid to the officers).

[80] 12 USC §§ 1464(d)(7)(B) (FHLBB), 1730 (j)(2) (FSLIC), 1786(j)(2) (NCUA), 1818(h)(2) (FRB and OCC) (1982).

permanent order must be filed within thirty days after service of the order, but the filing of an appeal does not stay the order unless the reviewing court orders otherwise.[81]

The appeals court uses a "substantial evidence" standard of review for administrative decisions. The court must give deference to the findings and conclusions of the agency, and may not reverse its action unless the findings are not supported by substantial evidence on the record as a whole, or unless the remedies formulated constitute an abuse of discretion or are otherwise arbitrary and capricious.[82]

Several attempts have been made to thwart a supervisory agency's enforcement powers by seeking injunctive relief from a district court.[83] By statute, a district court has no jurisdiction to review agency actions,[84] so the party challenging the agency action usually contends that it is not seeking review of the order, but rather is seeking relief because the agency acted outside the scope of its authority and the order should not have been issued at all. These attempts have been consistently unsuccessful,[85] but the courts generally acknowledge that such an exception to the jurisdictional bar may exist in extreme situations in which it is apparent from the face of the record that the agency has grossly exceeded its authority in issuing the order.[86]

¶ 9.02 TRANSACTIONS WITH INSIDERS AND AFFILIATES

[1] Loans to or by Executive Officers of Member Banks

Under 12 USC § 375a, there are limitations on the circumstances under which a bank that is a member of the Federal Reserve System may make loans or

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[81] Id.

[82] See Sunshine State Bank v. FDIC, supra note 28; Bank of Dixie v. FDIC, supra note 7; Fitzpatrick v. FDIC, supra note 58; First Nat'l Bank v. Comptroller of the Currency, supra note 4.

[83] First Nat'l Bank of Grayson v. Conover, 715 F2d 234 (6th Cir. 1983); Groos Nat'l Bank v. Comptroller of the Currency, supra note 6; Abercrombie v. Comptroller of the Currency, 641 F. Supp. 598 (SD Ind. 1986); Somerfield v. FDIC, 609 F. Supp. 128 (DC Tenn. 1985).

[84] 12 USC § 1818(i)(1) (1982), which provides in part that "except as otherwise provided in this section no court shall have jurisdiction to affect by injunction or otherwise the issuance or enforcement of any notice or order under this section, or to review, modify, suspend, terminate, or set aside any such notice or order." See also 12 USC §§ 1464(8)(A), 1730(k)(2), 1786(j)(2) (1982).

[85] *Grayson*, 715 F2d at 234; *Groos*, 572 F2d at 889; *Abercrombie*, 641 F. Supp. at 598; *Somerfield*, 609 F. Supp. at 128.

[86] *Grayson*, 715 F2d at 236; *Groos*, 573 F2d at 894–895; *Abercrombie*, 641 F. Supp. at 602.

otherwise extend credit to its executive officers. Correspondingly, there are limitations on the member bank's executive officers extending credit to the bank.[87] The action extending credit must be "promptly reported" to the bank's board of directors. The statute requires that (1) the loan be one that the bank would be authorized to make to borrowers other than its officers; (2) the terms of the loan be "not more favorable than those afforded other borrowers"; (3) the officer supply a "detailed current financial statement"; and (4) the loan be due and payable on demand if the officer becomes indebted to other banks in excess of the limits permitted for loans to the officer.[88]

The statute specifically approves the following: (1) loans for the officer's personal residence when secured by a first mortgage lien;[89] (2) loans for educational expenses of the officer's children;[90] and (3) other loans as prescribed by regulation by the appropriate federal banking regulator.[91] The bank must report any loans made to its executive officers or loans made by its officers, as part of its reports to the banking regulatory agency.[92] An executive officer may incur indebtedness by indorsing or guaranteeing loans or other assets that the bank has previously acquired when the officer performs those actions "for the purpose of protecting the bank against loss" or for the purpose of "giving financial assistance to" the bank.[93] Violations of these rules subject the bank to liability under the provisions dealing with unsafe and unsound practices and to termination of insured status.[94]

Additional limitations affect the ability of member banks to make loans to their executive officers, to persons who are in a position to control 10 percent of the banks' voting stock, to companies controlled by the banks' executive officers, or to political campaign committees controlled by such persons or under circum-

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[87] 12 USC § 375a (1982). See generally Mattingly, "Insider Lending Restrictions and Reporting Requirements Under the Financial Institutions Regulatory and Interest Rate Control Act of 1978 As Amended," 3 Ann. Rev. Banking L. 21–87 (1984).

[88] 12 USC § 375a(1) (1982). When this occurs, the officer must report to the board of directors the circumstances regarding the loans. Id. at § 375a(6).

[89] Id. at § 375a(2).

[90] Id. at § 375a(3).

[91] Id. at § 375a(4). The bank may not make loans to a partnership where its executive officers have a majority interest in the partnership, except to the extent the loan would be permitted under this general category. In these cases, "the full amount of any credit so extended [to the partnership] shall be considered to have been extended to each officer of the bank who is a member of the partnership." Id. at § 375a(5). The regulations implementing Section 375(a)(4) are found at 12 CFR § 31 (1987) for national banks and at 12 CFR § 215 (1987) for state member banks.

[92] 12 USC § 375a(9) (1982).

[93] 12 USC § 375a(7) (1982).

[94] 12 USC § 375a(8) (1982), which makes a violation of Section 375a a violation of 12 USC § 1818.

stances in which the funds will benefit the executive officer.[95] In such cases, the loans may not aggregate an amount greater than that which the bank is permitted to loan to a single borrower.[96]

Additionally, the bank may not make such loans in excess of the limits that may be set by regulation by the banking agencies, except through advance approval of the bank's board of directors, with the interested officer abstaining from any direct or indirect participation in the vote.[97] Further, any loans must be made "on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons and . . . [must not] involve more than the normal risk of repayment or present other unfavorable features."[98] The bank also may not pay an overdraft of the officer at the bank.[99] However, the payment will not be viewed as an overdraft payment if it is a preauthorized transfer of funds from another account of the officer at the bank, or if there is a written preauthorized arrangement to extend credit that bears interest to pay the overdraft.[100] The provisions on loans to executive officers and to companies and political campaign committees controlled by executive officers also apply to FDIC-insured nonmember banks.[101]

Purchases and sales of securities and other property between a member bank and a member of the bank's board of directors are allowed under the federal banking laws as long as the purchase or sale is "in the regular course of business upon terms not less favorable to the bank than those offered to others," or has been approved by a majority of the board of directors who have no interest in the transaction.[102]

Officers have personal liability for knowingly violating or permitting an agent or officer of a member bank to violate the previously stated provisions.[103] Moreover, officers and directors who participate in or assent to such violations are liable in their personal and individual capacities to the bank, to its shareholders, and to other persons for all damages they might have sustained because of the violations.[104] There also are civil penalties, which may amount up to $1,000 per day while the violation continues. The penalty may be assessed against an

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[95] 12 USC § 375b (1982).

[96] The single borrower limits are contained in 12 USC § 84 (1982).

[97] 12 USC § 375b(2) (1982).

[98] 12 USC § 375b(3) (1982).

[99] 12 USC § 375b(4) (1982).

[100] 12 USC § 375b(6)(F) (1982).

[101] 12 USC § 1828(j)(2) (1982) makes the provisions of 12 USC § 375b applicable to FDIC-insured banks.

[102] 12 USC § 375 (1982).

[103] 12 USC § 503 (1982). This imposes liability for violations of 12 USC §§ 375, 375a, 375b, and 376, and the regulations implementing these sections.

[104] 12 USC § 503 (1982). A court has held that an officer may be liable for a civil penalty regardless of whether proven damages result. Fitzpatrick v. FDIC, supra note 58.

officer, director, employee, agent, "or other person participating in the conduct of the affairs of such member bank . . . " who violates the federal laws discussed previously.[105] In one case, a bank president was held liable for violation of the provisions against insider loans, although the president subsequently reported the loan to the banking regulatory agency. The court said that the president's good faith efforts were relevant to the determination of the penalty but not to the existence of the violation.[106]

[2] Loans to Officers of Banks Where Correspondent Accounts Are Maintained

Federal law limits the ability of a bank to make loans to executive officers of banks with whom the bank has a correspondent relationship.[107] These restrictions apply to all banks, as defined in the Bank Holding Company Act.[108] If a bank holds a correspondent account of another bank, neither bank may loan funds or extend credit to executive officers, directors, or other persons with a control interest of their correspondent bank, except as permitted by the statute. The loan must be "on substantially the same terms, including interest rates and collateral as those prevailing at the time for comparable transactions with other persons and does not involve more than the normal risk of repayment or present other unfavorable features.[109] There are civil penalties of up to $1,000 per day for violations.

[3] Transactions With Affiliates

Extensive regulations exist to deal with the transactions between a member bank, including its subsidiaries, and affiliates of the bank.[110] Member banks and their subsidiaries are prohibited from engaging in certain transactions with their affiliates. Firstly, they may not have "covered" transactions with any one affiliate that exceed 10 percent of the capital stock and surplus of the member bank, and they may not have such transactions with all affiliates that exceed 20 percent of the capital stock and surplus of the member bank.[111] Secondly, unless special conditions are met, they may not purchase "low-quality" assets, as defined by

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[105] 12 USC § 504(a) (1982). It applies to violations of 12 USC §§ 371c, 375, 375a, 375b, 376, and 503, and the regulations thereunder.

[106] Fitzpatrick v. FDIC, supra note 58.

[107] 12 USC § 1972 (1982).

[108] 12 USC § 1971 (1982).

[109] 12 USC § 1972(2)(A), 1972(2)(B), 1972(2)(C), 1972(2)(D) (1982).

[110] 12 USC § 371c (1982). These provisions also apply to nonmember FDIC-insured banks. 12 USC § 1828(j) (1982). See generally Rose & Talley, "Bank Transactions With Affiliates: The New Section 23A," 100 Banking LJ 423–438 (1983).

[111] 12 USC § 371c(a)(1) (1982).

law, from an affiliate.[112] Thirdly, loans and other credit made by the member bank to an affiliate, as well as guarantees or letters of credit issued on behalf of an affiliate, must be secured by collateral having a market value of at least 100 percent of the amount of the credit, depending on the nature of the collateral security.[113]

There are five categories of covered transactions. These are (1) loans or extensions of credit to the affiliate; (2) purchases or investments in securities issued by the affiliate; (3) purchases of assets from the affiliate except certain property exempted by order of the Federal Reserve Board; (4) acceptance, as collateral for a loan from any person, of securities issued by an affiliate; and (5) issuance of guarantees, acceptances, or letters of credit, "including an endorsement or standby letter of credit," on behalf of an affiliate.[114]

The statute exempts certain transactions from coverage. These exemptions include (1) transactions with a bank where there is an 80 percent or more voting control; (2) deposits in the ordinary course of business in a correspondent relationship; (3) credit given for "uncollected items received in the ordinary course of business"; (4) certain loans or credit that is fully secured by U.S. government securities or by a separate "earmarked deposit account"; (5) purchase of stock in companies engaged in certain kinds of operational activities for the bank; (6) purchase of assets with a "readily identifiable and publicly available market quotation" at the public price and purchasing loans on a nonrecourse basis; and (7) repurchase from an affiliate a loan sold to the affiliate subject to a repurchase agreement or with recourse by the member bank.[115]

[4] Restrictions on Transactions With Affiliates Under the Competitive Equality Banking Act of 1987

The amendments to the Bank Holding Company Act contained in the Competitive Equality Banking Act of 1987 expand the restrictions on dealings between a member bank and its subsidiaries.[116] These amendments, which also apply to FDIC-insured nonmember banks,[117] impose the following standards for transactions between a member bank (including its subsidiaries) and its affiliates. The transactions must be

(A) on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its

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[112] 12 USC § 371c(a)(3) (1982).

[113] 12 USC § 371c(c)(1) (1982).

[114] 12 USC § 371c(7) (1982).

[115] 12 USC § 371c(d) (1982).

[116] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 102(a), 101 Stat. 552, 564 (1987) (to be codified at 12 USC § 371c-1) (hereinafter CEBA).

[117] CEBA § 102(b) (amending 12 USC § 1828(j)).

subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies, or

(B) in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to nonaffiliated companies.[118]

These standards apply to (1) any covered transaction with an affiliate;[119] (2) the sale of securities or other assets to an affiliate; (3) the payment of money or the furnishing of services to an affiliate under a contract or otherwise; (4) a transaction in which the affiliate is an agent and receives a fee for services to the bank or another person; and (5) transactions with third persons in which the affiliate has a financial interest in the third party or participates in the transaction. Prohibitions exist against certain securities transactions with affiliates. These are discussed in Chapter 8. There is also a prohibition that runs against the bank, its subsidiaries, and any of its affiliates from advertising or entering into an agreement that states or suggests that the bank shall "in any way be responsible for the obligations of its affiliates."[120]

As discussed in Chapter 5, the 1987 amendments also impose certain restrictions on the joint marketing of products between institutions that formerly were known as nonbank banks and their affiliates, when they are controlled by companies that were not previously recognized as bank holding companies.[121]

[5] Tying Arrangements

Federal banking laws prohibit both state and national banks from tying the extension of credit or the provision of any other banking service to customer compliance with certain prohibited conditions.[122] Therefore, it is illegal for a bank to insist that its customers agree to any of the following conditions as a prerequisite for obtaining a loan from the bank or any other service:

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[118] CEBA § 102(a), (to be codified at 12 USC § 371c-1(a)(1)).

[119] For a discussion of covered transactions with affiliates, see supra ¶ 9.02[3]. For a discussion of certain restrictions on securities transactions, see ¶ 8.01[8].

[120] CEBA § 102(a), (to be codified at 12 USC § 371c-1(c)).

[121] CEBA § 101(c) (amending 12 USC § 1843(f)(3)). See also the restrictions applicable to savings and loan holding companies. Id. at §§ 104(b), 104(d) (amending 12 USC §§ 1730a(c), 1730a(d)(p)). See also ¶¶ 5.01[4], 5.03[2].

[122] 12 USC § 1972 (1982). The antitying provisions of the Bank Holding Company Act apply to conditions attached by a bank to its forbearance from demanding payment of a loan, because forbearing from demanding payment is the extension of credit. Nordic Bank PLC v. Trend Group, Ltd., 619 F. Supp. 542 (SDNY 1985). See generally Annot., "What Constitutes Violation of Provisions of Bank Holding Company Act Prohibiting Tying Arrangements (12 U.S.C.S. § 1972(1))," 74 ALR Fed. 578 (1985).

1. Obtaining additional credit, property, or service from the bank (other than a loan, discount, deposit, or trust service);
2. Obtaining additional credit, property, or service from a bank holding company or subsidiary of a bank holding company of the bank;
3. Providing additional credit, property, or service to the bank other than those "related to and usually provided in connection with a loan, discount, deposit or trust service";
4. Providing additional credit, property, or service to a bank holding company or subsidiary of a bank holding company of the bank;
5. Prohibiting the customer from obtaining other credit, property, or service from a competitor of the bank, or from a holding company or subsidiary of a bank holding company of the competitor, other than requirements reasonably imposed in a credit transaction to assure the soundness of the credit.[123]

The antitying provisions of 12 USC § 1972 were litigated in *B.C. Recreational Industries v. First Nat'l Bank.*[124] A firm to whom the bank had loaned money contended that the bank forced it to hire a business adviser, who required the firm to follow policies beneficial to the bank but detrimental to the firm. The firm claimed that this constituted a violation of the antitying statute. The court held that there was no cause of action stated by the debtor firm. The court interpreted the tying prohibitions as not interfering with the conduct of "appropriate traditional banking practices."[125] The bank's action in installing an adviser who would help protect the bank's investment was a legitimate bank practice that did not implicate the antitying statute.[126] The court also found no violation of the antitying provisions of the Sherman Act.

The same conclusion was reached in *Tose v. First Pennsylvania Bank.*[127] In that case, the bank imposed as a condition to refinancing a loan that financial

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[123] 12 USC § 1972(1) (A)–(E) (1982).

[124] 639 F2d 828 (1st Cir. 1981).

[125] Id. at 832. Accord McCoy v. Franklin Sav. Ass'n & Mortgage Management Co., 636 F2d 172 (7th Cir. 1980); Clark v. United Bank, 480 F2d 235 (10th Cir.), cert. denied, 414 US 1004 (1973).

[126] For other decisions interpreting 12 USC § 1972, see Duryea v. Third Northwest Nat'l Bank, 606 F2d 823 (8th Cir. 1979); Swerdloff v. Miami Nat'l Bank, 584 F2d 54 (5th Cir. 1978); Costner v. Blount Nat'l Bank, 578 F2d 1192 (6th Cir. 1978); Sterling Coal Co. v. United Am. Bank, 470 F. Supp. 964 (ED Tenn. 1979).

In McGee v. First Fed. Sav. & Loan Ass'n, 761 F2d 647 (11th Cir.), cert. denied, 474 US 905 (1985), the court held that a savings and loan association did not violate the tying statute by referring loan customers to a wholly owned subsidiary to obtain the appraisals required for real estate loans.

See generally "Section 1972: Augmenting the Available Remedies for Plaintiffs Injured by Anti-Competitive Bank Conduct," 60 Notre Dame L. Rev. 706–723 (1985).

[127] 648 F2d 879 (3d Cir.), cert. denied, 454 US 893 (1981).

control over the debtor firm be exercised by another person. The court held that the imposition of financial controls over the firm was "directly related to maintaining the security" of the bank's substantial investment, and the bank's demand for these controls could not "be considered unusual in the fact of substantial evidence that it had good reasons to be concerned about the loan."[128]

In *Parson's Steel, Inc. v. First Alabama Bank,*[129] the court followed the general rules stated above. It held that "a bank's requirement that financial control of an enterprise be placed in new hands when necessary to protect its investment before extending further credit, does not constitute a violation" of the antitying statute.[130] Further, in *Rae v. Union Bank,*[131] the court held that the antitying provisions of 12 USC § 1972 could not be the basis for a claim against a natural person.

In *Continental Bank v. Barclay Riding Academy, Inc.,*[132] the debtor claimed that the bank had violated the antitying provisions of 12 USC § 1972(1)(C) of the Bank Holding Company Act, because the bank had required additional security from its customer as a condition for extending further credit. The court held that there were no violations of the act. Relying on the legislative history, the court said that "appropriate and traditional transactions engaged in by a bank to protect its investments" are not violations of the act. Even if the bank's conduct involves "uncommon or unusual banking practices," no violation need exist where the actions are taken by a lender to protect its investment. Further, the court went on to say that "even if uncommon practices are not directly related to a bank's investment, they are violative of the Act only if they are anticompetitive."[133] Thus, there were three defenses to the charge of violation: namely, that (1) the bank's practices represented traditional banking practices; (2) the practices involved were directly related to the protection of the bank's investment; and (3) the practices were not anticompetitive.

In finding that the bank had acted appropriately to protect its investment, the court said:

> This case is representative of bailout situations in which debtors in serious financial straits, working with their creditors, enter into numerous types of transactions that protect the creditors' investments while permitting the debtor's businesses to continue. The complexity of the transactions and special needs of the parties involved determine the type of arrangement that will be made to secure the joint aims of the debtor and the creditor. Due to

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[128] Id. at 897.

[129] 679 F2d 242 (11th Cir. 1982).

[130] Id. at 244.

[131] 725 F2d 478 (9th Cir. 1984).

[132] Continental Bank v. Barclay Riding Academy, Inc., 93 NJ 153, 459 A2d 1163, cert. denied, 464 US 994 (1983).

[133] 459 A2d at 1170.

the complicated circumstances of many bailout cases, specific banking transactions utilized may appear uncommon, yet, in the milieu of bailouts, they constitute appropriate banking practices. As such, they do not violate the Act.[134]

[6] Interlocking Management Arrangements

A number of separate federal statutes prohibit officers, directors, and employees of banks from concurrently assuming similar responsibilities at other financial institutions. Under the Clayton Antitrust Act, no director, officer, or employee of any member bank of the Federal Reserve System can jointly hold a position as a director, officer, or employee of any other bank, savings bank, or trust company organized under federal or state law.[135] The prohibition against holding simultaneous positions does not apply to a bank owned by the United States, a bank in liquidation, a corporation principally engaged in foreign banking under agreement with the Board of Governors of the Federal Reserve System, a bank under common control, a bank in a separate and noncontiguous area, and a bank engaged in a different class of business from that of member banks.[136] The Board of Governors of the Federal Reserve System may, by regulation, permit an officer, director, or employee to serve in such capacity simultaneously at one other institution.[137]

Section 8 of the Clayton Act also prohibits serving as a director of two or more competing corporations, when one of the corporations exceeds a certain size, "other than banks, banking associations, trust companies, and common carriers . . . "[138] The Supreme Court has clarified that this part of the act does not apply to interlocks between a bank and nonbank competitors. In a case involving interlocks between an insurance company and a bank, as well as between an insurance company and a bank holding company, the Supreme Court concluded that there were no violations. Relying on the interpretation given this provision in the enforcement practices of the Department of Justice and the Federal Trade

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[134] 459 A2d at 1170–1171.

[135] 15 USC § 19 (1982).

[136] Id.

[137] Id. See Reg. L, 12 CFR § 212.4 (1987).

[138] Section 8, paragraph 4, of the Clayton Act, 15 USC § 19, provides as follows:

No person at the same time shall be a director in any two or more corporations, any one of which has capital, surplus, and undivided profits aggregating more than $1 million, engaged in whole or in part in commerce, other than banks, banking associations, trust companies, and common carriers subject to subtitle IV of title 49, if such corporations are or shall have been theretofore, by virtue of their business and location of operation, competitors, so that the elimination of competition by agreement between them would constitute a violation of any of the provisions of the antitrust laws.

Commission for many years, who declined to recognize such interlocks as violations, the court held that the prohibitions of Section 8 applied only when all the interlocked corporations were corporations other than banks.[139]

Other federal statutes deal directly with management interlocks between banks and commercial firms. Under the Banking Act of 1933 (commonly referred to as the Glass-Steagall Act), officers, directors, or employees of member banks of the Federal Reserve System are prohibited from serving concurrently as officers, directors, or employees of companies or partnerships engaged in securities underwriting or distribution, except as permitted by the Board of Governors.[140]

Further, under the Public Utility Holding Company Act of 1935, no registered holding company may have as an officer or director any executive officer, director, or representative of any bank except as the Securities and Exchange Commission may permit by regulation.[141] Under the Federal Power Act, interlocking arrangements between public utility companies and banks authorized to underwrite public utility securities are prohibited, except as authorized by the Federal Power Commission.[142]

The Depository Institutions Management Interlocks Act of 1978[143] prohibits interlocking relationships between depository institutions. The act applies to commercial banks, savings banks, trust companies, savings and loan associations, industrial banks, and credit unions. It also applies to bank holding companies and savings and loan holding companies.[144] The act prohibits any management official of a depository institution or holding company from serving simultaneously as a management official of any other depository institution or holding company that is unaffiliated, if the two institutions have offices within the same metropolitan area (as defined in the statute) or have offices in the same city or in contiguous cities.[145] Although this provision would permit some interlocking relationships, no management official of a depository institution with assets over $1 billion may serve as a management official of any other

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[139] BankAmerica Corp. v. United States, 462 US 122 (1983), rev'g United States v. Crocker Nat'l Corp., 656 F2d 428 (9th Cir. 1981). See generally Note, "Management Interlocks Between Banks and Other Financial Institutions: United States v. Crocker National Corporation," 2 Ann. Rev. Banking L. 355–372 (1983); Note, "Legitimizing Bank-Nonbank Interlocks (BankAmerica Corp. v. United States, 103 S. Ct. 2266 (1983))," 33 Emory LJ 1103–1150 (1984).

[140] 12 USC § 78 (1982). See Reg. R, 12 CFR § 218.1 (1987). See also ¶ 8.01.

[141] 15 USC § 79q(c) (1982). See 17 CFR § 250.70 (1987).

[142] 16 USC § 825d(b)(c) (1982).

[143] 12 USC §§ 1464, 1730, 1818, 3201–3207 (1982).

[144] 12 USC § 3201 (1982).

[145] 12 USC § 3202 (1982). The rules are more lenient when the assets of the bank are less than $20 million.

nonaffiliated depository institution with assets in excess of $500 million.[146] Administration of the act is enforced by the appropriate federal regulatory agency.[147]

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[146] 12 USC § 3203 (1982). There are grandfather provisions for officers whose service began before November 10, 1978. 12 USC § 3205 (1982).

[147] 12 USC § 3206 (1982).

10

Liquidation, Reorganization, and Supervision of Failing Banks and Thrift Institutions

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¶ 10.01 TERMINATION OF DEPOSIT INSURANCE

The federal banking regulatory agencies have special powers and responsibilities when the financial institutions under their supervision become insolvent or are in danger of failing; the general procedures of the federal Bankruptcy Code do not apply. Because they are specifically exempted from the federal Bankruptcy Code, financial institutions may not file petitions for protection, liquidation, or reorganization in bankruptcy.[1] Liquidation and reorganization of financial institutions are regulated by specific statutes governing those institutions. The present chapter describes the various powers possessed by the federal banking agencies to deal with weak and failing depository institutions.

Because the termination of deposit insurance is such a powerful sanction, which, as a practical matter, may force a failing institution to dissolve or merge with another institution, it is considered as part of this chapter on supervision of failing banks and thrifts. Both the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation have the power to terminate the deposit insurance they provide.[2] Each agency may institute proceedings to terminate insurance when its board of directors has determined that the institution:

1. Has engaged, or is engaging, in unsafe or unsound practices in conducting the business of the bank;
2. Is in an unsafe or unsound condition to continue operations as an insured bank; or
3. Has violated an applicable law, rule, regulation or order, or any condition imposed in writing by the corporation in connection with the grant-

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[1] 11 USC §§ 109(b), 109(d) (1982 & Supp. III 1985). Financial institutions are defined in the Bankruptcy Code to include banks, savings banks, cooperative banks, savings and loan associations, building and loan associations, homestead associations, credit unions, industrial banks, and any other similar institution that is an insured institution under the Federal Deposit Insurance Act.

[2] 12 USC § 1818(a) (1982) (FDIC); 12 USC § 1730(b)(1) (1982) (FSLIC).

ing of any application or other request by the bank, or any written agreement entered into with the corporation.[3]

Upon the determination by the insuring agency of grounds for termination of insurance, the agency is required to give notice to the primary regulator of the institution before taking action to terminate insurance.[4] This notice must include a statement of the practices or violations on which the termination proceeding will be based, and gives the primary regulator an opportunity to correct any problems.[5]

Once the FDIC or the FSLIC determines that appropriate corrective action has not occurred within the time period allowed, and decides to pursue termination of insurance, the agency gives notice to that effect, schedules an administrative hearing,[6] and issues a final order as to the status of the insurance.[7] If the institution fails to appear at the hearing, it is deemed to have consented to the termination of the insurance, and a termination order may follow immediately.[8]

The U.S. Court of Appeals has exclusive jurisdiction to review termination orders.[9] Appeals must be filed within thirty days after the date of service of the order.[10] The institution whose insurance has been terminated is required to give notice of the insurance termination to each of its depositors, account holders, or members.[11] Insured deposits in the institution on the effective date of termination of insurance continue to be insured for two years after the effective date of termination.[12] Any deposits made after the effective date of termination of insurance, whether they are new deposits or additions to existing deposits, are

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[3] 12 USC § 1818(a) (1982). Similar reasons justify termination of insurance by the FSLIC. 12 USC § 1730(b)(1) (1982). An additional reason given for the FSLIC to enable it to terminate insurance is when the insured institution "has violated its duty as such." Id.

[4] 12 USC § 1818(a) (1982) (FDIC); 12 USC § 1730(b)(1) (1982) (FSLIC). This notice goes to the Comptroller of the Currency in the case of a national or district bank, the Federal Home Loan Bank Board in the case of an insured federal savings bank, to the authority having supervision of the bank in the case of a state bank, and to the Board of Governors of the Federal Reserve System in the case of a state member bank. 12 USC § 1818(a) (1982). A copy of the notice must also be sent to the state supervisory authority in the case of a savings and loan institution. 12 USC § 1730(b)(1) (1982).

[5] 12 USC § 1818(a) (1982) (FDIC); 12 USC § 1730(b)(1) (1982) (FSLIC).

[6] The rules of practice and procedure that govern the termination of insurance are found at 12 CFR § 308 (1987) (FDIC) and 12 CFR § 509 (1987) (FSLIC).

[7] 12 USC § 1818(a) (1982) (FDIC); 12 USC § 1730(b)(1) (1982) (FSLIC).

[8] Id.

[9] 12 USC § 1818(h)(2) (1982) (FDIC); 12 USC § 1730(j)(2) (1982) (FSLIC).

[10] Id.

[11] The FDIC requires written notice to each of its depositors at the last address of record on the bank's books. In addition, the FDIC may publish notice of the termination in a local newspaper. 12 USC § 1818(a) (1982). For institutions insured by the FSLIC, the statute requires "prompt and reasonable" notice to all its insured members. 12 USC § 1730(d) (1982).

[12] 12 USC § 1818(a) (1982) (FDIC); 12 USC § 1730(d) (1982) (FSLIC).

not insured.[13] Withdrawals from insured accounts after the termination of insurance reduce the insurance coverage by the amount of the withdrawals.[14] The institutions must pay premiums for the continued insurance coverage.[15] During the two-year period in which FDIC insurance continues, the bank remains subject to the laws that control the rights and duties of federally insured banks.[16]

¶ 10.02 RECEIVERSHIPS

[1] Events That Justify the Appointment of a Receiver

When a financial institution is failing or has become insolvent, or is in danger of becoming insolvent shortly, the agency that chartered it has the power to appoint a receiver to wind up the institution's affairs. In the case of national banks, the chartering agency is the Comptroller of the Currency.

The Comptroller of the Currency may appoint a receiver and close a national bank when, after due examination of its affairs, the comptroller becomes satisfied that the bank is insolvent.[17] The comptroller may also appoint a receiver when the bank is dissolved,[18] or when any creditor of a national bank obtains a judgment against the bank and makes application to the comptroller that the judgment has remained unpaid for thirty days.[19]

The comptroller can find the bank insolvent when either or both of two events occur: (1) The institution's assets, taken at fair market value, are less than its liabilities[20] or (2) the bank is unable to meet is obligations as they become due.[21]

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[13] Id.

[14] Id.

[15] Banks continue to pay assessments just as an insured bank would. 12 USC § 1818(a) (1982). Savings and loan associations, however, must pay a final insurance premium within thirty days after the effective date of insurance termination equal to twice the last annual insurance premium payable. 12 USC § 1730(d) (1982).

[16] 12 USC § 1818(a) (1982). The statute expressly gives the FSLIC only the more limited power of examination during this period. 12 USC § 1730(d) (1982).

[17] 12 USC § 191 (1982).

[18] A bank may be dissolved if the directors knowingly violate, or knowingly permit any of the officers, agents, or servants of the bank to violate any of the regulations in Title 12 of the U.S. Code. The comptroller must file suit for this purpose, and the violation must be determined by a U.S. district court before the bank is declared dissolved. 12 USC § 93 (1982).

[19] 12 USC § 191 (1982).

[20] United States Sav. Bank v. Morgenthau, 85 F2d 811 (DC Cir.), cert. denied, 299 US 605 (1936); In re Franklin Nat'l Bank, 381 F. Supp. 1390 (EDNY 1974). This is called the balance sheet test.

[21] In re Conservatorship of Wellsville Nat'l Bank, 407 F2d 223 (3d Cir.), cert. denied, 396 US 832 (1969); Smith v. Witherow, 102 F2d 638 (3d Cir. 1939); In re Franklin Nat'l Bank, 381 F. Supp. 1390 (EDNY 1974).

By federal statute, the receiver appointed by the comptroller must be the FDIC.[22] The FDIC may also be appointed receiver of an insured state bank by the state authority having supervision over the bank, if that appointment is provided for by state law.[23] The FDIC then possesses all the rights, powers, and privileges granted by state law to a receiver of a state bank.[24]

The Federal Home Loan Bank Board, the chartering agency for federal savings and loan associations, has the power to appoint receivers for those institutions. The grounds for the appointment of a receiver are one or more of the following: (1) insolvency in that the assets of the association are less than its obligations to its creditors and others; (2) substantial dissipation of assets or earnings owing to any violation or violations of law, rules, or regulations, or to any unsafe or unsound practice or practices; (3) an unsafe or unsound condition to transact business; (4) willful violation of a cease and desist order that has become final; or (5) concealment of books, papers, records or assets of the association or refusal to submit books, papers, records, or affairs of the association for inspection to any examiner or to any lawful agent of the FHLBB.[25] In addition, the FHLBB may appoint a receiver for an association if the association consents to an appointment, if it is removed from membership in any Federal Home Loan bank, or if its status as an FSLIC-insured institution is terminated.[26]

If the receiver is appointed for the purpose of liquidating the association, the FSLIC is the statutorily required receiver.[27] The FHLBB may appoint the FSLIC as receiver for state-chartered insured institutions if it finds one of the grounds above, and if it has written approval of the state official having jurisdiction over the institution.[28] The FHLBB may also "federalize" the receivership of a state-chartered association by appointing the FSLIC receiver (and thus ending state control of the receivership) if the following three statutory conditions are met: (1) Either a state receivership has been in place for at least 15 days or an insured institution has been closed under state law; (2) at least one ground specified in 12 USC § 1464(d)(6)(A) exists with respect to such institution; and (3) a depositor has been unable to make a withdrawal of his or her account.[29] In

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[22] 12 USC § 1821(c) (1982).

[23] 12 USC § 1821(e) 1982).

[24] Id.

[25] 12 USC § 1464(d)(6)(A) (Supp. III 1985).

[26] 12 USC § 1464(d)(6)(B) (1982). See Annotation, 65 ALR Fed 302 (FHLBB appointment of receivers or conservators).

[27] 12 USC §§ 1464(d)(6)(D), 1729(b) (1982).

[28] 12 USC § 1729(c)(1)(B)(ii)(I) (1982 & Supp. III 1985). Subsections (c)(1)–(c)(3) and (d) were to expire in 1986. The Competitive Equality Banking Act of 1987, however, repealed the subsections providing for the expiration date. As a result, these provisions are now permanent. See Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 509(a), 101 Stat. 551, 635.

[29] 12 USC § 1729(c)(2) (1982 & Supp. III 1985). See also Fidelity Sav. & Loan Ass'n v. FHLBB, 689 F2d 803, 808 (9th Cir. 1982), cert. denied, 461 US 914 (1983). In *Fidelity*, there also was a controversy over the appointment of the FSLIC as a receiver. The

these cases, the FSLIC has the same powers and duties as when it is the receiver for federally chartered associations.[30]

[2] Discretion of the Agency and Scope of Judicial Review

The finding by the comptroller that a national bank is insolvent, and the subsequent appointment of the FDIC as the receiver of the bank as required by statute, has been held by one court to be a discretionary act that is not subject to judicial review.[31] Similarly, another court held that it would not substitute its judgment for the judgment of the comptroller, unless it appeared by convincing proof that the comptroller's action was plainly arbitrary, and made in bad faith.[32] When a state supervisory authority appoints the FDIC as receiver under a state statute, the discretion of the authority and the extent of judicial review also is determined by the state regulatory provisions. Some state statutes provide for a period of time in which the insolvent bank may contest the appointment of a receiver.[33] If such appointment is not contested during this period, the bank waives its objection to the liquidation of its assets.[34]

In contrast to national banks, savings and loan associations have more latitude in contesting the appointment of a receiver. Within thirty days after the appointment of a receiver by the FHLBB, a savings and loan association may bring an action in a federal district court for an order requiring the FHLBB to remove the receiver.[35] Courts agree that the only question on a challenge to the appointment of a receiver is whether one of the statutory grounds for appoint-

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California commissioner seized the association to liquidate it and appointed the FSLIC as receiver. Within minutes, the FHLBB independently appointed the FSLIC as receiver, thus making the receivership federal and removing any state control. In approximately thirty minutes, the receiver transferred the assets of the association to a newly created association. Fidelity sued, claiming the appointment was invalid under the statute set out above. Although there was no significant interruption in Fidelity's business, the court held that the association had been closed under state law and an account holder had been unable to withdraw from an account as required by the statute. In reaching this result, the court emphasized the importance of swift and coordinated action between state and federal officials.

[30] 12 USC § 1729(c)(1)(B)(i)(II) (1982 & Supp. III 1985).

[31] In re Franklin National Bank, 381 F. Supp. 1390 (EDNY 1974).

[32] United States Sav. Bank v. Morgenthau, 85 F2d 811, 814 (DC Cir.), cert. denied, 299 US 605 (1936).

[33] For example, California statutes provide that when the state Superintendent of Banks has taken possession of the property and business of a bank, or a receiver has been appointed, the bank has ten days to apply to the superior court to enjoin further proceedings. After a hearing, the court will either dismiss the bank's claim, or order the surrender of the property and business back to the bank. Cal. Fin. Code § 3101 and 3180 (West 1968). This ten-day period was held to be reasonable in State Sav. & Commercial Bank v. Anderson, 165 Cal. 437, 132 P 755 (1913), aff'd mem. 238 US 611 (1914).

[34] First State Bank v. Bank of America, 618 F2d 603 (9th Cir. 1980) (applying California law).

[35] 12 USC § 1464(d)(6)(A) (Supp. III 1985).

ment existed at the time the appointment was made.[36] Courts are split, however, on the standard of judicial review to be applied to this determination. The scope of judicial review is not clear from the statute, which provides that the court shall determine "upon the merits" whether to dismiss the association's action or to direct the FHLBB to remove the receiver.[37]

One court recently granted a full trial on the factual issue of whether statutory grounds existed for the appointment of a receiver,[38] while another court determined that the appointment of a receiver should be affirmed unless, looking solely at the administrative record kept by the FHLBB, the court determines that the board acted arbitrarily and capriciously.[39] More moderate views would allow an association to submit evidence, but would give the administrative record some deference.[40]

[3] General Powers and Duties of the Receiver

Once a receiver is appointed, all the assets of the institution immediately pass into the control of the receiver.[41] Further, the officers and directors of the institution, as well as the stockholders of a bank, are precluded from dealing in any way with the institution's assets while the receivership continues.[42]

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[36] Biscayne Fed. Sav. & Loan Ass'n v. FHLBB, 720 F2d 1499, 1504 (11th Cir. 1983), cert. denied, 467 US 1215 (1984), Fidelity Sav. & Loan Ass'n v. FHLBB, 689 F2d 803, 809 (9th Cir. 1982), cert. denied 461 US 914 (1983); Collie v. FHLBB, 642 F. Supp. 1147 (ND Ill. 1986). In *Biscayne*, the association and its majority stockholder sued to remove the FSLIC as receiver. Although the district court found a "pattern of outrageous conduct on the part of the Board's staff" relating to the receivership, the Court of Appeals held that the conduct of the staff was not a proper subject of inquiry in considering the legality of the receiver's appointment. The court said, "the sole question properly before . . . this Court is whether a statutory ground authorizing the appointment of the FSLIC exists." 720 F2d at 1503.

[37] 12 USC § 1464(d)(6)(A) (Supp. III 1985).

[38] Telegraph Sav. & Loan Ass'n v. FSLIC, 564 F. Supp. 862 (ND Ill. 1981), *aff'd*, 703 F2d 1019 (7th Cir.), cert. denied, 464 US 992 (1983).

[39] Guaranty Sav. & Loan Ass'n v. FHLBB, 794 F2d 1339 (8th Cir. 1986).

[40] Alliance Fed. Sav. & Loan v. FHLBB, 790 F2d 34 (5th Cir. 1986); Washington Fed. Sav. & Loan v. FHLBB, 526 F. Supp. 343 (ND Ohio 1981). Another view assures the association of an opportunity to be heard. *See* Collie v. FHLBB, 642 F. Supp. 1147, 1152 (ND Ill. 1986) (" '[U]pon the merits' means . . . that the court should be satisfied that the association has had a meaningful opportunity to make a case in opposition to the appointment of a receiver at some point during the process leading to the appointment. If it has not, then the court should provide that opportunity. If it has, however, the court need not offer another").

[41] Earle v. Pennsylvania, 178 US 449 (1900); Anderson v. Cronkleton, 32 F2d 170 (8th Cir. 1929); Hardesty v. Fairmont Supply Co., 123 W.Va. 161, 14 SE2d 436, cert. denied, 314 US 679 (1941).

[42] Wittnebel v. Loughman, 9 F. supp. 465 (DCNY) aff'd, 80 F2d 222 (2d Cir. 1935), cert. denied, 297 US 716 (1936).

[a] National Banks. The FDIC, as receiver, generally employs one of two approaches in taking over a failed bank: (1) liquidation, in which the FDIC liquidates the assets of the failed bank and pays its creditors, supplementing with insurance funds or (2) purchase and assumption, in which the deposits of the failed bank are taken over by a healthy institution. When the FDIC decides whether to liquidate an insolvent bank or to execute a purchase and assumption agreement for the assets of the bank, the agency is exercising discretion entrusted to it by law, and the Federal Tort Claim Act protects the FDIC from liability for such decisions.[43]

[i] Liquidation and distribution of assets. The general duties of the receiver in liquidating an insolvent bank are (1) to realize upon the assets of the closed bank, having due regard for the conditions of credit in the locality;[44] (2) to enforce the individual liability of the stockholders and directors of the bank; and (3) to wind up the affairs of the closed bank.[45] The FDIC also has the duty to notify all persons having claims against the bank that the bank is closed.[46]

The FDIC must make payment of the insured deposits in the bank as soon as possible.[47] Payment must be made either by cash or by making available to each depositor a transferred deposit in a new bank in the same community, or in another insured bank.[48] Insured depositors must submit proofs of claim, but payment is not made to a depositor until the FDIC has been subrogated to the rights of the depositor.[49] If the FDIC is not satisfied with respect to the validity of a claim for an insured deposit, it may require the final determination of a court of competent jurisdiction before paying the claim.[50] Payment of an insured deposit to any person by the FDIC will discharge the FDIC.[51]

Depositors having claims in excess of insurance, as well as other creditors of the bank, are permitted to file claims with the FDIC. When sufficient funds have been realized from liquidating the assets to justify a dividend to creditors, the

[43] FDIC v. Jennings, 615 F. Supp. 465 (WD Okla. 1985).

[44] Amendments specifically require the FDIC to "fully consider the adverse economic impact on local communities, including businesses and farms, of actions to be taken by it during the administration and liquidation of loans of a closed bank." Competitive Equality Banking Act of 1987, Pub. L. 100-86, § 507, 101 Stat. 551, 634 (1987) (to be codified at 12 USC § 1821(i)).

[45] 12 USC § 1821(d) (1982).

[46] The notice is to be made by advertisement in newspapers, for three consecutive months, to notify all depositors and creditors to present their claims. 12 USC §§ 193, 1821(d) (1982).

[47] 12 USC § 1821(f) (1982).

[48] Id.

[49] 12 USC § 1821(f) and (g) (1982). This right of subrogation may be recognized by express provision of state law, by allowance of claims by the authority having supervision of the bank, by assignment of claims by depositors, or by any other effective means.

[50] 12 USC § 1821(f) (1982).

[51] 12 USC § 1822(b) (1982).

board of directors of the FDIC orders payment of a ratable dividend.[52] If all creditors are paid in full and expenses have been recovered, any sums remaining after the distribution go to the shareholders of the bank.[53]

In summary then, the general procedure and priority of claims in liquidating an insolvent bank is as follows:

1. The FDIC is appointed receiver, the bank is closed, and the FDIC takes control of all assets, books, and records of the bank.
2. The FDIC sets off any claims it has against depositors' accounts, and otherwise determines the amount of insured deposits.[54]
3. The FDIC pays claims of insured depositors to the extent of their insurance.[55]
4. The FDIC liquidates the assets, defends claims against those assets, and deducts valid set-offs against the bank.
5. The expenses of the receiver in administering the liquidation are deducted from the receivership funds.[56]
6. The receivership reimburses the United States for any advances made in redeeming the circulating notes of the bank presented to the Treasury for payment.[57]
7. If sufficient funds have been realized, the FDIC makes a ratable distribution to the creditors of the bank. Creditors include depositors (for sums over the insured amount of their deposits), unsecured creditors, secured creditors,[58] and the FDIC.[59]

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[52] 12 USC § 194 (1982). See Note, "Creditors' Remedies Against the FDIC as Receiver of a Failed National Bank," 64 Tex. L. Rev. 1429–1462 (1986).

[53] Id.

[54] See 12 USC § 1822(d) (1982).

[55] 12 CFR § 3301 (1987) provides guidelines on how to determine the amount of an account that is insured. See generally Chapter 11 on deposit insurance.

[56] See 12 USC §§ 196, 1822(a) (1982).

[57] 12 USC § 194 (1982); see also Davis v. Elmira Sav. Bank, 161 US 275 (1896).

[58] A secured creditor may make a claim against the insolvent bank for the full amount it is owed, and may receive dividends on that claim in any ratable distribution. The secured creditor does not lose its security interest in the collateral, however, because liens arising by express agreement or operation of law are not invalidated by the insolvency of the bank. As the receiver liquidates the assets, the secured creditor is entitled to the proceeds due the secured creditor from the sale. The secured creditor is eligible for dividends from ratable distributions only until his or her claim has been paid in full, whether from the dividends, the proceeds of the sale of one secured creditor's collateral, or a combination of the two. See Ticonic Nat'l Bank v. Sprague, 303 US 406, 411–412 (1938); Scott v. Armstrong, 146 US 499, 510 (1892).

[59] The FDIC becomes a creditor of the bank because of its payments to insured depositors. It is subrogated to the depositors' claims against the bank. See 12 USC § 1821(g) (1982).

8. Stockholders divide up the residual, if any, in proportion to their stock holdings.[60]

An alternative method of payout, called the modified payout, has been used more frequently in the last few years in the case of liquidations. Here, the FDIC pays creditors in advance of the final liquidation of the bank's assets. The cash payment equals the creditors' proportionate share of what the FDIC estimates it will recover from the liquidation. If actual collections exceed the estimate, creditors receive additional payments.

[ii] Purchase and assumption agreements. A Court of Appeals for the Eleventh Circuit opinion includes a good description of the purposes and procedures of purchase and assumption agreements:[61]

> The Federal Deposit Insurance Corporation is a federal agency which insures bank deposits. As insuror one of the primary duties of the FDIC is to pay the depositors of a failed bank. The FDIC has two methods of accomplishing this duty. The simplest method is to liquidate the assets of the bank and then pay the depositors their insured amounts, covering any shortfall with insurance funds. This option, however, has two major disadvantages. Firstly, the sight of a closed bank, even an insured one, does not promote the utmost confidence in the banking system. Accounts are frozen, checks are returned unpaid, and a significant disruption of the intricate financial machinery results. Secondly, depositors may wait months to recover even the insured portion of their funds, and uninsured funds may be irrevocably lost.
>
> To avoid the significant problems with liquidation, the FDIC whenever feasible employs a "purchase and assumption" transaction in which the Corporation attempts to arrange for another bank to "purchase" the failed bank and reopen it without interrupting banking operations and with no loss to the depositors. A purchase and assumption involves three entities: the receiver of the failed bank, the purchasing bank, and the FDIC as insuror. In most cases, the FDIC is appointed receiver by the appropriate banking authority and thus acts in two separate capacities: as receiver and as corporate insuror.
>
> As soon as the receiver is appointed, the FDIC solicits bids from other banks for the purchase of the failed bank and assumption of its liabilities. The bids represent the "going concern" value of the failed bank. After receiving the bids, the FDIC Board of Directors determines whether the

[60] 12 USC § 194 (1982). The creditors, including the FDIC, receive interest on their claims from the date of insolvency to the date of full payment of their claims before any funds are distributed to the shareholders. Nat'l Bank of Commonwealth v. Mechanics Nat'l Bank, 94 US 437 (1877); FDIC v. Citizens State Bank, 130 F2d 102 (8th Cir. 1942).

[61] Gunter v. Hutcheson, 674 F2d 862 (11th Cir.), cert. denied, 459 US 826 (1982). See Burger, "Purchase and Assumption Transactions Under the Federal Deposit Insurance Act," 14 Forum 1146–1160 (1979).

purchase and assumption is feasible according to the statutory requirements of 12 USC § 1823(c).[62] If a bid is accepted, the purchasing bank agrees with the receiver to buy the assets and assume the liabilities of the failed bank.

While the purchase of a failed bank is an attractive way for other banks to expand their operations, a purchase and assumption must be consummated with great speed, usually overnight, in order to preserve the going concern value of the failed bank and avoid an interruption in banking services. Because the time constraints often prohibit a purchasing bank from fully evaluating its risks, as well as to make a purchase and assumption an attractive business deal, the purchase and assumption agreement provides that the purchasing bank need purchase only those assets which are of the highest banking quality. Those assets not of the highest quality are returned to the receiver, resulting in the assumed liabilities exceeding the purchased assets. To equalize the difference, the FDIC as insuror purchases the returned assets from the receiver which in turn transfers the FDIC payments to the purchasing bank. The FDIC then attempts to collect on the returned assets to minimize the loss to the insurance fund. In an appropriate case, therefore, the purchase and assumption benefits all parties. The FDIC minimizes its loss, the purchasing bank receives a new investment and expansion opportunity at low risk, and the depositors of the failed bank are protected from the vagaries of the closing and liquidation procedure.[63]

The FDIC also uses a "whole-bank purchase" technique for handling failed institutions. Under this approach the acquiring bank takes over all or substantially all of the failed bank's assets at a discount. The FDIC may keep some problem assets, such as insider loans, even under this approach. The purpose of the technique is to reduce the FDIC involvement and cash exposure in managing assets of failed banks.[64]

[b] Savings and Loan Associations. The FSLIC, as receiver for savings and loan associations, is authorized to:

1. Take over the assets of and operate the association;
2. Take such action as may be necessary to put it in a sound solvent condition;
3. Merge it with another insured institution;

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[62] The FDIC is prohibited from entering into a purchase and assumption agreement if the cost of that transaction exceeds the estimated cost of liquidating the bank (including paying the insured deposits). 12 USC § 1821(c) (1982). This restriction does not apply where the FDIC determines that the continued operation of the insured bank is essential to provide adequate banking services in the community. Id.

[63] *Gunter*, 674 F2d at 865–866 [notes and citations omitted].

[64] 49 Banking L. Rep. (BNA) 216 (August 10, 1987).

4. Organize a new federal association to take over its assets;
5. Proceed to liquidate its assets in an orderly manner; or
6. Make such other disposition of the matter as it deems appropriate.[65]

The FSLIC has discretion as to what actions it takes, as long as such action is in the best interest of the association, its savers, and the corporation itself.[66] In addition, the receiver has the duty to pay all valid credit obligations of the association.[67]

If the appointment of a receiver is made for the purpose of liquidating the association, the FHLBB is statutorily required to appoint the FSLIC as receiver.[68] Payment of insured deposits under the FSLIC is very similar to procedures under the FDIC. Payment is made either by cash or by making available a transferred account in another insured institution, and it must be made as soon as possible.[69] As with the FDIC, the FSLIC may require a proof of claim to be filed before paying the insured accounts, and, if it is not satisfied as to the validity of the claim, it may require court determination prior to payment.[70]

[4] Requirement of a Ratable Distribution

The requirement that any distribution to creditors be ratable[71] comes up in a variety of contexts. Transactions are frequently challenged as being preferential, in violation of the ratable distribution rule. A claim against the FDIC as receiver, to participate in the ratable distribution for creditors, is generally provable if (1) the claim exists before the bank's insolvency and does not depend on any new contractual obligations arising later; (2) liability on the claim is absolute, and certain in amount when suit is filed against the receiver; and (3) the claim is made in a timely manner, well before any distribution of the assets of the receivership other than a distribution through a purchase and assumption agreement.[72]

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[65] 12 USC § 1729(b)(1)(A) (1982).

[66] Id.

[67] 12 USC § 1729(b)(1)(B) (1982).

[68] 12 USC §§ 1464(a)(6)(D), 1729(b) (1982 & Supp. III 1985).

[69] 12 USC § 1728(b) (1982).

[70] Id.

[71] 12 USC § 194 (1982). The National Bank Act simply states that "the comptroller shall make a ratable dividend of the money so paid over to him by such receiver on all such claims as may have been proved to his satisfaction or adjudicated in a court of competent jurisdiction, and, as the proceeds of the assets . . . are paid over to him shall make further dividends on all claims previously proved or adjudicated; . . . " Id.

[72] First Empire Bank v. FDIC, 572 F2d 1361, 1367–1369 (9th Cir.), cert. denied, 439 US 919 (1978).

In *FDIC v. United States National Bank*,[73] the Court of Appeals for the Ninth Circuit considered several important issues relating to the rights of a creditor of an insolvent bank to a ratable distribution of the bank's assets. Franklin National Bank loaned $5 million to the United States National Bank (USNB) in exchange for capital notes of USNB, which stipulated that the notes were expressly subordinated to the payment of senior obligations of USNB. USNB became insolvent, and the FDIC took over as receiver. The FDIC then arranged for Crocker National Bank to purchase the assets and assume the liabilities of USNB. The corporate FDIC loaned money to the FDIC as receiver of USNB, taking a lien on the remaining assets of USNB, to facilitate the purchase and assumption agreement. Subsequently, Franklin National sued USNB, claiming that fraud in the loan transaction entitled it to rescind the subordinated capital note agreement and recover the full amount of the loan as a general creditor of USNB. About one year later, when Franklin National became insolvent, the FDIC became its receiver and, thus, was in the posture of suing itself.

The court first held that, assuming Franklin National was induced by fraud to enter into the capital note agreement, it could rescind that transaction and thereby elevate its position to a level of equality with other creditors. As a general creditor of USNB, Franklin National became entitled to share in the ratable distribution of the assets as a result of the purchase and assumption agreement with Crocker. Although Franklin National's claim was not "on the books" of USNB at the date USNB failed, it was entitled to participate in the ratable distribution of the assets because (1) the claim derived from a transaction prior to the insolvency; (2) it was not dependent on any new contractual obligations arising later; and (3) it was otherwise timely made. Because the ratable distribution was in the form of a purchase and assumption by Crocker National Bank of the assets and liabilities of USNB, the court held that ratable distribution would assure Franklin National Bank of total repayment of its claim. Thus, the FDIC as receiver of Franklin National was allowed to recover from the FDIC as receiver of USNB and to participate in the ratable distribution of assets arranged by the FDIC as receiver of USNB.

[a] Preferences. Section 91 of the National Bank Act declares any transaction or deposit or payment of money null and void if it is made after the insolvency of the bank or in contemplation of its insolvency, or if it is made to prefer one creditor over another or to avoid the rules of priority of payment in insolvency proceedings.[74]

A frequently litigated situation under the preference statute arises when deposit accounts are set off against debts owed to the now insolvent bank. For

[73] 685 F2d 270 (9th Cir. 1982).

[74] 12 USC § 91 (1982).

example, assume creditor *A* has $1,000,000 on deposit with the bank in excess of federal deposit insurance coverage, but creditor *A* also owes the bank $1 million for a loan. Because the ratable distribution to creditors of the bank is likely to pay only a small percentage of each creditor's claim, under ratable distribution, creditor *A* would have to pay the $1 million loan but would collect only a portion of its $1 million deposit claim. By allowing the loan debt to be set off against the deposit claim, creditor *A* avoids having to bear part of the loss in the ratable distribution. Other creditors may claim that this result makes the setoff operate as a preference to creditor *A* because it decreases the amount of assets available to the other creditors. The general rule, however, is that a valid setoff is not a preference in violation of the National Bank Act.[75] Only the balance, if any, after the setoff is deducted is considered an asset of the receivership.[76] Thus, a bank holding a checking account for a correspondent bank that had become insolvent was entitled to set off the funds in the checking account against obligations the correspondent bank owed under certificates of participation.[77]

Courts have looked to both general equitable principals and state law to determine whether a setoff should be allowed in the particular circumstances.[78] One example of a valid setoff was when the balance of a depositor's account was deducted from a note due the insolvent bank, even though the bank had sold an 80 percent participation interest in that note to a third party.[79] In another case, a bank that was the beneficiary under a letter of credit issued by an insolvent bank was permitted to deduct the amount owed to it on the letter of credit from a correspondent account of the insolvent bank it held, even though the beneficiary bank had not made a demand for payment under the letter of credit until after the issuing bank's insolvency.[80] Setoff was not allowed, however, in a case in which the Court of Appeals for the Ninth Circuit found that the agreement providing for setoff was unenforceable because it violated the public policy of

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[75] Scott v. Armstrong, 146 US 499 (1892), Interfirst Bank-Abilene v. FDIC, 777 F2d 1092 (5th Cir. 1985).

[76] Scott v. Armstrong, 146 US 499 (1892), Hibernia Nat'l Bank v. FDIC, 733 F2d 1403, 1407 (10th Cir. 1984).

[77] Interfirst Bank-Abilene v. FDIC, 777 F2d 1092 (5th Cir. 1985).

[78] FDIC v. Liberty Nat'l Bank & Trust Co., 806 F2d 961 (10th Cir. 1986). See also American Sur. Co. v. Bethlehem Nat'l Bank, 314 US 314, 316 (1941) ("Congress has seen fit not to anticipate by specific rules solution of problems that inevitably arise in national bank liquidations. Instead, it chose achievement of a 'just and equal distribution' of an insolvent bank's assets through the operation of familiar equitable doctrines evolved by the courts.")

[79] FDIC v. Mademoiselle, 379 F2d 660 (9th Cir. 1967). Accord Hibernia Nat'l Bank v. FDIC, 733 F2d 1403 (10th Cir. 1984). In Mademoiselle, the assignee of the 80 percent participation interest was not allowed a preference over general creditors of 80 percent of the value of the setoff.

[80] FDIC v. Liberty Nat'l Bank & Trust, 806 F2d 961 (10th Cir. 1986). The court also held, however, that the beneficiary bank's claim against the receiver as a confirming bank on another letter of credit was contingent and could not be set off.

protecting depositors and creditors and maintaining public confidence in the stability of the banking system.[81]

Similarly, the FDIC is authorized to set off amounts due to depositors as insurance payments from any amounts owed by the depositor to the insolvent bank.[82] When the FDIC withholds such amounts, however, it does not have the same strategic effect as a creditor's setoff, and is more of an efficiency measure. It will protect the FDIC to some extent, however, in those cases in which an outstanding loan by the insolvent bank may be uncollectable.

[b] Application to Purchase and Assumption Agreements. Purchase and assumption agreements may violate the National Bank Act provision requiring a ratable distribution when the agreement provides full recovery for some creditors but little chance of recovery for others. The FDIC has no authority to determine which creditors may or may not be able to recover from the insolvent bank, and it must make equitable, if not equal, provision for all creditors.

In *First Empire Bank v. FDIC*,[83] the Court of Appeals for the Ninth Circuit held that the FDIC should have either (1) included First Empire's claim as the beneficiary of standby letters of credit in the purchase and assumption agreement it arranged or (2) left sufficient assets in the receivership to allow distribution to unassumed creditors equal to that undertaken by the acquiring bank to the creditors it had accepted. The court found that by excluding First Empire's claims from the purchase and assumption agreement, it had preferred the other creditors and had violated the provisions of the National Bank Act requiring a ratable distribution among all creditors.[84] The circuit court arrived at the same result in a case in which the FDIC was acting as the receiver of a state-chartered bank, pursuant to California law.[85]

[5] Enforcing Obligations; Defenses the FDIC May Avoid

When the FDIC becomes the receiver of a failed bank, it may pursue legal claims against individuals and firms whose misconduct has contributed to the

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[81] FDIC v. Bank of America Nat'l Trust & Sav. Ass'n, 701 F2d 831 (9th Cir.), cert. denied, 464 US 935 (1983). In this case, a setoff involved a $5 million subordinated capital note, which Bank of America purchased. The court held that the capital note had characteristics both of stock and debt. It was like stock because the holder of the note was subordinated to the rights of general creditors of the bank. The effect of the setoff by Bank of America frustrated this purpose and put Bank of America ahead of all of the other depositors and creditors of the Puerto Rican bank by the amount of the setoff.

[82] 12 USC § 1822(d) (1982).

[83] 572 F2d 1361 (9th Cir.), cert. denied, 439 US 919 (1978).

[84] Id. at 1371.

[85] Woodbridge Plaza v. Bank of Irvine, 815 F2d 538 (9th Cir. 1987). California law, like federal law, prohibited preferences to any depositor or creditor.

bank's failure.[86] In some cases, the agency may pursue claims against officers and directors of the bank for their breach of fiduciary obligations or other dereliction of duty.[87] Similarly, when the FDIC acquires the assets of an insolvent bank, it may find itself in the position of having to enforce notes and other obligations it has acquired. A number of cases have arisen in which the obligors on these instruments have asserted defenses when the FDIC attempted to obtain payment. The FDIC may be able to avoid these defenses under certain circumstances.

[a] Holder in Due Course Status. If the FDIC has acquired a note as a holder in due course,[88] it may be able to avoid certain defenses. When the FDIC acquires a note under a purchase and assumption agreement as part of the takeover of a failed bank, the Court of Appeals for the Sixth Circuit has held that the FDIC has a status equivalent to that of a holder in due course of the note.[89]

In *FDIC v. Wood*,[90] the FDIC, as a holder in due course, was able to enforce the note free from the defense that the note provided for interest at a rate that violated state usury laws.[91] The court found that as a matter of federal common law, the FDIC should be viewed as having holder in due course status, which it requires to carry out its statutory functions. Although state law might not view the FDIC as a holder in due course, the court believed that there ought to be a uniform national rule allowing the FDIC to engage successfully in purchase and assumption transactions. The court held that "when the FDIC in its corporate capacity, as part of a purchase and assumption transaction, acquires a note in good faith, for value, and without actual knowledge of any defense against the note, it takes the note free of all defenses that would not prevail against a holder

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[86] 12 USC § 1821(d) (1982).

[87] See FDIC v. Jennings, 615 F. Supp. 465 (WD Okla. 1985). In this action, the FDIC filed suit against six former officers and directors of the insolvent Penn Square Bank, claiming that they failed to set bank policies or to control daily bank operations, made illegal insider loans, and violated loan lending limits. The FDIC also sued the accounting firm that audited the bank. The FDIC claimed that the firm's negligence in auditing the bank caused losses of more than $65.7 million to the bank and its creditors, and sought recovery of these losses plus punitive damages. The complaint charged the firm with failing to follow generally accepted auditing standards and its own internal audit guidelines, and for being unable to provide an independent opinion because of loans from the banks to partners of the accounting firm. See also Galbraith & Seidel, "FDIC vs. Imprudent Banking Officials: The Enforcement Apparatus," 104 Banking LJ 92–126 (1987); Searle, "Director's Liability and the Relationship Between Bankers and Regulators," 6 Ann. Rev. Banking L. 291–297 (1987).

[88] See §§ 16.01, 16.02 for a discussion of holder in due course status.

[89] FDIC v. Wood, 758 F2d 156 (6th Cir.), cert. denied 474 US 944 (1985). See also Gunter v. Hutcheson, 674 F2d 862 (11th Cir.), cert. denied, 459 US 826 (1982).

[90] 758 F2d 156 (6th Cir.), cert. denied, 474 US 944 (1985).

[91] Id.

in due course."[92] Moreover, the FDIC's status as a holder in due course cannot be affected by the mere existence of information revealing a defense in the files of a bank that the FDIC takes over. According to the court, the FDIC must have actual knowledge of the defense and must have it as of the date of the purchase and assumption agreement.[93] Following this approach, the court treated the FDIC as a holder in due course, although it had acquired the note in question nearly twenty months after it was due.

The court extended the *Wood* doctrine in *FDIC v. Leach*.[94] In *Leach*, the court held that the FDIC was not subject to the defense of failure of consideration.[95] The FDIC had acquired the note in a purchase and assumption transaction and was without actual knowledge of the failure of consideration defense at the time of the purchase and assumption agreement.

[b] The Shield Statute. A federal statute protects the FDIC from unknown collateral agreements when it acquires obligations in the course of its statutory duties. This statute, called the "shield" statute, provides:[96]

> No agreement which tends to diminish or defeat the right, title or interest of the corporation in any asset acquired by it under this section, either as security for a loan or by purchase, shall be valid against the corporation unless such agreement (1) shall be in writing, (2) shall have been executed by the bank and the person or persons claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the bank, (3) shall have been approved by the board of directors of the bank or its loan committee, which approval shall be reflected in the minutes of said board or committee, and (4) shall have been, continuously from the time of its execution, an official record of the bank.[97]

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[92] Id. at 161.

[93] Id. at 162.

[94] 772 F2d 1262 (6th Cir. 1985).

[95] Id.

[96] The shield statute has its origin in the *D'Oench* doctrine, which protected the FDIC from agreements that did not appear on the books of the bank. This doctrine was first articulated in *D'Oench, Duhme & Co. v. FDIC*, 315 US 447 (1942), in which the Supreme Court refused to entertain defenses to agreements that would deceive creditors or the FDIC, or would have that effect. Actual intent to defraud was not required; if the debtor signed an agreement that would have the effect of deceiving creditors or the FDIC, he would be estopped from asserting any defenses. In *D'Oench*, the debtor was estopped from asserting a defense of failure of consideration, and was liable on the notes he signed, despite the fact he had been promised by the bank's president that the notes would never be called for payment. See generally Norcross, "The Bank Insolvency Game: FDIC Super Powers, The D'Oench Doctrine and Federal Common Law," 103 Banking LJ 316–356 (1986).

[97] 12 USC § 1823(e) (1982).

FDIC v. Lattimore Land Corp.[98] is a typical case applying the shield statute. The Lattimore Land Corporation was the obligor on a promissory note that ultimately was assigned to the Hamilton National Bank and was acquired by the FDIC when Hamilton failed. In the FDIC's suit to obtain payment of the note, the Lattimore Land Corporation raised the defense that there was an alleged oral agreement by a predecessor of Hamilton National Bank to give Lattimore additional loan funds. This alleged agreement had been violated, and therefore constituted a defense to payment of the note. The court held that the statute made any unwritten side agreements, such as that alleged by Lattimore, irrelevant to the claim of the FDIC. It made no difference in the application of the statutory shield that the obligors on the note were free of wrongdoing and were not customers of the bank that was insured by the FDIC.[99]

The shield statute will also apply when the collateral agreement is in writing but is not made a part of the official records of the bank.[100] The FDIC is similarly protected by the shield statute from claims of an oral accord and satisfaction on a note.[101] The Court of Appeals for the Seventh Circuit, in a 1987 case, held that the fact that an individual signed a guaranty with the amount blank did not preclude the FDIC from enforcing the obligation against him.[102] In *FDIC v. Venture Contractors, Inc.*,[103] Davis and several other individuals were guarantors on a bank loan to Venture Contractors. When the FDIC pursued payment against the guarantors, Davis alleged that there had been an oral agreement that he would guarantee only a certain risk, known as the Oketo development project, for which the loans had been repaid. The court held that Davis's alleged side agreement met none of the requirements of the shield statute, and Davis, rather

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[98] 656 F2d 139 (5th Cir. 1981).

[99] Accord. Chatham Ventures, Inc. v. FDIC, 651 F2d 355 (5th Cir. 1981), cert. denied, 456 US 972 (1982) (court applied the shield statute even though the FDIC acquired only a partial interest in a note).

[100] FDIC v. De Jesus Velez, 678 F2d 371 (1st Cir. 1982). Capital debentures issued by the bank became due but were not redeemed. The bank arranged loans with the holders of the debentures taking back notes and entering into a letter agreement that the bank would not collect the notes until it first redeemed the debentures. These agreements were kept in the bank president's personal safe and not made a part of the official records of the bank. The bank failed, the FDIC acquired the assets, and sued to collect the notes. The holders of the debentures argued that the letter agreement was a defense, as well as the basis for a right to set off the amount represented by the debentures against the debt represented by the notes. The court held that the shield statute prohibited recognition of the agreement because it had not been approved by the bank's board of directors and was not included in the official records of the bank.

[101] FDIC v. Hoover-Morris Enterprises, 642 F2d 785 (5th Cir. 1981). Accord Black v. FDIC, 640 F2d 699 (5th Cir.), cert. denied, 454 US 838 (1981).

[102] FDIC v. Venture Contractors, Inc., 825 F2d 143 (7th Cir. 1987).

[103] Id.

than the FDIC or other creditors, should be responsible for signing the guaranty in blank.[104]

The shield statute, however, does not apply when the note, on its face, indicates bilateral obligations, and the other obligations are not met. In *Howell v. Continental Credit Corp.*,[105] Mrs. Howell and Continental Credit entered into an agreement in which Continental agreed to purchase broadcasting equipment and lease it to Mrs. Howell. To obtain the necessary financing, roughly $900,000, Continental discounted the leases with Drovers National Bank and assigned all of its rights under the leases to the bank. Mrs. Howell, to secure her performance under the leases, deposited $1 million worth of common stock in an escrow account at the bank. Instead of using all of the money to purchase equipment for Mrs. Howell, Continental apparently used most of it for other purposes. When Drovers National Bank became insolvent, the FDIC was appointed receiver, and acquired the leases in a purchase and assumption agreement.

The Court of Appeals for the Seventh Circuit upheld Mrs. Howell's defense that Continental failed to provide adequate consideration. The court ruled that the shield statute was inapplicable "where the document the FDIC seeks to enforce is one ... which facially manifests bilateral obligations and serves as the basis of the lessee's defense."[106] Mrs. Howell's defense "arises directly and explicitly from the provisions of the leases which were in the bank's files and which the FDIC now seeks to enforce."[107] The Supreme Court considered the scope of the shield statute in *Langley v. FDIC*.[108] Petitioners owed money to the Planters Trust & Savings Bank on a note entered into as part of a real estate transaction. When petitioners failed to pay an installment on the note, Planters bank sued for payment. Petitioners defended on the ground that the bank had obtained the note from petitioners by making various misrepresentations as to the amount of the property involved and the extent of its mineral nature. The loan documentation and the bank's records did not show any reference to these representations. After the litigation over the note had commenced, the FDIC became aware of the petitioners' defenses when it conducted an examination of the bank. Soon thereafter, the state authorities closed the bank and appointed as receiver the FDIC, which obtained the note as part of a purchase and assumption arrangement. The FDIC then sought to enforce the note and successfully raised the federal shield statute as a bar to the defenses raised by the petitioners.

The *Langley* decision resolved the meaning of the term "agreement" in the statute. Although petitioners argued that the term included only express

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[104] Id.

[105] 655 F2d 743 (7th Cir. 1981).

[106] Id at 746.

[107] Id at 747.

[108] 108 S. Ct. 396 (1987).

promises and not representations that amounted to conditions to the petitioners' performance of their contract to pay the note, the Supreme Court refused to accept this distinction. In the Court's view, the shield statute was enacted to enable the FDIC to rely on the records of the bank in evaluating the bank's worth, to determine its soundness, and to decide how to deal with the bank when it is failing. This purpose would be defeated by permitting a note that is unqualified on its face to be subject to undisclosed conditions. Because the shield statute also requires that any agreement must become an official bank record "contemporaneously" with the execution of the note in order to be enforceable against the FDIC, the statute serves the additional purposes of assuring that the bank itself will exercise "mature consideration of unusual loan transactions by senior bank officials, and prevent fraudulent insertion of new terms, with the collusion of bank employees, when a bank appears headed for failure."[109] Neither of these purposes would be served by permitting the enforcement of undisclosed "conditions."[110]

The Supreme Court also rejected the argument that the FDIC would be subject to a defense of fraud. Petitioners argued that if fraud made the obligation entirely void, there would then be no interest of the FDIC in the note that was diminished or defeated by giving effect to the defense. The FDIC conceded that fraud in the factum, where a party signs an instrument not knowing its true nature or contents, would not be barred by the shield statute because such fraud makes the obligation void. But since the petitioners had at most shown only fraud in the inducement, which would make the obligation voidable but not void, the petitioners could not raise that defense.[111] Finally, the Court ruled that any knowledge of the misrepresentations by the FDIC prior to its acquiring the note was irrelevant to the operation of the statute. Congress intended to make the requirements of the statute apply with certainty. "An agreement that meets them prevails even if the FDIC did not know of it; and an agreement that does not meet them fails even if the FDIC knew."[112]

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[109] Id. at 401.

[110] The *Langley* decision, thus, rejects the reasoning of the Eleventh Circuit in Gunter v. Hutcheson, 674 F2d 862 (11th Cir.), cert. denied, 459 US 826 (1982), where the court held the shield statute did not protect the FDIC from defenses based upon the misrepresentations of an insolvent bank's former officers because these misrepresentations made the transaction invalid from the beginning and were not a separate side "agreement." *Langley*, 108 S. Ct. at 399. In *Gunter*, the court went on to hold that the FDIC was protected because of its holder in due course rights under federal common law and its immunity under Section 29(c) of the Securities Exchange Act of 1934. The approach of *Langley* is consistent with the view expressed in FDIC v. Hatmaker, 756 F2d 34, 37 (6th Cir. 1985), that the shield statute bars an obligor from raising a fraud in the inducement defense based on bank misrepresentations as to how a blank note would be filled in.

[111] 108 S. Ct. at 402.

[112] Id. at 403.

[c] Section 29(c) of the Securities Exchange Act. Section 29(c) of the Securities Exchange Act of 1934,[113] which provides that violations of the act do not constitute a defense to the collection of obligations by persons who acquired the obligation "in good faith for value and without actual knowledge of the violation,"[114] may protect the FDIC from such defenses when trying to enforce notes and obligations of an insolvent bank. In *Gilman v. FDIC*,[115] Section 29(c) permitted the FDIC to enforce a note notwithstanding the violation of Regulation U. On February 16, 1976, the Comptroller of the Currency declared Hamilton National Bank insolvent and appointed the FDIC as receiver. The FDIC then arranged for the sale of the bank's assets to First Tennessee by means of a purchase and assumption agreement entered into the same day. This agreement gave First Tennessee the right to return any undesirable loans to the receiver. Simultaneously, the corporate FDIC completed an agreement with the receiver obligating the FDIC to purchase loans that First Tennessee might return. Following this arrangement, First Tennessee acquired the Gilman note. Gilman claimed that under the securities laws and margin regulations it was not obligated to pay the note, and sent letters in March 1976 to the FDIC, First Tennessee, and Hamilton National Bank asserting these defenses. First Tennessee decided to return the Gilman note to the FDIC as receiver, which in turn, sold the note to the FDIC as insurer. Gilman then sued Hamilton National and the FDIC, seeking rescission of the note.

The court assumed for the purposes of the appeal that Gilman had a right to rescind a loan made in violation of Regulation U. The court found, however, that Section 29(c) permitted the FDIC to enforce the note notwithstanding the potential securities violations. Gilman argued that the FDIC had actual knowledge at the time the insurance corporation acquired the note because of the letters sent by Gilman. The court held, firstly, that the FDIC is under no duty to examine the assets of a failed bank before it undertakes steps to effect a liquidation or reorganization, because the FDIC must act quickly to protect the insolvent bank's status as a going concern. The court then held that for purposes of Section 29(c), both the receiver and the corporate FDIC should be viewed as having acquired the Gilman note on February 16, 1976, when an irrevocable commitment was made to repurchase any assets First Tennessee might decide to return. To hold otherwise would interfere with the ability of the FDIC to accomplish a restructuring of insolvent banks through purchase and assumption arrangements.

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[113] 15 USC § 78cc(c) (1982).

[114] Id.

[115] 660 F2d 688 (6th Cir. 1981). See also Gunter v. Hutcheson, 674 F2d 862 (11th Cir.), cert. denied, 459 US 826 (1982) (holding that Section 29(c) protected the FDIC from claims of fraudulent misrepresentation in violation of the federal securities laws).

[6] Resolving Disputed Claims; Jurisdiction and Choice of Law

[a] Banks. A federal statute provides that claims involving the FDIC are cases that arise under the laws of the United States, and thus federal courts have subject matter jurisdiction over those claims, without regard to the amount in controversy.[116] However, if the FDIC is acting in its capacity as receiver of a state bank, and the action involves only the rights or obligations of depositors, creditors, stockholders, and such state bank under state law, the federal courts do not have subject matter jurisdiction over these claims, and the proper forum is in state court.[117] The Federal Tort Claims Act[118] may further limit jurisdiction, for where it applies, it is the exclusive remedy for plaintiffs.[119]

In a suit filed by the FDIC in its corporate capacity against the bank officers and directors for negligence and breach of fiduciary duty, the defendants could not assert any claim against the FDIC in its capacity as receiver of the closed bank, because it was not a party to the suit, and the court had no jurisdiction over it.[120] Yet in another case, the FDIC was sued in both its capacities—as a receiver appointed under state law and as an insuring corporation.[121] The FDIC as insurer had been sued, admittedly, only to ensure recovery of any judgment that might be awarded, because the receivership had no assets remaining at the time of suit. The Court of Appeals for the Ninth Circuit held that Section 1819 conferred federal jurisdiction on the court, because the suit sought to impose liability on the corporation, and thus involved obligations of the corporation. The dissent argued, however, that the court should look at the claim itself, rather than at the parties named in the action. In this case, plaintiff was trying to recover for actions by the FDIC in its capacity as receiver of the insolvent bank, and the dissent urged that the matter should have been remanded to state court without reaching the merits.[122]

Transactions between the FDIC as receiver and the FDIC in its corporate capacity have been upheld against claims that they were sham transactions designed to confer jurisdiction on the federal courts.[123] One court found that it

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[116] 12 USC § 1819 Fourth (1982).

[117] Id.

[118] See 25 USC §§ 2674–2680 (1982).

[119] See FDIC v. Air Atl., Inc., 389 Mass. 950, 452 NE2d 1143 (1983). See also Gregory v. Mitchell, 634 F2d 199 (5th Cir. 1981); Safeway Portland E.F.C.U. v. FDIC, 506 F2d 1213 (9th Cir. 1974).

[120] FDIC v. Butcher, 660 F. Supp. 1274, 1283 (ED Tenn. 1987).

[121] Woodbridge Plaza v. Bank of Irvine, 815 F2d 538 (9th Cir. 1987).

[122] Id. at 544–546 (Fletcher, J., dissenting).

[123] FDIC v. Braemoor Assoc., 686 F2d 550 (7th Cir. 1982), cert. denied, 461 US 927 (1983); FDIC v. De Jesus Velez, 678 F2d 371 (1st Cir. 1982).

was necessary under the statutory scheme that the FDIC be permitted to operate in a dual capacity simultaneously, as a receiver and an insurer.[124]

[b] Savings and Loan Associations. An issue of statutory interpretation has developed in determining when and whether a party may file suit against the FSLIC to resolve disputed claims before seeking review through the administrative procedures within the FSLIC and FHLBB. Three federal statutes are at issue:

1. Section 1730(k)(1) provides that any suit in which the FSLIC is a party is deemed to arise under the laws of the United States, and the federal courts have original jurisdiction without regard to the amount in controversy.[125] It further provides that for any action in which the FSLIC is a party in its capacity as receiver, and which involves only the rights or obligations of investors, creditors, stockholders and an institution chartered under state law, federal courts do not have original jurisdiction. These actions must be brought in state court.[126]

2. Section 1464(d)(6)(C) provides that no court may restrain or affect the exercise of powers or functions of a receiver, except at the request of the FHLBB.[127]

3. Section 1729(d) provides that the FSLIC has the power to settle, compromise, or release claims in favor of or against the insured institutions, and to do all other things that may be necessary in connection therewith, subject only to the regulation of the FHLBB.[128]

Several courts have held, after reviewing these statutory provisions, that the plaintiff's sole remedy was a petition to the FHLBB, with judicial review then available under the Administrative Procedure Act.[129] The Court of Appeals for

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[124] *De Jesus Velez*, 678 F2d at 371.

[125] 12 USC § 1730(k)(1) (1982).

[126] Id.

[127] 12 USC § 1464(d)(6)(C) (1982).

[128] 12 USC § 1729(d) (1982).

[129] North Mississippi Sav. & Loan Ass'n v. Hudspeth, 756 F2d 1096 (5th Cir. 1985), cert. denied, 474 US 1054 (1986) (Counterclaim for specific performance or damages for breach of contract by a former officer dismissed after FSLIC was appointed receiver; court found it had no subject matter jurisdiction because the FSLIC's suspension of payments under the contract was a discretionary act in its capacity as a receiver, and thus subject to review solely by the FHLBB); Chupik Corp. v. FSLIC, 790 F2d 1269 (5th Cir. 1986) (Plaintiff's suit against the FSLIC, as receiver of an insolvent association, seeking to foreclose its materialman's liens against real estate the receiver had acquired while liquidating the assets, was dismissed. The court, relying on *Hudspeth*, held that Chupik was required to exhaust administrative procedure remedies before pursuing adjudication in the court system); York Bank & Trust Co. v. FSLIC, 663 F. Supp. 1100 (MD Pa. 1987) (District court dismissed plaintiff's suit against the FSLIC, contesting the FSLIC's determination that certain certificates of deposit it owned, with a face value exceeding $1

the Ninth Circuit, however, held in 1987 that the FSLIC has no power to adjudicate creditor claims and is not immune to suit against it as receiver, but that the doctrine of exhaustion of administrative remedies may be applicable in certain cases.[130] After a review of the statutory provisions, the regulations promulgated by the FHLBB, and the legislative intent of Congress, and after a comparison between the powers of the FDIC and the FSLIC, the court found that *Hudspeth* in effect expanded the FSLIC's receivership authority, which the Ninth Circuit declined to do.[131] Until this issue is resolved, it appears that a plaintiff's ability to sue the FSLIC may depend on the jurisdiction in which the case is heard.

¶ 10.03 FINANCIAL ASSISTANCE TO WEAK BANKS

The Garn-St Germain Depository Institutions Act of 1982 significantly expanded the powers of the federal regulatory agencies to provide assistance to financial institutions in precarious financial condition. The Competitive Equality Banking Act of 1987 further enlarges these powers. The amendments extend deadlines that had expired for authority conferred by the Garn-St Germain Act and provide additional methods of assistance for failing institutions. Generally, assistance to failing institutions under these statutes takes three different forms: (1) direct financial aid through loans, deposits, or purchase of assets; (2) arranging mergers or acquisitions by other financial institutions; and (3) capital infusion through new net worth certificates purchased by the FDIC or FSLIC.

[1] Direct Financial Aid

The FDIC and the FSLIC may provide financial assistance in a variety of forms to ailing institutions in order to prevent closure and to restore them to normal operations. The boards of directors of these regulatory agencies may pursue various courses of action with regard to any institution insured by them when the action is taken either to prevent the closing of the institution or to restore a closed institution to normal operations. These actions include the following: (1) making loans; (2) making deposits; (3) purchasing the assets or securities; (4) assuming the liabilities; or (5) making contributions.[132]

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million, were only insured to the extent of $100,000, holding that any claim arising from the exercise of the FSLIC's power as receiver had to be channeled through the administrative process).

[130] Morrison-Knudsen Co. v. CHG Int'l, Inc., 811 F2d 1209 (9th Cir. 1987).

[131] The circuit court also said that the FSLIC's interpretation of the statutes presented serious constitutional problems under a *Northern Pipeline* [Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 US 50 (1982)] analysis, but it did not have to reach that issue under its resolution of the case. 811 F2d at 1221–1222.

[132] 12 USC § 1823(c)(1) (1982) (FDIC); 12 USC § 1729(f)(1) (1982) (FSLIC).

[2] Merger Assistance

Aid may be given to facilitate mergers or asset acquisitions of institutions in financial jeopardy. This assistance may take the form of loans, contributions, guarantees, or assumptions of liabilities, and may be given directly to the acquiring entity.[133] Unless the federal agency finds that the continued operation of the insured institution is "essential to provide adequate banking services in its community," the assistance provided by the federal agency cannot be in an amount exceeding what the agency determines as "reasonably necessary to save the cost of liquidating" the institution.[134]

[a] Garn-St Germain Depository Institutions Act. The Garn-St Germain Act gives the FDIC and the FSLIC authority to approve "extraordinary acquisitions" of failing institutions by out-of-state financial institutions.[135] The failing institution need not be closed, but it must be "in danger of closing."[136] Moreover, the regulatory agencies may approve acquisitions by acquiring depository institutions that are different from the failing institution. Thus, the act permits not only interstate acquisitions, but also interindustry combinations as a means of rescuing foundering institutions. Out-of-state banks and bank holding companies, for example, may now acquire ailing savings institutions when the conditions of the act are met.[137]

The act establishes a procedure for approving these combinations, which procedure requires the consent of both the appropriate federal supervisory agency and the state regulatory authority, but the objection of the state authority can be overridden by a unanimous vote of the federal agency.[138] If the bank is not closed however, but only found to be "in danger of closing," the FDIC may not

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[133] 12 USC § 1823(c) (1982) (FDIC); and 12 USC § 1729(f) (1982) (FSLIC).

[134] 12 USC § 1823(c)(4)(A) (1982) (FDIC); a similar provision for thrift institutions is found at 12 USC § 1729(f)(4)(A) (1982).

[135] 12 USC § 1823(f) (1982) (FDIC); 12 USC § 1730(m) (1982) (FSLIC).

[136] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 502(b), 101 Stat. 551, 623-625 (to be codified at 12 USC § 1823(f)(3)). A bank "in danger of closing" is defined as an insured bank with respect to which the chartering authority certifies in writing that:

> (1) The bank is not likely to be able to meet the demands of such bank's depositors or pay the obligations of the bank in the normal course of business, and there is no reasonable prospect that the bank will be able to meet such demands or pay such obligations without federal assistance; or
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> (2) The bank has incurred or is likely to incur losses that will deplete all or substantially all of the capital of the bank, and there is no reasonable prospect for the replenishment of the bank's capital without federal assistance.

Id. § 502(d), at 627 (to be codified at 12 USC § 1823(f)(8)).

[137] 12 USC § 1823(f) (1982).

[138] 12 USC § 1823 (1982) (banks); 1730a(m) (1982) (savings and loans).

assist in a merger unless the board of directors or trustees of the bank being acquired has requested in writing that the FDIC assist in an acquisition or merger, and the state bank supervisor of the state in which the bank in danger of closing is located approves the acquisition.[139]

The act establishes priorities for the federal agencies to consider before authorizing acquisitions under this authority. These priorities are as follows:

1. Between depository institutions of the same type within the same state;
2. Between depository institutions of the same type:
   a. In different states that by statute specifically authorize such acquisitions;
   b. In the absence of such statutes, in different states that are contiguous;
3. Between depository institutions of the same type in different states other than the states described in item (2);
4. Between depository institutions of different types in the same state;
5. Between depository institutions of different types:
   a. In different states, that by statute specifically authorize such acquisitions; or
   b. In the absence of such statutes, in different states that are contiguous;
6. Between depository institutions of different types in different states other than the states described in item (5).[140]

The provisions allowing mergers across state lines were originally passed as temporary measures, but they have been extended permanently.[141]

Amendments made by the Competitive Equality Banking Act of 1987 now grant an acquiring out-of-state bank holding company expansion rights in the state of acquisition through the bank holding company structure.[142] Similarly, the amendments now prevent regional compact restrictions from applying to a holding company that makes an acquisition under the emergency authority.[143] These changes were made to prevent the application of state legislation that prohibited certain branching activities by acquiring banks, thus discouraging these banks from entering into such emergency acquisition agreements.

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[139] Competitive Equality Banking Act of 1987, Pub. L. No. 100–86, § 502(b), 101 Stat. 551, 624 (to be codified at 12 USC § 1823(f)(3)).

[140] Id. § 502(c)(2), at 625–626 (amending 12 USC § 1823(f)(6)). In addition, in the case of a minority-controlled bank, the FDIC must seek an offer from other minority-controlled banks before proceeding with the bidding priorities. Id.

[141] Id. § 509, at 635.

[142] Id. § 509(c), at 625 (to be codified at 12 USC § 1823(f)(4)(D)).

[143] Id. (to be codified at 12 USC § 1823(f)(4)(E)).

The Garn-St Germain Act prohibits acquisitions "which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States."[144] It also prohibits the approval of acquisitions whose effect may be to substantially lessen competition unless there is a finding that the "anti-competitive effects of the proposed transactions are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served."[145] These provisions on the preservation of competition apply only to acquisitions and sales of insured banks approved by the FDIC. There is no comparable provision relating to thrift institutions regulated by the FSLIC. The act also authorized mergers of financially weak federal credit unions with other federally insured depository institutions when a merger with another insured credit union is not possible.[146]

[b] Judicial Review of Agency Decisions to Give Merger Assistance. A court considered the merger provision of the Garn-St Germain Act in a case involving the acquisition of First Federal Savings and Loan Association by a subsidiary of Citicorp.[147] The plaintiffs in the case launched a broad challenge against the decision of the FSLIC about which of the competing offers for restructuring the association to accept. The court held that judicial review of the agency decision was proper under the act, but that the decision of which bid or emergency arrangement to accept was a matter for the discretion of the agency that the court could review only for abuse in exercising its discretion.

A rejected bidder argued that the court should require the FSLIC to augment the record, in court, so that the court could examine the manner in which the agency evaluated the various alternatives, but the court refused to follow this direction. The FSLIC, in the court's opinion, should be able to deal with the emergency presented by a financial institution failure without having to subject its complicated calculations for evaluating alternative arrangements to a protracted dispute on review. In addition, as the FSLIC needed to deal with financial institutions in a confidential manner to encourage and evaluate proposals, the preservation of the confidentiality of the information submitted to the FSLIC on which it based its judgment also justified denying the request to force the agency to spread its information on the record.[148]

Another Citicorp acquisition provided an opportunity for judicial review of the acquisition provisions. In *Getty v. FSLIC*,[149] the FSLIC solicited bids from

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[144] 12 USC § 1823(f)(7)(A) (1982).

[145] 12 USC § 1823(f)(7)(B) (1982).

[146] 12 USC § 1785(b) (1982). See also ¶ 6.05 on emergency acquisitions.

[147] Hartigan v. FHLBB, 746 F2d 1300 (7th Cir. 1984).

[148] Id.

[149] 805 F2d 1050 (DC Cir. 1986).

both Citicorp and Getty for National Permanent Bank, a federally chartered mutual savings bank, under the emergency thrift acquisition provisions of the Garn-St Germain Act. After a series of rebidding, the FSLIC accepted Citicorp's bid. Getty challenged the FSLIC's action. After initially losing its request for a stay, and after procedural disputes to obtain access to interagency memoranda involved in the FSLIC decision process, Getty's appeal was heard. The court ruled for Getty on two issues. Firstly, 12 USC § 1730a(m)(3)(B) enumerates priorities for the FSLIC to consider based on geographical considerations and the nature of the institutions. The FSLIC erred by not providing an explanation of how it considered these statutory priorities. Secondly, when the FSLIC decides to request a rebid, the act permits other bidders who were within a defined range of the "initial lowest acceptable offer" to submit a new offer as well.[150] The FSLIC had refused to allow Getty to submit a further modified bid after the last Citicorp bid.

The court held that Getty was entitled to rebid because it was within the prescribed range of "the offer FSLIC would accept but for the rebidding requirement of subsection (3)(A)."[151] Having ruled for Getty, the court faced the issue of what relief would be appropriate in view of the consummation of the acquisition by Citicorp. The court said that it would be inappropriate for the FSLIC to go through a process of rebidding only to reject a better offer from Getty because it favored the management abilities of Citicorp. In the court's opinion, the FSLIC could not reopen the issue of the qualifications of the bidders after having determined those qualifications to have been adequate at the outset, when it solicited the bids. The court also ruled that fairness required allowing Citicorp, as well as Getty, to submit a new bid.[152]

[3] Net Worth Certificates

The Garn-St Germain Act permits the FDIC and the FSLIC to provide capital assistance to ailing institutions they insure through the purchase of new net worth certificates.[153] The expiration date of these provisions has been extended several times, with the most recent amendment setting the expiration date at October 16, 1991.[154] Using the FSLIC as the example, the net worth certificate program works as described in the following text.

Qualified institutions may issue net worth certificates, which the FSLIC will purchase with promissory notes of the financial institution for regulatory pur-

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[150] 12 USC § 1730(m)(3)(a) (1982).

[151] *Getty*, 805 F2d at 1060.

[152] Id at 1062. After this decision, the parties were reported to have settled the case.

[153] 12 USC § 1823(i) (Supp. III 1985) (FDIC); 12 USC § 1729(f) (1982) (FSLIC).

[154] Competitive Equality Banking Act of 1987, Pub. L. No. 100-186, § 509(b), 101 Stat. 551, 635.

poses. The amount of certificates the FSLIC may purchase is tied to the percentage of net worth of the issuing institution and the amount of operating losses it has sustained. For example, the FSLIC may purchase certificates in an amount up to 70 percent of the institution's operating losses when the institution has a net worth less than or equal to one percent.[155] Losses occasioned by mismanagement or speculation in futures or forward contracts may not be included in this calculation.[156]

Qualified institutions are those insured by the FSLIC that have a net worth of 3 percent of assets or less, have incurred losses during the two previous quarters, have not incurred losses as a result of speculative transactions or excessive operating expenses, will have a net worth of not less than 0.5 percent of assets after the FSLIC purchases the certificates, and have agreed to comply with terms and conditions set by the FSLIC.[157] In addition, the institution must have at least 20 percent of its loans invested in residential mortgages or in securities backed by residential mortgages.[158]

When a state insuring agency agrees to indemnify the FSLIC, the FSLIC may acquire net worth certificates of institutions insured under state law.[159] Although the FSLIC may establish conditions for the institution to satisfy as part of its agreement to purchase net worth certificates, including conditions relating to plans of operation, restrictions on operations, supervisory action, and agreements to merge or reorganize, the FSLIC may not force the institution to consent to a merger or acquisition or to agree to make specified management personnel changes if the institution will have a positive net worth for a minimum period of time after the purchase of the certificates.[160]

The certificates held by the FSLIC have priority over claims based upon an equity interest in the institution, but the certificates are subject to the prior payments of accounts, certificates of deposit, and certain other debt obligations of the institution.[161] The FDIC has comparable authority to buy net worth certificates of qualified insured banks.[162]

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[155] 12 USC §§ 1729(f)(5)(E), 1823(i)(5) (1982).

[156] 12 USC §§ 1729(f)(5)(B)(iii), 1823(i)(2)(C) (1982).

[157] 12 USC § 1729(f)(5)(B) (1982).

[158] Id.

[159] 12 USC § 1729(f)(5)(L) (1982).

[160] 12 USC § 1729(f)(5)(C)(ii) (1982).

[161] 12 USC § 1729(f)(5)(A)(iv) (1982). A 1986 report of the General Accounting Office presented a dismal picture of the net worth certificate program. Of the 118 thrift institutions receiving net worth assistance from the FHLBB, none has repaid any of the principal amounts and only eight have made interest payments on the certificates. The income capital certificate program also had few repayments. The report is described in 47 Banking L. Rep. (BNA) 5 (July 7, 1986).

[162] See generally 12 USC § 1823(i) (1982 & Supp. III 1985).

¶ 10.04 NEW BANKS AND BRIDGE BANKS

[1] Deposit Insurance National Banks

As soon as possible after the closing of an insured bank, the FDIC has the authority to organize a new bank to assume the insured deposits of the closed bank, if it finds it advisable and in the interest of the depositors or the public.[163] A new bank is a temporary device, organized in an attempt to create another bank to replace the closed bank. The new bank must be located in the same community as the closed bank.[164] The new bank is organized as a national bank, but is managed by an officer appointed by the FDIC board of directors.[165]

The FDIC must transfer the amount of insurance due each depositor (from his or her insured deposit in the closed bank) to the new bank.[166] The new bank may accept demand deposits, but accounts by an individual depositor may not exceed $100,000.[167] The FDIC bears the expenses in operating the new bank.[168]

When it is desirable to do so, in the judgment of the board of directors, the FDIC will offer capital stock of the new bank for sale.[169] When a sufficient amount of stock has been subscribed and paid for, the comptroller will make the necessary changes to the organizational papers and will issue a certificate of authority to commence business. At that point the bank is no longer a new bank, but a full-fledged national bank.[170]

If capital stock is not offered for sale, or an inadequate amount of capital is raised, the FDIC may offer to transfer the business of the new bank to another insured bank in the same community.[171] Unless capital stock is sold, or the assets and liabilities of the new bank assumed, the FDIC must wind up the affairs of the new bank.[172] In that case, the FDIC owns the assets of the new bank and is liable for its obligations.[173]

[2] Bridge Banks

Congress recently empowered the FDIC to set up "bridge banks," a new

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[163] 12 USC § 1821(h) (1982).

[164] Id.

[165] Id. at § 1821(i).

[166] Id. at § 1821(j).

[167] Id. at § 1821(i). An exception exists where the new bank is the only bank in the community. In that case, deposits may exceed the $100,000 insured limit.

[168] Id. at § 1821(j).

[169] Id. at § 1821(k). The stockholders of the closed insured bank must be given first opportunity to purchase any shares of common stock offered.

[170] Id.

[171] Id. at § 1821(l).

[172] Id.

[173] Id.

vehicle for dealing with failed institutions.[174] A bridge bank is a temporary device that gives the FDIC more time to set up a satisfactory merger, purchase and assumption, or other transaction that cannot be accomplished at the time of failure.[175] A bridge bank is a new national bank established by the FDIC to take over the assets and liabilities of a failed bank and to carry on its business for a limited time. The FDIC may establish a bridge bank only if one of the following conditions exist: (1) The net cost of reorganizing and operating the bridge bank will not exceed the cost of liquidating the failed bank (including the cost of paying the insured deposits); (2) the continued operation of the failed bank is essential to provide adequate banking services in its community; or (3) the continued operation of the failed bank is in the best interest of the depositors of the closed bank and the public.[176]

The FDIC may assist the sale or merger of a bridge bank in the same way as any other bank.[177] In addition, when a bridge has taken over a bank that was eligible for an interstate acquisition, the bridge bank remains eligible for an interstate acquisition under the same circumstances.[178] A bridge bank terminates when one of the following occurs: (1) The bridge bank merges or consolidates with another bank that is not a bridge bank; (2) the bridge bank sells all or substantially all of the stock of the bridge bank other than to the FDIC or to another bridge bank; (3) a holding company or another bank that is not a bridge bank assumes all, or substantially all, of the deposits or other liabilities of the bridge bank; or (4) a period of two years following the date the bridge bank was organized expires without any other disposition of the assets and liabilities of the bank having occurred.[179]

¶ 10.05 OTHER REGULATORY POWERS

The Bank Conservation Act of 1933[180] enables the Comptroller of the Currency to appoint a conservator, rather than a receiver, in any case in which the comptroller deems it necessary to conserve the assets of the bank for the

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[174] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 503, 101 Stat. 551, 629-632 (to be codified at 12 USC § 1821(i)).

[175] H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess. 174-175 (1987).

[176] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 503, 101 Stat. 551, 629-632 (to be codified at 12 USC § 1821(i)).

[177] Id.

[178] Id.

[179] Id., § 509(a)(10), at 631-632. The board of directors of the FDIC may extend the time for winding up the affairs of the bridge bank for up to one year if it is in the best interest of the depositors of the closed bank and the public. Id.

[180] 12 USC §§ 201-213 (1982).

benefit of its depositors and other creditors.[181] A national bank conservator is granted all the rights, powers, and privileges of, and is subject to the duties and obligations of, receivers of insolvent national banks.[182] With the protection of deposit insurance, the many regulatory measures national banks are subject to, and the variety of mechanisms by which the federal agencies may deal with failing banks, the appointment of a conservator will be rare.

Similar powers were granted to the FHLBB in the Home Owners Loan Act of 1933.[183] The findings required to appoint a conservator are the same as those required for appointing as receiver. If the appointment is not made for the purpose of liquidation, the FHLBB is not required to appoint the FSLIC as conservator. The appointed conservator has authority to operate the association and conserve its assets as authorized by the FHLBB.[184] The appointment of a conservator may be challenged in the same manner as the appointment of a receiver.

Because cease and desist orders are available to stop or prevent practices "which might result in abnormal risk of loss to a banking institution or shareholders,"[185] they are available and useful in preventing insolvency that may be caused by violations of regulations. A more complete discussion of cease and desist orders is given in Chapter 9. Similarly, the federal banking agencies have authority to remove and discipline officers and directors of the depository institutions they regulate. These powers are also discussed in Chapter 9.

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[181] Id. at § 203.

[182] Id.

[183] 12 USC § 1464(d)(6)(A) (Supp. III 1985).

[184] 12 USC § 1464(d)(6)(D) (1982).

[185] First Nat'l Bank v. Department of the Treasury, 568 F2d 610, 611 n.2 (8th Cir. 1978).

11

Deposits and Deposit Insurance

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¶ 11.01 THE FEDERAL DEPOSIT INSURANCE CORPORATION

Despite the many safeguards provided by the Federal Reserve System, many banks failed in the Great Depression of the 1930s. To strengthen the banking system and to create public confidence in the banks, Congress passed the Banking Act of 1933, which established a system of federal guarantees of deposits in national banks. The vehicle for this protection is the Federal Deposit Insurance Corporation. The original act created a corporation with $150 million of stock subscribed by the U.S. Treasury and further stock purchased by the Federal Reserve banks.[1] This was later amended to replace the stock, which was repaid, with a reserve fund of $1 billion and with power to borrow from the Treasury up to $3 billion, at current interest rates, when the director of the FDIC felt it was needed.[2] Today, most commercial banks are insured by the FDIC.[3]

The FDIC is managed by a three-member Board of Directors, consisting of the Comptroller of the Currency and two other directors appointed by the president of the United States, with the advice and consent of the Senate. The appointed directors serve six-year terms, and one of the appointees serves as chairman.[4] The directors cannot hold office in or own the stock of any bank insured by the FDIC. The board has rule-making power to carry out the purposes of the law.[5]

Federal statutes authorize the FDIC to "sue and be sued."[6] This provision gives courts jurisdiction to award money damages against the FDIC only for claims that would otherwise be permitted under the Federal Torts Claims Act.[7] For a claim to be pursuable against the FDIC under the Federal Torts Claims Act, the claim must first have been presented to the federal agency, and it must have been denied by the agency in writing or a period of six months must have elapsed after the claim was filed with the agency.[8] Failure to follow this procedure has resulted in the dismissal of claims alleging violations of due process and equal protection under the federal civil rights laws when the FDIC assumed control over the assets of a bank in which plaintiffs had an interest.[9]

The FDIC has the following responsibilities:

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[1] Banking Act of 1933, ch. 89, § 8, 48 Stat. 162, 168–169.

[2] 12 USC § 1824 (1982).

[3] See ¶ 2.01.

[4] 12 USC § 1812 (1982).

[5] 12 USC § 1819 Tenth (1982).

[6] 12 USC § 1819 Fourth (1982).

[7] Gregory v. Mitchell, 634 F2d 199 (5th Cir. 1981). Accord, Safeway Portland Employees' Federal Credit Union v. FDIC, 506 F2d 1213 (9th Cir. 1974). See 28 USC § 2679(a) (1982).

[8] 28 USC § 2675 (1982).

[9] Gregory v. Mitchell, 634 F2d 199 (5th Cir. 1981).

1. It insures deposits;
2. It supervises the liquidation of insolvent banks that it has insured;
3. It seeks to rehabilitate weak banks and to arrange measures that will forestall bank failures and depositor losses; and
4. It exercises general supervisory authority over the state banks that it insures but that are not members of the Federal Reserve System. In this last capacity, it has the power to conduct bank examinations, to pass on mergers and consolidations, to regulate the establishment of branches, as well as the power to exercise other regulatory control.

The breadth of the FDIC's powers is evident from the scope of its regulations. Table 11-1 lists the current FDIC regulations.[10]

[1] Insured Deposits

The FDIC insures deposits in national banks, state banks, and savings banks. All banks, state and national, that are members of the Federal Reserve System are required to be insured.[11] State nonmember banks may apply for insurance with the FDIC, as may the branches of foreign banks.[12] In 1982, Congress made industrial banks and similar financial institutions eligible for federal deposit insurance.[13] Most commercial banks have FDIC insurance. Under current statutes, each account in a bank insured by the FDIC is insured to a maximum of $100,000.[14] The amount of insurance has not always been this high. Table 11-2 shows past maximum limits on insured deposits.

The deposits insured include checking, savings, time, or thrift accounts, certificates of deposit, letters of credit, and traveler's checks.[15] The insurance also covers other paper issued by the insured bank for cash, items in the process of collection, and other accounts due customers.[16]

[a] Definition of "Deposit." The Federal Deposit Insurance Act defines the term "deposit" as follows:

> (1) the unpaid balance of money or its equivalent received or held by a bank in the usual course of business and for which it has given or is obligated to give credit, either conditionally or unconditionally, to a commercial,

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[10] FDIC regulations are found at 12 CFR pt. 300 (1988).

[11] 12 USC § 1814(b) (1982).

[12] 12 USC § 1815 (1982).

[13] 12 USC §§ 1813(a), 1815(a) (1982).

[14] 12 USC § 1821(a) (1982).

[15] 12 USC § 1813(l) (1982).

[16] Id.

TABLE 11-1 **Regulations of the Federal Deposit Insurance Corporation**

12 CFR Pt.	*Regulation*
	SUBCHAPTER A—PROCEDURE AND RULES OF PRACTICE
300–302	[Reserved]
303	Applications, requests, submittals, delegations of authority, and notices of acquisition of control
304	Forms, instructions, and reports
305–306	[Reserved]
307	Notification of changes of insured status
308	Rules of practice and procedures
309	Disclosure of information
310	Privacy Act regulations
311	Rules governing public observation of meetings of the Corporation's Board of Directors
	SUBCHAPTER B—REGULATIONS AND STATEMENTS OF GENERAL POLICY
324	Agricultural loan loss amortization
325	Capital maintenance
326	Minimum security devices and procedures for insured nonmember banks
327	Assessments
328	Advertisement of membership
329	Interest on deposits
330	Clarification and definition of deposit insurance coverage
331	Insurance of trust funds
332	Powers inconsistent with purposes of Federal deposit insurance law
333	Extension of corporate powers
334	[Reserved]
335	Securities of nonmember insured banks
336	Employee responsibilities and conduct
337	Unsafe and unsound banking practices
338	Fair housing
339	Loans in areas having special flood hazards
340	[Reserved]
341	Registration of securities transfer agents
342	Applications for a stay or review of actions of bank clearing agencies
343	Insured State nonmember banks which are municipal securities dealers
344	Recordkeeping and confirmation requirements for securities transactions
345	Community reinvestment

12 CFR Pt.	*Regulation*
346	Foreign banks
347	Foreign activities of insured State nonmember banks
348	Management official interlocks
349	Reports and public disclosure of indebtedness of executive officers and principal shareholders to a State nonmember bank and its correspondent banks
350	Disclosure of financial and other information by FDIC-insured State non-member banks
351	International operations
352	Nondiscrimination on the basis of handicap
353	Reports of apparent crimes affecting insured nonmember banks

Source: 12 CFR pt. 300 (1988).

checking, savings, time, or thrift account, or which is evidenced by its certificate of deposit, thrift certificate, investment certificate, certificate of indebtedness, or other similar name, or a check or draft drawn against a deposit account and certified by the bank, or a letter of credit or a traveler's check on which the bank is primarily liable: *Provided*, That, without limiting the generality of the term "money or its equivalent," any such account or instrument must be regarded as evidencing the receipt of the equivalent of money when credited or issued in exchange for checks or drafts or for a promissory note upon which the person obtaining any such credit or instrument is primarily or secondarily liable, or for a charge against a deposit account, or in settlement of checks, drafts, or other instruments forwarded to such banks for collection.

(2) trust funds as defined in this chapter received or held by such bank, whether held in the trust department or held or deposited in any other department of such bank.

(3) money received or held by a bank, or the credit given for money or its equivalent received or held by a bank, in the usual course of business for a special or specific purpose, regardless of the legal relationship thereby established, including without being limited to, escrow funds, funds held as security for an obligation due to the bank or others (including funds held as dealers reserves) or for securities loaned by the bank, funds deposited by a debtor to meet maturing obligations, funds deposited as advance payment on subscriptions to United States Government securities, funds held for distribution or purchase or securities, funds held to meet its acceptances or letters of credit, and withheld taxes: *Provided*, That there shall not be included funds which are received by the bank for immediate application to

TABLE 11-2 **Maximum Limits on Insured Deposits**

Year	Limit
1934	$ 2,500
1934	$ 5,000
1950	$ 10,000
1966	$ 15,000
1969	$ 20,000
1974	$ 40,000
1980	$100,000

the reduction of an indebtedness to the receiving bank, or under condition that the receipt thereof immediately reduces or extinguishes such as indebtedness.

(4) outstanding draft (including advice or authorization to charge bank's balance in another bank), cashier's check, money order, or other officer's check issued in the usual course of business for any purpose, including without being limited to those issued in payment for services, dividends, or purchases, and

(5) such other obligations of a bank as the Board of Directors, after consultation with the Comptroller of the Currency and the Board of Governors of the Federal Reserve System, shall find and prescribe by regulation to be deposit liabilities by general usages except that the following shall not be a deposit for any of the purposes of this chapter or be included as part of the total deposits or of an insured deposit:

(A) any obligation of a bank which is payable only at an office of such bank located outside of the States of the United States, the District of Columbia, Puerto Rico, Guam, American Samoa, the Trust Territory of the Pacific Islands, and the Virgin Islands; and

(B) any international banking facility deposit, including an international banking facility time deposit, as such term is from time to time defined by the Board of Governors of the Federal Reserve System in regulation D or any successor regulation issued by the Board of Governors of the Federal Reserve System.[17]

The Supreme Court considered the scope and policy of this definition in *Federal Deposit Insurance Corporation v. Philadelphia Gear Corp.*[18] The Court held that a standby letter of credit backed by a contingent promissory note does not constitute a deposit for purposes of federal deposit insurance. The case arose as a result of the insolvency of the Penn Square Bank. Penn Square Bank issued a standby letter of credit to Philadelphia Gear at the request of the bank's customer, Orion. The letter of credit permitted Philadelphia Gear to draw against it when Philadelphia Gear certified in writing that Orion had not paid Philadel-

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[17] 12 USC § 1813(e) (1982).

[18] 479 US 426 (1986).

phia Gear for goods sold. Penn Square Bank required a promissory note from Orion when it issued the letter of credit. Although this note was unconditional on its face, Orion and Penn Square agreed that Orion would be liable on the note only if Penn Square was required to make payment to Philadelphia Gear under the standby letter of credit. Penn Square subsequently became insolvent, and Philadelphia Gear made a demand upon the FDIC, as the insurer of the deposits of Penn Square, for payment under the letter of credit to the extent of the $100,000 of federal deposit insurance. Philadelphia Gear claimed that the letter of credit was a deposit.

Philadelphia Gear's argument rested upon the proviso to the statutory definition of deposit. The proviso states that the receipt of a "promissory note upon which the person obtaining any such credit or instrument is primarily or secondarily liable" is the equivalent of money.[19] Using this proviso, Philadelphia Gear argued that Penn Square Bank had issued a letter of credit in exchange for "money or its equivalent," and therefore the letter of credit was a "deposit" under the statute. Both the District Court and the Court of Appeals for the Tenth Circuit had accepted Philadelphia Gear's reading of the statute.

The Supreme Court took the view that the federal deposit insurance scheme was intended to "safeguard the hard earnings" of individuals against the possibility of bank failure. Congress wanted to insure that someone who put tangible assets into a bank could always get those assets back.[20] In this case, neither Orion nor Philadelphia Gear gave any assets unconditionally to the bank. Orion's obligation on the promissory note was contingent. The Court then found that the FDIC had interpreted the term "deposit" to exclude letters of credit backed by contingent obligations, and Congress had enacted legislation containing the definition of "deposit" without indicating any desire to alter the agency's interpretation. In taking this position, the Supreme Court specifically noted that the FDIC had conceded that deposit insurance would cover a letter of credit that was backed by an "uncontingent promissory note." In short, if this had been a standard commercial letter of credit arrangement, in which the bank's customer gave the bank funds to use in paying the letter of credit, or permitted the bank to charge the customer's account for the letter of credit, it would meet the definition of "deposit" for the purposes of the federal deposit insurance.[21]

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[19] 12 USC § 1813 (e) (1982).

[20] 479 US 426 (1986).

[21] In FDIC v. European Am. Bank & Trust Co., 576 F. Supp. 950 (SDNY 1983), the court considered what definition should be applied to determine the base of a bank's deposits for the purpose of calculating insurance premium assessments by the FDIC. The problem arose because of the manner in which transactions through the Clearing House Interpayment System (CHIPS) of the New York Clearing House Association were handled. Under CHIPS, funds were transferred electronically within the system from one bank to another. The court upheld the FDIC determination that the definition of "deposit" in the act was satisfied because the balances in question represented "the unpaid balance of money or its equivalent received or held by a bank in the usual course of

[b] Mistaken Payment in Excess of Insurance. The question of what happens when a depositor of an insolvent insured bank is mistakenly paid more than the federal insurance limits justify was considered in a 1985 federal court of appeals case. The court was asked to consider if the FDIC could recover payments made by mistake in excess of the insurance limits.[22] In this case, persons who held cashier's checks from Penn Square Bank were required to return payments of the checks made after Penn Square became insolvent to the extent the amounts received exceeded federal deposit insurance limits. The defendants in this case had redeemed certificates of deposit from Penn Square and received cashier's checks in payment. A number of defendants were involved, and the cashier's checks in question varied in amounts from nearly $1.5 million, in the case of one defendant, to a series of checks aggregating over $450,000, in the case of another defendant. The defendants redeemed the certificates without any knowledge of the impending failure of Penn Square and deposited the cashier's checks in their banks for collection.

Before the checks were presented for payment, the comptroller declared Penn Square insolvent, appointed the FDIC as receiver, and established the Deposit Insurance National Bank (DINB) to administer the payments of funds of Penn Square that were federally insured. As a means of enforcing the deposit insurance limitations, the FDIC established a computer program to reject items drawn against Penn Square accounts in excess of $100,000, but the program failed to catch the cashier's checks. By the time the mistake in the computer program was discovered, DINB had paid the cashier's checks issued to the defendants. The FDIC then brought suit to recover the amounts in excess of the $100,000 insured limit. (The defendants were entitled to $100,000 for each of their accounts because a cashier's check is insured as a "deposit" under the Federal Deposit Insurance Act.) The FDIC claimed it was entitled to restitution of the amount paid by mistake under normal principles of unjust enrichment.

The court concluded that the defendants had been unjustly enriched because they were entitled only to payment of the insured amounts. Although the defendants argued that UCC § 3-418, which makes payments final in favor of a holder in due course, applied to their situation, the court firmly rejected the defendants' argument. Firstly, the court said that the Federal Deposit Insurance Act definition converted the cashier's checks to "deposits" as a matter of law, so the rules of the UCC applicable to negotiable instruments were "irrelevant."[23] Secondly, the court reasoned that the defendants, as holders of uncollected cashier's checks, were creditors of the insolvent Penn Square Bank. When Penn

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business and for which it has given or is obligated to give credit . . . ." The court further stated that the balances also qualified as "credit given for money or its equivalent received by a bank, in the usual course of business for a special or specific purpose . . . ."

[22] FDIC v. McKnight, 769 F2d 658 (10th Cir. 1985), cert. denied sub nom. All Souls Episcopal Church v. FDIC, 475 US 1010 (1986).

[23] 769 F2d at 661.

Square became insolvent, the National Bank Act provisions on the liquidation of insolvent national banks took precedence over the UCC. Although the defendants acted in good faith, they, as creditors of Penn Square, must be treated accordingly. The critical point in the defendants' relationship to Penn Square was the time at which the bank closed. When this event occurred, it "cast in stone" the relationship of defendants to the bank. They were simply creditors of the bank, with no right to preference over other creditors. A holder of a cashier's check is not entitled to preference over general creditors of the bank, although the holder may be entitled to payment to the extent of the insured amount.[24]

[2] Computing the Amount of Insurance: Rules for Multiple Accounts

The Federal Deposit Insurance Act defines the term "insured deposit"[25] firstly as the "net amount due" after deducting any offsets that may be appropriately deducted from the deposit, and excluding any part of the deposit in excess of the insured limit, which currently is $100,000. Further, the definition provides the following:

> Such net amount shall be determined according to such regulations as the Board of Directors may prescribe, and in determining the amount due to any depositor, there shall be added together all deposits in the bank maintained in the same capacity and the same right for his benefit either in his own name or in the names of others except trust funds which shall be insured as provided in subsection (i) of § 1817 of this title.[26]

When a bank holds trust funds in a fiduciary capacity, the funds are insured up to the $100,000 limit "for each trust estate," and this insurance is "separate from and additional to that covering other deposits of the owners of such trust funds or the beneficiaries of such trust estates."[27] Additionally, there are special provisions that deal with the deposit of public money by public officers and certain pension plans and retirement accounts.[28]

The FDIC has adopted regulations to clarify the application of these rules.[29] These regulations address (1) how accounts held in more than one name are to be treated for determining the insurance limits; (2) under which circumstances accounts owned by an individual must be added together to determine the maximum amount insurable; and (3) how joint accounts are to be treated. There are record-keeping requirements and rules that make how the account signature

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[24] Id. at 662.

[25] 12 USC § 1813(m)(1) (1982).

[26] Id.

[27] 12 USC § 1817(i) (1982).

[28] 12 USC §§ 1821(a)(2), 1821(a)(3) (1982).

[29] 12 CFR §§ 330.0–330.101 (1987).

card is completed and how the interest of parties to the account is disclosed important in determining deposit coverage.

In the mid-1980s, the federal banking regulators expressed concerns over the growing practice, particularly among thrift institutions, of obtaining large deposits through the services of money brokers. At one point, the Comptroller of the Currency reported that the thrift industry held approximately $34 billion in brokered funds, and he estimated that this amount could grow to $260 billion by the end of 1985.[30] Several concerns were expressed about the use of brokered deposits. Among these were (1) the cost to the institutions of obtaining such deposits; (2) the possibility of favored treatment in extending loans to those serving as money brokers in placing the deposits; and (3) the destabilizing influence that large amounts of deposits on these terms might have on weak financial institutions, which might turn to brokered funds to shore up shaky financial conditions. Further, the federal regulators believed that the practice of money brokers placing deposits in this manner could be deleterious to the deposit insurance system. If federal deposit insurance covered funds so deposited, the individual investors would be protected from risk, although such funds might have been placed in otherwise financially weak institutions, under terms that may have contributed to the institutions' weakness.

As a result of such concerns, the FDIC and the Federal Home Loan Bank Board adopted a joint regulation that limited FDIC and Federal Savings and Loan Insurance Corporation insurance coverage of deposits made by a money broker to $100,000 per broker, rather than $100,000 for each client of the broker.[31] This rule was challenged immediately. In *FAIC Securities, Inc. v. United States*,[32] a federal court of appeals ruled the regulation invalid. The court held that the Federal Deposit Insurance Act of 1950, and the corresponding statutes applicable to federal savings and loan deposit insurance, plainly contemplated the insurance of funds placed for depositors by brokers. The efforts of the two deposit-insuring agencies to restrict the insurance of broker-placed deposits constituted action in excess of the statutory authority given them by Congress.

[3] The Deposit Insurance System

To provide security for the insured accounts, the FDIC is required to assess each insured bank an annual amount equal to one-twelfth of one percent of the bank's deposit liability.[33] This assessment is collected semiannually and is calcu-

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[30] Comptroller of the Currency, Speech to National Council of Savings Institutions Seminar, reprinted in 42 Wash. Fin. Rep. (BNA) 265 (1984).

[31] 49 Fed. Reg. 13,003 (1984).

[32] FAIC Securities, Inc. v. United States, 768 F2d 352 (DC Cir. 1985).

[33] 12 USC § 1817(b) (1982).

lated according to a statutory formula that applies the percentage rate to the institution's "assessment base."[34] Although the basic annual rate is one-twelfth of one percent of adjusted deposits, insured banks are entitled to a credit for a portion of the FDIC's assessment income after expenses and losses during the preceding year have been accounted for.[35] This results in a substantially lower effective assessment rate. Insured banks must file four reports a year on the condition of the bank, including, among other matters, its deposit liabilities.[36]

The funds accumulated by the FDIC for insuring deposits constitute a permanent insurance fund.[37] These assets are the reserves that guarantee the FDIC's ability to fulfill its insurance obligations. At the close of 1986, the extent of this fund was $18.253 billion.[38] The Board of Directors of the FDIC may invest this money in U.S. bonds or in other obligations guaranteed by the United States, but such investments may not be made in amounts over $100,000 at any one time without the consent of the Secretary of the Treasury.[39] Current funds not so invested may be kept in a checking account with the Secretary of the Treasury or in a Federal Reserve bank that the secretary designates.[40] Smaller accounts to be used in liquidating banks may be kept at the discretion of the Board.[41] When needed for insurance purposes, the FDIC is authorized to borrow from the Treasury up to $3 billion.[42] The FDIC has not needed to exercise this authority.

[4] General Regulatory Authority of the FDIC

In addition to insuring deposits and serving as the responsible authority when bank solvency is threatened, the FDIC engages in the regulation of insured banks not subject to regulation by the Board of Governors of the Federal Reserve System or the Comptroller of the Currency. The powers of the FDIC to deal with failing and insolvent banks are covered in Chapter 10. Special assistance to facilitate interstate and interindustry mergers of failing depository institutions is explained in Chapters 6 and 10. Chapters 7 and 9 describe the powers that the federal banking regulators have to examine, supervise, and control the activities of depository institutions. The text that immediately follows briefly identifies some of these other major regulatory activities of the FDIC.

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[34] Id.

[35] 12 USC § 1817(d) (1982).

[36] 12 USC § 1817(a) (1982).

[37] 12 USC § 1821(a) (1982).

[38] FDIC, Annual Report (1986).

[39] 12 USC § 1823(a) (1982).

[40] 12 USC § 1823(b) (1982).

[41] Id.

[42] 12 USC § 1824 (1982).

1. *Examination of banks.* The FDIC has authority to conduct examinations of any insured state nonmember bank.[43] In addition, it may conduct special examinations of any insured bank, state or national, whenever "in the judgment of the Board of Directors such special examination is necessary to determine the condition of any such bank for insurance purposes."[44] The power to conduct examinations includes the power to take testimony under oath and to examine the affairs of bank affiliates.[45]

2. *Approval of mergers and consolidations.* When an insured bank merges or consolidates with another insured bank, any one of three federal authorities may be involved—the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, or the FDIC. Selection of the appropriate regulatory agency depends on the status of the bank that will survive the consolidation. If the surviving bank is not a member of the Federal Reserve System but is an insured bank, the FDIC has the authority to approve or disapprove the merger.[46]

3. *Branch banks.* No state-insured bank that is not a member of the Federal Reserve may operate a new branch without the prior consent of the FDIC.[47] Similarly, no state nonmember insured bank may move its main office or branch from one location to another or operate a foreign branch without the prior consent of the FDIC.[48]

4. *Regulation of the payment of interest and dividends on deposits.* At one time the FDIC regulated the amount of interest and dividends paid by state nonmember insured banks on deposits.[49] The Depository Institutions Deregulation and Control Act of 1980, however, eliminated regulation of interest on deposits.[50]

5. *Regulation to prevent unsafe and unsound banking practices.* The FDIC has broad authority to regulate all insured banks because of its statutory authority to terminate the insurance of any insured bank that engages in "unsafe or unsound practices," or that is in an "unsafe or unsound condition."[51] As mentioned previously and explained in Chapter 2, the FDIC must cooperate with the Board of Governors of the Federal Reserve System and with the Comptroller of

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[43] 12 USC § 1820(b) (1982).

[44] Id.

[45] 12 USC § 1820(c) (1982).

[46] 12 USC § 1828(c) (1982).

[47] 12 USC § 1828(d) (1982).

[48] Id.

[49] 12 USC § 1828(g)(1) (1982).

[50] Depository Institution Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, §§ 203, 207(b)(2)–207(b)(3), 94 Stat. 144 (1980) (codified at 12 USCA §§ 3502, 3506 (1982)). See ¶ 3.04[6] for a discussion of the Deregulation Committee.

[51] 12 USC § *1818(a) (1982)*. See ¶ *9.01*.

the Currency when the insured bank is regulated by either of these agencies.[52] In addition, the FDIC has the authority to issue cease and desist orders when any state nonmember insured bank engages in "unsafe or unsound practices."[53] For a discussion of regulatory authority to deal with "unsafe or unsound" banking practices, see Chapter 9.

¶ 11.02 THRIFT INSTITUTION DEPOSIT INSURANCE

Separate federal deposit insurance systems exist for savings and loan associations and credit unions. These are explained in the sections immediately following.

[1] Federal Savings and Loan Insurance Corporation

The FSLIC is an instrumentality of the United States and has its principal office in the District of Columbia. Its purpose is to insure the accounts of eligible savings institutions. The FHLBB has the statutory authority to direct and operate the FSLIC.[54]

The FSLIC insures the accounts of all federal associations and federal mutual savings banks. It also may insure the accounts of state associations, building and loan societies, and cooperative banks that meet the eligibility requirements.[55] The FSLIC may refuse to accept an application for insurance if it finds that the management of the applicant or its financing policies are "inconsistent with economical home financing" or with the purposes of the federal savings and loan insurance legislation. It must reject any application if it finds that "the capital of the applicant is impaired or that its financial policies of management are unsafe."[56] The FSLIC also has the power to make adjustments to the financial statements of applicants as it finds necessary. When an application is accepted, the applicant agrees to allow the FSLIC to conduct examinations as it deems necessary, to pay the expense of those examinations, and to make available information as the FSLIC may require.[57] The power to examine

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[52] See ¶ 2.03.

[53] 12 USC § 1818(b)(1) (1982). See First Nat'l Bank v. Smith, 610 F2d 1258 (5th Cir. 1980); Independent Bankers' Ass'n of America v. Heimann, 613 F2d 1164 (DC Cir. 1979); cert. denied 449 US 823 (1980); Groos Nat'l Bank v. Comptroller of the Currency, 573 F2d 889 (5th Cir. 1978); First Nat'l Bank of Eden v. Department of the Treasury, 568 F2d 610 (8th Cir. 1978).

[54] 12 USC § 1725(a) (1982).

[55] 12 USC § 1726(a) (1982).

[56] 12 USC § 1726(c) (1982).

[57] 12 USC § 1726(b) (1982).

insured institutions extends to affiliates of those institutions.[58] In making examinations, the FSLIC can take testimony under oath and can issue subpoenas.[59]

Accounts that may be insured by the FSLIC include share, certificate, or deposit accounts as approved by the FSLIC.[60] The amount of insurance available has increased over time; as of 1988, accounts may be insured up to an aggregate amount of $100,000 for any one member of investor.[61] Individuals, partnerships, associations, incorporations, and governmental bodies are all eligible for the insurance.[62]

The FSLIC has the authority to establish reserves for its insuring activities.[63] Each institution that is insured by the FSLIC is assessed a premium for insurance that initially is equal to one twelfth of one percent of the total amount of all the insured accounts of the institution. This premium is then subject to adjustment by a statutory formula.[64] The FSLIC may make further assessment against the insured institutions when such assessment is necessary to pay losses and expenses of up to one eighth of one percent of the total accounts of the insured members.[65] The board may also require that the insured institutions place deposits with the FSLIC.[66]

The FHLBB has regulatory responsibility over the insured institutions. The power to conduct examinations has already been mentioned. In addition, an insured institution must agree to limit its lending to an area of 100 miles from its principal office, except as otherwise provided by the regulation of the FSLIC.[67] The FSLIC regulates securities issued by the insured institution,[68] as well as the sales, plans and practices, and advertising, if any, of the insured institutions.[69] The FSLIC may require the maintenance of such reserves as it deems necessary before any dividends may be paid by the institution.[70]

[2] The Financial Rescue of the Federal Savings and Loan Insurance System by the Competitive Equality Banking Act of 1987

During the second half of the 1980s, large numbers of savings and loan associations encountered serious financial difficulty or failure. Faced with an

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[58] 12 USC § 1730(m)(1) (1982).
[59] 12 USC § 1730(m)(2) (1982).
[60] 12 USC § 1724(c) (1982).
[61] 12 USC § 1728(a) (1982).
[62] 12 USC §§ 1728(a), 1728(d) (1982).
[63] 12 USC § 1727 (1982).
[64] 12 USC § 1727(b) (1982).
[65] 12 USC § 1727(c) (1982).
[66] 12 USC § 1727(h) (1982).
[67] 12 USC § 1726(b) (1982).
[68] Id.
[69] Id.
[70] Id.

insurance fund that was not adequate to handle the costs of these failures, Congress devised a new financing scheme to provide the FSLIC with emergency funds. Title III of the Competitive Equality Banking Act of 1987[71] establishes a complex financing structure for infusing new funds into the FSLIC. Funds for the insurance system are to be raised through a new Financing Corporation, which is authorized to issue long-term bonds to the public. The proceeds from the Financing Corporation's borrowings are to be channeled to the FSLIC. Repayment of the bonds is supported by the power of the Financing Corporation to assess FSLIC-insured institutions.[72]

The Financing Corporation is a mixed ownership government corporation,[73] managed by a three-member directorate comprising the Director of the Office of Finance of the Federal Home Loan banks and two presidents of the Federal Home Loan banks selected by the FHLBB.[74] The chairman of the FHLBB selects the chair of the directorate from among these three members.[75] The members of the directorate serve without compensation, and the Financing Corporation is prohibited from paying employees. The Financing Corporation may call on personnel of the Federal Home Loan banks to act for the corporation and may charge their administrative expenses to the Federal Home Loan banks.[76] The FHLBB has regulatory authority over the directorate.[77]

The powers of the Financing Corporation are limited to issuing nonvoting capital stock to the Federal Home Loan banks, investing in securities issued by the FSLIC as authorized by the act, issuing debt obligations, assessing insured institutions as authorized by the act, and engaging in certain general corporate powers.[78] The corporation has authority to "exercise such incidental powers not inconsistent with [the enumerated powers] . . . as are necessary or appropriate to carry out . . ." the act.[79]

The Financing Corporation is capitalized through the purchase of nonvoting capital stock by the Federal Home Loan banks. This stock is transferable only among the Home Loan banks. The total amount that the banks may invest in the Financing Corporation is $3 billion, with a maximum amount for each

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[71] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (1987) (hereinafter CEBA).

[72] For a general description of the financing scheme, see 49 Banking Rep. (BNA) 331–333 (1987).

[73] CEBA §§ 302, 303 (to be codified at 12 USC § 1441; amending 31 USC § 9101(2)).

[74] CEBA § 302 (to be codified at 12 USC § 1441(b)). The act requires the selection of the bank presidents to be rotated among the various presidents of the Federal Home Loan banks. Id.

[75] CEBA § 302 (to be codified at 12 USC § 1441(b)(5)).

[76] CEBA § 302 (to be codified at 12 USC § 1441(b)(6), 1441(b)(7), 1441(b)(9)).

[77] CEBA § 302 (to be codified at 12 USC § 1441(b)(8)).

[78] CEBA § 302 (to be codified at 12 USC § 1441(c)).

[79] Id.

Federal Home Loan bank set by a formula based on each bank's reserves and undivided profits.[80] The FHLBB determines when and how much capital stock may be issued, although the apportionment of the stock among the Federal Home Loan banks is provided for by formula in the act.[81]

The Financing Corporation's authority to borrow money through the issuance of debt securities is limited to no more than $3.75 billion per year, with an overall total of $10.825 billion.[82] The cap on borrowings of the corporation is also tied to the amount of nonvoting capital stock issued, and to the amount of certain securities acquired by the corporation to secure repayment of the debt. The Financing Corporation must purchase an amount of certain qualified zero coupon bonds that is equal to the principal amount of its obligations, and it must hold these securities in a segregated account to secure the repayment of the obligations.[83] Thus, the formula for determining the maximum amount that the Financing Corporation may borrow is the lesser of (1) five times its outstanding nonvoting capital stock; (2) the total face amount of the securities held in the segregated account; or (3) $10.825 billion.[84]

The debt obligations of the Financing Corporation are lawful investments for fiduciaries, trusts, and public funds under the control of the United States.[85] Although these obligations are not backed by the full faith and credit of the United States but are the sole obligation of the Financing Corporation, they are exempt from state tax to the same extent that the obligations of the Federal Home Loan banks are exempt.[86] They are taxable by the United States.[87]

The Financing Corporation assesses FSLIC-insured institutions for the interest and financing expenses it has incurred.[88] With the approval of the FHLBB, the Financing Corporation may impose a regular assessment on insured institutions at an annual rate of one twelfth of one percent of the amount of the accounts of each insured institution; by unanimous vote of the directorate,

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[80] CEBA § 302 (to be codified at 12 USC § 1441(d)(2), (3)).

[81] CEBA § 302 (to be codified at 12 USC § 1441(d)(4), (5)).

[82] CEBA § 302 (to be codified at 12 USC § 1441(e)(1)).

[83] CEBA § 302 (to be codified at 12 USC § 1441(g)). These securities must be obligations of the United States, the Federal National Mortgage Association, the Government National Mortgage Association, certain obligations sold by the Federal Home Loan Mortgage Corporation, or other securities authorized for purchase by fiduciaries and trust funds under state law. Id. The maximum amount of such non-interest-bearing securities that the Financing Corporation may acquire is limited to $2.2 billion based on purchase price. Id.

[84] CEBA § 302 (to be codified at 12 USC § 1441(e)).

[85] CEBA § 302 (to be codified at 12 USC § 1441(e)(5)).

[86] CEBA § 302 (to be codified at 12 USC § 1441(e)(7), (8)).

[87] See H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess. 156, reprinted in 1987 U.S. Code and Cong. Ad. News 552, 625 (hereinafter H.R. Conf. Rep. No. 261).

[88] CEBA § 302 (to be codified at 12 USC § 1441(f)).

with Board approval, a supplemental assessment may be imposed at an annual rate of up to one eighth of one percent.[89] Payments by insured institutions of assessments under these provisions reduce the FSLIC's authority to impose insurance under its normal powers to charge premiums for the FSLIC insurance funds.[90] Thus, as written in the conference report, "no institution can be required to pay on an annual basis more than a premium of one-twelfth of one percent, plus an additional premium of one-eighth of one percent, whether the premiums are paid to the FSLIC, the Financing Corporation, or a combination of both."[91] The Financing Corporation may relieve an institution from paying an assessment when a reduction "is necessary to assist in the sale or other disposition" of the institution because it is in a weak financial condition.[92] The corporation also may impose an exit fee on institutions that leave the FSLIC-insured system.[93] However, the act imposes a one-year moratorium on institutions leaving the system.[94]

The Financing Corporation may use the funds raised by the issuance of its obligations only for purchase of capital stock or capital certificates of the FSLIC or to refund previously issued obligations.[95] The capital *certificates* are nonredeemable; the capital *stock* is redeemable and nonvoting, and is not eligible for dividends.[96] The FSLIC is required to establish an equity return account, in which earnings of the FSLIC, calculated in accordance with a statutory formula, are accumulated for payoff of the capital stock.[97]

Among the miscellaneous provisions of the act is a provision conferring a super priority on security interests of the Federal Home Loan banks. The conference report explains that this provision is in recognition of the status of these banks as lenders of last resort, and it is intended to give these banks a "priority lien position, unless another creditor has obtained a perfected security interest in the property."[98] The section applies to security interests granted to a

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[89] Id.

[90] CEBA § 305 (to be codified at 12 USC § 1727(j)).

[91] H.R. Conf. Rep. No. 261, supra note 87, at 162.

[92] CEBA § 302 (to be codified at 12 USC § 1441(f)(4)(C)).

[93] CEBA § 302 (to be codified at 12 USC § 1441(f)(4)(A)). There are special "equalization" provisions for institutions that previously paid exit fees, and there are other special exceptions in the act.

[94] CEBA § 306(g) (amending 12 USC § 1727(h)(1)).

[95] CEBA § 302 (to be codified at 12 USC § 1441(e)(3)).

[96] Id; CEBA § 304 (amending 12 USC § 1725(b)(1)(A)).

[97] CEBA § 304 (amending 12 USC § 1725(b)(2)).

[98] H.R. Conf. Rep. No. 261, supra note 87, at 163. The new provisions state:

> Notwithstanding any other provision of law, any security interest granted to a Federal Home Loan Bank by any member of any Federal Home Loan Bank or any affiliate of any such member shall be entitled to priority over the claims and rights of any party (including any receiver, conservator, trustee, or similar party having rights

Federal Home Loan bank by any other Federal Home Loan bank or any affiliate of such a bank

[3] Measures to Improve FHLBB and FSLIC Regulation of Financially Weak Institutions

Title IV of the Competitive Equality Banking Act of 1987 contains important provisions that deal with the authority of the FHLBB and the FSLIC to supervise financially weak thrift institutions. Its provisions range from accounting requirements to requirements for programs of capital forbearance. In general, the act gives authority in these areas to the FHLBB in the case of federally chartered thrift institutions and to the FSLIC in the case of state-chartered, FSLIC-insured thrift institutions.

[a] Accounting Principles. The Competitive Equality Banking Act sets rules for the accounting principles to be followed by the federal thrift regulators. In general, except as may be otherwise provided, the requirement is that

> the Board shall prescribe, by regulation, uniformly applicable accounting standards to be used by all associations for the purpose of determining compliance with any rule or regulation issued by the Board or the Federal Savings and Loan Insurance Corporation to the same degree that generally accepted accounting principles are used to determine compliance with rules and regulations of the Federal banking agencies.[99]

The FHLBB also is required to establish additional regulations, consistent with those used by the federal commercial bank regulators, for classifying assets, appraising assets, and reappraising assets acquired by foreclosure. It authorizes use of certain specific financial accounting standards by institutions engaged in troubled debt restructuring. Under the FHLBB's power to classify assets of federally chartered associations, the supervisory agent has discretion to require an association to establish larger loan loss reserves and to require the association to classify nonperforming assets.[100] Amounts held in an association's loss reserves may be treated as capital for regulatory purposes.[101]

> of a lien creditor) other than claims and rights that—(1) would be entitled to priority under otherwise applicable law; and (2) are held by actual bona fide purchasers for value or by actual secured parties that are secured by actual perfected security interests.

CEBA § 306 (amending 12 USC § 1430(e)).

[99] CEBA § 402 (to be codified at 12 USC § 1467(b)(1)). The parallel rule for state-insured thrifts is at § 402(b) (to be codified at 12 USC § 1730h(b)(1)).

[100] CEBA § 402 (to be codified at 12 USC § 1467(a)). The parallel authority for state-insured thrifts is at § 402(b) (to be codified at 12 USC § 1730h(a)).

[101] Id.

[b] Capital Forbearance Programs. The Competitive Equality Banking Act sets forth principles for capital forbearance programs. The FHLBB and FSLIC are directed to adopt "capital recovery regulations for regulating and supervising troubled but well-managed and viable associations . . . ."[102] The act requires the FHLBB to adopt regulations that allow weakened associations to continue to operate and to participate in a capital recovery program if certain conditions are met. In the case of institutions with a net worth of 0.5 percent or more, the conditions are as follows:

1. The weak capital condition is the result of losses on loans in which "economic conditions in a designated economically depressed region" have adversely affected the value of the collateral for the loans or where the loans were made by a minority association at least 50 percent of whose loans are to minorities, for one- to four-family residences;
2. The weak capital condition "is not the result of imprudent operating practices" as determined by the board;
3. The association obtains board approval for a plan to increase the institution's capital; and
4. The association complies with the plan and reports properly on its progress.[103]

At the board's discretion, associations with a net worth of less than 0.5 percent may participate in a capital recovery program. However, in addition to meeting the conditions mentioned above, the FHLBB must determine that the institution possesses "reasonable and demonstrable prospects of returning to a satisfactory capital level."[104]

The FHLBB and the FSLIC obtain authority under the act to set minimum capital requirements. This may be done on a case-by-case basis, as the regulators determine it necessary for a particular institution. Thrift regulators may require that an association submit for approval by the regulators a plan to increase capital to an acceptable level, and they may enforce compliance with the plan. Further, the regulators may treat a failure to maintain capital at the established level as an "unsafe or unsound practice."[105] The act further deals with capital forbearance by extending for five additional years forbearance measures that

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[102] CEBA § 404(a) (to be codified at 12 USC § 1467a(a)), 404(b) (to be codified at 12 USC § 1730i(a)).

[103] CEBA § 404(a) (to be codified at 12 USC § 1467a(b)), 404(b) (to be codified at 12 USC § 1730i(b)).

[104] CEBA § 404(a) (to be codified at 12 USC § 1467a(c)), 404(b) (to be codified at 12 USC § 1730i(c)).

[105] CEBA §§ 406(a) (to be codified at 12 USC § 1464(s)), 406(b) (to be codified at 12 USC § 1730(t)).

may have been agreed to in certain cases involving acquisitions of insured institutions.[106]

When either the FHLBB or the FSLIC has approved a plan for increasing capital, as outlined previously, the FSLIC has authority, notwithstanding any other provision of federal law, "to purchase capital instruments" of the associations. These instruments must pay dividends at a reasonable rate as determined by the FSLIC. In the event the association liquidates or reorganizes, these instruments also have priority over the claims of holders of equity interests in the association. The FSLIC negotiates with the association for warrants for the purchase of stock in the association as a condition for the FSLIC's purchase of the association's capital instruments.[107]

[c] General Supervisory Powers. Further provisions in the Competitive Equality Banking act deal with the supervisory powers of the FHLBB. The act directs the board to "issue guidelines which provide greater flexibility for supervisory agents, examiners, and other employees and agents of the Board . . . in applying regulations, standards, and other requirements of the Board . . . with regard to particular situations or particular thrift institutions."[108] Although this direction is vague as to its scope, another paragraph of the act particularizes the mandate by indicating that the guidelines must contain provisions relating to renegotiated loans, recognizing additional financial capability of borrowers, establishing an appraisal review procedure, and other matters.[109]

Among the supervisory provisions is a requirement that the board establish an informal review procedure that would allow insured institutions to obtain review by an independent arbiter of supervisory decisions on the appraisal value of loans held by the institution or collateral for loans, on the classification of loans held by the association, or on requirements to establish reserves for losses.[110] Decisions made by this informal review process may not be challenged in court proceedings, as they are not subject to judicial review as such, but any formal administrative or judicial remedy otherwise available for testing the original decision that was the subject of the informal review procedures is not lost and may be pursued. The "findings, recommendations, or conclusions" reached under the informal review process are not admissible in evidence in any administrative or judicial proceeding challenging the original decision.[111]

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[106] CEBA § 414 (to be codified at 12 USC § 1730a(m)(1)(A)(iv)).

[107] CEBA § 405 (to be codified at 12 USC § 1729(f)(6)).

[108] CEBA § 407(a).

[109] Id. at § 407(b).

[110] CEBA § 407(d) (to be codified at 12 USC § 1442a).

[111] Id.

[d] Holding Corporation for Troubled Assets. Additionally, the Competitive Equality Banking Act calls for the FHLBB to conduct a feasibility study of establishing a corporation to hold troubled real estate assets acquired by thrift institutions.[112] It directs a modification in procedures followed by the board in approving and disapproving various types of applications.[113] Further, it calls for expanded use of minority thrift institutions as depositaries or financial agents of the United States.[114] Finally, it calls for persons who are employed by a conservator or by the FSLIC to assist in the management or liquidation of an insured institution as independent contractors, consultants, or counsel to disclose to the persons with whom they deal any limitation on their authority to make "legally binding representations on behalf of" the conservator or FSLIC.[115]

¶ 11.03 CREDIT UNION SHARE INSURANCE

The National Credit Union Administration Board must insure the accounts of all member federal credit unions.[116] It may also insure the member accounts of credit unions organized under state law when such credit unions meet the eligibility requirements.[117] Before approving applications of credit unions for insurance, the board must consider the financial condition and management policies of the applicant, as well as the character and fitness of the applicant's management.[118] Upon approval of the application, each applicant agrees to pay the reasonable cost of such examinations as the board may deem necessary to determine eligibility and to protect the insurance fund. The applicant must also agree to provide the board with all information it desires in order to fulfill its regulatory responsibilities. Insured credit unions must maintain reserves as required by the act and must further agree to pay the premium charges for insurance.[119] The credit union also agrees to comply with the other regulations issued by the board under its statutory authority over insured credit unions.[120] In addition, all insured credit unions are required to make reports to the board of their condition.[121]

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[112] CEBA § 409.

[113] Id. at § 410.

[114] Id. at § 412.

[115] CEBA § 413 (to be codified at 12 USC § 1730(b)(4)).

[116] 12 USC § 1781(a) (1982).

[117] Id.

[118] 12 USC § 1781(c) (1982).

[119] 12 USC § 1781(b) (1982).

[120] Id.

[121] 12 USC § 1782(a) (1982).

Share insurance is financed by a national credit union share insurance fund, which is held in the Treasury of the United States.[122] The Secretary of the Treasury manages the investment of the fund,[123] and the fund itself is financed by insurance premiums assessed against the insured credit unions. These premiums are calculated according to a formula requiring insured institutions to pay an amount equal to one-twelfth of one percent of the total amount of member accounts in the credit union, subject to various adjustments.[124] In addition, the fund may be increased by loans from the United States.[125]

The board has the power to conduct examinations of insured credit unions.[126] Further, it may terminate the insurance of any credit union for engaging in unsafe or unsound practices or for violating board regulations.[127] Like the other bank regulatory agencies, it has authority to issue cease and desist orders to prevent violations or unsafe or unsound practices,[128] to remove directors or officers for violations or breach of fiduciary duty,[129] and to remove officers or directors who have been charged with committing serious crimes.[130] It also has the authority to regulate mergers, consolidations, asset transfers, and conversions of credit unions,[131] and it serves as the agent for liquidating federal credit unions that are insolvent.[132] A court or other authority having jurisdiction may appoint the board as the agent to manage the liquidation of credit unions organized under state law.[133] The board may also act to prevent liquidation by making loans, acquiring assets, establishing accounts, and encouraging mergers or sales of assets of insured credit unions.[134]

Member accounts in insured credit unions are insured to a maximum of $100,000 for each member.[135] Insured credit unions are qualified as depositories for the public money of the United States, and, as such, credit unions may be employed as the fiscal agent of the United States.[136] All insured credit unions are authorized to maintain share draft accounts that allow the owners of the

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[122] 12 USC § 1783(a) (1982).
[123] 12 USC § 1783(c) (1982).
[124] 12 USC § 1782(c)(2) (1982).
[125] 12 USC § 1783(d) (1982).
[126] 12 USC § 1784 (1982).
[127] 12 USC § 1786(b) (1982).
[128] 12 USC § 1786(e) (1982).
[129] 12 USC § 1786(g) (1982).
[130] 12 USC § 1786(i) (1982).
[131] 12 USC § 1785(b) (1982).
[132] 12 USC § 1787(a) (1982).
[133] 12 USC § 1787(b) (1982).
[134] 12 USC § 1788 (1982).
[135] 12 USC § 1787(c)(1) (1982).
[136] 12 USC § 1789a (1982).

accounts to make withdrawals by negotiable or transferable interest to third-party payees. Thus, credit unions may afford their shareholders privileges that are equivalent to checking conveniences available at commercial banks. However, the authority to grant checking privileges is limited to accounts that are owned either by individuals or by organizations of a nonprofit nature.[137]

Insured credit unions also have the benefit of the preemption of state usury limitations. Federal law permits the credit union to charge, "on any loan," interest at a rate of not greater than one percent in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve bank in the district where the credit union is located, or at any higher rate allowed by the laws of the state in which the credit union is located.[138]

Congress has established a National Credit Union Central Liquidity Facility to provide credit to member credit unions, enabling them to meet their various short-term and temporary credit needs.[139] The major function of the facility is to make advances to its members to meet their liquidity needs.[140] The board will not extend credit to credit unions for purposes of expanding their loan portfolios.[141]

The Central Liquidity Facility is part of the National Credit Union Administration and is managed by the National Credit Union Administration Board.[142] The facility serves only member credit unions, which may be chartered under state or federal law, and which subscribe to the capital stock of the facility. Each credit union must subscribe in an amount not less than one-half of one percent of the credit union's capital and surplus.[143] The facility may draw on loans from the Secretary of the Treasury if it lacks sufficient funds to meet the liquidity needs of its member credit unions.[144]

In addition to its responsibility to meet these needs, the Central Liquidity Facility, with authorization of the board, may assist in the collection and settlement of checks, share drafts, or other instruments of payment drawn on or issued by member credit unions in the facility.[145] The board has authority to establish rules and regulations for the collection and settlement of such payment items and to define the "rights, powers, responsibilities, duties and liabilities, including standards relating thereto, of such entities and other parties to any such

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[137] 12 USC § 1785(f) (1982). See generally Annot., "Authority of Credit Union to Engage in 'Sharedraft' Business," 14 ALR4th 1355 (1982).

[138] 12 USC § 1785(g) (1982).

[139] 12 USC §§ 1795–1795i (1982).

[140] 12 USC § 1795e (1982).

[141] 12 USC § 1795e(a)(1) (1982).

[142] 12 USC § 1795b (1982).

[143] 12 USC § 1795c(a) (1982).

[144] 12 USC § 1795e(b) (1982).

[145] 12 USC § 1795f(b) (1982).

items or their collection and settlement."[146] The legislation granting this authority to the board allows it to adopt, if it so decides, general banking practices and, in instances in which they would not otherwise apply, "federal reserve regulations and operating letters, the Uniform Commercial Code and Clearing House rules."[147]

¶ 11.04 DEPOSIT INSURANCE BACKED BY THE FULL FAITH AND CREDIT OF THE UNITED STATES

In 1982, the financial instability of many savings and loan associations and the projections of large losses among some associations generated speculation as to whether the assets of the deposit-insuring agencies were adequate to assure depositors of the safety of their funds. To allay these concerns, Congress passed resolutions assuring that deposits insured by the federal government through the FSLIC or the FDIC were backed by the full faith and credit of the United States. These resolutions state that Congress "reaffirms that deposits, up to the statutorily prescribed amount, in federally insured depository institutions are backed by the full faith and credit of the United States."[148]

When Congress enacted Title 9 of the Competitive Equality Banking Act of 1987, it included a similar resolution. This resolution says:

> a. Findings—The Congress finds and declares that—
>
> 1. since the 1930's, the American people have relied upon Federal deposit insurance to ensure the safety and security of their funds in federally insured depository institutions; and
>
> 2. the safety and security of such funds is an essential element of the American financial system.
>
> b. Sense of Congress.—In view of the findings and declarations contained in subsection (a), it is the sense of the Congress that it should reaffirm that deposits up to the statutorily prescribed amount in federally insured depository institutions are backed by the full faith and credit of the United States.[149]

The financial difficulties of federally insured institutions have led to examination of the existing system of deposit insurance. A major question under consideration is whether the current system of deposit insurance and regulatory action, in the event of institutional insolvency, lacks sufficient restraining effect on institutional investment policies, given that depositors are protected by the

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[146] 12 USC § 1795f(b)(3) (1982).

[147] Id.

[148] H.R. Con. Res. 290, 96 Stat. 2639 (1982).

[149] CEBA § 901.

federal deposit insurance regardless of the degree of risk contained in the institution's investment practices. Although Congress has received proposals for reform of the federal deposit insurance systems for banks and thrift institutions, it has not made fundamental changes.[150]

¶ 11.05 WITHHOLDING TAX ON INTEREST PAID

For a brief period, Congress considered the idea of requiring banks and other financial institutions to withhold tax on interest and dividends paid to customers. In 1982, Congress passed legislation requiring the payor of any interest, dividend, or patronage dividend to withhold ten percent of the amount of the payment as a tax.[151] However, before the legislation became effective, Congress repealed its provisions by adopting the Interest and Dividend Tax Compliance Act of 1983.[152]

Although the 1983 measure eliminates compulsory withholding on interest and dividends, it contains features that affect the reporting and collection of federal taxes on such income. The act continues the requirement of "backup withholding," initiated in the 1982 law, for accounts in which the payee furnishes an incorrect taxpayer identification number to the payor or fails in other ways to satisfy his or her duties under the law.[153] The rate at which this backup withholding must be made is 20 percent. The law places an obligation on the payor to withhold taxes when (1) the payee fails to give the payor a taxpayer identification number; (2) the Secretary of the Treasury notifies the payor that the payee has furnished an incorrect taxpayer information number; (3) the Secretary notifies the payor that the payee has not properly reported interest or dividends; and (4) the payee fails to give proper certification that the backup withholding rules do not apply to the payee.[154] Penalties apply when a bank or other payor of interest or dividends fails to file information returns or to provide

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[150] See, e.g., "'Recommendations for Change in the Federal Deposit Insurance System,' Report of the working group on financial institutions reform of the Cabinet Council on Economic Affairs," Fed. Banking L. Rep. (CCH) ¶ 86,181 (Jan. 1985). The FDIC solicited comments on its policies for taking over failed banks by purchase and assumption arrangements, which protect depositors of even uninsured funds. 50 Fed. Reg. 19,088 (1985). See also Goodman & Shaffer, "The Economics of Deposit Insurance: A Critical Evaluation of Proposed Reform," 2 Yale J. Reg. 145–162 (1984).

[151] The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §§ 301–308, 96 Stat. 324, 576–591 (1982). The act was scheduled to take effect on July 1, 1983, but the effective date was extended by action of the Secretary of the Treasury until July 31, 1983. It never became effective, because of repealing legislation as discussed in the text.

[152] Pub. L. No. 98-67, tit. I, 97 Stat. 369 (1983).

[153] 26 USC § 3406 (Supp. III 1985).

[154] Id.

the correct taxpayer identification numbers of the payee.[155] The act creates a presumption that a taxpayer who underpays tax due on income shown on the information reports filed by the payor is subject to the penalty for negligent failure to pay taxes.[156]

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[155] 26 USC § 6676 (Supp. III 1985).

[156] 26 USC § 6653 (1982 and Supp. III 1985).

12

Financial Transactions Regulation, Money-Laundering Controls, and Crimes Related to Bank Transactions

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¶ 12.01 FINANCIAL TRANSACTIONS OFFENSES

In response to national concern over the involvement of criminals in laundering proceeds of crime through various parts of the financial system, and in an effort to strengthen the hand of federal criminal justice enforcement agencies, Congress has passed extensive legislation requiring the reporting of certain financial transactions and the establishment of certain conduct as federal crimes. As this legislation affects banks and other depository institutions, its major features are described here. This discussion cannot review all of the federal laws that may be the basis for criminal or civil liability in transactions with financial institutions. That body of law is too extensive for the abbreviated treatment appropriate to the scope of this text. However, some of the significant aspects of this body of law are identified here in order to alert bankers and their counsel to some of the legal concerns that these federal law enforcement measures create.

[1] Financial Record-Keeping Requirements

The Bank Secrecy Act of 1970[1] was enacted by Congress for the express purpose of requiring the maintenance of records and the making of reports by financial institutions where such papers would "have a high degree of usefulness in criminal, tax, and regulatory investigations and proceedings."[2] The act authorizes the Secretary of the Treasury to promulgate appropriate regulations to carry out this purpose.[3]

Generally, the secretary may require federally insured banks to record the identity of account holders,[4] to make and maintain reproductions of certain checks, drafts, and other instruments presented to it for payment or received by it for deposit,[5] and to require and retain the identity of all persons who engage in certain domestic and foreign currency transactions.[6] Uninsured banks and institutions[7] also may be required to maintain these same records and reports.[8] When

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[1] Pub. L. No. 91-508, 84 Stat. 1114 (1970), codified at 12 USC §§ 1730d, 1829b, 1951–1959 (1982); 31 USC §§ 5311–5323 (1982 & Supp. III 1985) (formerly codified at 31 USC §§ 1051–1062, 1081–1083, 1101–1105, 1121–1122).

[2] 12 USC §§ 1829b(a), 1951(a) and 31 USC § 5311 (1982).

[3] 12 USC §§ 1829(b), 1953(a) (1982). For regulations, see 31 CFR pt. 103 (1987).

[4] 12 USC § 1829b(c) (1982). See 31 CFR § 103.34 (1987).

[5] 12 USC § 1829b(d) (1982); 12 USC § 1953 (1982); 31 CFR §§ 103.33, 103.34 (1987).

[6] 12 USC § 1829b(e) (1982); 31 CFR §§ 103.22, 103.23 (1987).

[7] Businesses that engage in one of the functions listed in 12 USC § 1953(b) (1982), i.e., any "business which supplies a means for transferring or transmitting funds or credits domestically or internationally," H.R. Rep. No. 975, 91st Cong., 2d Sess. 19, reprinted in 1970 U.S. Code Cong. & Admin. News 4403, must also comply with these record-keeping requirements.

[8] 12 USC § 1953(a)(1) (1982).

any of these requirements as set out by the Secretary of the Treasury is willfully violated, the act imposes civil and criminal penalties.[9]

Under 12 USC § 1955 (1982), the Secretary of the Treasury may impose civil fines on both the company and its individual officers and employees for willful violations of the regulations. The fine may not exceed $1,000, and the secretary may bring suit to enforce the penalty if necessary. There are two provisions establishing criminal penalties. Penalties of up to $1,000 and one year in jail for the willful violation of any of the above regulations by any person are provided for under 12 USC § 1956 (1982). Although some provisions of the act refer to "uninsured" banks or institutions, as mentioned previously, the secretary has authority to establish record-keeping requirements for federally insured banks and institutions as well as for uninsured institutions.[10] Moreover, the scope of the secretary's authority is not limited to financial institutions, but extends to any person who engages in banking functions such as issuing or redeeming monetary instruments, transferring funds or credits, operating a currency exchange, dealing in foreign currency, operating a credit card system, or "performing such similar, related, or substitute functions for any of the foregoing or for banking as may be specified by the secretary in regulations."[11] The criminal penalties provided in 12 USC §§ 1956 and 1957 apply to "whoever" commits a willful violation of the regulations.

Additionally, stiffer penalties are provided in 12 USC § 1957 (1982) for certain willful violations of any regulation adopted by the Secretary of the Treasury to carry out the above-mentioned provisions of the Bank Secrecy Act. Whoever willfully violates these regulations, in furtherance of the commission of a federal felony, is punishable by a fine of $10,000 or imprisonment for not more than five years, or both.[12]

[2] Reporting of Currency Transactions

[a] Bank Secrecy Act of 1970. The Bank Secrecy Act of 1970 authorizes the Secretary of the Treasury to promulgate regulations to collect information on

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[9] California Bankers Ass'n v. Schultz, 416 US 21, 26 (1974); 12 USC §§ 1955–1957 (1982).

[10] The regulation of the Secretary of the Treasury defines "bank" broadly to include all commercial banks, savings and loan associations, credit unions, and other institutions. 31 CFR § 103.11 (1987). The regulations establish additional reporting requirements for certain persons, such as casinos and brokers and dealers in securities. 31 CFR §§ 103.35, 103.36 (1987). The legislative history of the act indicates there was no specific reference to "insured" banks and institutions because the legislators believed that "the necessary legal and administrative machinery [was] already in existence." H.R. Rep. No. 975, supra note 7, at 19.

[11] 12 USC § 1953(b) (1982).

[12] See also 31 CFR § 103.49(a) (1985); H.R. Rep. No. 975, supra note 7, at 20.

foreign and domestic currency transactions.[13] Under the act and regulations, the Secretary can gather data as described in this section to obtain "reports or records" that "have a high degree of usefulness in criminal tax, or regulatory investigations or proceedings."[14] These regulations cover the following transactions.

1. *Domestic currency transactions.* Financial institutions are required to file reports for every deposit, withdrawal, exchange of currency, or other payment or transfer "which involves a transaction in currency of more than $10,000."[15]

2. *Export and import of monetary instruments.* As authorized by the Bank Secrecy Act, the Secretary of the Treasury requires individuals or institutions to make reports whenever they physically transport more than $10,000 in currency or monetary instruments into or out of the United States on any one occasion.[16] or whenever they receive currency or monetary instruments of more than $5,000 from outside the United States on any one occasion.[17] A transfer of funds

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[13] 31 USC § 5313 (1982) (formerly codified as 31 USC § 1081). The requirements of the Bank Secrecy Act for reporting currency transactions are discussed at ¶ 12.01[2].

[14] 31 USC § 5311 (1982) (formerly codified as 31 USC § 1051).

[15] 31 CFR § 103.22 (1987). See also 31 CFR §§ 103.11, 103.21 (1987). Although 31 USC § 5313 allows the Secretary of the Treasury to require reports of transactions in not only coins and currency, but also "other monetary instruments" the Secretary prescribes, the Secretary's regulation is limited to those involving coins and currency. Also, the act permits the Secretary to set the amount of transactions that should be reported.

[16] 31 USC § 5316 (1982 & Supp. III 1985); 31 CFR § 103.23 (1987).

[17] 31 USC § 5316 (1982 & Supp. III 1985); 31 CFR § 103.23 (1987). The definition of "monetary instruments" is a broad one. It includes instruments such as traveler's checks, money orders, investment securities in bearer form or indorsed in such a manner as to pass title by delivery, and bank checks in bearer form or indorsed in blank or with the name of the payee omitted. The regulation reads as follows:

> *Monetary instruments.* (1) Monetary instruments include:
>
> (i) Currency;
>
> (ii) All negotiable instruments (including personal checks, business checks, official bank checks, cashier's checks, third-party checks, promissory notes (as that term is defined in the Uniform Commercial Code), traveler's checks, and money orders) that are either in bearer form, endorsed without restriction, made out to a fictitious payee (for the purposes of § 103.23) or otherwise in such form that title thereto passes upon delivery;
>
> (iii) Incomplete instruments (including personal checks, business checks, official bank checks, cashier's checks, third-party checks, promissory notes (as that term is defined in the Uniform Commercial Code), traveler's checks, and money orders) signed but with the payee's name omitted; and
>
> (iv) Securities or stock in bearer form or otherwise in such form that title hereto passes upon delivery.
>
> (2) Monetary instruments do not include warehouse receipts or bills of lading.

31 CFR § 103.11(K) (1987).

through normal banking procedures not involving physical transportation of currency or monetary instruments need not be reported.[18]

Numerous exceptions are provided for banks. For instance, banks need not report currency or other monetary obligations mailed or shipped through the postal service or by common carrier.[19] They are also not required to report overland shipments of such instruments when the shipments are of normal amounts for the customer's business and involve an established customer maintaining a deposit relationship with the bank.[20] Other exemptions have been granted, including an exemption to U.S. banks near the Canadian border that, as part of their normal business, physically transport currency on a continuing basis to Canadian banks.[21]

Additionally, any money or monetary instruments in the process of being transported into or out of the United States for which a report has not been filed are subject to seizure and forfeiture to the United States.[22] Case law has held that the entire amount of money transported in violation of this section is subject to forfeiture, not just the amount in excess of the amount required to be reported.[23]

3. *Transactions with foreign financial agencies.* Persons living or conducting business in the United States (including associations and corporations) who engage in any transaction or maintain any relationship with a foreign financial agency must keep records and file reports, as the Secretary of the Treasury prescribes, listing the identities of the parties involved and describing the transaction or relationship.[24] The regulations require persons who have "a financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country" to report such interests on their

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[18] 31 CFR § 103.23(d) (1987).

[19] 31 CFR § 103.23(c)(2) (1987).

[20] 31 CFR § 103.23(c)(3) (1987).

[21] 31 CFR pt. 103 app. (1987) (Section 103.23, Exemptions From 364).

[22] 31 USC § 5317(c) (Supp. III 1985) (formerly codified as 31 USC § 1101). The 1984 amendments authorized customs officers to stop and conduct warrantless searches of vehicles with respect to which "the officer has reasonable cause to believe there is a monetary instrument being transported in violation" of the export/import requirements. 31 USC § 5317(b) (Supp. III 1985). See also 31 CFR § 103.48 (1987). See generally Annotation, "Criminal Liability For Failure to Report Export or Import of Monetary Instrument as Required by Provision of Currency and Foreign Transactions Reporting Act (31 USCS § 1101)," 59 ALR Fed. 438 (1982).

[23] United States v. Currency Totalling $48,318.08, 609 F2d 210 (5th Cir. 1980); United States v. One 1964 MG, 584 F2d 889 (9th Cir. 1978). A forfeiture of nearly $1.5 million in currency was upheld in United States v. $1,497,081.78, 777 F2d 1451 (11th Cir. 1985).

[24] 31 USC § 5314 (1982).

yearly tax returns.[25] Such persons are required to keep records of these financial interests for five years in the event that inspection is later authorized.[26]

4. *Foreign currency transactions.* Financial institutions and other persons who engage in foreign currency transactions must submit reports covering these transactions with the Federal Reserve bank in their district.[27] Such provisions were added by amendments to the Bank Secrecy Act in 1973, so that the Secretary of the Treasury could obtain complete and current data on the nature and sources of capital flows, movements of which can have a significant impact on the proper functioning of the international monetary system.[28] Regulations adopted by the secretary to implement these statutes require that reports be filed by those persons who engage in any transaction in foreign exchange, in any transfer of credit between a person within and a person outside the United States, or in the export of U.S. currency.[29] Banks and banking institutions are required to report, at various intervals, their assets, liabilities, and positions in foreign currency,[30] as well as the assets, liabilities, and positions of their foreign branches and majority-owned foreign subsidiaries.[31]

Prior to amendments to the law made by the Money Laundering Control Act of 1986, there was a division of authority as to whether the reporting requirements extended to "structured transactions," or "smurfing," in which cashier's checks and similar monetary instruments that individually were less than $10,000 in value were acquired, but for which the total amount exceeded

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[25] 31 CFR §§ 103.24, 103.32 (1987). See California Bankers Ass'n v. Shultz, 416 US 21, 37 (1974).

[26] 31 CFR § 103.32 (1987).

[27] 31 USC § 5315 (1982) (formerly codified as 31 USC §§ 1141, 1142); 31 CFR § 128.2 (1987).

[28] 31 USC § 5315 (1982).

[29] 31 CFR § 128.2 (1987).

[30] 31 CFR § 128.31 (1987).

[31] 31 CFR § 128.33 (1987). The civil and criminal penalties that apply to other portions of the act do not apply to 31 USC § 5315 (1982) on reporting foreign currency transactions. Section 5315 (formerly codified as 31 USC § 1142) was added to the act in 1973, and it gives the Secretary of the Treasury authority to "prescribe regulations . . . requiring reports on foreign currency transactions conducted by a United States person or a foreign person controlled by a United States person." This authority is in addition to and is broader than the secretary's authority to require reports under other provisions of the act, such as those relating to the export and import of monetary instruments. At one time, the sections of the act that set forth the general penalties for violations, 31 USC § 5322 (1982) (formerly codified as 31 USC §§ 1058, 1059) (authorizing fines and imprisonment) appeared to apply to this foreign currency transaction reporting section. The revisions now make clear that these penalties do not apply to violations of that section. 31 USC § 5322 (1982 & Supp. III 1985) and Revision Notes.

the $10,000 value that was required to be reported.[32] Additional problems were created as a result of the secretary's placing the reporting burden only on financial institutions.[33] If a bank was not aware that a person was structuring transactions to avoid the $10,000 reporting requirement, the bank could not be found to have violated the reporting statute because it lacked knowledge of the need to report; thus the regulations of the secretary under the act did not subject individuals who were not financial institutions to the reporting requirement.[34]

[b] Structured Transactions and Penalties for Reporting Violations. The Money Laundering Control Act of 1986 amended the provisions of the Bank Secrecy Act to deal with the problems discussed in the preceding section.[35] It answers the question whether a series of transactions that separately do not violate the reporting requirements for certain financial transactions can be a single "structured transaction" in violation of the act. In pertinent part, it provides as follows:

> § 5324. Structuring transactions to evade reporting requirement prohibited
>
> No person shall for the purpose of evading the reporting requirements of section 5313(a) with respect to such transaction—
>
> (1) cause or attempt to cause a domestic financial institution to fail to file a report required under section 5313(a);
>
> (2) cause or attempt to cause a domestic financial institution to file a report required under section 5313(a) that contains a material omission or misstatement of fact; or

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[32] There were numerous cases and a split among the federal courts on this issue. See United States v. Denemark, 779 F2d 1559 (11th Cir. 1986); United States v. Giancola, 783 F2d 1549 (11th Cir.), cert. denied, 107 S. Ct. 669 (1986).

[33] For cases interpreting who constituted a financial institution that had an obligation to report, see United States v. Goldberg, 756 F2d 949 (2d Cir.), cert. denied, 472 US 1009 (1985) (partnerships and joint ventures could be regarded as financial institutions required to report); United States v. Mouzin, 785 F2d 682 (9th Cir.), cert. denied, 107 S. Ct. 574 (1986) (a single individual could qualify as a nonbank financial institution).

[34] United States v. Varbel, 780 F2d 758 (9th Cir. 1986). See also United States v. Anzalone, 766 F2d 676 (1st Cir. 1985). But see United States v. Cook, 745 F2d 1311 (10th Cir. 1984), cert. denied, 469 US 1220 (1985); United States v. Puerto, 730 F2d 627 (11th Cir.), cert. denied, 469 US 847 (1984); United States v. Tobon-Builes, 706 F2d 1092 (11th Cir. 1983); United States v. Thompson, 603 F2d 1200 (5th Cir. 1979); United States v. Sanchez Vazquez, 585 F. Supp. 990 (ND Ga. 1984).

[35] Pub. L. No. 99-570, Tit. I, subtit. H, 100 Stat. 3207-18 (1986). See also Annot., "Liability For Structured Transactions Under The Currency and Foreign Transactions Reporting Act: A Prelude to the Money Laundering Control Act of 1986," 6 Ann. Rev. Banking L. 325–340 (1987).

(3) structure or assist in structuring, or attempt to structure or assist in structuring, any transactions with one or more domestic financial institutions.[36]

The Money Laundering Control Act also amends the monetary transaction reporting requirements by giving the Secretary of the Treasury authority to adopt regulations to define the term "at one time," which is used in 31 USC § 5316(a). The Secretary's definition may cumulate "closely related events in order that such events may collectively be considered to occur at one time. . . ."[37] This allows the regulations to reach circumstances in which a person has structured his or her transactions so that they are a series of separate transactions at different times to avoid the $10,000 reporting amount for monetary instruments imported or exported from the United States. The act also modifies the definition of "attempts" under 31 USC 5316(a)(1), relating to reports on exporting or importing monetary instruments, so that it covers any person that "transports, is about to transport, or has transported" monetary instruments defined in the act.[38]

The Money Laundering Control Act increases the penalties for violations of the currency transaction reporting rules. A structured transaction violation carries a civil penalty for willful violators of up to the amount of the money involved.[39] Willful violators of the foreign financial agency transaction reporting rules may be penalized $25,000 or the amount of the transaction, up to $100,000.[40]

Financial institutions and their officers and employees who willfully violate the reporting rules are subject to increased civil penalties, which may range up to $100,000 for each violation.[41] In addition, the Secretary of the Treasury has authority to fine financial institutions up to $500 for negligent violations.[42] The civil penalties are in addition to any criminal penalties that may be imposed on the offender.[43] The criminal penalties for persons who willfully violate the reporting provisions "while violating another law" of the United States or as part of a pattern of illegal activity involving more than $100,000 in a twelve-

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[36] 31 USCA § 5324 (West Supp. 1987). See S. Rep. No. 433, 99th Cong., 2d Sess. (1986) (to accompany S. 2683), reprinted in Fed. Banking L. Rep. (CCH), Special Report 1, Money Laundering Crimes Act of 1986, at 47-48 (No. 1145, Sept. 12, 1986) (hereinafter Special Report).

[37] 31 USCA § 5316(d) (West Supp. 1987).

[38] 31 USCA § 5316(a)(1) (West 1983 & Supp. 1987).

[39] 31 USCA § 5321(a)(4) (West Supp. 1987).

[40] 31 USCA § 5321(a)(5) (West Supp. 1987).

[41] 31 USCA § 5321(a)(1) (West Supp. 1987).

[42] 31 USCA § 5321(a)(6) (West Supp. 1987).

[43] 31 USCA § 5321(d) (West Supp. 1987).

month period are increased to a fine of not more than $500,000 and imprisonment for up to ten years.[44]

[3] Money-Laundering Controls

The Money Laundering Control Act of 1986 makes the "laundering of monetary instruments" a federal crime, makes "engaging in monetary transactions in property derived from specified unlawful activity" a crime, amends the Right to Financial Privacy Act and the Bank Secrecy Act, including changes in the currency reporting rules, and provides for new federal forfeiture powers.[45]

[a] Money-Laundering Offenses. The Money Laundering Control Act makes it a criminal offense to launder monetary instruments. This crime is committed whenever a party to a financial transaction knows the property involved represents the proceeds of some form of unlawful activity and the proceeds are in fact from certain specified unlawful activities. The offender must have the intent to violate the law in one of three ways: (1) by promoting the carrying on of certain specified illegal activities; (2) by conducting the transaction knowing it is designed to conceal the circumstances of proceeds obtained from specific unlawful activities; or (3) by knowing the transaction is designed to avoid federal transaction reporting rules.

The act also makes it a crime to transport monetary instruments from the United States to other countries or to bring them into the United States when the person does so with the intent to promote the specified illegal activities or to conceal proceeds of illegal activities or avoid reporting requirements. This provision of the act is set forth as follows:

> § 1956. Laundering of monetary instruments
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> (a)(1) Whoever, knowing that the property involved in a financial transaction represents the proceeds of some form of unlawful activity, conducts or attempts to conduct such a financial transaction which in fact involves the proceeds of specified unlawful activity—
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> (A) with the intent to promote the carrying on of specified unlawful activity; or
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> (B) knowing that the transaction is designed in whole or in part—
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> (i) to conceal or disguise the nature, the location, the source, the ownership, or the control of the proceeds of specified unlawful activity; or
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> (ii) to avoid the transaction reporting requirement under State or Federal law,

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[44] 31 USCA § 5322(b) (West Supp. 1987).

[45] Pub. L. No. 99-570, Tit. I, subtit. H, 100 Stat. 3207-18–3207-39 (1986). The act is a part of the Anti-Drug Abuse Act of 1986, Pub. L. No. 99-570, 100 Stat. 3207.

shall be sentenced to a fine of not more than $500,000 or twice the value of the property involved in the transaction, whichever is greater, or imprisonment for not more than twenty years, or both.

(2) Whoever transports or attempts to transport a monetary instrument or funds from a place in the United States to or through a place outside the United States or to a place in the United States from or through a place outside the United States—

(A) with the intent to promote the carrying on of specified unlawful activity; or

(B) knowing that the monetary instrument or funds involved in the transportation represent the proceeds of some form of unlawful activity and knowing that such transportation is designed in whole or in part—

(i) to conceal or disguise the nature, the location, the source, the ownership, or the control of the proceeds of specified unlawful activity; or

(ii) to avoid a transaction reporting requirement under State or Federal law,

shall be sentenced to a fine of $500,000 or twice the value of the monetary instrument or funds involved in the transportation, whichever is greater, or imprisonment for not more than twenty years, or both.[46]

To establish that a crime has taken place under the first part of this provision, the following must be proven. Firstly, it must be shown that there was knowledge that the property involved constituted proceeds of some form of unlawful activity. However, there need not be knowledge of the specific offense that created the proceeds or knowledge that the proceeds derived from the specified illegal activities in the act.[47] "He or she need only know that it [the property] represents the proceeds of some form of unlawful activity." As stated in the act, it is enough to know that the property "represented proceeds from some form, though not necessarily which form, of activity that constitutes a felony under State or Federal law, regardless of whether or not such activity" is enumerated within the specified illegal activities in the act.[48] This provision serves to prevent defendants from claiming that they thought the proceeds were from a crime that was not one of the specified illegal activities in the act, and thus from escaping liability under the act.[49]

Secondly, the person must conduct or attempt to conduct a financial transaction that involves the "proceeds of specified unlawful activity." There are two elements under this second aspect—a financial transaction in which certain unlawful proceeds are used. Thus, the act covers any commercial transaction,

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[46] 18 USC § 1956(a) (Supp. IV 1986).

[47] Special Report, supra note 36, at 37.

[48] 18 USC § 1956(c)(1) (Supp. IV 1986).

[49] Special Report, supra note 36, at 37.

not just bank transactions.[50] However, although proceeds used in the transaction may be generated by the violation of state or federal law, there is no money laundering offense under this part of the act unless the crime is one of those specifically enumerated in the act.[51] Such crimes include most of the Racketeer Influenced and Corrupt Organizations (RICO) predicate offenses, federal financial crimes, and foreign drug offenses. In addition, each transaction is a separate offense.[52]

Thirdly, the defendant must have engaged in the transaction either with the intent to promote a crime specified in the act or with knowledge that the transaction was designed to conceal a crime. Thus, there is a scienter requirement, in addition to the knowledge of the nature of the proceeds required in the first part of the definition of the money laundering offense. Congress deliberately chose to include the "intent" or "knowledge" requirements, and not the broader standard of "reason to know" or "reckless disregard."[53] However, Congress stated its belief that the customary treatment of "willful blindness" as meeting the knowing standard would apply to the act.[54] The following example was furnished:

> Thus, a currency exchanger who participates in a transaction with a known drug dealer involving hundreds of thousands of dollars in cash and accepts a commission far above the market rate, could not escape conviction, from the first tier of the offense, simply by claiming that he did not know for sure that the currency involved in the transaction was derived from crime. On the other hand, an automobile car dealer who sells a car at market rates to a person whom he merely suspects of involvement with crime, cannot be convicted of this offense in the absence of a showing that he knew something more about the transaction or the circumstances surrounding it.[55]

Subparagraph 2 of this provision makes it a crime to engage in illegal international money-laundering transactions and provides "knowledge" requirements similar to those discussed above.

A person who violates the money-laundering provisions of the act is subject to a civil penalty to the United States in the amount of the greater of the value of the property involved in the transaction or $10,000.[56] The Senate Committee report stated that this provision was not intended to create a private remedy for persons other than the government.[57]

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[50] Special Report, supra note 36, at 36.

[51] 18 USC § 1956(c)(7) (Supp. IV 1986).

[52] Special Report, supra note 36, at 38.

[53] Special Report, supra note 36, at 34.

[54] Special Report, supra note 36, at 36.

[55] Id.

[56] 18 USC § 1956(b) (Supp. IV 1986).

[57] Special Report, supra note 36, at 38.

[b] Monetary Transactions Involving Proceeds of Crime. The Money Laundering Control Act also makes it a crime to engage in monetary transactions in property derived from specified unlawful activity.[58] Such offense occurs when there is a "monetary transaction," that is, a transaction with a financial institution such as the deposit, withdrawal, or transfer of money or a monetary instrument. The transaction must involve property derived from or proceeds of the specified criminal offenses in the act. The defendant must have knowingly engaged in the transaction, although there is no need to prove knowledge that the property was from a "specified unlawful activity."[59]

[c] RICO and Other Enforcement Measures. The money-laundering and monetary transaction offenses have been added to the list of acts that are predicate offenses and that constitute racketeering under RICO.[60] The provisions authorizing wiretaps and similar investigative procedures also have been extended to the money-laundering and monetary transaction crimes.[61] In addition, both money-laundering and monetary transaction offenses may be based on transactions outside the territorial United States when a U.S. citizen is involved and certain other conditions are met.[62]

[4] Special Enforcement Powers

The Money Laundering Control Act of 1986 gives additional powers to federal regulators to investigate violations and enforce the provisions of the act and the currency reporting requirements.

[a] Authority to Investigate Violations. The Money Laundering Control Act gives the banking regulatory agencies additional authority to examine financial institutions for compliance with the monetary transaction recordkeeping and reporting rules.[63] The act also expands the regulatory authority given to the Secretary of the Treasury to conduct civil investigations of violations. The

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[58] 18 USC § 1957 (Supp. IV 1986).

[59] The statute makes it illegal when a person "knowingly engages or attempts to engage in a monetary transaction in criminally derived property. . . ." 18 USC § 1957(a) (Supp. IV 1986).

[60] 18 USC §§ 1952 (Supp. IV 1986), 1961 (1982 & Supp. IV 1986).

[61] 18 USC § 2516(1) (1982 and Supp. IV 1986).

[62] 18 USC §§ 1956(f), 1957(d) (Supp. IV 1986). See Special Report, supra note 36, at 40.

[63] 12 USC §§ 1818(i)(2)(i), 1818(s) (Supp. IV 1986); 12 USC §§ 1464(d), 1730, 1786 (1982 & Supp. IV 1986).

authority extends to compelling financial institutions and their officers and employees to produce records and to testify under oath.[64]

The provisions for compelling the production of information raised concern about efforts to obtain information from U.S. branch offices regarding records held by foreign offices of the banks in nations with secrecy laws. The Senate Committee dealt with these concerns in its Report:

> Under the new section . . . this summons authority may be used against any financial institution, whether foreign or domestic, regulated by the Treasury Department. Concerns have been raised about the application of this authority to obtain records of foreign financial activity through the issuance of a subpoena to a U.S. branch of a predominantly offshore financial institution. The primary concern is that compliance with such a subpoena may force the institution to violate the strict financial privacy laws of other nations, such as the Bahamas or the Cayman Islands, from which records may be sought. It is the Committee's intention that efforts should be made, at least in the first instance, to resolve any conflicts that may arise between U.S. law enforcement interests and foreign secrecy laws through diplomatic efforts. If diplomatic efforts prove to be unsuccessful, however, the Committee expects such conflicts to be resolved by a careful balancing of the competing interests, in accordance with the decision of the U.S. Court of Appeals for the Eleventh Circuit in *United States v. Bank of Nova Scotia*. . . .[65]

[b] Compelling Information About Foreign Bank Records Protected Under Foreign Law. *United States v. Bank of Nova Scotia*, a 1982 case, tested the ability of United States law enforcement officials to obtain information from a bank about records in a foreign branch of the bank.[66] The case involved the Bank of Nova Scotia, a Canadian bank with agencies and branches in many countries, including the United States and the Bahamas. A federal grand jury, in the course of a tax and narcotics investigation, issued a subpoena to the bank in the United States calling for the production of records that were maintained in bank offices in the Bahamas. The bank defended against production of the records on the ground that compliance with the subpoena would violate the Bahamian bank secrecy law and, therefore, enforcement of the subpoena against the bank would

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[64] Special Report, supra note 36, at 43.

[65] Id.

[66] In re Grand Jury Proceedings, (United States v. Bank of Nova Scotia), 691 F2d 1384 (11th Cir. 1982), cert. denied, 462 US 1119 (1983). For a description of the history of the matter after the U.S. Supreme Court denied certiorari, which eventually led to the bank's compliance, see Olsen, "Discovery in Federal Criminal Investigations," 16 NYU J. Int'l L. & Pol. 999, 1014 (1984). The *Bank of Nova Scotia* decision approves the use of Section 40 of the Restatement (Second) of Foreign Relations Law of the United States (1965). See also the discussion of the *Bank of Nova Scotia* case in the congressional report on the Money Laundering Control Act at ¶ 12.01[4][a].

deny it due process.[67] The court said that the Bank of Nova Scotia had not made a good-faith effort to comply with the subpoena, that the Bahamian government had not taken action to prevent the bank from complying, and that imposing sanctions against the bank would not result in denial of a constitutionally required forum for litigating a claim the bank possessed.[68]

In the second *Bank of Nova Scotia* case,[69] the United States served a grand jury subpoena on the Miami office of the bank to obtain bank records relating to alleged narcotics offenses. The bank moved to quash the subpoena, claiming it compelled the bank to violate the bank secrecy laws of the Bahamas and the Cayman Islands. The court denied the motion and ordered the bank to produce. When the bank still had not complied after further motions and court orders to produce, the district court found that the bank had not tried to comply with the subpoena in good faith and thus held the bank in contempt. Subsequently, the Bahamas issued an order permitting the bank to produce the documents, but the bank initially failed to produce all the documents sought by the grand jury. After further delay, the documents were produced. When the bank appealed the district court's contempt order and fine, the court of appeals upheld the order. The court, relying on Section 40 of the Restatement, found that the United States' interest in enforcement of the narcotics laws outweighed the interest of the foreign jurisdiction in its secrecy laws. Because the bank voluntarily undertook to do business in different countries, the court viewed the bank's complaints of being caught between conflicting governmental demands unsympathetically. The court reviewed the district court's findings, regarding the bank's lack of good faith in trying to comply with the subpoena, and upheld the sanctions imposed.

The Bank of Nova Scotia was also involved in *United States v. Davis*.[70] There the bank sought to comply with a subpoena of bank records relating to a customer who was involved in a money-laundering scheme, but the customer applied for a preliminary injunction against the bank in a Cayman Islands court. The U.S. court ordered the customer to cease the litigation and compelled his

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[67] The bank relied upon Societe Internationale Pour Participations Industrieles et Commerciales v. Rogers, 357 US 197 (1958), where the failure of the plaintiff to comply with a court order for production of banking records involving a Swiss bank account was held not ground for dismissal of the plaintiff's action.

[68] The court relied upon In re Grand Jury Proceedings (United States v. Field), 532 F2d 404 (5th Cir. 1976), cert. denied, 429 US 940 (1976), where contempt penalties for refusing to testify pursuant to a subpoena were upheld notwithstanding the witness's claim that the testimony would subject him to criminal penalty in his country of residence.

[69] In re Grand Jury Proceedings, (United States v. Bank of Nova Scotia), 740 F2d 817 (11th Cir. 1984), cert. denied, 469 US 1106 (1985).

[70] 767 F2d 1025 (2d Cir. 1985).

consent to the disclosure of the records.[71] The court of appeals affirmed, following a Section 40 analysis that weighted the United States interests strongly.[72]

Federal Internal Revenue and Justice Department officials believe that foreign laws regulating banks and related commercial transactions have provided a haven for hiding billions of dollars of underworld assets in avoidance of federal taxes.[73] Additional authority to compel banks to produce information was given to the Secretary of the Treasury by the Money Laundering Control Act of 1986.

[c] Forfeiture of Property. The Money Laundering Control Act provides expanded forfeiture provisions and makes subject to forfeiture

> (A) Any property, real or personal, which represents the gross receipts a person obtains, directly or indirectly, as a result of a violation of [the money-laundering or monetary transaction violation sections] . . . or which is traceable to such gross receipts.
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> (B) Any property within the jurisdiction of the United States, which represents the proceeds of any offense against a foreign nation involving the manufacture, importation, sale or distribution of a controlled substance . . . within whose jurisdiction such offense or activity would be punishable by death or imprisonment for a term exceeding one year and which would be punishable by imprisonment for a term exceeding one year if such act or activity had occurred within the jurisdiction of the United States.
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> (C) Any coin and currency (or other monetary instrument . . .) or any interest in other property, including any deposit in a financial institution, traceable to such coin or currency involved in a transaction or attempted transaction in violation of section 5313(a) or 5324 of title 31 may be seized

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[71] The constitutionality of compelling consent to the disclosure was upheld against a claim of violation of the fifth amendment prohibition against self-incrimination, because signing the consent form did not amount to testimonial communication. United States v. Guidoni, 732 F2d 814 (11th Cir.), cert. denied, 469 US 932 (1984). But see In re Grand Jury Investigation, 599 F. Supp. 746 (SD Tex. 1984), where the court held that the compulsion did involve testimonial communication in violation of the fifth amendment.

[72] In United States v. Chase Manhattan Bank, 584 F. Supp. 1080 (SDNY 1984), the court upheld a subpoena of records from a Hong Kong branch of Chase. See also Garpeg, Ltd. v. United States, 583 F. Supp. 789 (SDNY 1984) (Chase ordered to produce bank records of corporation that was not itself under investigation by the IRS). The interests of the foreign country in nondisclosure were held to prevail in United States v. First Nat'l Bank, 699 F2d 341 (7th Cir. 1983), which involved an effort by the IRS to collect back taxes. The Section 40 Restatement analysis has been used to uphold discovery orders in civil litigation where production of foreign records has been sought. Graco, Inc. v. Kremlin, Inc., 101 FRD 503 (ND Ill. 1984).

[73] Hearings, United States Senate, Governmental Affairs Subcommittee on Investigations, March 15-16, 1983, reported in 40 Wash. Fin. Rep. (BNA) 567 (Mar. 21, 1983). (The Subcommittee presented a report on these activities entitled "Crime and Secrecy: The Use of Offshore Banks and Companies.")

> and forfeited to the United States Government. No property or interest in property shall be seized or forfeited if the violation is by a domestic financial institution examined by a Federal bank supervisory agency or a financial institution regulated by the Securities and Exchange Commission or a partner, director, officer, or employee thereof.[74]

"Gross receipts" refers to the commission or profit earned on the transaction, and not to the property that may be transferred as part of it.[75] The act does not allow the forfeiture of property owned by persons who have no knowledge of the activity that is the basis for the forfeiture.[76] The act provides procedures for the seizure by the Attorney General or in some cases by the Secretary of the Treasury.[77] Additionally, when a court convicts a person of the money-laundering or monetary transaction provisions, the court may order forfeiture of the gross receipts gained as a result of the offense or traceable to it, as part of the sentence for conviction.[78]

Finally, the act expands the authority for warrantless searches of persons crossing the U.S. border by allowing such searches to determine whether the person crossing the border has complied with the requirements for reporting on the export and import of monetary instruments in 31 USCA § 5316. Failure to file the required report or the filing of an erroneous report under 31 USC § 5316 is ground for forfeiture. This forfeiture includes "a deposit in a financial institution, traceable" to a monetary instrument for which the report was not filed.[79]

[d] Immunity for Reports of Violations. Under the Financial Privacy Act, financial institutions are authorized to notify the United States of information relating to violations of laws without adverse consequences under the act.[80] The Money Laundering Control Act expands this protection. It immunizes the institution, officer, or employee who reports a violation from liability to the customer of the institution for the disclosure, regardless of any state or federal law to the contrary. This protection, however, extends only to "information which may be relevant to a possible violation of any statute or regulation," as defined in the following: "Such information may include only the name or other identifying information concerning any individual or account involved in and the nature of any suspected illegal activity."[81] Further, the act authorizes a court to order a financial institution to delay giving notice to its customer of the receipt

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[74] 18 USC § 981(a)(1) (Supp. IV 1986).

[75] See Special Report, supra note 36, at 49.

[76] 18 USC § 981(a)(2) (Supp. IV 1986).

[77] 18 USC § 981(b) (Supp. IV 1986).

[78] 18 USC § 982(a) (Supp. IV 1986).

[79] 31 USCA § 5317(c) (West Supp. 1987).

[80] 12 USC § 3403(c) (Supp. IV 1986).

[81] 12 USC § 3403(c) (Supp. IV 1986). See discussion at ¶ 13.01[2][c].

of a subpoena or court order relating to a grand jury request for records, notwithstanding the other requirements of the privacy act.[82]

[e] Change in Bank Control. Procedures for approval of changes in the control of regulated financial institutions by the banking regulatory agencies also are affected by the Money Laundering Control Act. Agencies are directed to investigate the persons who are acquiring control, to determine independently the accuracy of certain information submitted regarding these persons, and to prepare a written report of their investigations. In addition, the agencies must provide a period for public comments on the acquisition, and the notice for public comment must identify the persons who will acquire control, "unless the agency determines in writing that such disclosure or solicitation would seriously threaten the safety or soundness of such bank."[83]

¶ 12.02 OTHER CRIMINAL LAWS RELATING TO BANK TRANSACTIONS

Criminal law has an important role in the regulation of the conduct of officers, directors, and employees of financial institutions. Much of the criminal law that controls the activities of those engaged in banking is state law. Each state has laws dealing with embezzlement, forgery, fraud, and so forth. In addition, there are many laws dealing with financial transactions, such as state and federal securities laws, antitrust laws, and antiracketeering laws, to name but a few. As previously noted in the discussion of the federal regulatory scheme, many of the requirements in the federal banking laws are backed up by criminal sanctions if a violation occurs. (See Chapter 9.) Additionally, there are federal statutes that are specially aimed at crimes committed by banks and bank officers or that are committed in the course of financial transactions that involve them. This discussion touches on some of these special federal criminal laws,[84] and in particular, those that have special significance.

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[82] 12 USC § 3413 (1982 & Supp. IV 1986). See ¶ 13.01[2][c].

[83] 12 USC §§ 1817(j)(2), 1730(q)(2) (Supp. IV 1986).

[84] Congressional concern over misconduct by bank insiders is not misplaced. Out of the 594 national banks that failed from 1864 to 1920, 228 (more than one-third) of the failures were attributable to criminal acts. Pratt, Bank Frauds—Their Detection and Prevention 3-4 (2d ed. 1965), (citing 1 Ann. Rep. of the Comptroller of the Currency 183 (1920)). More recently, a House of Representatives study said that misconduct by bank officers was a major factor in about one half of all commercial bank failures and one quarter of all thrift failures from 1980 to 1983. Government Operations Commerce, Consumer and Monetary Affairs Subcommittee, "Federal Response to Criminal Misconduct and Insider Abuse in the Nation's Financial Institutions," H.R. Rep. No. 1137, 98th Cong., 2d Sess. (1984). The comptroller stated to Congress in 1987 that "We know that improper insider transactions are contributing factors in some bank failures; but we also

It should be noted that beyond the specific prohibitions mentioned in the sections that follow, bank officers and others may also be convicted of conspiring to commit an offense against the United States, when any one of the parties involved in the conspiracy takes any action to "effect the object of the conspiracy."[85] Further, any person who "aids, abets, counsels, commands, induces or procures" the commission of any offense against the United States is open to the same punishment as the principal offender.[86]

[1] Bank Bribery

Section 215 of 18 USC makes it a federal felony to bribe a bank officer or employee and for a bank officer or employee to accept a bribe.[87] As part of the Crime Control Act of 1984, Congress amended this section to increase the offense from a misdemeanor to a felony, with correspondingly stiffer penalties, and to enlarge its scope to reach transactions relating to most federally regulated depository institutions. Because the 1984 amendments reached broadly to encompass any person who "directly or indirectly" solicits or receives "anything of value for himself or for any other person or entity" other than the financial institution the person represents, without regard to the intent of the actors, the act created widespread concern in the banking industry that numerous innocent and accepted practices, such as a customer's buying lunch for a bank officer, might now be federal crimes. Congress responded to these concerns with the

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know that the majority of failures are better explained by different factors, including poor management and economic problems. The interrelationship between these factors is often complex, however, and the real impact of each can be difficult to assess accurately. The experience of the Office of the Comptroller of the Currency (OCC) indicates, however, that insider abuse is a significant contributing factor in approximately one third of the national banks that fail, and fraud is a major causative factor in a considerably smaller percentage of the failures." Statement of Robert L. Clarke. Comptroller of the Currency, before the H. R. Subcomm. on Commerce, Consumer, and Monetary Affairs, Comm. on Government Operations 4 (Nov. 19, 1987). See generally Morse, "Bank Insiders and Willful Misapplication Statute," 92 Banking LJ 715 (1975); Buchalter & Allen, "Bank Insider Abuses—When Does the Axe Fall?" 96 Banking LJ 804 (1979).

[85] 18 USC § 371 (1982).

[86] 18 USC § 2 (1982).

[87] 18 USC § 212 (1982) makes it a crime for a bank officer to bribe a bank examiner. Those found guilty may be fined up to $5,000, plus the amount of money given, plus imprisonment up to one year. 18 USC § 213 (1982) makes it an offense for bank examiners to accept gratuities or loans. See Annot., "Construction and Application of 18 USCS § 213 Punishing Acceptance of Loan or Gratuity by Bank Examiner," 19 ALR Fed. 340-342 (1974). Also 18 USC § 1909 (1982) prohibits bank examiners from accepting compensation for performing services for any bank.

Bank Bribery Amendments Act of 1985.[88] Under these amendments, the scope of the act is narrowed to violations committed with a "corrupt" purpose undertaken with "intent to influence or reward" a bank officer or accepted by the officer with a "corrupt" purpose "intending to be influenced or rewarded." The relevant portion of 18 USC § 215(a) (Supp. IV 1986) provides that the following actions are federal crimes:

> Whoever—
> (1) corruptly gives, offers, or promises anything of value to any person, with intent to influence or reward an officer, director, employee, agent, or attorney of a financial institution in connection with any business or transaction of such institution; or
> (2) as an officer, director, employee, agent, or attorney of a financial institution, corruptly solicits or demands for the benefit of any person, or corruptly accepts or agrees to accept anything of value from any person, intending to be influenced or rewarded in connection with any business or transaction of such institution; . . . .[89]

The penalty provisions include a fine of $5,000 or three times the value of the bribe, whichever is greater, and/or five years in prison. When the value of the bribe is not over $100, these penalties are reduced so that the violator may be fined "not more than $1,000 or imprisoned not more than one year, or both."[90]

As noted previously, 18 USC § 215 makes it a crime both for a person to offer or give a bribe and for a bank officer to solicit or accept a bribe. The report of the House Judiciary Committee on the bill explains the relationship between the two parts of the legislation:

> Subsection (a)(2) is directed at the persons whose action is sought to be influenced—an employee, officer, director, agent, or attorney of a financial institution. Subsection (a)(2) makes it an offense for such officials corruptly to seek or accept anything of value from any person if the giving, offering, or promising of that thing of value would be a violation of subsection (a)(1). The use of "corruptly" narrows the current-law offense, which makes any seeking or acceptance criminal, without regard to the intent or purpose of the person seeking or accepting the payment. Subsection (a)(2) also requires

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[88] Pub. L. No. 99-370, 100 Stat. 779 (1986) (codified at 18 USC § 215 (Supp. IV 1986)). See also, Dennis & Chafetz, "The New Bank Bribery Act: A Trap for the Unwary," 102 Banking LJ 316-348 (1985).

[89] "Financial institution" is defined to include banks insured by the FDIC, institutions insured by the FSLIC, credit unions insured by the National Credit Union insurance fund, Federal Home Loan banks and members of the Federal Home Loan Bank System, Federal Land banks, Intermediate Credit banks, Banks for Cooperatives, Production Credit Associations and Federal Land Bank Associations, small business investment companies, bank holding companies, and savings and loan holding companies. 18 USC § 215(b) (Supp. IV 1986).

[90] 18 USC § 215(a) (Supp. IV 1986).

> proof that the giving, offering, or promising of the thing would have violated subsection (a)(1). The latter requirement means that it must be proved that the thing of value was corruptly given, offered, or promised.[91]

The House Committee also defines "corruptly," drawing upon a treatise on federal jury practice and jury instructions. The Committee states:

> The term "corruptly" means that the act is done "voluntantly [sic] and intentionally, and with the bad purpose of accomplishing either an unlawful end or result, or a lawful end or result by some unlawful method or means. The motive to act corruptly is ordinarily a hope or expectation of either financial gain or other benefit to one's self, or some aid or profit or benefit to another."[92]

Bank officers found to have engaged in conduct prohibited by 18 USC § 215 are subject to civil as well as criminal liability, and the bank, its shareholders, or other persons who have sustained damages may recover damages, including punitive damages, from the officer.[93]

The Comptroller of the Currency has issued guidelines to assist officials of financial institutions in complying with the bribery laws.[94] The guidelines encourage national banks to adopt codes of conduct for their employees. The comptroller believes "the legislative history of the 1985 Act makes clear that the guidelines would be relevant to, but not dispositive of any . . . decision by the Department of Justice to initiate prosecution under the Act."[95] The guidelines are intended to permit national banks to identify specific situations in which a bank officer may appropriately accept something of value, and also to permit "case-by-case" review by the bank of other situations through a written disclosure procedure. The comptroller stresses that "bank officials cannot avoid the prohibitions of the 1985 Act by merely reporting to management the acceptance of gifts."

The guidelines are as follows:

> C. Guidelines for Compliance with the Federal Bank Bribery Law
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> The OCC encourages all national banks to adopt internal codes of conduct or written policies or to amend their present codes of conduct to include the provisions suggested in the guidelines. The guidelines relate

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[91] H.R. Rep. No. 335, 99th Cong., 2d Sess. 6, reprinted in 1986 U.S. Code Cong. & Admin. News 1782, 1787.

[92] Id.

[93] 12 USC § 503 (1982); Hometowne Builders, Inc. v. Atlantic Nat'l Bank, 477 F. Supp. 717 (ED Va. 1979).

[94] Comptroller of the Currency, Guidelines for Compliance with the Federal Bribery Law, 52 Fed. Reg. 46,046–46,048 (1987).

[95] Id. at 46,046.

only to the federal bank bribery law ("1985 Act") and do not address other areas of conduct that a national bank may find advisable to cover in its code of conduct. A national bank's code of conduct or policies should be designed to alert bank officials about the 1985 Act, as well as to establish and enforce written policies on acceptable business practices. Consistent with the intent of the 1985 Act to proscribe corrupt activities within financial institutions, the bank's code of conduct should prohibit any employees, officers, directors, agents or attorneys of a national bank from: (1) soliciting for themselves or for a third party (other than the bank itself) anything of value from anyone in return for any business, service or confidential information of the bank and (2) accepting anything of value (other than bona fide salary, wages, fees or other compensation in the usual course of business referred to in the 1985 Act at 18 USC 215(c)) from anyone in connection with the business of the bank, either before or after the transaction is discussed or consummated.

In its code of conduct, a national bank may, however, specify appropriate exceptions to the general prohibition of accepting something of value in connection with bank business. There are a number of instances where a bank official, without risk of corruption or breach of trust, may accept something of value from someone doing or seeking to do business with the bank. The most common examples are the business luncheon or the holiday season gift from a customer. In general, there is no threat of a violation of the statute if the acceptance is based on a family or personal relationship existing independent of any business of the institution; if the benefit is available to the general public under the same conditions on which it is available to the bank official; or if the benefit would be paid for by the bank as a reasonable business expense if not paid for by another party.

Other exceptions to the general prohibition regarding acceptance of things of value in connection with bank business may include:

(a) acceptance of gifts, gratuities, amenities or favors based on obvious family or personal relationships (such as those with the parents, children or spouse of a bank official) when the circumstances make it clear that it is those relationships, rather than the business of the bank concerned, which are the motivating factors;

(b) acceptance of meals, refreshments, travel arrangements or accommodations, or entertainment, all of reasonable value, in the course of a meeting or other occasion, the purpose of which is to hold bona fide business discussions or to foster better business relations, provided that the expense would be paid for by the bank as a reasonable business expense if not paid for by another party (the bank may establish a specific dollar limit for such occasions);

(c) acceptance of loans from other banks or financial institutions on customary terms to finance proper and usual activities of bank officials, such as home mortgage loans, except where prohibited by law;

(d) acceptance of advertising or promotional material of reasonable value such as pens, pencils, note pads, key chains, calendars and similar items;

(e) acceptance of discounts or rebates on merchandise or services that do not exceed those available to other customers;

(f) acceptance of gifts of reasonable value related to commonly recognized events or occasions, such as a promotion, new job, wedding, retirement, Christmas or bar or bat mitzvah (the bank may establish a specific dollar limit for such occasions); or

(g) acceptance of civic, charitable, educational, or religious organizational awards for recognition of service and accomplishment (the bank may establish a specific dollar limit for such occasions).

By adopting a code of conduct with appropriate allowances for such circumstances, a national bank recognizes that acceptance of certain benefits by its officials does not amount to a corrupting influence on the bank's transactions. The policy or code may also provide that, on a case-by-case basis, a national bank may approve of other circumstances, not identified above, in which a bank official accepts something of value in connection with bank business, provided that such approval is made in writing on the basis of a full written disclosure of all relevant facts and is consistent with the bank bribery statute.

In issuing guidance under the statute in the area of business purpose entertainment or gifts, the OCC is not establishing rules about what is reasonable or normal in fixed dollar terms. What is reasonable in one part of the country may appear lavish in another part of the country. A national bank should seek to embody the highest ethical standards in its code of conduct. In doing this, a national bank may establish in its own code of conduct a range of dollar values which cover the various benefits that its officials may receive from those doing or seeking to do business with the bank.

The code of conduct should provide that, if a bank official is offered, or receives something of value beyond what is authorized in the bank's code of conduct or written policy, the official should disclose that fact to an appropriately designated official of the bank. The national bank should keep contemporaneous written reports of such disclosures. An effective reporting and reviewing mechanism should serve to prevent situations that might otherwise lead to implications of corrupt intent or breach of trust and should enable the bank to better protect itself from self-dealing. However, a bank official's full disclosure evidences good faith when such disclosure is made in the context of properly exercised supervision and control. Management should review the disclosures and determine that what has been accepted is reasonable and does not pose a threat to the integrity of the national bank. Thus, individuals cannot avoid the prohibitions of the bank bribery statute by simply reporting to management the acceptance of various gifts.

The OCC recognizes that a serious threat to the integrity of a national bank occurs when its officials become involved in outside business interests or employment that give rise to a conflict of interest. Such conflicts of interest may evolve into corrupt transactions that are covered under the 1985 Act. Accordingly, national banks are encouraged to prohibit, in their

codes of conduct or policies, their officials from self-dealing or otherwise trading on their positions with the bank or accepting from someone doing or seeking to do business with the bank a business opportunity not available to other persons or that is made available because of the official's position with the bank. In this regard, a national bank's code of conduct or policy should require that its officials disclose all potential conflicts of interest, including those in which they have been inadvertently placed because of business or personal relationships with customers, suppliers, business associates or competitors of the bank.[96]

[2] Misapplication of Funds

Any officer, director, agent, employee, or other person connected in any capacity with any bank whose funds are insured by the Federal Deposit Insurance Corporation, which person "embezzles, abstracts, purloins or willfully misapplies" any bank funds (including assets entrusted to the bank's custody), shall be fined up to $5,000 or imprisoned up to five years or both.[97] The purpose of this statute is to preserve and protect the assets of any bank having a federal relationship, that is, any bank that is a member of the Federal Reserve System or whose deposits are federally insured.[98] To prosecute a violation of 18 USC § 656 (1982) successfully, four essential elements must be proven: (1) that the accused was an officer, director, agent, or employee of, or otherwise connected with, a bank; (2) that the bank was federally insured; (3) that the accused willfully misapplied money or funds of said bank; and (4) that the accused acted with intent to injure or defraud the bank.[99]

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[96] Id. at 46,048–46,049.

[97] 18 USC § 656 (1982). If the amount embezzled, abstracted, purloined, or misapplied is less than $100, the penalty cannot exceed $1,000 or one year in jail or both. Id. See also Annotation, "Bank Officers' or Employees' Misapplication of Funds as State Criminal Offense," 34 ALR 4th 547 (1984).

[98] Garrett v. United States, 396 F2d 489 (5th Cir.), cert. denied, 339 US 952 (1968).

[99] United States v. Mann, 517 F2d 259 (5th Cir. 1975), cert. denied, 423 US 1087 (1976); United States v. Landers, 576 F2d 94 (5th Cir. 1978). See also Annot., "Who Is 'Officer, Director, Agent, or Employee' of Bank, or Is 'Connected in Any Capacity' With Bank and Therefore Subject to Prosecution and Punishment For Misapplication of Bank Funds Under 18 U.S.C.S. § 656," 57 ALR Fed. 537 (1982); Annotation, "What Constitutes Willful Misapplication of Bank Funds by Bank Officer or Employee in Violation of 18 U.S.C.S. § 656," 51 ALR Fed. 420 (1981); Note, "Criminal Prosecution of Bank Personnel Under The Misapplication Statute: The Proper Mens Rea Standard For Establishing Intent," 37 Vand. L. Rev. 1397–1419 (1984). Although the language of Section 656 does not specifically include an intent requirement, as did its predecessor (former 12 USC § 592), courts have stated that the Revisor's Notes following Section 656 clearly indicate that elimination of such a showing was not intended. See, e.g., United States v. Beattie, 594 F2d 1327 (9th Cir. 1979).

The statute does not require that an accused be acting in an "official capacity" as an officer or director when funds are misapplied.[100] To fall within the list of persons so prescribed, it is enough that an accused be connected in some capacity with a bank, which connection enables that person to gain access to bank funds.[101] This language reaches beyond those persons who because of their status as bank officers, directors, agents, or employees fall within the literal dictates of the statute, and includes such nonbank personnel as the proof department manager of a service corporation employed to handle the bookkeeping of a federally insured bank[102] and the controlling stockholder of a national bank who had been active in bank affairs.[103]

Persons not within the statutory language of Section 656 may nevertheless be charged with aiding and abetting one who is.[104] To sustain a conviction, it must be shown that the alleged aider and abettor encouraged or participated in the principal's commission of the crime and that the principal is in fact guilty.[105]

It is not necessary for purposes of Section 656 that the willful misapplication of funds results in an actual loss to the bank;[106] the offense is complete immediately upon the act of misapplication with intent to injure or defraud.[107] Indeed, Section 656 may be violated even in instances where the bank involved actually benefits from the misuse of its funds.[108] Injury to the bank is limited to

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[100] United States v. Dreitzler, 577 F2d 539, 547 (9th Cir. 1978), cert. denied, 440 US 921 (1979). Contra, Golden v. United States, 318 F2d 357 (1st Cir. 1963).

[101] United States v. Dreitzler, 577 F2d at 547.

[102] United States v. Edick, 432 F2d 350 (4th Cir. 1970).

[103] Garrett v. United States, 396 F2d 489 (5th Cir.), cert. denied, 339 US 952 (1968).

[104] United States v. Tokoph, 514 F2d 597 (10th Cir. 1975).

[105] Id. at 603. In United States v. Anderson, 709 F2d 563 (9th Cir. 1983), the court held that the government, in order to establish an aiding and abetting violation, must show that (1) a bank employee misapplied bank funds and (2) that the defendant charged with aiding and abetting knew of the bank employee's offense and acted with the intent to further it.

[106] United States v. Tokoph, 514 F2d at 603; United States v. Scheper, 520 F2d 1355 (4th Cir. 1975); United States v. Landers, 576 F2d 94 (5th Cir. 1978). A person cannot be convicted of violating 18 USC § 656 on misapplication of bank funds by an officer of the bank when the funds consist of worthless instruments. Thus, the defendant could not be found in violation for his handling of a check on which the drawer had good defenses and the bank could not claim status as a holder in due course. United States v. Kellerman, 729 F2d 281 (4th Cir. 1984).

[107] "[M]isapplication may be found where it is shown that a bank is deprived of its right to have custody of its funds, that is, its right to make its own decisions as to how the funds are used." United States v. Dreitzler, 577 F2d 539, 546 (9th Cir. 1978), cert. denied, 440 US 921 (1979). See also United States v. Duncan, 598 F2d 839 (4th Cir.), cert. denied, 444 US 871 (1979).

[108] United States v. Caldwell, 544 F2d 691 (4th Cir. 1976).

those losses that are pecuniary in nature, and does not include damage to reputation.[109]

Intent to "injure or defraud" does not require a showing that an accused affirmatively intended to injure or defraud a bank; proof that the defendant acted knowingly and that the natural tendency of such actions might cause injury to the bank is sufficient, regardless of improper motive.[110] There is a split of authority on whether conduct amounting to reckless disregard of the bank's interests, as distinguished from mere indiscretion or foolhardiness, is sufficient to fulfill the intent requirement of Section 656.[111]

For instances in which the actions of an accused either are specifically made illegal by statute (e.g., theft of bank funds) or are made illegal only when committed with intent to injure or defraud (e.g., an officer making a loan to a corporation while knowing that the corporation is a sham), approval of such actions by the bank's board of directors is no defense to the crime of misapplication, as the board has no authority to approve of a crime of fraud on the bank.[112] Similarly, neither is subsequent repayment of the funds to the bank a defense.[113]

Examples of conduct held to violate Section 656 are readily found in circumstances involving the granting of loans. Included are instances in which a bank officer secures a loan for himself or herself[114] or for a third party[115] by

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[109] "While damage to a bank's reputation may eventually result in some deterioration in the bank's financial condition, such loss would be too indirect and speculative and we decline to construe the statute as comprehending it." United States v. Arthur, 544 F2d 730, 736 (4th Cir. 1976).

[110] United States v. Killian, 541 F2d 1156 (5th Cir. 1976); United States v. Schoenhut, 576 F2d 1010 (3d Cir.), cert. denied, 439 US 964 (1978). There is an excellent analysis of the intent requirement in Berger, "Criminal Liability of Bank Directors," 30 Am. J. Comp. L. 537 (1982).

[111] Giragosian v. United States, 349 F2d 166 (1st Cir. 1965); United States v. Schoenhut, 576 F2d at 1024; United States v. Welliver, 601 F2d 203 (5th Cir. 1979). See United States v. Adamson, 665 F2d 649 (5th Cir. 1982), where the court, though finding that reckless disregard was, for purposes of Section 656, the equivalent of "intent to injure or defraud," did so only with "considerable unease." United States v. Adamson, 665 F2d at 656. In a later proceeding in United States v. Adamson, 700 F2d 953 (5th Cir.), cert. denied, 464 US 833 (1983), the court expressly overruled *Welliver* and held that proof of knowledge rather than reckless disregard was required under Section 656.

[112] United States v. Beran, 546 F2d 1316 (8th Cir. 1976), cert. denied, 430 US 916 (1977); Mulloney v. United States, 79 F2d 566 (1st Cir.), cert. denied, 296 US 658 (1935).

[113] United States v. Beran, 546 F2d at 1321; United States v. Acree, 466 F2d 1114 (10th Cir. 1972), cert. denied, 410 US 913 (1973). See also Dodge v. United States, 74 F2d 267 (9th Cir. 1934), where the leaving of a promissory note by defendant in the account of a depositor from which funds were unlawfully withdrawn was held no defense.

[114] United States v. Krepps, 605 F2d 101 (3d Cir. 1979).

[115] United States v. Kennedy, 564 F2d 1329 (9th Cir. 1977), cert. denied, 435 US 944 (1978). In United States v. Shively, 715 F2d 260 (7th Cir. 1983), cert. denied, 465 US 1007 (1984), the court said "it has been held to be a misapplication per se for a bank

lending money to a nominal borrower who then transfers the funds to the intended beneficiary, even when the nominal borrower is financially able to repay the loan and is fully aware of the legal responsibility to do so. Also included are cases in which an officer approves loans in excess of either the officer's credit authority[116] or the customers' maximum borrowing limit[117] without the approval of other bank officers. Officers who grant loans without obtaining sufficient collateral[118] or without securing a binding obligation for repayment,[119] and who subsequently attempt to cover up the transaction, have also been successfully prosecuted.

Other examples of conduct held to violate Section 656[120] include the use of cashier's checks without requiring payment of security,[121] the honoring of overdrafts,[122] participation in check-kiting schemes,[123] the use of interbank deposits to secure preferential treatment on personal loans,[124] the payment of bribes,[125] and the use of bank funds for payment of personal expenses.[126]

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officer or employee to funnel funds to himself by making a bank loan to a third party." See also United States v. Steffen, 641 F2d 591 (8th Cir.), cert. denied, 452 US 943 (1981).

[116] United States v. Hockridge, 573 F2d 752 (2d Cir.), cert. denied, 439 US 821 (1978); United States v. Riebold, 557 F2d 697 (10th Cir.), cert. denied, 434 US 860 (1977).

[117] United States v. Schmidt, 471 F2d 385 (3rd Cir. 1972).

[118] United States v. Moraites, 456 F2d 435 (3d Cir.), cert. denied, 409 US 891 (1972).

[119] United States v. Welliver, 601 F2d 203 (5th Cir. 1979).

[120] See Annot., "What Constitutes Willful Misapplication of Bank Funds by Bank Officer or Employee in Violation of 18 U.S.C.S. § 656," supra note 99.

[121] United States v. Reynolds, 573 F2d 242 (5th Cir. 1978).

[122] United States v. Bevans, 496 F2d 494 (8th Cir. 1974); Swingle v. United States, 389 F2d 220 (10th Cir.), cert. denied, 392 US 928 (1968).

[123] United States v. Giordano, 489 F2d 327 (2d Cir. 1973); United States v. Duncan, 598 F2d 839 (4th Cir.), cert. denied, 444 US 871 (1979) (checks held in bookkeeping department for substantial periods of time and not debited to officer's [account] found to be misapplication even though officer had sufficient funds at bank to cover undebited checks). In Williams v. United States, 458 US 279 (1982), the Supreme Court held that a check kiting scheme did not violate the "false statements" statute, 18 USC § 1014 (1976). This resolved a conflict between the circuits on the question. Compare United States v. Williams, 639 F2d 1311 (5th Cir. 1981), rev'd, 458 US 279 (1982), with United States v. Sher, 657 F2d 28 (3d Cir. 1981), cert. denied, 458 US 1121 (1982). The petitioner in *Williams* also was convicted of misapplication of bank funds under 18 USC § 656 (1976), but the Supreme Court did not review that conviction. Williams v. United States, 458 US at 281 n.2. The *Williams* decision is discussed in ¶ 12.02[3].

[124] United States v. Brookshire, 514 F2d 786 (10th Cir. 1975); United States v. Larson, 581 F2d 664 (7th Cir. 1978).

[125] United States v. Arthur, 544 F2d 730 (4th Cir. 1976).

[126] United States v. Gordon, 410 F2d 1121 (5th Cir.), cert. dismissed, 396 US 938 (1969); United States v. Bevans, 496 F2d 494 (8th Cir. 1974).

Officers, agents, or employees of any savings and loan association, credit union, or other institution whose accounts are insured either by the Federal Savings and Loan Insurance Corporation, by the administrator of the National Credit Union Administration, or by any small business investment company[127] are also prohibited from embezzling, abstracting, or willfully misapplying the funds of their institution.[128] Violators may be fined up to $5,000 and imprisoned for no more than five years.[129]

[3] False Entries

18 USC § 1005 was enacted to proscribe criminal conduct outside the reach of the willful misapplication language of Section 656.[130] Structurally, Section 1005 is divided into three paragraphs, each one stating a separate and distinct crime.[131] These are (1) the unauthorized issuance or circulation of bank notes by an officer, director, agent, or employee of any bank whose deposits are insured by the FDIC; (2) the unauthorized creation, issuance, or assignment of any bank obligation (including certificates of deposit, drafts, orders, bills of exchange, acceptances, notes, debentures, and bonds), mortgage, judgment or decree; and (3) the making of any false entry in "any book, report or statement" by any person with intent to injure or defraud such bank, its officers, or examiners. Punishment may not exceed $5,000 or five years' imprisonment, or both.[132]

By their terms, the first two paragraphs of the section do not literally require proof that the accused intended to injure or defraud the bank. However, the courts that have specifically addressed the issue of whether such intent should be required have split on the question. The Fifth Circuit has ruled that the statute itself is too plain on its face to require judicial construction.[133] The Ninth Circuit, on the other hand, drawing support from the reviser's notes to both Sections 656 and 1005, has concluded that Congress did not intend to delete the

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[127] Officers, agents, and employees of any bank within the Farm Credit System, as well as those of several Federal agencies, are also included in the statute. 18 USC § 657 (1982).

[128] 18 USC § 657 (1982).

[129] Id. If the amount involved is less than $100, a fine of up to $1,000 and imprisonment for up to one year will be imposed. Id.

[130] United States v. Michael, 456 F. Supp. 335 (DNJ 1978) aff'd mem., 605 F2d 1198 (3d Cir. 1979), cert. denied, 444 US 1032 (1980). Sections 656, 334, and 1005 all have their congressional roots in former 12 USC § 592, which was subdivided into its present form in 1948 mainly for purposes of clarification. 18 USC § 656 Note (1982).

[131] Harrison v. United States, 279 F2d 19, 23 (5th Cir.), cert. denied, 364 US 864 (1960).

[132] 18 USC § 1005 (1982). For civil liability, see 12 USC § 503 (1982).

[133] *Harrison*, 279 F2d 19, 23. In United States v. Tidwell, 559 F2d 262 (5th Cir. 1977), cert. denied, 435 US 942 (1978), the court specifically declined to overrule the *Harrison* decision.

intent requirement from the first and second paragraphs.[134] The Supreme Court has yet to hear the issue.

The majority of cases under Section 1005 have dealt with the false entry paragraph (Paragraph 3). This paragraph is not limited to a defined class of persons, as is Paragraph 1, but applies to any person who has access to bank records or who otherwise causes their falsification.[135] The requisite intent to injure or defraud may be proven by establishing that the natural tendency of the accused's knowledge and voluntary actions may have been to injure the bank.[136] Such intent may be inferred from the circumstances surrounding the transaction and the nature of the accused's conduct.[137] Where a mere clerical mistake is involved[138] or where the accused, without knowledge, verifies a report containing a false entry made by another,[139] no violation has occurred, as the requisite intent is lacking. Further, it is not necessary that the accused personally write the false entry, nor that the accused specifically direct another to insert false information; it is enough that the accused set into motion actions that necessarily result in the making of a false entry in the normal course of business.[140] Such entries may be the result of either an actual misstatement or an omission of material information.[141] It is not an offense under the statute to make an entry that correctly reflects a transaction, even where the transaction is part of a fraudulent or otherwise illegal scheme.[142]

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[134] United States v. Pollack, 503 F2d 87, 90–92 (9th Cir. 1974).

[135] Edick v. United States, 432 F2d 350, 352 (4th Cir. 1970).

[136] United States v. Southers, 583 F2d 1302, 1305 (5th Cir. 1978). In contrast to Section 656 (see ¶ 12.02[2]), a mere finding of recklessness would not in itself suffice to establish the element of intent required for § 1005. United States v. Adamson, 700 F2d 953, cert. denied, 464 US 833 (1983). United States v. McAnally, 666 F2d 1116 (7th Cir. 1981).

[137] United States v. Adamson, 700 F2d 953, cert. denied, 464 US 833 (1983); United States v. Bevans, 496 F2d 494 (8th Cir. 1974).

[138] United States v. Allen, 47 F 696 (D. Ill. 1880).

[139] United States v. Herrig, 204 F 124 (D. Mont. 1913); United States v. Booker, 98 F 291 (DND 1899); contra *Allen*, 47 F at 699. See Cochran v. United States, 157 US 286 (1895) where willful ignorance or gross negligence by one verifying a report would serve to fulfill the intent requirements. See also Annotation, 81 L. Ed. 498 (1937).

[140] United States v. Giles, 300 US 41 (1937); United States v. Krepps, 605 F2d 101 (3d Cir. 1979). See Morse v. United States, 174 F 539 (2d Cir.), cert. denied, 215 US 605 (1909), where a bank vice-president who supplied false information on slips of paper later copied in routine course of business was found guilty of false entry.

[141] United States v. Krepps, 605 F2d 101 (3d Cir. 1979) (bank officer's failure to reveal himself as the beneficiary of several loans made to other parties was held to violate § 1005, even though the named debtors were financially capable of repaying the loans).

[142] United States v. Erickson, 601 F2d 296 (7th Cir.), cert. denied, 444 US 979 (1979).

The language "any book, report or statement" is not limited to a bank's formal financial accounting records or journals[143] or to those reports that are required to be made by law,[144] but it is broad enough to cover any document or record of a bank that would reveal pertinent information for its officers or directors.[145] Thus, information recorded in loan files, loan applications,[146] minutes of board meetings,[147] and interoffice memos[148] falls within the ambit of Section 1005. As the statute prohibits making false entries, not false reports, each false entry constitutes a separate and distinct crime, even though several may be made in the same statement or report.[149]

Examples of conduct held violative of Section 1005 include the making of false entries in reports to the Comptroller of the Currency,[150] the FDIC,[151] and Federal Reserve banks,[152] and in bank statements and records, for the purpose of deceiving bank officers and examiners.[153] The withholding of deposit slips from a bank's bookkeeping department, causing false balances to be recorded in ledgers of the bank, was found to constitute a false entry,[154] as was the conduct of an officer who directed the withholding of checks drawn on insufficient funds, thereby concealing their status as overdrafts and allowing the officer to omit reporting them to the bank's board of directors.[155]

As Section 656 has its counterpart for institutions insured by the FSLIC, so does Section 1005. Section 1006, an amalgam of eleven prior sections scattered throughout the U.S. Code,[156] makes it a criminal violation for any officer, agent, or employee of any institution insured by the FSLIC or the National Credit Union Administration, with intent to defraud, to draw any order or bill of

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[143] United States v. Foster, 566 F2d 1045 (6th Cir. 1977), cert. denied, 435 US 917 (1978).

[144] Harper v. United States, 170 F 385 (8th Cir. 1909).

[145] Foster, 566 F2d at 1052.

[146] See United States v. Docherty, 468 F2d 989, 992 (2d Cir. 1972).

[147] Lewis v. United States, 22 F2d 760 (8th Cir. 1927), aff'd, 279 US 63 (1929); United States v. Steffen, 641 F2d 591 (8th Cir.), cert. denied, 452 US 943 (1981).

[148] United States v. Kennedy, 564 F2d 1329 (9th Cir. 1977), cert. denied, 435 US 944 (1978).

[149] Bower v. United States, 296 F 694 (9th Cir.), cert. denied, 266 US 601 (1924).

[150] Phillips v. United States, 201 F 259 (8th Cir. 1912); United States v. Reece, 280 F 913 (D. Idaho 1922).

[151] Crenshaw v. United States, 116 F2d 737 (6th Cir. 1940), cert. denied, 312 US 703 (1941), cert. dismissed per stipulation, 314 US 702 (1941).

[152] Hiatt v. United States, 4 F2d 374 (7th Cir. 1924), cert. denied, 268 US 704 (1925).

[153] United States v. Stokes, 471 F2d 1318 (5th Cir. 1973); United States v. Mayr, 487 F2d 67 (5th Cir. 1973), cert. denied, 417 US 914 (1974).

[154] United States v. Giles, 300 US 41 (1937).

[155] United States v. Bevans, 496 F2d 494 (8th Cir. 1974).

[156] See 18 USC § 1006 Notes.

exchange or issue any note, debenture, bond, or other obligation without proper authority, or make any false entry in any book, report, or statement.

This section further contains a conflict of interest provision whereby officers, agents, and employees are prohibited from receiving, either directly or indirectly and with intent to defraud, any profit or benefit from any transaction entered into by the institution. Typical of such conduct would be an officer's willful failure to disclose a common business interest between the officer and a loan applicant where the proceeds of such loan are used to further the common business venture.[157] Penalties of up to $10,000 and five years' imprisonment are provided.[158] Section 1014 makes it a federal offense for anyone to make any false statement or report knowingly, or to willfully overvalue any property, for the "purposes of influencing in any way" the action of a federally insured institution with regard to a loan, application, or other financial transaction.[159] It is not necessary that the false statement be an application in and of itself[160] or that it appear in a formal application.[161] Further, the statute is not limited by its language to written statements, but covers those made orally as well.[162]

In *Williams v. United States*,[163] the U.S. Supreme Court, in a case described as a classic check-kiting situation, concluded that 18 USC § 1014 did not apply to petitioner's scheme of writing checks drawn on insufficient funds. The majority of the Court, in a split decision, reasoned that passing a check drawn on insufficient funds did not constitute the making of a false statement under Section 1014 because "a check is not a factual assertion at all, and therefore cannot be characterized as 'true' or 'false.'"[164] Under the Uniform Commercial Code, a check is an order to the drawee to pay, which carries the obligation of the drawer to pay the amount of the check on dishonor and notice of dishonor.[165] For

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[157] See, e.g., United States v. Hykel, 461 F2d 721 (3d Cir. 1972), where a savings and loan officer concealed his interest in a mortgage loan made to his coventurers; the loan enabled the coventurers to purchase property upon which the success of the venture depended.

[158] 18 USC § 1006 (1982).

[159] See Annot., "Validity, Construction, and Application of 18 U.S.C.S. § 1014 and Similar Predecessor Statutes Making it Federal Offense to Make False Statement or Report, or to Overvalue Property, for Purpose of Influencing Action of Federal or Federal-Affiliated Lending Institutions or Agencies," 16 ALR Fed. 825 (1973).

[160] United States v. Zwego, 657 F2d 248 (10th Cir. 1981) cert. denied, 455 US 919 (1982). Signing a promissory note which contains a statement that the purpose of the loan was "business expense and marketing operation" when the signer knew that statement was false constitutes the making of a false statement within the meaning of the statute. United States v. Shively, 715 F2d 260 (7th Cir. 1983), 465 US 1007 (1984).

[161] *Zwego*, 657 F2d at 250.

[162] Id.; United States v. Sackett, 598 F2d 739 (2d Cir. 1979).

[163] 458 US 279 (1982).

[164] Id. at 286.

[165] Id. at 285. See UCC §§ 3-104, 3-413.

similar reasons, the Court concluded that the use of the checks to obtain credit from the banks in which the checks were deposited did not amount to an "overvaluing" of property or security, because "the value legally placed upon them [the checks] was the value of petitioner's obligation," which literally was equal to the face amount of the checks.[166] Conceding that the basis for its decision was a technical one, the majority supported its view on the grounds that Congress could not have intended to enact a national bad check law.[167]

As the focus of Section 1014 is on the accused's intent (i.e., on whether the false statement was made for the purpose of influencing the actions of an insured bank) and not on the statement's impact, it is of no consequence whether the false statement actually influenced the bank in any of its decisions.[168] Those convicted are subject to fines of up to $5,000 and imprisonment for up to two years.[169] Accordingly, it would seem that there is some overlap between Sections 1014 and 1005, as both prohibit the making of false statements by any person, regardless of bank affiliation. Case law shows that both officers and nonofficers

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[166] 458 US at 285–86.

[167] Id. at 287. A person who forges documents in order to obtain payment from a bank under a letter of credit is guilty of making false statements in violation of 18 USC § 1014. Unlike the *Williams* case, forgery of documents to show delivery of goods that, in fact, were never delivered constituted a misrepresentation. United States v. Tucker, 773 F2d 136 (7th Cir. 1985), cert. denied, 106 S. Ct. 3337 (1986). *Williams* also was distinguished in United States v. Worthington, 822 F2d 315 (2d Cir. 1987), where the court held that a check drawn on a fictitious bank account could be a false statement for purposes of 18 USC § 1001. For additional cases interpreting the false statements statute, see United States v. Price, 763 F2d 640 (4th Cir. 1985); United States v. Davis, 730 F2d 669 (11th Cir. 1984); United States v. Shaid, 730 F2d 225 (5th Cir.), cert. denied, 469 US 844 (1984).

[168] United States v. Philips, 606 F2d 884 (9th Cir. 1979), cert. denied, 444 US 1024 (1980); United States v. Johnson, 585 F2d 119 (5th Cir. 1978) (defendant convicted under Section 1014 even though the institution, by participating in scheme along with defendant, knew of the statement's falsity and was therefore not influenced by it). See also United States v. Baity, 489 F2d 256 (5th Cir. 1973), where defendant who submitted a false financial statement only after the loan was made was found guilty of violating § 1014. As to whether the statement must be "material," compare United States v. Kernodle, 367 F. Supp. 844 (MDNC 1973) (no requirement), with United States v. Henderson, 645 F2d 569 (7th Cir.), cert. denied, 454 US 850 (1981). "Actual reliance by the savings and loan on a defendant's false statements is not necessary for a conviction under Section 1014. It is enough that the statement has the capacity of influencing the savings and loan." United States v. Glassey, 715 F2d 352, 353 (7th Cir.), cert. dismissed, 464 US 1032 (1983). See also United States v. Braverman, 522 F2d 218, 223 (7th Cir.), cert. denied, 423 US 985 (1975).

[169] 18 USC § 1014 (1982). For civil liability see 12 USC § 503 (1982).

Section 1014 has been applied to conspiracies to commit bank fraud by submitting false credit card slips for collection. United States v. DeBiasi, 712 F2d 785 (2d Cir.), cert. denied, 464 US 962 (1983).

have been prosecuted under each for substantially similar conduct.[170] However, Section 1014 seems to be directed at officers, directors, and employees only when they aid and abet others in the falsification of loan or credit applications,[171] or when they apply for loans from other financial institutions on behalf of their own banks.[172]

While the prohibitions of Section 1014 are intended to protect federally insured financial institutions, those of 18 USC §§ 1007 and 1008 are directed at protecting the insuring institutions themselves. Sections 1007 and 1008 prohibit the making of any knowingly false statements to the FDIC and FSLIC, respectively, for the purpose of "influencing in any way" the actions of the respective corporation. Violations of either statute are punishable by a fine of not more than $5,000 and up to two years in jail.[173]

Under Section 493, it is also a violation of federal law for any bank employee to pass or to attempt to pass what the employee knows to be a false, forged, counterfeited, or altered note, instrument, or document.[174] The statute further outlaws the act of forging, counterfeiting, or altering notes, obligations, or instruments in imitation of those issued by savings and loan associations, credit unions, and various government agencies and corporations.[175] Violators are subject to fines of not more than $10,000 or imprisonment for not more than five years, or both.[176]

[4] Other Federal Criminal Offenses

Under 12 USC § 92a, the Comptroller of the Currency may grant national banks the right to exercise the same fiduciary powers allowed state banks under the laws of the state in which the national bank is located. These powers include acting as trustees, executors, administrators, assignees, receivers, and guardians of estates.[177] It is a federal offense for any bank officer, director, or employee to make or receive a loan utilizing any funds held in trust under one of the above

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[170] For example, cf. United States v. Kernodle, 367 F. Supp. 844 (MDNC 1973) (officers of bank were indicted under Section 1014 for misrepresenting financial status of loan applicant on a financial statement), with United States v. Docherty, 468 F2d 989 (an individual borrower was indicted under Section 1005 for making a false entry on a loan application).

[171] See United States v. Griffen, 579 F2d 1104 (8th Cir.), cert. denied, 439 US 981 (1978); United States v. Kramer, 500 F2d 1185 (10th Cir. 1974).

[172] United States v. Gleason, 616 F2d 2 (2d Cir. 1979), cert. denied, 444 US 1082, cert. denied, 445 US 931 (1980) (two separate appeals).

[173] 18 USC §§ 1007, 1008 (1982).

[174] 18 USC § 493 (1982).

[175] Id.

[176] Id.

[177] 12 USC § 92a(a) (1982).

powers.[178] Violators are subject to fines of not more than $5,000, imprisonment for not more than five years, or both.[179]

Any insured bank that is in default on any assessment due to the FDIC is prohibited from paying any dividends on its capital stock or interest on its capital notes or debentures while it remains in default.[180] The officers or directors who participate in the making of such payments can be fined up to $1,000 or imprisoned for up to one year, or both.[181]

Under authority of the National Banking Act,[182] national banks were entitled to issue circulating notes upon depositing with the Treasurer of the United States certain bonds of the United States.[183] These circulating notes constituted part of the national currency, and they continue to be recognized by law as legal tender for all debts, taxes, duties, and dues.[184] National banks no longer issue circulating notes, but much of the legislation relating to them remains on the statute books, including 18 USC § 334, which provides that any officer of a national bank who countersigns or delivers any circulating note except in strict accordance with the National Banking Act, as amended, shall be fined not more than $5,000 or imprisoned not more than five years, or both.[185]

In the event that a national emergency is proclaimed by the president of the United States, the Secretary of the Treasury (with the approval of the president) is authorized to regulate, limit, or restrict the transaction of any banking business by any member bank of the Federal Reserve.[186] Any officer, director, or employee of any member bank who transacts any business in violation of such regulations is subject to a fine of not more than $10,000 and imprisonment for a term not exceeding ten years.[187]

Under 18 USC § 1004 it is unlawful for a bank officer or employee to certify a check before the amount of that check has been regularly deposited in the bank by the check's drawer. A fine of up to $5,000 and imprisonment for up to five

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[178] 12 USC § 92a(h) (1982).

[179] Id. For criminal statutes dealing with bankruptcy, trustees, etc., see 18 USC §§ 151–155 (1982).

[180] 12 USC § 1828(b) (1982).

[181] Id.

[182] Act of June 3, 1864, ch. 106, 13 Stat. 99 (codified in scattered Sections of 12, 31 USC); 12 USC § 38 (1982).

[183] 12 USC §§ 101, 101a (1982).

[184] 31 USC § 5103 (1982). At the close of 1960 there were $55 million in national bank notes still in circulation; however, when unfit for further circulation they are cancelled and retired upon receipt at the United States Treasury. Mann, Encyclopedia of Banking and Finance (rev. ed. Garcia 1962).

[185] 18 USC § 334 (1982).

[186] 12 USC § 95(a) (1982).

[187] Id.

years may be imposed.[188] Although no intent to injure or defraud the bank is required,[189] the officer's certification must be done willfully and with actual knowledge that the drawer has insufficient funds on deposit at the bank.[190]

To avoid any likelihood of public confusion over government sponsorship or association, 18 USC § 709 prohibits the misleading use by any person or business entity of any words or names, or their combination, already in use by a federal agency. For instance, unless permitted by federal law (e.g., the institution receives a federal charter), the use of such words as "national," "federal," "United States," "reserve," and "Deposit Insurance" as part of a business name is prohibited, as is the use of the names of any of the governmental agencies, such as the FDIC, the National Credit Union, or the Federal Home Loan bank.[191] It is also an offense to falsely advertise or represent that an entity is a member of the Federal Reserve System, or that its deposits are insured by the FDIC, when such is not in fact the case.[192] Any officer or member of any entity in violation of this statute who participates or knowingly acquiesces in the use of such words or names may be fined up to $1,000 and imprisoned for up to one year.[193]

Under 2 USC § 441b, it is unlawful for any national bank to make, or for any officer or director of any national bank to consent to the making of, a "contribution or expenditure" in connection with any election to any political office.[194] "Contributions or expenditures" have been defined to include any direct or indirect payment, distribution, advance, deposit, gift of money, service, or loan, although many loans made in accordance with applicable banking laws and in the ordinary course of business are not prohibited.[195] Upon a determination by

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[188] 18 USC § 1004 (1982). Such actions may also subject the bank to a forfeiture of its membership in the Federal Reserve System. 12 USC §§ 331, 501 (1982).

[189] United States v. Giordano, 489 F2d 327 (2d Cir. 1973).

[190] Id. at 332 n.5.

[191] 18 USC § 709 (1982 & Supp. III 1985). See United States v. U.S.I.A. Homes, Inc., 409 F. Supp. 483 (EDNY 1976), where the court enjoined the use of the initials "U.S.I.A." upon the government's contention that such use would tend to lead the public to believe that the private corporation employing such initials was associated with the United States Information Agency, although the use of such initials was not specifically prohibited by Section 709.

[192] 18 USC § 709 (1982 & Supp. III 1985).

[193] Id.

[194] 2 USC § 441b (1982).

[195] 2 USC § 441b(2) (1982). See Federal Election Comm'n v. Lance, 635 F2d 1132 (5th Cir.), cert. denied, 453 US 917 (1981), where an FEC subpoena against Bert Lance for production of documents, issued during an investigation of suspected violations of Section 441b involving extensions of credit by two national banks to the Bert Lance for Governor Campaign Committee, was enforced by the Fifth Circuit en banc. The national banks allegedly permitted the campaign committee repeatedly to overdraw its accounts to pay campaign expenses and required no interest on these amounts upon repayment. See also ¶¶ 9.02, 13.02.

the Federal Election Commission that a contribution or expenditure has been knowingly and willfully made in violation of Section 441b, the commission may refer the violation to the Department of Justice for criminal proceedings.[196] If the expenditure or contribution in the aggregate exceeds $2,000 during one calendar year, the violator shall be fined not more than $25,000 or 300 percent of any contribution, or imprisoned for not more than one year, or both.[197]

Title 18 Section 1009 punishes any willfully and knowingly made statement or rumor that is both untrue and derogatory to the financial standing of the FSLIC by imposing a fine of not more than $1,000 or imprisonment of not more than one year, or both.[198]

The federal wire fraud statute (18 USC § 1343) has been applied to transactions involving bank cards.[199] This statute makes it an offense punishable by a fine of not more than $1,000 or up to five years imprisonment, or both, to transmit fraudulently "by means of wire, radio or television communications in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of" carrying out a fraudulent scheme. This statute applies to anyone who engages in such fraudulent activities, not just to bank officers and employees, and obviously has a broad application to electronic funds transfers and similar banking transactions involving computer links.

In a case involving a merchant who violated the statute in a bank card scheme, the Second Circuit held that the offense stated by the statute only required that the interstate communication be "reasonably foreseeable" by the actor. The merchant did not have to personally initiate the interstate communication, nor even have actual knowledge of it. In the court's view, it was reasonably foreseeable that "when a defendant requests authorization with respect to a card not issued by a local bank, an interstate computer check is likely to follow."[200]

In *Bell v. United States*,[201] the Supreme Court was called upon to interpret 18 USC § 2113(b) of the Bank Robbery Act, which makes it a federal crime when one "takes and carries away, with intent to steal or purloin, any property or money or any other thing of value exceeding $100 belonging to, or in the care, custody, control, management, or possession of any bank, credit union, or any savings and loan association." Petitioner managed to steal money from the bank through false pretenses by altering an indorsement on a check that was not his

[196] 2 USC § 437g(a)(5)(C) (1982).

[197] 2 USC § 437g(d)(1)(A) (1982).

[198] 18 USC § 1009 (1982).

[199] 18 USC § 1343 (1982). United States v. DeBiasi, 712 F2d 785 (2d Cir.), cert. denied, 464 US 962 (1983). The case also involved conviction for fraudulent use of credit cards under 15 USC § 1644(a), and conspiracy to commit bank fraud under 18 USC § 1014.

[200] United States v. Muni, 668 F2d 87, 90 (2d Cir. 1981).

[201] 462 US 356 (1983).

own, depositing the check into his account at the bank, and then closing the account to withdraw the amount of the account. The Court held that the statute was not limited to common law larceny; it also covers the crime of obtaining money under false pretenses. In rejecting the argument that Congress intended to limit the scope of the act to the common law definition of larceny, the Court said, "We cannot believe that Congress wished to limit the scope of the amended Act's coverage, and thus limit its remedial purpose, on the basis of an arcane and artificial distinction more suited to the social conditions of 18th century England than the needs of 20th century America."[202]

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[202] Id. at 362.

13

Bank Customer Privacy and Other Bank Activities Subject to Special Regulation

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¶ 13.01 PRIVACY FOR FINANCIAL RECORDS OF BANK CUSTOMERS

Banks must exercise caution in divulging records of the financial transactions of their customers. The circumstances under which information may be given to federal agencies is affected by federal statutes. Additionally, there are state laws that affect the disclosure of information.[1] Furthermore, rights of

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[1] See Nichols v. Council on Judicial Complaints, 615 P2d 280 (Okla. 1980); People v. Muchmore, 92 Cal. App. 3d 32, 154 Cal. Rptr. 488 (1979) (upholding a state statute that allowed police to obtain bank records without notifying the customer in advance). See

privacy may exist under state law doctrines or may flow from express or implied contractual relationships.[2]

[1] Rights to Privacy Under the U.S. Constitution

The Supreme Court considered the extent to which the Fourth and Fifth Amendments to the Constitution establish a privacy right for banks and their customers in *California Bankers Association v. Shultz*[3] and *United States v. Miller*.[4]

Shultz upheld the constitutionality of the Bank Secrecy Act. The act, described in Chapter 12, requires banks to keep records of certain financial transactions. The Court first held that no due process right of the bank was violated by the requirement that the banks maintain records of transactions involving their customers.[5] The Court further found that nothing in the record-keeping requirements violated any Fourth Amendment privacy right of the banks, since the record-keeping provisions did not require that any information be disclosed to the government.[6] The bank had no privilege against compulsory self-incrimination, because that privilege does not protect a corporation. The depositor-customers of the bank could not claim a violation of their privilege against self-incrimination as a result of the record-keeping requirements, because the records involved were created by a third party—the bank—and not by the customer.[7]

The constitutionality of the reporting requirements of the act was also challenged in *Shultz*. The Court first upheld the constitutionality of the foreign reporting requirements. Because of the special concern of Congress that foreign currency transactions and financial institutions were being used to circumvent the enforcement of the laws of the United States, the Court found the act to be reasonable and consistent with the Fourth Amendment.[8] The Court also considered the domestic reporting requirements, concluding that there was no violation of any Fourth Amendment rights of the bank. Much of the information required by the act to be kept was information the bank already possessed or

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generally Note, "Banking Disclosures, Financial Privacy and the Public Interest," 6 Ann. Rev. Banking L. 391–411 (1987); Nicewander, "Financial Record Privacy—What Are and What Should Be the Rights of the Customer of a Depositary Institution," 16 St. Mary's LJ 601–637 (1985); Rasor, "Controlling Government Access to Personal Financial Records," 25 Washburn LJ 417–436 (1986).

[2] See Suburban Trust Co. v. Waller, 44 Md. App. 335, 408 A2d 758 (1979).

[3] 416 US 21 (1974).

[4] 425 US 435 (1976).

[5] 416 US at 50.

[6] Id. at 52.

[7] Id. at 55.

[8] Id. at 63.

would acquire in its own interests.[9] The Court did not find it appropriate to decide whether the domestic reporting requirements violated any Fourth or Fifth Amendment rights of the customer.[10] The Court also found it premature to resolve whether any Fifth Amendment rights of the customers could be violated by the foreign reporting requirements.[11]

The constitutionality of *disclosure* of records pertaining to customer transactions was faced by the Supreme Court in *United States v. Miller.*[12] In *Miller,* the Court held that the Fourth Amendment did not give a bank customer a right of privacy in records held by his bank. The United States had served subpoenas upon Miller's bank ordering the production of records involving transactions Miller had made. Without informing Miller, the bank produced the records. Subsequently, Miller was indicted, and copies of checks obtained with the subpoenas were used during the trial. Miller claimed that the procedures followed by the government to obtain his records to establish a criminal charge against him violated his Fourth Amendment right to be free from unreasonable searches and seizures. Miller further argued, and the lower court agreed, that the subpoenas used to obtain the records were invalid. The Supreme Court held that regardless of whether the subpoenas were validly issued, Miller had no privacy right to the records held by the bank. As the Court said, "All of the documents obtained, including financial statements and deposit slips, contain only information voluntarily conveyed to the banks and exposed to their employees in the ordinary course of business." The Court also said, "The depositor takes the risk, in revealing his affairs to another, that the information will be conveyed by that person to the Government."[13] Even though the information is given to the bank on a promise of confidentiality, there is no privacy right protected by the Fourth Amendment.[14]

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[9] Id. at 67.

[10] Id. at 69, 75.

[11] Id. at 72.

[12] 425 US 435 (1976).

[13] Id. at 442–443.

[14] Id. In a footnote, the Court suggested that a different case might be presented if the bank had turned over the records in response to only an informal oral request rather than the legal compulsion of a subpoena. Id. at 445 n.7.

The Supreme Court held in 1984 that the target of an investigation by the Securities and Exchange Commission (SEC) was not entitled to notification when the SEC issued subpoenas to third parties pursuant to an investigation of matters that could implicate the target. In the course of that opinion, the Court said that the Financial Privacy Act granted customers of banks and similar financial institutions certain rights to be notified that would not otherwise exist as a matter of due process, or as a matter of general congressional intent from the legislation dealing with the SEC. The Court noted that the Financial Privacy Act carefully limits the circumstances under which persons are entitled to protection. The Court also concluded that there was no basis for an entitlement to notice as a matter of general standards in conducting an administrative investigation using a sub-

[2] Right to Financial Privacy Act

[a] Conditions of Disclosure. After the *Miller* decision, Congress moved to limit the circumstances under which federal agencies may obtain financial records. The Right to Financial Privacy Act of 1978[15] limits federal agency access to the financial records of customers of financial institutions. The act applies to all financial institutions—banks, savings and loan associations, credit card issuers, credit unions, consumer finance agencies, and trust companies. The financial institution may disclose information about its customers to the federal agency only when one of the five following conditions has been satisfied:

1. The customer has authorized disclosure;
2. The records are disclosed in response to an administrative summons or subpoena;
3. The records are disclosed in response to a search warrant;
4. The records are disclosed in response to a judicial subpoena; or
5. The records are disclosed in response to a written request that follows the procedure set forth in the Right to Financial Privacy Act.[16]

The act establishes specific procedures that the requesting agency must follow in order to obtain information under any of the previously listed methods.[17] Advance notice must be given to the customer unless a delay of notice order is granted upon application of the government authority or unless an emergency exists.[18] The act also establishes a procedure by which the customer may challenge the request for the information.[19]

The Right to Financial Privacy Act does not apply to the disclosure of information under the following eleven circumstances:[20]

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poena, because there would be administrative difficulties in administering such a notification requirement, as there would be the danger that legitimate investigations would be impeded by giving notice to persons who might have a motivation to thwart the investigation. SEC v. O'Brien, 467 US 735 (1984). See generally, McTaggert v. United States, 570 F. Supp. 547 (ED Mich. 1983).

[15] 12 USC §§ 3401–3422 (1982 & Supp. IV 1986).

[16] 12 USC § 3402 (1982).

[17] 12 USC §§ 3404–3408 (1982). A court has found that a customer is entitled to a copy of the administrative subpoena issued for his records. Although proper notice is given of a subpoena, the customer is entitled to further notice of additional oral requests for additional information. Hunt v. SEC, 520 F. Supp. 580 (ND Tex. 1981).

[18] 12 USC § 3409 (1982).

[19] 12 USC § 3410 (1982). For cases raising issues of the legitimacy of the demand for the information, see Donovan v. U.A. Local 38 Plumbers & Pipe Trades Pension Funds, 569 F. Supp. 1488 (ND Cal. 1983); Pennington v. Donovan, 574 F. Supp. 708 (SD Tex. 1983); United States v. Wilson, 571 F. Supp. 1417 (SDNY 1983); Grafstrom v. SEC, 532 F. Supp. 1023 (SDNY 1982); Hancock v. Marshall, 86 FRD 209 (DDC 1980).

[20] See 12 USC § 3413 (1982 & Supp. IV 1986).

1. When the records disclosed are not identified as belonging to or derived from the records of a particular customer;
2. When the disclosure is pursuant to examination or supervision by the appropriate regulatory agency;
3. When the disclosure is authorized by the Internal Revenue Code;[21]
4. When a federal statute otherwise requires the disclosure;
5. When the government agency has authority under the Federal Rules of Civil or Criminal Procedure or comparable rules of other courts in connection with litigation to which the government agency and the customer are parties;[22]
6. When the disclosure is pursuant to the order of an administrative law judge in a proceeding in which both the agency and the customer are parties;
7. When the government agency is requesting for law enforcement purposes only the name, address, account number, and type of account of any customer or group of customers associated with a financial transaction or class of transactions or with a foreign country;
8. When the financial records are sought in connection with an investigation of the financial institution itself;
9. When the agency seeks the information in administering a government loan or loan insurance program;
10. When the disclosure is in response to a subpoena or court order that is part of a grand jury proceeding, and in such cases a court may order the institution not to notify its customer of the subpoena or order in accordance with procedures set in the act;[23]
11. When the disclosure is of the customer's name and address to the Treasury, the Social Security Administration, or the Railroad Retirement Board for the purpose of administering the Social Security Act and Railroad Retirement Act.[24]

Disclosures made under the last four circumstances, items 8, 9, 10, and 11, are subject to additional restrictions limiting the use of the information.[25]

[b] Special Circumstances and Procedures. There are special safeguards for financial information about a customer obtained by a grand jury under a sub-

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[21] See United States v. MacKay, 608 F2d 830 (10th Cir. 1979).

[22] See Clayton Brokerage Co. v. Clement, 87 FRD 569 (D. Md. 1980).

[23] 12 USC § 3413(i) (Supp. IV 1986).

[24] 12 USC § 3413(k) (Supp. IV 1986). The financial institution is barred from redisclosing the request and the information contained in it. Id.

[25] 12 USC § 3413(h) (1982).

poena to the institution.[26] The information may be used only for the specified purposes of "considering whether to issue an indictment or presentment by that grand jury, or of prosecuting a crime for which that indictment or presentment is issued, or for a purpose authorized by rule 6(e) of the Federal Rules of Criminal Procedure; . . . ."[27] If not so used, the records must be returned or destroyed. The custody of the records must be controlled by the government. Further, the records "shall be returned and actually presented to the grand jury." This clause has sparked judicial consideration of to whom the institution may give the records.[28]

Additionally, there are special procedures for financial records obtained by the Federal Bureau of Investigation (FBI) for counterintelligence purposes.[29] The director of the FBI must certify in writing to the financial institution that the records are sought for such a purpose and "that there are specific and articulable facts giving reason to believe that the customer or entity whose records are sought is a foreign power or an agent of a foreign power" as defined in the Foreign Intelligence Surveillance Act of 1978.[30] The Attorney General of the United States must establish guidelines for the use of such information, and the Attorney General must report periodically to designated congressional bodies.[31] The financial institution may not disclose that the FBI either sought or obtained the information.[32]

[c] Scope and Operation of Act. The Right to Financial Privacy Act extends only to records of those who qualify as "customers." Under the definitions, a customer can only be an individual or a partnership of five or fewer individuals and their authorized representatives.[33] The act also specifies that the financial institution must be acting for such a person or providing a service or acting as a fiduciary "in relation to an account maintained in the person's name . . . ."[34] A

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[26] 12 USC § 3420 (1982).

[27] 12 USC § 3420(2) (1982). In United States v. Theron, 116 FRD 58 (D. Kan. 1987), the court authorized the bankruptcy trustee of a bankrupt corporation to obtain access to financial records obtained by a grand jury of a bankrupt corporation and the individual defendants who once controlled the corporation, so that the trustee in bankruptcy could trace allegedly fraudulent transfers of the corporation. However, corporations are not persons protected under the financial privacy act.

[28] In In re Castiglione, 587 F. Supp. 1210 (ED Cal. 1984), the court said it was improper to give the records to the agents who served the subpoena on the institution. But a different view of the statute was expressed in United States v. Kington, 801 F2d 733 (5th Cir. 1986), cert. denied, 107 S. Ct. 1888 (1987); United States v. Residence Located at 218 3d Street, 622 F. Supp. 908 (WD Wis. 1985).

[29] 12 USC § 3414(a)(5) (Supp. IV 1986).

[30] 12 USC § 3414(a)(5)(A) (Supp. IV 1986).

[31] 12 USC §§ 3414(a)(5)(B), 3414(a)(5)(C) (Supp. IV 1986).

[32] 12 USC § 3414(a)(5)(D) (Supp. IV 1986).

[33] 12 USC §§ 3401(4), 3401(5) (Supp. IV 1986).

[34] 12 USC § 3401(5) (Supp. IV 1986).

corporation is not a customer protected by the act.[35]

Amendments to the act in 1986 offer a limited immunity to information that a financial institution reports regarding violations of law. But this immunity is limited in its scope. It applies only to information that consists of "the name or other identifying information concerning any individual or account involved in and the nature of any suspected illegal activity."[36] The statute says, "Nothing in this chapter shall preclude any financial institution, or any officer, . . . or agent of a financial institution, from notifying a Government authority that such institution, or officer, . . . or agent has information which may be relevant to a possible violation of any statute or regulation."[37] As the statute uses the words "may be relevant," there should be room for recognizing the need for reasonable discretion by the institution in supplying information to authorities, although it is not certain that a violation in fact has occurred. When the bank supplies the information protected by the statute, it is immunized from liability under any state statute, constitution, or other law or regulation.[38]

When records are obtained by a government agency under the act or as "otherwise provided by law," the agency must pay the financial institution assembling the records.[39] The Board of Governors of the Federal Reserve System has the authority to establish the rates and conditions for payment.[40] Further, any agency or financial institution that violates the Right to Financial Privacy Act is subject to a civil penalty of $100 plus any actual damages, punitive damages when the violation is willful or intentional, and the reasonable attorney fees of any successful complainant.[41]

The Right to Financial Privacy Act only limits access to information by federal agencies.[42] A court has held that the act preempts state regulation of disclosure of bank records.[43]

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[35] Spa Flying Serv., Inc. v. United States, 724 F2d 95 (8th Cir. 1984). See Donovan v. U.A. Local 38 Plumbers & Pipe Trades Pension Funds, supra note 19; Donovan v. Nat'l Bank, 696 F2d 678 (9th Cir. 1983).

[36] 12 USC § 3403(c) (Supp. IV 1986).

[37] Id.

[38] Id. See Nikrasch v. State, 698 SW2d 443 (Tex. Ct. App. 1985), which found that a bank did not violate the act by giving police information about a customer who leased a safe deposit box.

[39] 12 USC § 3415 (1982). The act does not entitle the bank to reimbursement when it is the target of the investigation. In re Grand Jury Proceedings, 636 F2d 81 (5th Cir. 1981). The institution is not entitled to reimbursement for producing records of those not protected as customers under the act. Pittsburgh Nat'l Bank v. United States, 771 F2d 73 (3d Cir. 1985).

[40] 12 USC § 3415 (1982).

[41] 12 USC § 3417(a) (1982).

[42] See Nichols v. Council on Judicial Complaints, 615 P2d 280 (Okla. 1980); Doe v. Board of Professional Responsibility, 717 F2d 1424 (DC Cir. 1983).

[43] McGloshen v. USDA, 480 F. Supp. 247 (WD Ky. 1979) (a state statute requiring

[d] Privacy Act of 1974. All federal agencies must comply with the Privacy Act of 1974.[44] Thus, this act imposes an additional layer of requirements for the federal regulatory agencies but not for most depository institutions, as they would not be federal agencies.[45]

Under the 1974 Privacy Act, all federal agencies are limited in the extent to which they can disclose any record of an individual maintained by that agency.[46] Unless the individual consents in writing, a court order is required, or the disclosure must fall within one of the limited exceptions provided in the statute.[47] The agencies must maintain an accurate accounting of each disclosure made.[48] Upon request, an individual may gain access to the records of any agency that pertain to that individual.[49] A procedure is provided by which the individual may request a revision of records that he or she believes are not "accurate, relevant, timely, or complete."[50]

Each agency that maintains records on individuals may maintain in its records only such information as is "relevant and necessary" to accomplish a purpose of the agency as required by statute or executive order of the president.[51] The agency must publish annually in the *Federal Register* a notice describing its system of record keeping.[52] Further, it has a duty to "make reasonable efforts to assure that such records are accurate, complete, timely, and relevant for agency purposes" whenever it gives out information about an individual to another person.[53] The agency must attempt to notify an individual whose records are obtained under compulsory legal process.[54] The agency also must adopt rules that establish methods by which an individual may obtain access to the record,

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ten days' advance notice to the customer held displaced by federal law). See also SEC v. First Tennessee Bank N.A., 445 F. Supp. 1341 (WD Tenn. 1978) (state privacy statute does not apply to federal agencies); In re East Nat'l Bank, 517 F. Supp. 1061 (D. Colo. 1981) (there is no cause of action against bank under state privacy laws if the procedures of the act are followed in giving appropriate notice to customer).

[44] 5 USC § 552a (1982 & Supp. IV 1986). See also Annot., "What Are Reports Prepared or Used by 'Agency Responsible for the Regulation or Supervision of Financial Institutions,' Within Freedom of Information Act (5 USCS § 522(6)(8))," 48 ALR Fed. 814 (1980).

[45] 5 USC § 552(f) (Supp. IV 1986).

[46] 5 USC § 552a (1982 & Supp. IV 1986).

[47] 5 USC § 552a(b) (1982 & Supp. IV 1986).

[48] 5 USC § 552a(c) (1982).

[49] 5 USC § 552a(d) (1982).

[50] 5 USC § 552a(d)(2)(B) (1982).

[51] 5 USC § 552a(e) (1982).

[52] 5 USC § 552a(e)(4) (1982).

[53] 5 USC § 552a(e)(6) (1982).

[54] 5 USC § 552a(e)(8) (1982).

request an amendment to it, and appeal adverse determinations on any request for amendment.[55]

[3] Privacy Rights Under Other Laws

State judicial decisions sometimes regard bank customers as having rights of confidentiality in their financial transactions with banks because the banker is viewed as having a special relationship with the customer, similar to that of a trustee or fiduciary. Other decisions have suggested occasions when it may be appropriate to recognize an implied contract right to confidentiality as part of the banker-customer relationship.

An Oklahoma court held that a bank could be held liable to its customer when the bank's loan officer disclosed confidential financial investment information to the spouses of top company officers who then used the information to acquire the investment property.[56] The case involved a real estate transaction. A customer of the bank disclosed information about the property, including its attractive price, in seeking a loan from the bank to finance the investment. The loan officer turned down the loan, but informed the officers' spouses of the property at a cocktail party. They then purchased the real estate. Referring to the bank's own practices of cultivating public confidence and trust, the court held that the "bank's relationship to a loan applicant implicitly imposes the duty to keep the contents of loan applications confidential." Although the court said that the loan application was an arm's-length transaction and not a fiduciary relationship, it also said that the bank should pursue a policy of fair dealing and evenhandedness, which would prevent it from using its advantageous position to acquire knowledge of confidential financial information from its customers to the customers' detriment. Moreover, the bank could not be excused on the ground that the loan officer's disclosure was outside the scope of his employment, because the officer had a specific duty to exercise care in safeguarding the information given to him.

In *Barnett Bank of W. Fla. v. Hooper*,[57] the Florida Supreme Court ruled that a bank's duty to disclose information to a customer with whom the bank has a fiduciary relationship outweighed a duty of confidentiality toward another customer. In this case, the bank knew that the second customer had been check kiting, and decided to dishonor checks drawn by that customer against insufficient funds. However, the bank also approved a loan to the first customer, a loan that was used for an investment with the second customer, deposited in the

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[55] 5 USC § 552a(f) (1982).

[56] Djowharzadeh v. City Nat'l Bank & Trust Co., 646 P2d 616 (Okla. Ct. App. 1982). See also Peterson v. Idaho First Nat'l Bank, 83 Idaho 578, 367 P2d 284 (1961).

[57] 498 So2d 923 (Fla. 1986).

second customer's account, and then applied by the bank to eliminate overdrafts in that customer's account. The court said:

> Accordingly, we find that where a bank becomes involved in a transaction with a customer with whom it has established a relationship of trust and confidence, and it is a transaction from which the bank is likely to benefit at the customer's expense, the bank may be found to have assumed a duty to disclose facts material to the transaction, peculiarly within its knowledge, and not otherwise available to the customer. Where the bank defends its breach of duty on the ground that it owes a conflicting duty of confidentiality to a second customer, the jury is entitled to weigh the one duty against the other.[58]

The dissent argued that no duty of trust and confidence had been established with the first customer.

State constitutions may be the basis for privacy rights that are more extensive than those found in the U.S. Constitution. Thus, an appellate court in Illinois has held that there is a constitutional right under the Illinois Constitution to privacy in one's bank records.[59] The defendant in this case sought to have suppressed in a criminal case evidence obtained from her bank records pursuant to a subpoena issued to the bank of which she did not have notice. The court held that the Illinois Constitution had a provision that went beyond the U.S. Constitution, which provision protected against "invasions of privacy." In the court's view, this justified finding a right of privacy in bank records notwithstanding the contrary decision by the U.S. Supreme Court.

> We believe that it is reasonable for our citizens to expect that their bank records will be protected from disclosure because in the course of bank dealings, a depositor reveals many aspects of her personal affairs, opinion, habit and association which provide a current biography of her activity. Such a biography should not be subject to an unreasonable seizure by the state government. Furthermore, we reject the idea set out in *Miller* that a citizen waives any legitimate expectation in her financial records when she resorts to the banking system. Since it is virtually impossible to participate in the economic life of contemporary society without maintaining an account at the bank, opening a bank account is not entirely volitional and should not be seen as conduct which constitutes a waiver of an expectation of privacy.

The court then held that the right of privacy was not invaded because the issuance of the subpoena was reasonable.[60] Other states have also found privacy rights in their constitutions.[61]

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[58] Id. at 925.

[59] People v. Jackson, 116 Ill. App. 3d 430, 452 NE2d 85 (1983).

[60] Id. at 434, 452 NE2d at 89.

[61] See People v. Chapman, 36 Cal. 3d 98, 679 P2d 62, 201 Cal. Rptr. 628 (1984);

In *In re The Knoxville News-Sentinel Co.*,[62] the court found that a district court did not abuse its discretion when it entered a protective order to prevent the public disclosure of personal and financial information of a bank's customers, information that was revealed in exhibits in a lawsuit between the bank and the Federal Deposit Insurance Corporation. Concluding that there was a privacy interest in bank records, based on the policies contained in the Bank Privacy Act, on the provisions of other federal laws and regulations, such as the Freedom of Information Act (which contains an exemption for financial records held by officials who supervise financial institutions), and on confidentiality rules of the financial regulatory agencies, the court said, "Viewed together, these statutory and regulatory provisions clearly indicate Congress' intention that the banking records of individuals be kept in strict confidence. The privacy interests embodied in those provisions identify a compelling government interest in preserving the secrecy of personal financial records."[63]

¶ 13.02 REGULATION OF POLITICAL ACTIVITIES

Federal law limits the extent to which banks and other financial institutions may participate in political activities and make political contributions. Federally chartered financial institutions, such as national banks and federal savings and loan associations, generally are prohibited from making any contribution or expenditure with respect to election to a political office.[64] The definition of "contribution or expenditure" is broad. It includes any "direct or indirect" payment, loan, service, or other thing of value to any candidate, campaign committee, or political party in connection with an election.[65] It does not include loans made "in accordance with the applicable banking laws and regulations and in the ordinary course of business" by a national or state bank.[66]

Charnes v. DiGiacomo, 486 Pa. 32, 403 A2d 1283 (1979), cert. denied, 444 US 1032 (1980); Burrows v. Superior Court, 13 Cal. 3d 238, 529 P2d 590, 18 Cal. Rptr. 166 (1974). See also Annot., "Rights and Remedies of Financial Institution Customer in Relation to Subpoena Duces Tecum Exception to General Prohibitions of State Right to Financial Privacy Statute," 43 ALR4th 1157 (1986); Note, "A Right to Privacy in Bank Records: The Colorado Supreme Court Rejects *United States v. Miller*," 52 U. Colo. L. Rev. 529 (1981).

[62] 723 F2d 470 (6th Cir. 1983). But cf. Sharyland Water Supply Corp. v. Block, 755 F2d 397 (5th Cir.), cert. denied, 471 US 1137 (1985) (financial data submitted by borrower to government lending agency was not confidential under the Freedom of Information Act).

[63] In re The Knoxville News-Sentinel Co., 723 F2d 470, 477 (6th Cir. 1983).

[64] 2 USC § 441b(a) (1982).

[65] 2 USC § 441b(b)(2) (1982).

[66] Id.

The Federal Election Commission advises that the prohibitions of the act extend to political advertising, the purchase of political dinner tickets, the purchase of advertisements in political literature, and similar contributions. The Federal Election Commission has exclusive jurisdiction with respect to the civil enforcement of these provisions of the federal law.[67] The commission may issue advisory opinions. Further, any opinions given by the bank regulatory agencies would not be binding upon the commission.

Corporations organized under state law also are subject to some of the provisions of this federal law, but only as applied to federal elections.[68] Thus, state chartered depository institutions are subject to the law to a limited extent while federal institutions are subject to broader limitations. The Federal Election Commission has issued an advisory opinion that a subsidiary corporation, such as a service corporation, of a federally chartered savings and loan association would not be subject to the prohibitions of the act that apply to federally chartered institutions if the subsidiary were a state-organized corporation. The subsidiary corporation would have to be a distinct legal entity with a legitimate business function separate from the parent institution that would not be acting as an agent of the parent.[69] Such a state corporation, of course, still would be subject to the prohibitions of the act with respect to federal elections.

¶ 13.03 ANTICOMPETITIVE CONDUCT

[1] Antitrust Regulation

The antitrust laws are an important part of banking regulation. The scope of the antitrust laws is broad, and the application of the antitrust laws to banking is extensive. It is not possible to summarize the impact of this body of law in this brief section except in a very general way. The relevant antitrust laws for banks include the Sherman Act,[70] the Clayton Act,[71] the Bank Merger Act,[72] the Bank Holding Company Act,[73] the Federal Trade Commission Act,[74] and other stat-

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[67] 2 USC § 437c(b)(1) (1982).

[68] 2 USC § 441b(a) (1982).

[69] 1 Fed. Election Comp. Fin. Guide (CCH) Advisory Opinion, ¶ 5, 464 (Mar. 13, 1980).

[70] 15 USC §§ 1–7 (1982).

[71] 15 USC §§ 12–27 (1982 & Supp. IV 1986).

[72] 12 USC § 1828(c) (1982).

[73] 12 USC §§ 1841–1850 (1982 & Supp. IV 1986). See also Annot., "Denial by Board of Governors of Federal Reserve System of Application for Bank Merger or Acquisition on Monopolization or Anticompetitive Grounds Under § 3(c) of Bank Holding Company Act of 1956," 71 ALR Fed. 438 (1985).

[74] 15 USC §§ 41–58 (1982 & Supp. IV 1986).

utes. An extensive body of judicial decisions exists to interpret this legislation.

In brief, the Sherman Act penalizes both accomplished and attempted monopolization and its concomitant activities of price-fixing, boycott, division of sales territories, and others. Bankers must take great care to avoid cooperative agreements with competitors (whether in clearinghouse agreements or otherwise) that might give even the appearance of violating the price-fixing constraints of the Sherman Act. Under the act, such violations can be prosecuted as criminal offenses.[75]

The Clayton Act is directed against incipient monopoly and unfair trade practices such as tie-in sales and price discrimination directed to that end. It has been noted that routine and traditional bank practices take on a rather different character when viewed in light of the antitrust laws, and that practices such as compensating balances[76] and prime rates[77] become questionable under antitrust scrutiny.

The application of the Clayton Act to bank mergers and holding company acquisitions was established in the celebrated *Philadelphia National Bank*[78] decision in 1963. The Supreme Court held that Section 7 of the Clayton Act applied to bank mergers and that neither the federal scheme of regulation of banking nor the enactment of the Bank Merger Act immunized banks from the application of the antitrust laws. In holding that Section 7 applied, the Court rejected a broad definition[79] of the relevant market that would be affected by the reduction of competition between the merging banks. In decisions since that time, the Court refined its analysis of the competitive effects of bank mergers.[80]

Antitrust concerns are also evident in both the Bank Merger and Bank Holding Company Acts, which forbid acquisitions resulting in a monopoly (a Sherman Act violation) or which "substantially . . . lessen competition . . . unless . . . the anticompetitive effects . . . are clearly outweighed in the public interest by

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[75] United States v. Hunterdon County Trust Co., 1962 Trade Cas. (CCH) ¶ 70,263. It has been held that banks may cooperate to oppose a new charter without incurring antitrust liability. Central Bank v. Clayton Bank, 424 F. Supp. 163 (ED Mo. 1976), aff'd, 553 F2d 102 (8th Cir. 1977), cert. denied, 443 US 910 (1977).

[76] See Austin & Solomon, "The Antitrust Implications of Compensating Balances," 89 Banking LJ 675 (1972).

[77] See Nadler, "Compensating Balances and the Prime at Twilight," Harv. Bus. Rev. (Jan.–Feb. 1972).

[78] United States v. Philadelphia Nat'l Bank, 374 US 321 (1963).

[79] Id. at 360–361.

[80] See United States v. Third National Bank, 390 US 171 (1968); United States v. Phillipsburg Nat'l Bank, 399 US 350 (1970). In United States v. Marine Bancorporation, 418 US 602 (1974), the Court referred to the *local* nature of banking activities in analyzing the relevant geographic market. In a recent decision, a federal court upheld a wider geographic area as the relevant market because of the rural nature of the area involved. Wyoming Bancorporation v. Board of Governors, 729 F2d 687 (10th Cir. 1984).

the probable effect of the transaction in meeting the convenience and needs of the community to be served."[81]

At one time, the banking regulatory agencies did not regard thrift institutions as significant competitors of banks and thus did not include them in their analysis of the extent to which mergers of banks might reduce competition for banking services. In 1982, the Board of Governors took the position that "even though thrift institutions hold a substantial amount of the market's savings deposits and make a large number of the market's consumer loans, these institutions are insignificant competitors in the provisions of demand deposit services and commercial loans."[82]

On March 31, 1983, the Board of Governors of the Federal Reserve System announced a change in position. In its view, as a result of the Garn-St Germain Act, "thrift institutions have become, or at least have the potential to become, major competitors of commercial banks not only in the provision of consumer banking services but also in the provision of commercial lending services." Subsequently, in approving a merger between First Tennessee National Corporation with Mountain Financial Company, another bank holding company, the Board of Governors said it would take into account potential competition from thrift institutions in determining the competitive effects of the merger. The Board stated that in this case, thrift institutions provided "an alternative for consumer banking services" in the relevant banking market and that "the presence of thrift institutions and the competitive influence they exert in this market should be given considerable weight even though the thrift institutions are not presently exercising their recently expanded commercial lending powers to any significant extent."[83]

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[81] 12 USC §§ 1828(c)(5), 1842(c) (1982).

[82] See [Jan.-June] Wash. Fin. Rep. (BNA) No. 13, at A-18 (Mar. 29, 1982).

[83] 69 Fed. Reserve Bull. 298 (1983). The Comptroller of the Currency recognized the relevance of competition from thrifts in 1982 when he approved a merger between the Hartford National Bank and the Connecticut National Bank. The comptroller's opinion is described in [Jan.-June] 15 Wash. Fin. Rep. (BNA) No. 14, at A-9 (Apr. 5, 1982). The comptroller gave weight to competition from thrift institutions in approving a merger of First & Merchants Nat'l Bank into the Virginia Nat'l Bank. 41 Wash. Fin. Rep. (BNA) No. 21, at 814 (Nov. 28, 1983).

For a general discussion of the extent to which competition from thrift institutions should be considered in appraising the competitive effects of mergers between banks, see Note, "The Line of Commerce for Commercial Bank Mergers: A Product-Oriented Redefinition," 96 Harv. L. Rev. 907 (1983). See also Alcaly & Nelson, "Will Including Thrifts in the Banking Market Affect Mergers?", 97 Banking LJ 346 (1980); Friedlander & Slayton, "Determination of the Relevant Product Market in Bank Mergers: A Time for Reassessment?" 36 Bus. Law. 1537 (1981); Via, "Commercial Banking as the 'Line of Commerce' in Bank Amalgamations: A Reexamination." 99 Banking LJ 326 (1982). Additional merger cases where the Federal Reserve Board gave weight to competition from thrift institutions involve the formation of a bank holding company, Texas East

Although the U.S. Supreme Court has said that commercial banking provides a cluster of products and services that in combination constitute a market unique to commercial banks, and although the Court has rejected a wider product market definition that would include thrift institutions, the Court's actions were taken before the dramatic restructuring of the financial services industry by the Garn-St Germain Depository Institutions Act of 1982 and other federal legislation.[84] The Court left open the possibility that the structure of the banking industry might change so that the Court might reasonably include other institutions in the definition of the relevant market.[85] Lower court decisions have indicated that it is appropriate to give some weight to competition from thrift institutions in evaluating bank mergers.[86]

[2] Unfair Trade Practices

Banks are affected by the Federal Trade Commission Act,[87] which bans unfair and deceptive trade practices and gives the FTC power to adopt rules to prevent such practices. The FTC cannot exercise enforcement authority over banks and savings and loan institutions that are under the regulatory jurisdiction of the federal banking agencies.[88] However, the Board of Governors of the Federal Reserve System and the Federal Home Loan Bank Board have the authority to adopt regulations for banks and savings and loan associations to control "unfair or deceptive practices."[89] Moreover, when the FTC adopts a rule of this nature, the Board of Governors and the FHLBB must promulgate "substantially similar regulations" unless these bodies find the practices are not "unfair or deceptive" or, as to banks, the Board of Governors finds that adoption of the regulation would "seriously conflict with essential monetary and payment systems policies" of the Board.[90]

Under the statute, the FTC adopted regulations requiring certain sellers and creditors to place on consumer paper a legend that preserves the defenses of the

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BanCorp., Inc., 41 Wash. Fin. Rep. (BNA) No. 6, at 203 (Aug. 8, 1983); the acquisition by General Bank Shares Corp. of an Illinois bank, 41 Wash. Fin. Rep. (BNA) No. 10, at 357 (Sept. 12, 1983); the acquisition of Easton Nat'l Bank and Trust Co., by Merchants Bancorp., Inc., 41 Wash. Fin. Rep. (BNA) No. 17, at 668 (Oct. 31, 1983).

[84] See United States v. Philadelphia Nat'l Bank, 374 US 321 (1963); United States v. Connecticut Nat'l Bank, 418 US 656 (1974). See also United States v. Phillipsburg Nat'l Bank, 399 US 350 (1970).

[85] See United States v. Connecticut Nat'l Bank, 418 US 656 (1974).

[86] United States v. First Nat'l State Bancorporation. 499 F. Supp. 793 (DNJ 1980); United States v. Zions Utah Bancorporation, No. C-79-0769-A (D. Utah Aug. 21, 1980).

[87] 15 USC §§ 41-58 (1982 & Supp. IV 1986).

[88] 15 USC § 45(a)(2) (1982).

[89] 15 USC § 57a(f)(1) (1982).

[90] Id.

consumer. This legend prevents any holder of the paper, including a bank, from having the special rights of a holder-in-due-course.[91] The FTC Act also is the basis for a rule governing credit practices, which the banking regulatory agencies enforce. This rule deals with matters such as confessions of judgment, waivers of exemption, assignments of wages, security interest in household goods, and obligations to cosigners.[92]

Specific statutes apply to banks to deal with other aspects of competitive practices, such as management interlocks, tying arrangements, holding companies, regulatory approval of consolidations and mergers, and securities transactions.[93]

[3] Consolidations and Mergers

Consolidations and mergers of banks are subject to the regulatory authority of the federal banking agencies when a national bank, a member bank of the Federal Reserve System, or an institution insured by the Federal Deposit Insurance Corporation is involved. In general, the federal banking agency with regulatory authority is that agency that normally has authority over the successor institution. When there is a consolidation or merger involving a national bank, which consolidation or merger results in a national bank, the prior approval of the Comptroller of the Currency must be obtained.[94] When the merger or consolidation results in a state member bank, the Board of Governors must approve the transaction.[95] When the surviving bank is to be a nonmember insured bank, approval of the FDIC is necessary.[96] When any insured bank merges with a noninsured bank or institution, the FDIC must grant prior approval.[97] A consolidation that occurs through the creation of a bank holding company or through the acquisition of a bank by a bank holding company must have approval of the Federal Reserve Board, as discussed in Chapter 5.

Before the federal regulatory agency concerned may approve a consolidation or merger, it must consider the financial resources of the institutions concerned, as well as "the convenience and needs of the community to be served."[98] In addition, the agency is directed not to approve any consolidation or merger that would have a monopoly effect or that would substantially lessen

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[91] See ¶ 16.06[1]. For a discussion of the regulations regarding this legend, see ¶ 16.06.

[92] 12 CFR §§ 227.11–227.16 (1987). For a discussion of the credit practices rule, see ¶ 26.05.

[93] The statutes that deal with the practices listed are discussed at ¶¶ 5.02, 8.01, 9.02, 13.03.

[94] 12 USC §§ 215, 215a (1982).

[95] 12 USC § 1828(c)(2)(B) (1982).

[96] 12 USC § 1828(c)(2)(C) (1982).

[97] 12 USC § 1828(c)(1)(A) (1982).

[98] 12 USC § 1828(c)(5) (1982).

competition.[99] Unless an emergency exists, the federal banking agency must give notice of the proposed transaction[100] prior to granting approval and must request a report from the Attorney General on the competitive factors involved in the transaction.[101] The federal statutes contain provisions designed to protect the rights of dissenting shareholders.

The congressional entrusting of responsibility to the comptroller for approving mergers between national banks has been held to preclude a federal court from passing on the validity of the merger under the National Bank Act before the comptroller had an opportunity to evaluate the merger.[102]

A series of cases in the Supreme Court and lower federal courts has established a framework for deciding when a bank has standing to challenge a merger or acquisition that it believes will adversely affect it competitively. This framework consists of a two-pronged test. Firstly, the complaining bank must show that the challenged action "has caused . . . injury in fact, economic or otherwise." Secondly, the test requires that "the interest said to be protected by the complainant is arguably within the zone of interest to be protected or regulated by the statute or constitutional guarantee in question."[103]

These standing rules were important in a case in which the Comptroller of the Currency approved the acquisition of a weak bank as an emergency measure.

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[99] Id. Congress gave the Federal Reserve Board a similar mandate when the Board considers mergers, acquisitions, and consolidations under the Bank Holding Company Act. 12 USC § 1842(c) (1982). In Mercantile Tex. Corp. v. Board of Governors, 638 F2d 1255 (5th Cir. 1981), the court held the statutory direction to consider community convenience and needs was not a license to the Board to consider "undefined anti-competitive factors." 638 F2d at 1262. See also Washington Mut. Sav. v. FDIC, 482 F2d 459 (9th Cir. 1973); Republic of Tex. Corp. v. Board of Governors, 649 F2d 1026 (5th Cir. 1981).

[100] 12 USC § 1828(c)(3) (1982).

[101] 12 USC § 1828(c)(6) (1982). The Bank Merger Act gives the Attorney General thirty days to prepare a report on the competitive factors involved in the merger unless an emergency exists that requires earlier action. Absent the declaration of an emergency, the merger may not be consummated until the thirty days have elapsed. Id. The act also provides that any action based upon the antitrust laws against such a merger must be brought within the same time periods and that the "commencement of such an action shall stay the effectiveness of the agency's approval unless the court shall otherwise specifically order." 12 USC § 1828(c)(7) (1982). The automatic stay does not apply to actions filed by private parties. It applies only to actions brought by the Attorney General of the United States. Vial v. First Commerce Crop., 564 F. Supp. 650 (ED La. 1983), appeal dismissed without opinion, 725 F2d 674 (5th Cir. 1984).

[102] Nehring v. First DeKalb Bancshares, Inc., 692 F2d 1138 (7th Cir. 1982) (dissenting minority stockholder not entitled to challenge the plan for distributing shares of the merged company to prior stockholders until the merger is evaluated by the Comptroller of the Currency).

[103] Association of Data Processing Serv. Orgs. Inc. v. Camp, 397 US 150, 152–153 (1970); Arnold Tours v. Camp, 400 US 45 (1970); Investment Co. Inst. v. Camp, 401 US 617 (1971).

The plaintiff, who was a competing bank, complained that the acquisition had produced for it a new and larger competitor because the acquired bank would now be operated as a branch office of a larger banking system. The court agreed that the new affiliation represented "a change in the competitive configuration" of the banking community and so caused economic injury in fact to the plaintiff. There was more than the continuation of existing competition.[104] But in considering the second prong of the standing test, the court refused to let the plaintiff challenge the comptroller's determination of an emergency, because the procedures established for making such a finding were not designed to protect the interests of competitor banks.[105] Similarly, the court found that there was no standing to challenge compliance with the state emergency branch banking law, because, unlike ordinary branch banking restrictions, the emergency statutes did not create an interest enforceable by competitor banks.

When a bank holding company acquires a bank, approval of the Federal Reserve Board must be obtained. On the other hand, the Comptroller of the Currency has jurisdiction to approve the acquisition of a bank by a national bank. In *Marshall & Ilsley Corp. v. Heimann*,[106] a national bank that was controlled by a bank holding company acquired another bank. It was argued that the acquisition was unlawful because it had to be approved by the Board of Governors of the Federal Reserve System under the Bank Holding Company Act, and the approval of the Board had not been obtained. Plaintiffs argued that the court should pierce the corporate veil and treat the acquisition as in effect an acquisition by a bank holding company, requiring approval of the Board of Governors. The court held that the comptroller did not have authority to decide whether the Bank Holding Company Act has been violated. Therefore, the need for Board approval could not be decided in the case before the court. Plaintiffs had to take it to the Board.[107]

The Garn-St Germain Depository Institutions Act of 1982 and its subsequent amendments substantially expand the authority of the FDIC to arrange mergers. The act gives the FDIC authority to approve "extraordinary acquisitions" of failing institutions by out-of-state financial institutions and also gives the agency authority to approve acquiring institutions that are different from the failing institutions.[108]

Bank mergers and consolidations are also subject to the antitrust laws and

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[104] Marshall & Ilsley Corp. v. Heimann, 652 F2d 685, 692 (7th Cir. 1981), cert. denied, 455 U.S. 981 (1982).

[105] Id. at 694.

[106] 652 F2d 685 (7th Cir. 1981), cert. denied, 455 US 981 (1982).

[107] Id. at 699–700.

[108] The interstate and interindustry consolidations are discussed at ¶ 6.05. The acquisition of thrift institutions by bank holding companies is discussed at ¶ 6.06. See ¶ 10.03[2].

rules governing interference with competition.[109] Even though a merger has been approved by the banking regulatory authorities, such approval will not immunize the institutions involved from prosecution for violation of these laws. Banks also may become affiliated with other banks and other financial institutions through the activities of bank holding companies, as discussed in Chapter 5. The applicability of federal legal restrictions against interstate banking is reviewed in Chapter 6.

[4] Change in Control

The Board of Governors, the Comptroller of the Currency, and the FDIC have authority under the Change in Bank Control Act of 1978 to approve the acquisition of control of the banks within their supervisory jurisdiction. Written notice must be given to the relevant regulatory agency in advance of the proposed acquisition, and a period of time is allowed for the agency to review the proposal.[110] If the agency does not disapprove the proposed acquisition within the time provided or does not extend the period as provided by law, the acquisition may be completed.

The federal banking agency may disapprove the proposed acquisition on ground of adverse competitive effects, jeopardy to the financial condition of the bank, or inability to provide appropriate management for the bank.[111] Additionally, amendments made in 1986 by the Money Laundering Control Act direct the banking agencies to investigate the backgrounds of persons who apply to acquire control, and establish a procedure for public review and comment.[112]

Regulations of the FDIC require notice to be given whenever any person acquires more than a 10 percent ownership interest in a bank subject to the

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[109] See also Sayers, "Bank Expansion and Probable Future Competition," 102 Banking LJ 100–141 (1985); Staff, Davidson, & McDonald, "Increased Bank Merger Activity: Causes and Effects," 24 Am. Bankr. LJ 67–86 (1986). See 12 USC § 1828(c)(7)(1982), and discussion at ¶¶ 13.03[1], 13.03[2].

[110] 12 USC § 1817(j)(1) (Supp. IV 1986). The Change in Bank Control Act, 12 USC § 1817 (1982 & Supp. IV 1986), expressly requires the Comptroller of the Currency to issue its nondisapproval of the acquisition of a national bank prior to the acquirer's obtaining control. In a case where the new controlling party failed to obtain prior nondisapproval from the comptroller, but did obtain such a letter from the comptroller after acquiring control, the court held that any private claim that might arise under Section 1817(j) of the act became moot. The court also held that a federal district court has no jurisdiction to review an alleged violation of the Bank Holding Company Act, because the Federal Reserve Board has exclusive jurisdiction. Central Nat'l Bank v. Rainbolt, 720 F2d 1183 (10th Cir. 1983).

[111] 12 USC § 1817(j)(7) (1982).

[112] 12 USC § 1817(j)(2) (Supp. IV 1986); 12 USC § 1730(q)(2) (1982). See also ¶ 12.01[4][e].

supervision of the FDIC. In a case where a group of persons acquired more than 10 percent of the stock of a bank and together constituted its largest stockholder, the notice requirement applied, although individually no one owned more than 10 percent. The FDIC was entitled to an injunction barring the group from assuming control of the bank when they failed to give the notice required by the regulation, because the FDIC was entitled to believe that the collective shares would be voted as a block.[113]

¶ 13.04 LOCAL CREDIT NEEDS: THE COMMUNITY REINVESTMENT ACT OF 1977

In the mid-1970s, Congress was persuaded of the need for legislation to ensure that financial institutions provide adequate service to their local communities. The problem perceived by Congress was that some financial institutions took deposits from their local neighborhoods and communities but did not make credit available to those same areas. It was charged that some financial institutions refused to make loans in "redlined" areas, and that often these areas presented no greater investment risks, but rather were simply older areas of the community or were areas in which racial minorities resided. There was particular concern expressed as to the failure of depository institutions to make residential mortgage loans available in such areas.

To deal with these problems, Congress first adopted the Home Mortgage Disclosure Act of 1975.[114] Under this act, every depository institution (i.e., commercial bank, savings bank, savings and loan association, or credit union) that makes federally related mortgage loans is subject to record-keeping requirements if it has an office located within a standard metropolitan statistical area. Such depository institutions must compile and maintain data showing the mortgage lending activity of the institution according to census tract to reveal the areas of its mortgage lending activity.[115] The institutions must make the information available to the public in accordance with the regulations of the Federal Reserve Board.[116]

Two years later, Congress enacted the Community Reinvestment Act of 1977.[117] This act expressly states that

> (1) regulated financial institutions are required by law to demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business;

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[113] FDIC v. D'Annunzio, 524 F. Supp. 694 (ND W. Va. 1981).

[114] 12 USC §§ 2801–2811 (1982 & Supp. IV 1986).

[115] 12 USC § 2803 (1982 & Supp. IV 1986).

[116] Id.

[117] 12 USC §§ 2901–2905 (1982).

(2) the convenience and needs of the communities include the need for credit services as well as deposit services; and

(3) regulated financial institutions have continuing and affirmative obligations to help meet the credit needs of the local communities in which they are chartered.[118]

The purpose of the act is "to require each appropriate Federal financial supervisory agency to use its authority when examining financial institutions, to encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions."[119]

To carry out the act, whenever a federal financial supervisory agency examines a financial institution, the agency must assess the institution's record in meeting the credit needs of its community, including its low- and moderate-income neighborhoods. This assessment must be taken into account by the supervisory agency in evaluating any application for a deposit facility by the institution.[120] The act applies to all federal financial supervisory agencies including the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, and the FHLBB. The regulated financial institutions whose activities must be evaluated include all banks that are insured by the FDIC and all savings institutions that are insured by the Federal Savings and Loan Insurance Corporation.

The evaluations of the efforts made by a depository institution in meeting the credit needs of its community are relevant whenever that institution applies to one of the federal regulatory agencies for approval of one of the following: a charter, deposit insurance, a branch office or similar facility to accept deposits, the relocation of an office, a merger or consolidation with another institution, or the acquisition of shares or assets of another financial institution.[121]

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[118] 12 USC § 2901(a) (1982).

[119] 12 USC § 2901(b) (1982).

[120] 12 USC § 2903 (1982).

[121] 12 USC § 2902 (1982). See generally Bettauer, "Federal and State Anti-Redlining Laws: Must National Banks Comply With Bath?", 97 Banking LJ 329–345 (1980); Jennings, "Preemption and State Anti-Redlining Regulation: The Need for Clarification," 11 Fordham Urb. LJ 225–261 (1982–1983); Notes, "Community Bank Regulations: Another Attempt to Control Red-Lining," 28 Cath. UL Rev. 635–661 (1979); "Red-Lining, Disinvestment and the Role of Mutual Savings Banks: A Survey of Solutions," 9 Fordham Urb. LJ 89 (1980).

II

Bank Payments and Negotiable Instruments

14

Sources of Commercial Banking Law and Basic Principles Governing Commercial Paper

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¶ 14.01 SOURCES OF COMMERCIAL LAW

The United States is a federation of states, and under the Constitution each state is a separate legal entity with authority to enact and enforce laws and with a separate system of courts and administrative tribunals. Thus, the commercial banking lawyer must be concerned with the laws of each of the fifty states as well as the law of the United States. Each of these fifty-one jurisdictions has delegated much law- or rule-making power to its administrative agencies. Each state has administrative agencies with regulatory, rule-making, and adjudicatory responsibilities over banks and other depository institutions. Additionally, separate agencies supervise other types of financial institutions, regulate the issuance of securities, oversee insurance firms, and regulate a myriad of other activities from barbering to mining.

The proliferation of jurisdictions and regulatory bodies can create confusion, especially where modern business transactions that use electronic technology constantly cross physical jurisdictional boundaries with a rapidity undreamed of at the time most banking and commercial laws were enacted. One of a lawyer's chief functions is to untangle this maze of laws in order to make the rules that govern particular transactions clearer to business people. The doc-

trines that control the solution to these problems are part of the subjects of law known as the conflict of laws and constitutional law. The development of the law in individual cases lies within the special ken of the legal profession; but bank officers are entitled to know some of the basic rules that will guide them in consulting with their lawyers.

[1] Federal Power Over Commercial Laws

The U.S. Constitution is the supreme law of the land[1] and provides standards for both state and federal law. The Constitution gives certain powers expressly to the federal government—Congress, the president, and the U.S. courts. The federal government has enumerated powers and must draw its authority to legislate from a grant of power contained in the Constitution. When state legislative authority is at issue, the U.S. Constitution limits such authority in two ways. Firstly, the Constitution contains specific provisions limiting the power of the states to act, as in the prohibitions in the Bill of Rights against governmental action in violation of those provisions. Secondly, the supremacy clause of the U.S. Constitution makes the laws of Congress superior to state law when a conflict exists between federal and state law or when the Congress has acted to regulate the subject matter to the exclusion of state legislation. Absent either of these two types of limitations, state governments have general authority to legislate in order to promote the health, safety, and welfare of persons within their jurisdiction in what is referred to as a general "police power."[2] As a result, state legislative bodies have broad, general sovereign authority, subject to the additional limitations of their own state constitutions and laws, to adopt laws dealing with contracts, property, legal remedies, and other matters. Thus, in many areas, particularly in matters involving commerce, the states may act so long as they do not conflict with the U.S. Constitution or laws adopted by Congress, and the Congress has not indicated an intention to preempt the matter from state regulation. For example, the general body of law dealing with family relationships is largely based on state statutes and decisions of courts about state laws. However, federal law affects the power of states to act even in this area of traditional state concern. States may not enact laws pertaining to family property that discriminate in violation of the due process and equal protection clauses.[3] Moreover, Congress can pass laws under its constitutionally enumerated authority that affect such relationships and are binding on the states. The federal law, for example, can prohibit credit discrimination. Although the Constitution authorizes Congress to operate in a certain area, some cases may

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[1] U.S. Const. art. VI, cl. 2.

[2] See generally J. Nowak, R. Rotunda & J. Young, Constitutional Law §§ 3.1–3.5 (3d ed. 1986).

[3] U.S. Const. amend. XIV, § 1.

present no clear indication whether Congress has intended to exercise exclusive control over that subject. Where Congress has not retained exclusive control, state law may operate concurrently with federal law in the same area. Considerable uncertainty arises, however, where Congress has not specifically excluded the states from engaging in regulation in a particular area. As seen in Part I, this is precisely the case with many laws governing the organization and regulation of banks.

Commercial law, an intricate web of federal and state laws, governs the legal nature of the contracts and other documents involved in transactions that constitute the business of banking. The Constitution gives the Congress power to make laws governing "Commerce with foreign Nations, and among the several States, and with the Indian Tribes."[4] It was originally believed that "commerce" power extended only to commerce that crossed state lines, and not to purely intrastate transactions.[5] However, as business has expanded, it has been held that the federal power extends to any transaction that affects interstate commerce.[6] In the present state of commercial operations, commerce includes almost any business transaction.

Although the commerce clause gives Congress power over an enormous range of business transactions, this power has only been exercised in some areas. Among these are consumer rights and fair trade practices. The trend of increased congressional intervention in the commercial field will probably be accelerated in the future.

In banking, Congress has broad powers. Among the constitutional powers that Congress possesses are powers "to coin money, regulate the value thereof, and of foreign coin."[7] From early decisions to the present, the U.S. Supreme Court has expansively interpreted these powers to give Congress broad authority to regulate banking.[8] Although Congress has left much regulation of banking

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[4] U.S. Const. art. I, § 8, cl. 3.

[5] See Gibbons v. Ogden, 22 US (9 Wheat.) 1, 65 (1824); cf. Paul v. Virginia, 75 US (8 Wall.) 168, 183 (1868).

[6] See Katzenbach v. McClung, 379 US 294 (1964); Moore v. Mead's Bread, 348 US 115 (1954); Wichard v. Filburn, 317 US 111 (1942). For the meaning of "commerce among" the states, see 1 Crosskey, Politics and the Constitution, Chs. 1 et seq. (1953); J. Nowak, R. Rotunda & J. Young, Constitutional Law, Ch. 4 (3d ed. 1986).

[7] U.S. Const. art. I, § 8, cl. 5.

[8] See Smith v. Kansas City Title & Trust Co., 255 US 180 (1921) (upholding the Federal Farm Loan Act); First Nat'l Bank v. Fellows, 244 US 416 (1917) (upholding Federal Reserve System); Owensboro Nat'l Bank v. Owensboro, 173 US 664 (1899) (upholding the power to limit taxing national banks); Legal Tender Cases, 79 US (12 Wall.) 457 (1870) (upholding laws making U.S. Treasury notes legal tender for all debts); Veazie Bank v. Fenno, 75 US (8 Wall.) 533 (1869) (upholding federal tax on state bank notes); McCulloch v. Maryland, 17 US (4 Wheat.) 316 (1819) (state tax on national bank notes invalid). For a discussion of the powers conferred upon Congress by the clauses in the U.S. Constitution permitting Congress to borrow money, to coin money and regulate

corporations and individual commercial transactions to state law, federal laws, such as the federal statutes on electronic fund transfers and credit disclosures, deal with special subjects. Further, Congress has created regulatory agencies to oversee banks' activities. These agencies have had an ever growing role in shaping the law applicable to the transactions in which banks may engage. As discussed later, the Board of Governors of the Federal Reserve System has been given a very special role of oversight and lawmaking with respect to the nation's payments system.

[2] State Commercial Law—The Uniform Commercial Code

Even before the founding of the American colonies, the law governing commercial transactions in Europe was a separate body of law. During medieval and Renaissance times this law was known as the Law Merchant. In both England and Europe it was administered by a separate system of courts from that governing land and family matters. In Europe it is still a separate system of law governed by statutes known as commercial codes, which are usually administered by special commercial tribunals.

In England and the United States the commercial law became largely statutory. Although the statutes varied from state to state, they were administered by common-law courts so that the commercial law of the United States as a whole was in great confusion. At the end of the nineteenth century, the American Bar Association, through the Commission on Uniform Laws, drafted and pushed for adoption in the various state legislatures many uniform statutes that at one time covered most of the field of commercial law. These uniform laws touched upon most of the everyday banking transactions but became incomplete and obsolete as modern commercial practices evolved; the Uniform Commercial Code has replaced most of these laws.

The requirements of commercial paper and the procedures for banks to collect it are governed almost wholly by statute and agency regulation. Before the adoption of the UCC, the Uniform Negotiable Instruments Act, known officially as the Negotiable Instruments Law (NIL), codified the law on negotiable paper payable in money. The NIL was adopted in all the states and territories. Three different uniform statutes dealt with goods and documents of title relating to goods: the Uniform Sales Act, the Uniform Warehouse Receipts Act, and the

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its value see J. Nowak, R. Rotunda & J. Young, *Constitutional Law* § 5.7 (3d ed. 1986). See id. at § 3.2 for discussion of Justice Marshall's historic *McCulloch v. Maryland* decision where the Supreme Court gave a broad reading to the "necessary and proper" clause which gives Congress "the power . . . to make all laws which shall be necessary and proper for carrying into execution the foregoing powers, and all other powers vested by this Constitution in the government of the United States or in any department or officer thereof." U.S. Const. article I, § 8, cl. 18.

Uniform Bills of Lading Act.[9] Other uniform acts dealt with other types of commercial practices, and there were many non-uniform local state laws.

The UCC supersedes most of the previous uniform laws dealing with commercial transactions and incorporates in a single code subject matter previously scattered among many separate statutes.

Its broad scope is seen from the following listing of the articles it contains:

Article 1	General Provisions
Article 2	Sales
Article 2A	Leases
Article 3	Commercial Paper
Article 4	Bank Deposits and Collections
Article 5	Letters of Credit
Article 6	Bulk Transfers
Article 7	Warehouse Receipts, Bills of Lading, and Other Documents of Title
Article 8	Investment Securities
Article 9	Secured Transactions; Sales of Accounts and Chattel Paper
Article 10	Effective Date and Repealer
Article 11	Effective Date and Transition Provisions

The UCC has been adopted in all states (Louisiana has not adopted all of the UCC because of the state's civil law orientation). Since the UCC is the major source of law for modern commercial transactions, the discussion that follows states the rules laid down by it. In some cases it is useful to consider the prior uniform statutes as an aid to understanding the UCC. Where relevant, this pre-UCC law is discussed.

The UCC was extensively amended by the Commissioners on Uniform State Laws and the American Law Institute in 1972 and again in 1977. These revisions principally dealt with Article 9 (secured transactions) and Article 8 (investment securities). Article 2A (leases) became part of the UCC in 1987.

Although a substantial number of states have adopted the 1972 amendments and many states have adopted the 1977 amendments, there are states that have not enacted these changes. Because the amendments make significant changes in the UCC, it is essential to determine which version of the UCC is in effect in any given state.[10] Of course, the failure of some states to adopt the amendments has created a lack of uniformity among the states in their basic commercial law. Table 14-1 lists the states that have adopted the UCC, shows

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[9] These statutes have been repealed by the UCC. See UCC § 10-102.

[10] The states in fact have individually made many changes to various parts of the UCC that depart from the uniform text. This book generally discusses the provisions of the official uniform text without identifying state variations.

TABLE 14-1 State Enactments of UCC and Amendments*
EFFECTIVE DATES OF STATE ADOPTIONS

State	*UCC*	*1972 Amendments*	*1977 Amendments*
Alabama	1-1-67	2-1-82	
Alaska	1-1-63	7-1-83	
Arizona	1-1-68	1-1-76	
Arkansas	1-1-62	1-1-74	6-28-85
California	1-1-65	1-1-76	1-1-75
Colorado	7-1-66	1-1-78	7-1-82
Connecticut	10-1-61	10-1-76	10-1-79
Delaware	7-1-67	1-1-84	1-1-84
D.C.	1-1-65	3-16-82	
Florida	1-1-67	1-1-80	10-1-87
Georgia	1-1-64	7-1-78	
Hawaii	1-1-67	7-1-79	7-1-86
Idaho	1-1-68	7-1-79	7-1-85
Illinois	7-2-62	7-1-73	1-14-88
Indiana	7-1-64	1-1-86	9-1-88
Iowa	7-4-66	1-1-75	
Kansas	1-1-66	1-1-76	7-1-86
Kentucky	7-1-60	7-1-87	7-1-87
Louisiana**	1-1-75**		
Maine	12-31-64	1-1-78	
Maryland	2-1-64	1-1-81	7-1-86
Massachusetts	10-1-58	1-1-80	3-1-84
Michigan	1-1-64	1-1-79	4-24-87
Minnesota	7-1-66	1-1-77	1-1-79
Mississippi	3-31-68	4-1-78	
Missouri	7-1-65		
Montana	1-2-65	10-1-83	10-1-83
Nebraska	9-2-65	7-19-80	
Nevada	3-1-67	7-1-75	7-1-85
New Hampshire	7-1-61	8-21-79	7-24-87
New Jersey	1-1-63	12-1-81	
New Mexico	1-1-62	1-1-86	6-19-87
New York	9-27-64	7-2-78	9-1-82
North Carolina	7-1-67	7-1-76	
North Dakota	7-1-66	1-1-74	7-1-85
Ohio	7-1-62	1-1-79	9-20-84

(continued)

TABLE 14-1 *(cont'd)*

State	*UCC*	*1972 Amendments*	*1977 Amendments*
Oklahoma	1-1-63	10-19-81	11-1-84
Oregon	9-1-63	1-1-74	9-20-85
Pennsylvania	7-1-54	5-25-83	
Rhode Island	1-1-62	1-1-80	1-1-88
South Carolina	1-1-68		
South Dakota	7-1-67	7-1-83	***
Tennessee	7-1-64	1-1-86	7-1-86
Texas	7-1-66	1-1-74	9-1-83
Utah	1-1-66	7-1-77	
Vermont	1-1-67		
Virgin Islands	7-1-65		
Virginia	1-1-66	7-1-74	1-1-85
Washington	7-1-67	6-30-82	6-11-86
West Virginia	7-1-64	7-1-75	5-23-79
Wisconsin	7-1-65	7-1-74	4-24-86
Wyoming	1-2-62	7-1-83	5-27-83

*Table 14-1 was revised on June 15, 1988, based on materials then available to the author.
**Louisiana has not adopted Articles 2, 6, and 9. The adoption of Articles 7 and 8 first became effective 1-1-79.
***Adopted in 1986, effective date not available.

the effective dates of adoption, indicates which states have adopted the 1972 and 1977 amendments, and further shows the effective dates of those adoptions.

The process of updating the UCC is ongoing. A permanent editorial board considers the need for revision. In 1987, the two sponsoring organizations, the American Law Institute and the Commissioner on Uniform State Laws, approved a new Article 2A on leases of personal property. Work is also underway on revisions to other articles, including Article 6 on bulk transfers.

For a number of years, the sponsoring organizations of the UCC have given serious attention to revisions of Articles 3 and 4 so that those articles would accommodate changes in the banking and commercial practices by which funds are transferred and payments made, such as check truncation, wire transfers, and other forms of electronic banking. A drafting committee prepared several drafts of a "Uniform New Payments Code" in the early 1980's. This project attempted to develop a unified code that would apply to all payment systems, paper checks, and transfers that are electronic in form, but this concept was abandoned when it appeared impossible to reconcile the many conflicting view-

points that would be affected by a dramatically new statutory scheme. In its place, drafting efforts were begun to revise existing Articles 3 and 4, on commercial paper and bank deposits and collections, to correct some widely recognized problems, and to develop a new Article 4A that would deal with the large dollar wire transfer transaction generally conducted by large corporate enterprises.[11]

Although the UCC covers a wide area of commercial law, it could not and does not attempt to state all the law applicable to commercial transactions. The general provisions of the UCC expressly state that the UCC is to be supplemented by general principles of law:

> Supplementary General Principles of Law Applicable
>
> Unless displaced by the particular provisions of this act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.[12]

The supplemental principles of law that the above provision incorporates into the UCC represent a vast body of legal doctrine. This law cannot be covered in any detail in a book such as this. There are standard legal treatises on each of these subjects. Additionally, the various Restatements of the Law, published by the American Law Institute, are helpful and authoritative sources of information about the law on these various topics.[13]

Although there is a permanent editorial board of the UCC that works to preserve its uniformity, the states in fact have individually made many changes to various parts of the UCC that depart from the uniform text. This book generally discusses the provisions of the official uniform text without identifying state variations.

Many standard treatises cover the UCC or particular subjects treated in the UCC. Some of the major works are listed in the following table.

[3] The Role of the Federal Government as the Source of Commercial Law

The UCC is state law and does not directly apply to the U.S. government. Where the U.S. government is a party to a transaction, the pertinent law derives

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[11] As of this writing, drafts of some of these amendments have been prepared and are in the process of review by various study groups and the sponsor organizations of the UCC.

[12] UCC § 1-103. All references to the UCC in this handbook are to the 1978 official text. When reference is made to an earlier version of the UCC, this is specifically noted.

[13] Particularly helpful to the commercial lawyer are Restatement (Second) of Contracts (1979); Restatement (Second) of Agency (1957); Restatement (Second) of Torts (1977); Restatement (Second) of Trusts (1957); Restatement of Security (1941).

TABLE 14-2 Legal Treatises on the Uniform Commercial Code and Related Subjects

H. Bailey, *Brady on Bank Checks* (6th ed. 1987).
H. Bailey, *Secured Transactions* (2d ed. 1981).
B. Clark, *The Law of Bank Deposits, Collections and Credit Cards* (1981).
B. Clark, *The Law of Secured Transactions* (1980).
D. Dobbs, *Remedies* (1973).
J. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits* (1984).
D. Epstein, *Debtor-Creditor Law* (3d ed. 1985).
G. Gilmore, *Security Interests in Personal Property* (1965).
R. Goode, *Commercial Law* (1982).
F. Hart & W. Willier, *Commercial Paper Under the Uniform Commercial Code* (1972).
W. Hawkland, *Uniform Commercial Code Series* (1982).
R. Henson, *Secured Transactions* (2d ed. 1979).
F. Miller & A. Harrell, *The Law of Modern Payment Systems and Notes* (1985).
R. Nordstrom, *Sales* (1987).
N. Penney & D. Baker, *The Law of Electronic Fund Transfer Systems* (1980).
B. Stone, *Uniform Commercial Code* (2d ed. 1984).
J. Vergari & V. Shue, *Checks, Payments, and Electronic Banking* (1986).
G. Wallach, *The Law of Sales Under the Uniform Commercial Code* (1981).
C. Weber & R. Speidel, *Commercial Paper* (3d ed. 1982).
J. White & R. Summers, *Uniform Commercial Code* (2d ed. 1980).

from the Constitution, federal statutes, regulations of the particular department or agency involved, decisions of the federal courts and, in some cases, the decisions of the U.S. regulatory agencies. Federal government checks, for example, have long been held subject to federal law, and not to the UCC,[14] which is state law. The federal law applied by the courts, however, is often patterned after the UCC.[15] Also, Congress can choose explicitly to defer to state law. As discussed later, the federal role in determining the law applicable to the collection of checks and electronic payments has become of major importance since the enactment of the Expedited Funds Availability Act and the Federal Reserve Board's adoption of Regulation CC, entitled "Availability of Funds and Collection of Checks."

Many federal acts apply to special businesses such as national banks, where the regulation of government agencies may be the ruling law, or establish federal

[14] Clearfield Trust Co. v. United States, 318 US 363, 366 (1942).
[15] Bank of America v. United States, 552 F2d 302, 304–305 (9th Cir. 1977).

rules for specific types of transactions and practices, as in the areas of consumer credit and unfair business practices. Also, federal and not state law applies to business transactions on federal reservations, within the territories, and in other areas governed directly by the U.S. government. In many cases that arise in this situation, however, diligent search may not reveal any federal statute, agency ruling, or decision that applies to the case in hand. When this happens, a court may look to the general law on the subject, such as the UCC, to decide what the federal law ought to be.[16] Thus, as a practical matter, in many modern commercial transactions, there is a combination of both federal and state law.

[a] Federal Administrative Agencies. Banks, both state and national, are controlled in many of their activities by the Federal statutes, such as, among others, those creating the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and other banking agencies discussed in Part I. These bodies are authorized to issue regulations governing the activities of federal and state banks within the areas of their jurisdiction. When these agencies issue regulations within their authority, the regulations are superior to and prevail over any conflicting state law unless it is an area where Congress has permitted the states to exercise such legislative power.[17]

General federal law governs the procedures federal agencies must follow in their rule-making, adjudicatory, and other regulatory functions. The Administrative Procedures Act applies generally to federal agencies and contains provisions on these matters.[18] Specific procedural rules applicable to each particular agency often are found in the statutes establishing the agency and authorizing its activities as discussed in Part I of this book. Other federal acts of general application, such as the Freedom of Information Act,[19] may have important ramifications for the conduct of federal agency business.

Federal agency regulations are published in the Federal Register, with proposed regulations published in advance for comment by interested parties. Subsequently, the regulations become codified in the Code of Federal Regulations.[20] Additionally, the agencies issue circulars, interpretations, and other

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[16] E.g., United States v. Wegematic Corp., 360 F2d 674, 676 (2d Cir. 1966).

[17] See Fidelity Fed. Sav. & Loan Assn. v. de la Cuesta, 458 US 141 (1982), holding that FHLBB regulations for federally chartered savings and loan associations preempted state laws restricting exercise of due-on-sale clauses in mortgage lending agreements.

[18] Administrative Procedure Act, Ch. 324, 60 Stat. 237 (1946) (codified as amended at 5 USC §§ 551–559, 701–706, 1305, 3105, 3344, 4301, 5335, 5372, 7521 (1982 & Supp. IV 1986). See K. Davis, Administrative Law Treatise (2d ed. 1978).

[19] Freedom of Information Act, 80 Stat. 250 (1966) (codified as amended at 5 USC § 552 (1982 & Supp. IV 1986)).

[20] Federal statutes require the publication of federal rules. 5 USC §§ 551–559, 1501–1511 (1982).

important information in various publications of each agency. The Board of Governors publishes important information on legal actions it has taken as well as various economic data in the Federal Reserve Bulletin. The Comptroller of the Currency distributes rulings and interpretations it makes. The regulations and rulings of the Federal Reserve Board have been compiled by the Board in a three-volume Federal Reserve Regulatory Service. Current developments that involve banking regulatory matters are covered in the Bureau of National Affairs publication *Banking Report*. Other treatises and looseleaf services on federal banking law are available from commercial publishers.

[b] Preemption of Federal Over State Rules. The interaction of the laws and rules governing banking is not only complicated but, in some cases, may be flatly contradictory. Quite often both state and federal statutes and regulations contain provisions that indicate which laws and rules take precedence. The following table shows the order of precedence of various state and federal rules.

Determining when a conflict exists between federal and state law is often not a simple matter. There are two types of circumstances where conflict may be found. The first situation involves direct conflict, as when the federal law directs an individual to do one thing and the state law directs the individual to do something else. When it is impossible to follow both state and federal commands, the federal law prevails. The second situation is more difficult to determine. Congress may legislate in a particular area with the intent of precluding state legislation on the same subject matter because such state legislation would be inconsistent with the objectives of the federal law. Deciding when a conflict of this nature exists involves a review of the particular provisions of state and federal law and their effect on the objectives expressed in the congressional legislation.[21] With such a test, the outcome of any particular controversy rests in great measure upon a detailed analysis of the particular facts and circumstances, and it is difficult to express any but the most general guidelines. The following statement by the U.S. Supreme Court may be helpful in understanding the Court's approach:

> *Absent explicit preemption language, Congress's intent to supersede state* law altogether may be found from a scheme of federal regulations so pervasive as to make reasonable the inference that Congress left no room to supplement it, because the act of Congress may touch a field in which the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject, or because the object sought to be obtained by federal law and the character of obligations imposed by it may reveal the same purpose .... Even where Congress has

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[21] For a general discussion of the doctrine of federal preemption, see J. Nowak, R. Rotunda & J. Young, Constitutional Law § 9.1–9.4 (3d ed. 1986).

TABLE 14-3 **Hierarchy of Laws**

- Constitution of United States
- Laws passed by Congress
- Rules of federal agencies authorized by Congress
- State constitutions
- State statutes
- Regulations of state agencies

> not entirely displaced state regulation in a specific area, state law is preempted to the extent that it actually conflicts with federal law. Such a conflict arises when compliance with both federal and state regulations is a physical impossibility, . . . or where state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.[22]

The preemption doctrine is particularly difficult to apply in many areas of commercial banking law because the federal government has established a regulatory framework for controlling banks and commercial banking transactions that is both pervasive and fragmentary. The framework is pervasive in view of the wide variety of depository institutions and commercial banking practices that are touched by the federal controls and what often appears to be a broad delegation of authority to administrative agencies, but it is fragmentary in that the scheme has developed in patchwork fashion over the years; although the constitutional power to override state commercial law is clear, it often is difficult to decide to what extent Congress intended to supplant the basic commercial law that otherwise would be operative. The application of state laws to transactions engaged in by national banks is illustrative. No doubt exists that national banks are instruments of federal policy, and state laws that interfere with a national bank's performing the functions assigned to it by federal law are invalid. But national banks engage in many transactions where state law determines the rights and duties of the parties. "In particular, the contracts of national banks have always been governed and construed by state laws, at least insofar as those laws have been of general application and have not been in conflict with federal law."[23]

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[22] Pacific Gas & Elec. Co. v. State Energy Resources Conservation & Dev. Comm'n, 461 US 190, 203-04 (1983).

[23] Best v. United States Nat'l Bank, 303 Or. 557, 564, 739 P2d 554, 561 (1987). *Best* held that the state law obligations of good faith in the performance of contracts applied to fees a national bank charged its customers for not sufficient funds (NSF) checks. Although the comptroller could regulate national banks in a manner which indicated an intent to preempt the application of state contract law to bank service charges, such as NSF fees, the

Even when it is determined that federal law should control, Congress may not have supplied the specific substance of the law to govern the transaction. In cases where a court must fashion the substantive rule of decision, the court may look to the principles of state law for guidance in formulating the rule. When the state law is generally accepted among the states, such as the UCC, its adoption as the basis for the federal rules is even more compelling, because it promotes uniformity, certainty, and simplicity in defining the rights and duties of the parties to commercial transactions.

The federal preemption doctrine applies not only when Congress passes a law, but also when a federal agency enacts regulations within its authority to regulate.[24] Thus, actions by the federal banking regulatory agencies also may have the effect of preempting state law.

In *Security Federal Savings & Loan Association v. de la Cuesta*, the U.S. Supreme Court used sweeping language to describe the authority of the Federal Home Loan Bank Board to regulate federal savings and loan associations.[25] At issue was the power of the board to adopt a regulation preempting state law that limited enforcement of "due-on-sale" clauses in mortgage lending documents. In upholding the power of the board to override the state restrictions, the Court said that Section 5(a) of the Home Owners' Loan Act of 1933[26] gave the board "plenary authority" to regulate federal associations. The Court said:

> The broad language of § 5(a) expresses no limits on the Board's authority to regulate the lending practices of federal savings and loans. As one court put it, "[i]t would have been difficult for Congress to give the Bank Board a broader mandate."[27]

Although the Court noted that it was not called upon to decide whether the federal act or the board's regulations occupied the "entire field of federal savings and loan regulations," it did find that "Congress invested the Board with broad authority to regulate federal savings and loans so as to affect the statute's purposes, and plainly indicated that the Board need not feel bound by existing state law."[28]

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comptroller had not done so in the court's opinion. See also Franklin Nat'l Bank v. New York, 347 US 373 (1954), which held a state law prohibiting use of the word "savings" in advertising by national banks was preempted because it interfered with the power to receive deposits.

[24] See Fidelity Sav. & Loan Ass'n. v. de la Cuesta, 458 US 141 (1982).

[25] Id.

[26] 12 USC § 1464(a) (1982).

[27] 458 US at 161.

[28] Id. at 162 n.16. On the scope of the Board's power, compare the majority opinion with Justice O'Connor's concurring opinion which emphasized that the Board's power to preempt state law "is not limitless," id. at 171, and with the dissenting opinion of Justice Rehnquist which stressed that the Board's regulatory powers were to be exercised to

[c] Authority of Federal Reserve System to Regulate Certain Payment Methods. The Federal Reserve System has played a special role in the development of the U.S. banking system, particularly in the arrangements and facilities for collecting checks, providing bank credit, and supervising depository institutions. In its capacity as the central banker for the United States, with its holdings of reserves of member banks and others engaged in transactions subject to its jurisdiction, the Federal Reserve System has developed facilities for the processing of check collection, the transmission of funds by electronic means, and the handling of transactions in U.S. government securities. These systems, by themselves, give the Board of Governors and the Federal Reserve banks great powers over the manner in which banking transactions are conducted. In addition, Congress has conferred on the Board of Governors special statutory powers to regulate key aspects of modern commercial banking practice. Among the most important are electronic fund transfers and various aspects of consumer credit practices.[29]

Under the previously discussed constitutional principles that give supremacy to the duly enacted regulations of federal agencies over inconsistent state laws, the regulations of the Board of Governors take priority over the provisions of the UCC. In its Regulation J the board has adopted rules governing the collection of checks and other items and transfers of funds.[30] UCC § 4-103 also recognizes the importance of Federal Reserve Board regulations and operating rules by making these rules superior to those contained in the UCC and binding on all parties involved in the transaction.

When Congress enacted the Competitive Equality Banking Act of 1987 (CEBA),[31] it gave the Board of Governors sweeping new powers to become the central regulator of the nation's payment system. Congress directed the Board to exercise these powers to bring about substantial changes in the manner in which the nation's check clearing and payments systems operate in order to accomplish goals of greater speed and efficiency in making funds available for use by depositors. Congress adopted this legislation in Title VI of CEBA, which is entitled "The Expedited Funds Availability Act."[32] This legislation requires

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assure the "soundness" of the federal savings and loan system, id. at 172. For an example of a case (although not a preemption case) where the court found regulatory authority was lacking, because the agency exceeded the powers Congress gave it, see Board of Governors v. Dimension Fin. Corp., 474 US 361 (1986).

[29] See ¶¶ 18.02, 18.03, 26.03–26.06.

[30] 12 CFR § 210 (1987). For further discussion of Federal Reserve Board regulations and operating rules, see ¶ 3.03.

[31] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (1987) [hereinafter CEBA].

[32] CEBA, Pub. L. No. 100-86, Title VI 101 Stat. 552 (1987). Title VI is the Expedited Funds Availability Act. The Board has adopted rules to implement the act in a new Regulation CC, "Availability of Funds and Collection of Checks," which is effective September 1, 1988. Regulation CC will be codified at 12 CFR pt.229. The earlier pro-

depository institutions to make funds available for withdrawal in accordance with a statutorily prescribed schedule of availability.

Although the immediate focus of Title VI is on the creation of a scheme for making funds more quickly available to customers, there are other far-reaching consequences. As discussed in the following paragraphs, CEBA directs the Board of Governors of the Federal Reserve System to initiate changes to improve the manner in which checks and other payments are collected and gives the Federal Reserve Board rule making powers to bring about these changes.

1. *Federal Reserve Board authority to regulate check collection.* The act gives the Federal Reserve Board sweeping authority over the nation's payment system. It provides that the Board "shall have the responsibility to regulate—(A) any aspect of the payment system, including the receipt, payment, collection, or clearing of checks; and (B) any related function of the payment system with regard to checks."[33] Additionally, the Board is given specific authorization "to impose on or allocate among depository institutions the risks of loss and liability in connection with any aspect of the payment system, including the receipt, payment, collection, or clearing of checks, and any related function of the payment system with respect to checks."[34]

Acting under the authority granted in the Expedited Funds Availability Act, as this book was going to press, the Federal Reserve Board promulgated a new Regulation CC, "Availability of Funds and Collection of Checks," effective on September 1, 1988, which broadly regulates the bank collection and return of checks and other payment items. This regulation covers many aspects of the collection and return process that previously were regulated by the UCC. Because Regulation CC preempts state law, as discussed later, its provisions must be considered when dealing with check collection and return questions, funds availability problems, and other payments issues. Future supplements will examine the impact of Regulation CC.

2. *Preemption and Priority of State Law.* When the Federal Reserve Board acts under the authority granted by CEBA, the Board's regulations will preempt state law, including the provisions of the UCC that may be in effect in any state.[35] The only exception to this preemption of state law occurs when the state law or regulation provides a shorter period of time for a depository institution to make

posed regulation was published at 52 Fed. Reg. 47,112–47,179 (Dec. 11, 1987), amending 12 CFR pts. 210, 229.

[33] CEBA § 609(c)(1) (to be codified at 12 USC § 4008(c)(1)).

[34] CEBA § 611(f) (to be codified at 12 USC § 4010(f)). The statute provides that liability under this provision "shall not exceed the amount of the check giving rise to the loss or liability, and where there is bad faith, other damages, if any, suffered as a proximate consequence of any act or omission giving rise to the loss or liability." Id.

[35] CEBA § 608(b) (to be codified at 12 USC § 4007(b)).

deposited funds available for withdrawal by its customers than the federal schedules of availability. When a state law or regulation provides for a shorter availability period, this state law will supersede the provisions of CEBA and also, as a result of specific language in CEBA, will be binding on all federally insured depository institutions in such state.[36]

3. *Improving the Collection of Checks and Electronic Payments.* The Board's broad general authority parallels a wide ranging charge by Congress to the Board to consider various techniques for the improvement of check processing and payment collections. Congress directed the Board to consider adopting regulations to require a number of substantial changes in the manner in which the payments system currently operates. These include check truncation, incentives to institutions to return items promptly to the institution of first deposit, automation of the process of returning unpaid checks, standardized procedures for check indorsement and automation of the reading of indorsements, prompt notification of nonpayment of checks, procedures for return of all checks through the Federal Reserve System, development of an electronic clearing house that would eliminate the transmission of paper instruments, and allowing the return of unpaid checks directly to the depository institution.[37] Part of the Board's responsibilities under CEBA include the preparation of reports on the progress made in specific implementation of the funds availability provisions of CEBA as well as a broader study of the feasibility of modernizing the check payment system through the development of an electronic clearinghouse process.[38]

[4] Conflict of Laws Doctrines

A major objective behind the enactment of the UCC was the elimination of differences in the laws on commercial subjects among the states, so that commercial transactions could be planned on a national basis without the need for complex investigation of the particular laws of each state, and the elimination of disputes arising as a result of differences between the laws of the states when transactions involved more than one state.[39] The UCC's goal of having a uniform national law applicable to commercial transactions, although achieved in many important respects, could not be completely realized. Differences in interpretations of the UCC, nonuniform modifications by the states, as well as differences in the laws of the states in areas not covered by UCC create the possibility for conflicts when a commercial transaction touches more than one state. In such instances, the conflict between the laws of the states that are

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[36] CEBA § 608(a) (to be codified at 12 USC § 4007(a)).

[37] CEBA § 609(b) (to be codified at 12 USC § 4008(b)).

[38] CEBA § 609(d) (to be codified at 12 USC § 408(d)).

[39] UCC § 102(2)(c).

affected are resolved in accordance with the body of law known as conflict of laws.[40]

The UCC, anticipating these difficulties, contains provisions dealing with such conflicts. It adopts as a general policy the principle that the parties should be able to agree on the state law that applies to their transaction as long as the transaction bears "a reasonable relation" to the state law selected.[41] The general policy of the UCC on this matter is stated as follows:

> Except as provided hereinafter in this section, when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties. Failing such agreement this Act applies to transactions bearing an appropriate relation to this state.[42]

The comment explains what the drafters intended by the "appropriate relation" test. Prior court decisions in a jurisdiction on conflict of laws questions where the court has refused to apply a statute of the jurisdiction should not necessarily be followed in situations that involve the UCC:

> Where a transaction has significant contacts with a state which has enacted the Act and also with other jurisdictions, the question what relation is "appropriate" is left to judicial decision. In deciding that question, the court is not strictly bound by precedents established in other contexts. Thus a conflict-of-laws decision refusing to apply a purely local statute or rule of law to a particular multi-state transaction may not be valid precedent for refusal to apply the Code in an analogous situation. Application of the Code in such circumstances may be justified by its comprehensiveness, by the policy of uniformity, and by the fact that it is in large part a reformulation and restatement of the law merchant and of the understanding of a business community which transcends state and even national boundaries. . . . In particular, where a transaction is governed in large part by the Code, application of another law to some detail of performance because of an accident of geography may violate the commercial understanding of the parties.[43]

Specific conflict-of-laws provisions govern transactions in specific subject matters. Article 9 on secured transactions contains a detailed provision on the perfection of security interests in multiple state transactions.[44] There also is a reference to conflict-of-laws provisions in the article on investment securities.[45]

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[40] For a statement of the general rules in this area of the law, see Restatement (Second) of Conflict of Laws (1971).

[41] UCC § 1-105(1).

[42] Id.

[43] UCC § 1-105 comment 3.

[44] UCC § 9-103.

[45] See UCC § 8-106. See generally Leflar, "Conflict of Laws Under the U.C.C.," 35 Ark. L. Rev. 87 (1981).

A special provision on the liability of a bank covers action or nonaction in handling checks or other items. This provision, UCC § 4-102, set forth in the following text, governs as to the matters covered by it rather than the general rule in Section 1-105 set out previously.[46] The rule reads as follows:

> The liability of a bank for action or non-action with respect to any item handled by it for purposes of presentment, payment or collection is governed by the law of the place where the bank is located. In the case of action or non-action by or at a branch or separate office of a bank, its liability is governed by the law of the place where the branch or separate office is located.[47]

This rule is intended to reach broadly so that banks engaged in handling checks and other items for collection may determine with certainty what actions should be taken by the banks themselves and what they may expect banks in other jurisdictions to do. The comment to this provision states its purposes:

> Subsection (2) is designed to state a workable rule for the solution of otherwise vexatious problems of the conflicts of laws:
>
> a. The routine and mechanical nature of bank collections makes it imperative that one law govern the activities of one office of a bank. The requirement found in some cases that to hold an indorser notice must be given in accordance with the law of the place of indorsement, since that method of notice became an implied term of the indorser's contract, is more theoretical than practical.
>
> b. Adoption of what is in essence a tort theory of the conflict of laws is consistent with the general theory of this Article that the basic duty of a collecting bank is one of good faith and the exercise of ordinary care. Justification lies in the fact that, in using an ambulatory instrument, the drawer, payee, and indorsers must know that action will be taken with respect to it in other jurisdictions. This is especially pertinent with respect to the law of the place of payment.
>
> c. The phrase "action or non-action with respect to any item handled by it for purposes of presentment, payment or collection" is intended to make the conflicts rule of subsection (2) apply from the inception of the collection process of an item through all phases of deposit, forwarding, presentment, payment and remittance or credit of proceeds.[48]

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[46] UCC § 1-105(2) provides that when § 4-102 is applicable, it "governs and a contrary agreement is effective only to the extent permitted by the law (including the conflict of law rules) so specified [in § 4-102] . . . ." See UCC § 1-105 comment 5. But, there is also a specific provision in Article 4 which permits the parties to vary the effects of that article by agreement so long as there is no disclaimer of the responsibilities to act in good faith and to exercise ordinary care. UCC § 4-103(1). Thus, there may be agreements that vary the choice of law rules set forth in UCC § 4-102. UCC § 4-102 comment 2(d).

[47] UCC § 4-102(2).

[48] UCC § 4-102 comment 2.

The final part of this Chapter begins the consideration of the various types of commercial paper that the UCC covers. Before examining this paper and its characteristics, however, the next section discusses how money is defined. It is necessary to distinguish money from the instruments that are commercial paper under the UCC.

¶ 14.02 MONEY

Before considering the types of commercial paper banks handle, a brief look at what is money and some of the basic law defining it is useful. Money needs to be distinguished from other types of negotiable instruments, because the UCC provisions on negotiable instruments do not apply to money.[49] Similarly, money does not fall within the definition of "goods" in Article 2 of the UCC on sales.[50] Therefore, the rules in the UCC on the rights of purchasers of goods and negotiable instruments do not apply to money.

[1] Defining Money

Money has many definitions. Economists define money in terms of its use as a medium of exchange.[51] The Board of Governors of the Federal Reserve System, in carrying out its responsibilities to monitor the money supply of the nation, uses a set of definitions that includes demand deposits and sometimes other deposits and assets.[52] The legal definition of money is different still. In the

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[49] UCC § 3-103(1).

[50] UCC § 2-105(1).

[51] See J. Cochran, Money, Banking, and the Economy 5 (4th ed. 1979).

[52] The Board has changed the definitions it uses from time to time. It uses five categories to measure money, liquid assets, and debt: M-1, M-2, M-3, L, and Debt. See, e.g., 74 Fed. Reserve Bull., Table A3 (Jan. 1988). These categories are:

4. Composition of the money stock measures and debt is as follows:

M1: (1) currency outside the Treasury, Federal Reserve banks, and the vaults of commercial banks; (2) travelers checks of nonbank issuers; (3) demand deposits at all commercial banks other than those due to domestic banks, the U.S. government, and foreign banks and official institutions less cash items in the process of collection and Federal Reserve float; and (4) other checkable deposits (OCD) consisting of negotiable order of withdrawal (NOW) and automatic transfer service (ATS) accounts at depository institutions, credit union share draft accounts, and demand deposits at thrift institutions. The currency and demand deposit components exclude the estimated amount of vault cash and demand deposits respectively held by thrift institutions to service their OCD liabilities.

M2: M1 plus overnight (and continuing contract) repurchase agreements (RPs) issued by all commercial banks and overnight Eurodollars issued to U.S. residents by foreign branches of U.S. banks worldwide, Money Market Deposit Accounts (MMDAs), savings and small-denomination time deposits (time depos-

UCC, money is defined as "a medium of exchange authorized or adopted by a domestic or foreign government as a part of its currency."[53] The legal tender of the United States is defined more narrowly, including coins and currencies of the United States,[54] Federal Reserve notes, circulating notes of the Federal Reserve banks, and circulating notes of national banking associations.[55] Legal tender must be accepted "for all debts, public charges, taxes, and dues."[56]

The coins of the United States include the nickel, copper penny, subsidiary silver coins in denominations of ten, twenty-five, and fifty cents, silver dollars,

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its—including retail RPs—in amounts of less than $100,000), and balances in both taxable and tax-exempt general purpose and broker/dealer money market mutual funds. Excludes individual retirement accounts (IRA) and Keogh balances at depository institutions and money market funds. Also excludes all balances held by U.S. commercial banks, money market funds (general purpose and broker/dealer), foreign governments and commercial banks, and the U.S. government. Also subtracted is a consolidation adjustment that represents the estimated amount of demand deposits and vault cash held by thrift institutions to service their time and savings deposits.

M3: M2 plus large-denomination time deposits and term RP liabilities (in amounts of $100,000 or more) issued by commercial banks and thrift institutions, term Eurodollars held by U.S. residents at foreign branches of U.S. banks worldwide and at all banking offices in the United Kingdom and Canada, and balances in both taxable and tax-exempt, institution-only money market mutual funds. Excludes amounts held by depository institutions, the U.S. government, money market funds, and foreign banks and official institutions. Also subtracted is a consolidation adjustment that represents the estimated amount of overnight RPs and Eurodollars held by institution-only money market mutual funds.

L: M3 plus the nonbank public holdings of U.S. savings bonds, short-term Treasury securities, commercial paper and bankers acceptances, net of money market mutual fund holdings of these assets.

Debt: Debt of domestic nonfinancial sectors consists of outstanding credit market debt of the U.S. government, state and local governments, and private nonfinancial sectors. Private debt consists of corporate bonds, mortgages, consumer credit (including bank loans), other bank loans, commercial paper, bankers acceptances, and other debt instruments. The source of data on domestic nonfinancial debt is the Federal Reserve Board's flow of funds accounts. Debt data are based on monthly averages. Growth rates for debt reflect adjustments for discontinuities over time in the levels of debt presented in other tables.

Id.

[53] UCC § 1-201(24). See UCC § 3-107 & comment 1. The UCC definition includes foreign coin and currency.

[54] 31 USC § 5103 (1982).

[55] See 12 USC §§ 101–153 (1982) for a description of the authority given national banks to issue circulating notes.

[56] *31 USC § 5103 (1982). Before 1933, there were special provisions for each type of* money that determined its status as legal tender and controlled its circulation. Act of May 12, 1933, Ch. 25, § 43(b)(1), 48 Stat. 52 (1933); Act of June 5, 1933, Ch. 48, § 2, 48 Stat. 113 (1933). Some of the special statutes have not been repealed. There are special provisions for gold certificates. 31 USC §§ 5117 (1982).

and clad coins in denominations of ten, twenty-five, fifty cents, and one dollar.[57] There are special-issue coins such as the Eisenhower dollar[58] and coins issued to commemorate the bicentennial of the American Revolution.[59] There also is a Susan B. Anthony dollar.[60] The gold coins of the United States were discontinued and withdrawn from circulation on January 30, 1934.[61]

The currency of the United States includes United States notes, treasury notes of 1890, gold certificates, silver certificates, Federal Reserve notes, and circulating notes of Federal Reserve banks and national banking associations.[62] At one time the currency of the United States was backed by reserves of gold and silver. Gold certificates were issued against gold reserves equivalent to 100 percent of the value of the certificates; silver certificates were backed by a 100 percent silver reserve; the treasury notes of 1890 were secured by both silver and gold; Federal Reserve notes were secured by gold reserves equal to at least 25 percent of the issue and other collateral.[63]

The U.S. Court of Claims has held that the United States is under no obligation to tender payment in gold to a person who holds a bond that the United States originally promised to pay in gold coins. In *Gold Bond Holders Protective Council Inc. v. United States*,[64] the plaintiff owned a $50 gold liberty bond issued on October 24, 1918. The bond promised that when it was presented

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[57] Authority to mint clad coins, which are an alloy of copper and nickel, is given by 31 USC §§ 5111, 5112 (1982). Minting of the minor coins, the penny and the nickel, is also covered by 31 USC § 5111, 5112 (1982).

[58] 31 USC § 5112(e)(1) (1982).

[59] 31 USC § 324d (1976) (now repealed).

[60] 31 USC § 5112(d)(1) (1982).

[61] 31 USC § 5118(b) (1982).

[62] See 31 USC § 5119(b)(1), 5119(b)(2) (1982). U.S. currency notes are those issued pursuant to federal law. 31 USC §§ 5115, 5119(b) (1982). Treasury notes of 1890 are notes issued under the Act of July 14, 1890 ch. 708, 26 Stat. 289. 31 USC § 5119(b)(1) (1982).

At one time national banks issued notes that circulated as money. These "circulating notes" were secured by bonds of the United States. The National Bank Act authorized national banks to issue the notes as part of its plan to strengthen the currency of the United States. By 1870 these notes amounted to more than one-third of the total currency in circulation. National banks can no longer issue circulating notes. Although many of the provisions of the National Bank Act relating to circulating notes remain on the statute books (see 12 USC §§ 101–138, 168–178 (1982)), in 1935 the United States retired all of the bonds that carried the privilege of serving as security for issuance of the circulating notes. 12 USC §§ 101, 101a (1982).

[63] The issuance of silver certificates was authorized by Act of June 19, 1934, ch. 674, § 5, 48 Stat. 1178 (1934) (originally codified at 31 U.S.C. §§ 405, 821; repealed by Act of June 4, 1963, Pub. L. No. 88-36, Tit. I, § 1, 77 Stat. 54 (1963)). Issuance of gold certificates is authorized by 31 U.S.C. § 5117 (1982). The Act of June 12, 1945, ch. 186, 59 Stat. 237 (1945) established the gold reserve requirement for Federal Reserve notes at 25 percent. Before this act, the reserve requirement was 40 percent.

[64] 676 F2d 643 (Ct. Cl.), cert. denied, 459 US 968 (1982).

to the Treasurer of the United States on or after October 15, 1938, the United States would pay the principal and interest in gold coins of the current standard of value at that time. In 1981, the plaintiff presented the bond for payment and demanded payment in gold coins, or the equivalent value in currency. This value amounted to the sum of $1,253, because gold was selling for about $500 an ounce on the date the bond was presented for payment. The Court of Claims held that the plaintiff could not recover. In 1935 Congress enacted legislation that withdrew consent to sue the United States on the gold clause contained in the plaintiff's bond.[65] Thus, the doctrine of sovereign immunity barred the suit brought by the plaintiff.[66]

The United States has not been on the gold standard since 1934. Since that year, federal legislation has prohibited redemption of currency in gold.[67] Gold continued to serve as reserves for U.S. notes, treasury notes, Federal Reserve notes, and Federal Reserve deposits until Congress removed the requirement of a gold reserve for Federal Reserve deposits in 1965 and ended the gold reserve requirements for U.S. notes, treasury notes, and Federal Reserve notes in 1968.[68] Congress passed similar legislation dealing with silver reserves. Since June 24, 1968, silver certificates cannot be redeemed in silver bullion.[69] Legislation enacted in 1967 eliminated the requirement that the Secretary of the Treasury maintain 100 percent silver reserves for silver certificates.[70]

Nearly all of the currency in circulation today consists of Federal Reserve notes, issued by the Federal Reserve banks.[71] These are obligations of the United

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[65] 31 USC § 5118(c) (1982).

[66] Gold Bond Holders Protective Council Inc. v. United States, 676 F2d 643, 646 (Ct. Cl.), cert. denied, 459 US 968 (1982). In Gold Bond Holders Protective Council Inc. v. Atchinson, Topeka & Santa Fe Ry., 649 P2d 947, 950-951 (Alaska 1982), the owners of bonds that were issued in 1895 with a term providing for payment in gold tried to obtain payment in gold. In 1933, federal legislation eliminated the gold payment requirement, but a 1977 amendment to the statute authorized gold payments on obligations issued after October 28, 1977. 31 USC § 463 (1977) (31 USC 5118(d) (1982)). The Alaska Supreme Court held that this amendment did not restore the bond holders' right to payment in gold.

[67] 31 USC § 5119 (1982). The United States officially adopted the gold standard in 1900 with the Gold Standard Act of March 14, 1900. There is an excellent description of the monetary history of the United States in J. Cochran, supra note 51, at 34-49.

[68] Act of March 18, 1968, Pub. L. No. 90-269, 82 Stat. 50. Congress eliminated the requirement that Federal Reserve deposits be backed by a reserve of gold certificates in 1965. Act of March 3, 1965, Pub. L. No. 89-3, 79 Stat. 5 (1965). The reserve requirement originally was set at 40 percent, but was reduced to 25 percent in 1945.

[69] 31 USC § 5119(b)(1) (1982).

[70] Act of June 24, 1967, Pub. L. 90-29, § 1, 81 Stat. 77 (1967) (amending 31 USC § 405a-1, now at 31 USC 5116(b)(2) (1982)).

[71] Board of Governors, The Federal Reserve System, Purposes & Functions 105 (7th ed. 1984).

States as well as of the issuing Federal Reserve banks.[72] They are backed by collateral that equals 100 percent of the value of the notes and that consists of U.S. government securities and certain types of commercial paper.[73]

A federal law makes it a crime to print or photograph U.S. currency, but provides an exception for the publication of illustrations for "philatelic, numismatic, educational, historical, or newsworthy purposes" in certain publications when the illustrations are in black and white and are significantly different in size from the original. In *Regan v. Time, Inc.*,[74] a fragmented Supreme Court held that this prohibition applied to a photographic illustration of money on the cover of *Sports Illustrated* magazine. All but one member of the Court regarded the statutory publications exception that was limited to certain stated purposes as a violation of the First Amendment, but the Court divided over the validity of the size and color conditions to the exception.

[2] Gold and Foreign Exchange

Although federal law has eliminated the redemption of currency in gold since 1934 in domestic transactions, gold continues to play an important role because of gold reserve requirements, which lasted until 1968, and because of international monetary arrangements that pledged the United States to redeem the dollar with gold in international settlements. For a considerable period of time, federal law required the value of the dollar to be set at a fixed amount per ounce of gold. The price was set at $35 per ounce in 1934, and this became the rate established for foreign exchange in 1944, when the United States became a member of the International Monetary Fund.[75]

International economic considerations eventually made it impossible for the United States to maintain its international commitment to redeem dollars in gold at the $35 per ounce price.[76] In March 1968, the members of the International Monetary Fund agreed to maintain a two-tiered price system that separated the official price of gold, which was the basis for international exchange, from the private market price of gold, which was considerably higher. The two-tiered price system proved ineffective against stemming the foreign demand for

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[72] 12 USC § 411 (1982).

[73] 12 USC § 412 (1982).

[74] 468 US 641 (1984). The statute is 18 USC §§ 474, 504 (1982).

[75] Act of May 12, 1933, ch. 25, § 43(b)(2), 48 Stat. 51 (1933); 1934 Proclamation No. 2072, 48 Stat. 1730 (1933). The price previously had been set at $20.67 per ounce. The authority granted by the 1933 act to fix the value of the dollar expired in 1945. The Bretton Woods Agreements Act of 1944, ch. 339, 59 Stat. 512, ratified the international agreement which set the foreign exchange rate at $35.00. See generally H. Rep. No. 1095, 90th Cong., 2d Sess., reprinted in [1968] U.S. Code Cong. & Admin. News 1760, 1761.

[76] See S. Rep. No. 94-1148, 94th Cong., 2d Sess. (1976), reprinted in [1976] U.S. Code Cong. & Admin. News 5936–5945.

U.S. gold. On August 15, 1971, President Nixon suspended the conversion of the dollar into gold in international settlements. Four months later, the United States entered into the Smithsonian Agreement, which realigned exchange rates between currencies and resulted in an 8.5 percent devaluation of the dollar as the price of gold rose to $38.00 an ounce. In February 1973, the United States unilaterally devalued the dollar another 10 percent by raising the price of gold to $42.22. By the end of 1973, this structure collapsed. In November 1973, the governors of the central banks of Belgium, Germany, Italy, the Netherlands, Switzerland, the United Kingdom, and the United States terminated their 1968 agreement, which had established the two-tier system for pricing gold. The central banks became free to deal in gold in the private market. As a result, gold finally was removed as the basis for the international monetary system. Exchange rates between currencies no longer were tied to a fixed value in gold, but could float in response to economic conditions.[77] Congress adopted legislation in 1976 to implement these changes.[78]

As the United States moved away from the gold standard, restrictions on the private ownership of gold were eliminated.[79] Also, legislation in 1977 removed the gold clause prohibition for transactions on or after October 28, 1977. This prohibition had made contract clauses stipulating for payment of an obligation in gold or an amount of money measured in gold unenforceable.[80] Today, gold is not legal tender, but a highly speculative commodity subject to widely fluctuating prices. Banks should use caution in engaging in any gold transactions.[81]

The American Arts Gold Medallion Act of 1978 authorized the U.S. Mint to issue gold medallions. The Mint sells these medallions to the public through a purchase and distribution contract with a broker. The medallions are distributed

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[77] Id. J. Cochran, supra note 51, at 32, 46.

[78] Bretton Woods Agreements Act, amendments, Pub. L. No. 94-564, 90 Stat. 2660 (1976).

[79] Act of September 21, 1973, Pub. L. 93-110, § 3, 87 Stat. 352, as amended by Act of August 14, 1975, Pub. L. No. 93-373, § 2, 88 Stat. 445; Exec. Order No. 11,825, 40 Fed. Reg. 1003 (1974) reprinted in 12 USC § 95a note Section 9 (1982). The Gold Reserve Act of Jan. 30, 1934, ch. 6, §§ 3-4, 48 Stat. 337-340, vested title to gold in the United States and gave the federal government power to regulate and license private acquisition and use of gold. The acts of 1973 and 1974 repealed these provisions. They provided that no law, regulation, or order in effect on the effective date of the acts "may be construed to prohibit any person from purchasing, holding, selling, or otherwise dealing with gold in the United States or abroad." Pub. L. 93-110, § 3(b), as amended by Pub. L. No. 93-373, supra § 2.

[80] Act of Oct. 28, 1977, Pub. L. No. 95-147, § 54(c), 91 Stat. 1229. The gold clause prohibition was enacted in 1933. Act of June 5, 1933, ch. 48, § 1, 48 Stat. 113.

[81] See FDIC Policy Statement on Gold, 39 Fed. Reg. 43,765 (1974). Federal Reserve Board Letter to All State Member Banks (Dec. 9, 1974); Comptroller of the Currency Banking Circular No. 58 (Dec. 9, 1974).

and sold to a network of dealers, including banks, brokerage houses, and coin shops.[82]

¶ 14.03 COMMERCIAL PAPER

Banks routinely deal in various types of commercial paper. One of the most important categories of paper handled by banks is paper that qualifies as negotiable under Article 3 of the UCC. This paper includes checks, drafts, notes, certificates of deposit, cashier's checks, and similar instruments. Banks also may handle other types of paper. Documents of title, such as bills of lading issued by carriers for the transportation of goods, warehouse receipts, and similar documents are routinely used in commercial transactions. Investment securities such as stocks and bonds are another important category. Additionally, ordinary contracts may be encountered when parties having rights to payment or other valuable interests under contracts of various types may seek to use these rights as collateral for loans from banks. Special forms of contracts that create security interests in collateral such as Article 9 security agreements, real estate mortgages and deeds of trust, and other financing documents are common. This chapter briefly describes some of these different types of commercial paper. Chapters 15–21 explain in greater detail the rights and duties of parties to the type of commercial paper known as negotiable instruments. Special attention also is given to security agreements that create security interests in goods and other personal property under Article 9 of the UCC.

[1] Negotiable Instruments

The law of negotiable instruments has been codified as Article 3 of the UCC. The UCC recognizes four general classes of negotiable instruments: drafts, checks, notes, and certificates of deposit.[83] All types must be payable in money, must be signed by the maker or drawer of the instrument, must be payable on demand or at a definite time, must be payable to order or to bearer, and must contain "an unconditional promise or order to pay a sum certain in money."[84] The UCC does not foreclose the possibility that other forms of negotiable instruments may develop in the future. The UCC provisions apply only to writings that are negotiable instruments "within this article."[85] Additionally,

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[82] 31 USC § 5111 note (1982).

[83] UCC § 3-104.

[84] UCC § 3-104(1). For further discussion of the requirements for negotiability, see ¶ 14.04.

[85] UCC § 3-104 & comment 1.

specialized subcategories of negotiable instruments include cashier's checks, bank drafts, traveler's checks, share drafts, negotiable orders of withdrawal, and personal money orders. These specialized instruments are generally regarded as falling within the categories established by the UCC, although the UCC itself does not define them. Commentators have noted some difficulty in applying the standard UCC categories to personal money orders and traveler's checks.

The draft, of which the check is an example, is the most common form of commercial paper that appears in a bank. It is a contract that normally includes three parties: the drawer, the drawee, and the payee. It is an order by the drawer that instructs the drawee to pay a certain sum of money to a third party.[86] Drafts may also be two-party paper, in that the drawer and payee, drawer and drawee, or drawee and payee may be the same person. When a draft is "drawn on a bank and payable on demand" it is a check.[87]

Some drafts commonly used by insurance concerns have four parties. The agent of the insurance company draws the draft on the company payable to a beneficiary of a policy and payable at a certain bank or designating it as payable through a certain bank.[88]

The note, which is normally two-party paper, is simply a promise by the maker to pay a sum of money to the named payee. Notes can be drawn payable to the maker and then indorsed and transferred. When the drawer and the drawee on a draft are the same person, the draft is "effective as a note."[89] Where a doubt exists as to whether an instrument is a note or a draft, the holder may treat it as either one.[90]

The money order is a variation of a draft. Money orders may be sold by banks, by the post office, and by other entities. A drawer orders a drawee to make payment of a sum of money to the order of a specified person or to bearer. Usually, the institution that sells the money order is in the position of a drawee and the party that purchases and signs the instrument is in the position of a drawer. Because the drawee has not signed the instrument, it has no liability in contract on the instrument. However, it is customary for sellers of money orders to obtain payment for them in advance so that the money orders have little risk of being dishonored by the drawee for insufficient funds. Money orders are not always negotiable.[91]

The draft is called a cashier's check when it is a draft the bank has drawn on

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[86] UCC §§ 3-104(2)(a), 3-104(2)(b).

[87] UCC § 3-104(2)(b).

[88] For further discussion of these instruments, see ¶ 21.04.

[89] UCC § 3-118(a).

[90] UCC § 3-104(2)(b).

[91] For further description of money orders, see 4 W. Hawkland, Uniform Commercial Code Series § 3-104:20 (1986 and Supp.). For further discussion of money order liability, see ¶ 15.05.

itself. When it is a draft the bank has drawn upon a different bank, the instrument is referred to as a teller's check or bank draft. It is common for thrift institutions to use teller's checks.

In other specialized forms of drafts used in sales transactions, payment for goods sold is to be made against the presentation of documents or by drawing drafts against a letter of credit. Documentary drafts are drafts used in letter of credit transactions. Another form of draft, known as the trade acceptance, is a time draft drawn by a seller as drawer on a buyer as drawee for the payment of goods sold. The draft is presented for acceptance to the buyer, usually through banking channels, and, on the buyer's acceptance, may be used as collateral for a loan or discounted and transferred to a bank or other party who is willing to purchase the draft.

A banker's acceptance operates in a fashion similar to the trade acceptance, with the exception that a bank is the acceptor on the instrument. The banker's acceptance also is used in a sales transaction. The seller draws a time draft on a bank as drawee. The seller expects the bank to accept the draft because of prior arrangements, usually under an agreement which has established a letter of credit, which have created a commitment by the bank to accept drafts drawn on it. After the bank accepts the draft, it may be discounted and sold to other parties who are willing to deal in such instruments. Because the banker's acceptance carries the legal obligation of a bank as an acceptor of the instrument, the instrument is marketable, and there is a recognized market in which certain banks and dealers buy and sell these instruments.

The certificate of deposit, which is functionally similar to a note, is an "acknowledgment by a bank of receipt of money with an engagement to repay it."[92] It may be either negotiable or not negotiable.

[2] Letters of Credit

A letter of credit is a promise by a bank or another person that the issuer will pay when a draft or other specified demand for payment is made to the issuer in compliance with the conditions set forth in the letter of credit.[93] Article 5 of the UCC applies to letters of credit and defines their scope.[94] International customs and agreements also may apply. The letter of credit is not a promise to pay money, as in the case of a draft or note, but is a promise of the issuer to pay when drafts or similar written demands, as specified in the letter of credit, are made.

[3] Securities

Investment securities are a specialized form of contract rights. Article 8 of

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[92] UCC § 3-104(2)(c).

[93] UCC § 5-103(1)(a).

[94] UCC § 5-102. For further discussion of the letter of credit, see ¶¶ 17.02–17.04.

the UCC applies to investment securities. Such securities may be in the form of a written instrument, in which case the UCC refers to them as a "certificated security." They also may be in a form such that they are not represented by an instrument but merely consist of an interest or obligation carried on the books of the issuer. In the latter situation, the security is termed an "uncertificated security."[95] Investment securities are rights that represent "a share, participation, or other interest in property of or an enterprise of the issuer or an obligation of the issuer . . ."[96] and that meet additional requirements with respect to their treatment as a form of investment. Thus, investment securities under Article 8 may include obligations such as a note, debenture, or bond. They also include interests in a business or enterprise such as shares of stock and certificates of interests in business trusts, partnerships, or other ventures.

[4] Documents of Title

The most common types of documents of title are the warehouse receipt and the bill of lading. The former is an agreement by a warehouseman to store goods and deliver them to a named person. The latter is a similar contract by a carrier to ship goods and deliver them to a named person. Paper of this kind may be either two- or three-party paper. The person delivering the goods may contract to have them returned to him, or to his order, or to a third person or to his order. The rights and obligations created by this paper are covered by Article 7 of the UCC.[97] Some documents of title, such as bills of lading issued by interstate carriers, are also covered by federal law.

[5] Security Agreements

Paper carrying title to real estate or to goods is often used as security for loans. The most common contracts of this form in real estate transactions are the mortgage and the deed of trust. Paper that provides for a security interest in personal property is classified by the UCC as a security agreement.[98] Security agreements include what under earlier law was termed a chattel mortgage, conditional sales agreement, or trust receipt.[99] Sometimes the old terminology is still used, but this is of no legal consequence. If the UCC requirements are met, a valid security interest is created whatever the name used.[100] These transactions are discussed in Chapters 22–24.

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[95] UCC § 8-102.

[96] UCC § 8-102(1)(a).

[97] For further discussion of the rights and obligations created by documents of title, see ¶ 14.05[1].

[98] UCC § 9-105(l).

[99] These terms were created under statutes repealed by the UCC.

[100] See UCC §§ 9-102, 1-201 (37).

¶ 14.04 REQUIREMENTS FOR INSTRUMENTS TO BE NEGOTIABLE

The holder of a negotiable instrument may obtain special rights and advantages as compared with persons who have claims based upon ordinary contract rights. For an instrument to be a "negotiable instrument," it must meet the requirements set forth in the UCC, as follows:

> § 3-104. Form of Negotiable Instruments; "Draft"; "Check"; "Certificate of Deposit"; "Note"
>
> (1) Any writing to be a negotiable instrument within this Article must
>
> (a) be signed by the maker or drawer; and
>
> (b) contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this article; and
>
> (c) be payable on demand or at a definite time; and
>
> (d) be payable to order or to bearer.[101]

Before considering these requirements, it is worth noting that Section 3-104 applies to negotiable instruments "within this article." The comment to the section explains that the drafters used this language deliberately because it "leaves open the possibility that some writings may be made negotiable by other statutes or by judicial decision. The same is true as to any new type of paper which commercial practice may develop in the future."[102]

An obligation cannot be made a negotiable instrument by contract between the parties or by their conduct or by action labeling the obligation as negotiable. The law of estoppel may be applicable in a particular case to give rights to a bona fide purchaser or other person that are similar to the rights held by a holder in due course of a negotiable instrument, but this result depends upon principles of law outside the UCC and does not make the writing a negotiable instrument as such.[103]

[1] Advantages of Negotiability

The holder of a negotiable instrument has advantages over the transferee of ordinary contract rights. Firstly, the holder of a negotiable instrument may qualify as a holder in due course. Being a holder in due course will enable the holder to be free from many defenses of parties to the instrument that might otherwise be asserted in defense to a demand for payment and will enable the

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[101] UCC § 3-104.

[102] UCC § 3-104 comment 1.

[103] Id., comment 2.

holder to claim the instrument free from any claims of ownership by other parties.[104] Secondly, the holder of a negotiable instrument has a cause of action on the instrument against the parties who are liable on the instrument such as the drawer or maker and indorsers.[105] Having a cause of action on the instrument may give the holder a simpler claim than would be the case if the holder had to litigate a claim for payment based upon performance of a contract. Thirdly, the holder of a negotiable instrument is given the advantage of various presumptions, procedural rules, and substantive rights. When an instrument is given as payment of or as security for an antecedent obligation, no consideration is necessary for the instrument.[106] Signatures on the instrument are presumed to be genuine or authorized.[107] Further, once the signatures on an instrument are established, the holder is entitled to recover on the instrument by producing it unless a defense has been established.[108]

At one time there was an additional advantage in holding negotiable commercial paper, because the Federal Reserve Board required that the paper be negotiable in order for it to be eligible for rediscounting within the Federal Reserve System. The Board eliminated the need for commercial paper to be negotiable in 1970, and this change removed an important reason from a bank's standpoint for wanting commercial paper it took to be negotiable.[109]

[2] Requirements for Negotiability

Except in cases where special statutes and regulations protect consumers, the provisions of the UCC govern the nature and effect of most types of negotiable paper.[110] The requirements for negotiability are described in the subsections that follow. The basic statute that establishes these requirements is set out at the beginning of this section.

[a] Promise or Order. No set words are necessary to meet the requirement that an instrument contain a promise or order. Any words that show the intent of the person drawing the instrument to make an order or promise are sufficient.[111] The

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[104] UCC § 3-305.

[105] UCC §§ 3-413, 3-414, 3-415.

[106] UCC § 3-408.

[107] UCC § 3-307(1).

[108] UCC § 3-307(2).

[109] See 35 Fed. Reg. 6116 (1970), where the Federal Reserve Board eliminated its regulation prohibiting the discounting of commercial, agricultural, or industrial paper that was not negotiable in 12 CFR § 201.3(a) (1970); 9 Fed. Reserve Bull. 559 (1923). Although the Board's regulations prior to 1970 had required negotiability, the Federal Reserve Act did not impose such a requirement. See 12 USC § 343 (1982).

[110] The special consumer rules are discussed in ¶ 16.06.

[111] UCC § 3-104 & comment 5.

form of order that commonly appears in checks or drafts is simply "pay to the order of," but alternative language will be sufficient if it is "clearly the equivalent" of the language used in the UCC. When it is doubtful that the language used is the clear equivalent, the comment counsels the instrument should be viewed as not negotiable.[112]

"I or we promise to pay" is the usual printed form of the promissory note, but such words as "I undertake" will be a sufficient promise.[113] On the other hand, IOUs and due bills containing such statements as "due to X $100" are not promises, but mere acknowledgments of debt, while "borrowed $100" or "received $100" and the like are mere receipts, not promises. If the words are ambiguous, it is the policy of the UCC to treat such paper as nonnegotiable within Article 3.[114]

A negotiable instrument must not only contain an unconditional promise or order but alro must be free from any other promises or obligations. The UCC provides that a negotiable instrument must "contain an unconditional promise or order to pay a sum certain in money and *no other promise, order, obligation, or power given by the maker or drawer except as authorized by this article;* . . ."[115] Thus, a contract cannot be converted into a negotiable instrument by including phrases that otherwise would establish negotiability under UCC § 3-104. However, the UCC recognizes certain additional promises or obligations as appropriate. These include certain requirements with respect to collateral that are common in notes and other statements. The specific sections of the UCC dealing with the various requirements for negotiability contain details on which terms are permissible. In addition, there is a general provision that allows use of certain terms in a negotiable instrument without destroying its negotiability. That section provides as follows:

> § 3-112. Terms and Omissions Not Affecting Negotiability
>
> (1) The negotiability of an instrument is not affected by
>
> (a) the omission of a statement of any consideration or of the place where the instrument is drawn or payable; or
>
> (b) a statement that collateral has been given to secure obligations either on the instrument or otherwise of an obligor on the instrument or that in case of default on those obligations the holder may realize on or disposal of the collateral; or
>
> (c) a promise or power to maintain or protect collateral or to give additional collateral; or
>
> (d) a term authorizing a confession of judgment on the instrument if it is not paid when due; or

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[112] UCC § 3-104 comment 5.

[113] Id.

[114] See UCC §§ 3-102 comment 2, 3-104 comment 5.

[115] UCC § 3-104(1)(b) (emphasis added).

(e) a term purporting to waive the benefit of any law intended for the advantage or protection of any obligor; or

(f) a term in a draft providing that the payee by indorsing or cashing it acknowledges full satisfaction of an obligation of the drawer; or

(g) a statement in a draft drawn in a set of parts (Section 3-801) to the effect that the order is effective only if no other part has been honored.

(2) Nothing in this section shall validate any term which is otherwise illegal.

[b] Unconditional. The "promise or order" in a negotiable instrument must be *unconditional*, as set forth in the following guidelines:

§ 3-105. When Promise or Order Unconditional

(1) A promise or order otherwise unconditional is not made conditional by the fact that the instrument

(a) is subject to implied or constructive conditions; or

(b) states its consideration, whether performed or promised, or the transaction which gave rise to the instrument, or that the promise or order is made or the instrument matures in accordance with or "as per" such transaction; or

(c) refers to or states that it arises out of a separate agreement or refers to a separate agreement for rights as to prepayment or acceleration; or

(d) states that it is drawn under a letter of credit; or

(e) states that it is secured, whether by mortgage, reservation of title or otherwise; or

(f) indicates a particular account to be debited or any other fund or source from which reimbursement is expected; or

(g) is limited to payment out of a particular fund or the proceeds of a particular source, if the instrument is issued by a government or governmental agency or unit; or

(h) is limited to payment out of the entire assets of a partnership, unincorporated association, trust or estate by or on behalf of which the instrument is issued.

(2) A promise or order is not unconditional if the instrument

(a) states that it is subject to or governed by any other agreement; or

(b) states that it is to be paid only out of a particular fund or source except as provided in this section.

To be unconditional, the promise or order must stand on its own without relying upon an outside document or event except as specifically permitted by the UCC.[116] A provision in a note that it "is payable when my contract is

[116] UCC §§ 3-105, 3-112.

accepted" will make the instrument conditional and therefore nonnegotiable.[117]

However, when such expressions are mere statements of the transaction from which the instrument arises, such as statements of accounts found in voucher checks ("this check is in payment of the following account,"), they are not conditions and do not render the instrument nonnegotiable.[118] If requests are contained in the instrument for an act required in the course of business for payment of the instrument, such as requests often found on certificates of deposit, "payable on return of this certificate properly endorsed," or the words on a check, "payable when properly countersigned by the payee," they do not constitute conditions and therefore do not affect negotiability of the paper. These are not sufficient in themselves, however, to make the paper negotiable, or payable to order, and the instrument must qualify as a negotiable instrument apart from this language.[119]

Statements of the source of reimbursement of the account to be charged do not affect negotiability of instruments containing them. A promise to pay out of a particular fund, however, renders the instrument nonnegotiable.[120] For example, "pay to the order of X and charge my account" or "on account of contract" should not destroy negotiability,[121] but "pay out of my cotton returns"[122] or "out

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[117] UCC § 3-105(2). A note that contained a restriction to the effect that it could not be transferred, pledged, or assigned without the written consent of the maker was not a negotiable instrument because the promise to pay was not unconditional. First State Bank at Gallup v. Clark, 91 NM 117, 119, 570 P2d 1144, 1146 (1977).

The makers of a promissory note incorporated a condition in the body of the note that gave the makers the right to apply payments made under the note to a bank that held a first mortgage on real property. (The makers had purchased the land subject to that mortgage, but their sellers were obligated to pay the debt the mortgage secured.) The court held that this condition prevented the note from being a negotiable instrument. Illinois State Bank v. Yates, 678 SW2d 819, 824 (Mo. Ct. App. 1984). Because the note was nonnegotiable, the bank could not be a holder in due course and took the instrument subject to the defense that there was a partial failure of consideration.

See generally Annot., "What Constitutes Unconditional Promise to Pay Under UCC § 3-104(1)(b)," 88 ALR3d 1100 (1978).

[118] UCC § 3-105.

[119] UCC § 3-110(2) & comment 5.

[120] UCC § 3-105(1)(f), (g). When more than one interpretation of a provision in an instrument is possible, a court may prefer to adopt a construction that upholds the negotiability of the note. The Texas Court of Appeals took this approach in Grant Rd. Pub. Util. Dist. v. Coulson, 638 SW2d 616, 618–619 (Tex. Ct. App. 1982), where it construed a provision in a note that payment was to be made from the proceeds of sales of bonds as being a promise to pay from that source if funds were available but otherwise to pay from other sources and refused to construe the provision as meaning that payment could only come from the source stated because that would destroy the negotiability of the instrument.

[121] UCC § 3-105(1)(f). This was the result before the U.C.C. Utah Lake Irrigation Co. v. Allen, 64 Utah 511, 231 P 818 (1924); Slaughter v. Bank of Bisbee, 17 Ariz. 484, 154 P 1040 (1916); Hanna v. McCrory, 19 NM 183, 141 P 996 (1914); First Nat'l Bank v. Lightner, 74 Kan. 736, 88 P 59 (1906); Shepard v. Abbott, 17 Mass. 300, 60 NE 782 (1901).

[122] UCC § 3-105(2)(b). See the following pre-UCC case. Tomlin v. Neale, 76 Cal. App.

of my account"[123] are conditions if they are interpreted as making payment depend upon the existence of a balance in the specified accounts, and therefore, if so intended, they render the instrument nonnegotiable. Notes issued by governmental bodies are often payable out of "paving funds," "school taxes," and other particular funds. The UCC specifically exempts this paper from the particular fund rule and makes it negotiable.[124] Although all checks drawn upon bank accounts are expected to be paid from the balance of the appropriate account, the checks themselves contain no reference to such expectation and a careful examination will show that they are unconditional orders. When a bank pays on a check, even if the payment constitutes an overdraft, it is not a violation of the contract contained on the face of the check, and the bank may claim the amount from the depositor.[125]

Promissory notes of partners and unincorporated companies sometimes raise difficulties on the question of conditional promises. The general rule of law is that an instrument payable out of a particular fund is not negotiable.[126] If a partner in a business were to draw a note payable out of only his share of the business, it would be from a particular fund and therefore nonnegotiable.[127] But a note that limits payments only to the assets of the partnership, exempting personal property of the partners, is negotiable.[128] A similar rule applies to trusts.

It is a common practice to include in instruments descriptions of the transaction from which they originate. If such statements are merely descriptive of the transaction that gives rise to the instrument, they do not constitute conditions and are viewed as only informational. For example, "the transaction which gives rise to this instrument is the purchase of goods from the drawer" does not affect the negotiability of the draft on which it appears. "Value received in rent for the month of August" in a rent note, "this note is in payment of the first installment of a contract," and the like in notes do not destroy their negotiability, and abbreviated forms of such statements, "value received as per contract," are all construed as mere statements of the transactions and do not prevent the instrument containing them from being negotiable.[129] On the other hand, such provisions as "this is subject to and part of said contract," "payment to be made only as provided in contract," and their abbreviation, "subject to contract,"

726, 245 P 800 (1926). In Rogers v. Willard, 453 So2d 1175 (Fla. Dist. Ct. App. 1984), however, the court concluded that a note made payable out of "restaurant earnings" did not destroy the negotiability of the instrument because that language was not a condition that payment would be made from only that source.

[123] UCC § 3-105(2)(b). See the following pre-UCC cases. Glendora Bank v. Davis, 204 Cal. 220, 267 P 311 (1928); Rector v. Strauss, 134 Ark. 374, 203 SW 1024 (1918); Woodward v. Smith, 104 Wis. 365, 80 NW 440 (1899).

[124] UCC § 3-105(1)(g).

[125] UCC § 4-401(1).

[126] UCC § 3-105(2)(b).

[127] Id.

[128] UCC § 3-105(1)(h) & comment 7.

[129] UCC § 3-105(1)(b).

make the instruments dependent upon the terms of the contract and therefore conditional and nonnegotiable.[130]

A Florida case held that a mere reference in a note that it is being secured by a mortgage does not render the note conditional. However, when the terms of the mortgage "are by this reference made a part hereof" of the note, the note is conditional.[131]

The negotiability of an instrument is to be determined from an examination of the face of the instrument. The UCC provides that "a separate agreement does not affect the negotiability of an instrument."[132] It is possible for a separate writing to modify or affect a note or other negotiable instrument as between the immediate parties.[133] But the comment explains that the existence of a separate writing or oral agreement should not destroy the negotiability of a note. The comment states:

> Subsection (2) rejects decisions which have carried the rule that contemporaneous writings must be read together to the length of holding that a clause in a mortgage affecting a note destroyed the negotiability of the note. The negotiability of an instrument is always to be determined by what appears on the face of the instrument alone, and if it is negotiable in itself a purchaser without notice of a separate writing is in no way affected by it.[134]

The UCC is not clear as to the extent to which parol evidence may be used to vary the terms of a negotiable instrument. There is a provision, UCC § 3-118,

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[130] UCC § 3-105(2)(a). A check was not made conditional by a notation in its lower lefthand corner stating, "Payee must prove clear title to material." Furthermore, the statement did not give notice to the holder of the check to investigate and determine if the drawer had a defense to payment of the instrument. The court found the phrase ineffective to destroy negotiability or to give notice because it was located on the check where a drawer normally writes memoranda. It was "nothing more than a self-serving declaration" for the drawer's own record-keeping and informational purposes. Western Bank v. RaDec Constr. Co., 382 NW2d 406, 409-410 (SD 1986). See also ¶ 21.03[1].

[131] Holly Hills Acres, Ltd. v. Charter Bank of Gainesville, 314 So. 2d 209, 211 (Fla. Dist. Ct. App. 1974). When a mortgage bond states that it incorporates all of the covenants and conditions contained in a separate mortgage agreement, the bond is not a negotiable instrument because it states that it is subject to another agreement. UCC § 3-105(2)(a). "The fact that the incorporated mortgage may not actually contain any provisions that would impede the unconditional promise to pay is of no significance." In re Levine, 24 Bankr. 804, 811 (Bankr. SDNY 1982), rev'd on other grounds, 32 Bankr. 742 (Bankr. SDNY 1983), aff'd, 732 F2d 141 (2d Cir. 1984).

The incorporation of liens into the terms of a note does not make the note a nonnegotiable instrument. The court said that "the deeds of trust and security agreement given to secure the debt or promises to pay could not have rendered defendant's promise to pay uncertain or conditional." Thus, the incorporation of the liens in the note did not affect the negotiability of the instrument. International Minerals & Chem. Corp. v. Matthews, 71 NC App. 209, 321 SE2d 545, 547 (1984).

[132] UCC § 3-119.

[133] UCC § 3-119(1). See ¶ 16.05.

[134] UCC § 3-119, comment 5.

that gives rules of construction to apply in certain enumerated circumstances where the terms of an instrument are ambiguous. The comment to this section states that its purpose "is to protect holders and to encourage the free circulation of negotiable paper by stating rules of law which will preclude a resort to parol evidence for any purpose except reformation of the instrument. Except as to such reformation, these rules cannot be varied by any proof that any party intended the contrary."[135] In the next section, UCC § 3-119, which deals with when a separate writing may affect a negotiable instrument, the comment states that the UCC "does not attempt to state general rules as to when an instrument may be varied or affected by parol evidence, except to the extent indicated by the comment to the preceding section."[136] Cases have held that parol evidence may not be admitted to contravene the terms of a written instrument appearing complete and unconditional on its face.[137]

[c] **In Writing and Signed.** The requirement of writing simply means that no agreement that is oral can be negotiable. The term "writing" in the law includes longhand, typewriting, or any form of printing.[138] The signature, as has already been indicated, may be made by writing the name any place on the paper,[139] by mark, rubber stamp, printing, or lithography, if it can be identified sufficiently and is intended to serve as a signature.[140] Parol evidence is admissible to identify the signer.[141]

The requirement that a negotiable instrument be a "writing" excludes transfers of funds made by electronic communication methods from the definition of negotiable instrument. Thus, the law in the UCC relating to negotiable instruments does not specifically deal with electronic fund transfers and check collection and payment systems that involve processing by electronic means rather than transmission of the paper instruments, such as "wire transfers" and "check truncation." *This is discussed in Chapter 18.*

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[135] UCC § 3-118, comment 1.

[136] UCC § 3-119, comment 1.

[137] Trustees of Tufts College v. Parlane Sportswear Co., 4 Mass. App. 783, 342 NE2d 727 (1976); Texas Export Dev. Corp. v. Schleder, 519 SW2d 134 (Tex. Civ. App. 1975). For a discussion of the UCC rules on when a separate agreement may modify the terms of a negotiable note so as to provide the basis for a defense to payment of the note, including a discussion of the relevance of parol evidence to establish such a separate agreement, see ¶ 16.05.

[138] UCC § 1-201(46).

[139] UCC § 1-201(39). See Estate of Donohoe, 271 Pa. 554, 115 A 878 (1922).

[140] UCC §§ 3-401(2), 1-201(39). In Sequoyah State Bank v. Union Nat'l Bank, 274 Ark. 1, 621 SW2d 683, 684 (1981), the court held that the printed name of a bank on a money order constituted a signature.

[141] UCC § 3-401 comment 2. For further discussion of signatures made by agents and other representatives, see ¶¶ 15.04, 18.04, 20.08.

[d] Certainty as to Sum. Under the UCC, to be negotiable, an instrument must be payable in money.[142] The amount of the instrument will be sufficiently certain to meet the requirements of negotiability if the amount is stated on the instrument or can be calculated by a simple process of arithmetic and reference to the calendar at maturity. Thus, instruments payable with interest until maturity at a certain rate are negotiable.[143] Instruments payable with interest at a certain percentage until maturity (providing that the whole amount will bear a different rate in case of default) are equally negotiable, because the amounts can be calculated both before and after default.[144] In some cases, an instrument may be negotiable when it contains promises to pay in addition to its face value certain specific business charges even though the exact amount of these charges is unknown. For example, the promise to pay exchange,[145] cost of collection, or attorney fees does not destroy negotiability.[146]

The policy behind the sum certain rule is that "at any time of payment the holder is able to determine the amount then payable from the instrument itself with any necessary computation."[147] The comments state that "the computation must be one which can be made from the instrument itself without reference to any outside source, and this section does not make negotiable a note payable with interest 'at the current rate'."[148] Because of these requirements, a note with a variable interest rate dependent upon an external index is not payable in a sum certain.[149]

[e] Payable in Money. A negotiable instrument must be payable in money.[150] An instrument may be made payable in a foreign currency. When this is done, unless the instrument specifies otherwise, payment of the obligation may be satisfied by paying "that number of dollars which the stated foreign currency will purchase at the buying sight rate for that currency on the day on which the instrument is payable or, if payable on demand, on the day of demand."[151] The instrument may specifically require as the medium of payment that the instrument be payable in a foreign currency.[152] It is unclear from the language of UCC § 3-107 and comments if it would be acceptable for an instrument to be for a sum certain in a foreign currency but payable in U.S. dollars at a stated exchange rate

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[142] UCC § 3-104(1)(b).

[143] UCC § 3-106.

[144] UCC § 3-106(1).

[145] UCC § 3-106(1)(d).

[146] UCC § 3-106(1)(e).

[147] UCC § 3-106 comment 1.

[148] Id.

[149] See Farmers Prod. Credit Ass'n v. Arena, 145 Vt. 20, 481 A2d 1064 (1984); Northern Trust Co. v. E.T. Clancy Export Corp., 612 F. Supp. 712 (ND Ill. 1985).

[150] UCC §§ 3-104(1)(b), 3-107(1).

[151] UCC § 3-107(2).

[152] Id.

other than "the buying sight rate for that currency on the day on which the instrument is payable."[153]

[f] **Payable on Demand.** Instruments are payable on demand when they so state, or say they are payable at sight, or on presentation.[154] If no time for payment is expressed, the instrument is presumed to be payable on demand and negotiability is not affected by the omission of a definite date.[155] An instrument with blanks not filled in is not negotiable. A note that states on its face, "On demand but no later than 180 days after date," creates ambiguity as to whether it is payable on demand.[156]

When an instrument is payable on demand, the time when a cause of action will accrue against a party liable on the instrument will depend upon whether the party has primary liability as a maker or acceptor or secondary liability as a drawer or indorser. In the case of a maker or acceptor, the cause of action accrues on a demand instrument "upon its date or, if no date is stated, on the date of issue."[157] A cause of action against a drawer of a draft or an indorser of any type of instrument, on the other hand, "accrues upon demand following dishonor of the instrument."[158] Giving notice of dishonor is sufficient to constitute a demand for payment.[159]

When the instrument is a certificate of deposit, a different rule applies. Because a certificate of deposit is the type of instrument that may be held for a considerable length of time, a period that may exceed the applicable statute of limitations, the UCC provides that the cause of action against an obligor on either a demand or time certificate of deposit will accrue upon demand.[160]

When the issue is the time at which interest may begin to run on an instrument that has not been paid, "unless an instrument provides otherwise, interest runs at the rate provided by law for a judgment" and when the instrument is payable on demand, the interest begins to run "from the date of demand" in the case of a maker, acceptor, or other primary obligor.[161] In other cases, interest runs from the date of accrual of the cause of action unless the instrument provides otherwise.[162]

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[153] UCC § 3-107(2).

[154] UCC § 3-108.

[155] Id. In Harris & Harris v. Tabler, 232 Va. 75, 77, 348 SE2d 241, 243 (1986), the court ruled that a note without a due date is payable on demand and that a five-year statute of limitations begins to run on the date of issue. See ¶ 21.10[2].

[156] Seattle First Nat'l Bank v. Schriber, 282 Or. 625, 580 P2d 1012, 1013 (1978).

[157] UCC § 3-122(1)(b).

[158] UCC § 3-122(3).

[159] Id.

[160] UCC § 3-122(2) & comment 1. In the case of a time certificate of deposit, the demand may not be made, of course, until on or after the date of maturity.

[161] UCC § 3-122(4).

[162] Id.

A negotiable order of withdrawal (NOW) draft is a draft where the account to be debited is usually a savings account at a bank or thrift institution. Federal law authorizes depository institutions to offer NOW accounts. Because the NOW draft is not drawn on an account on which the drawer has a legal right of withdrawal on demand as is the case with a checking account, a question remains as to its legal classification. Although the institutions that offer NOW accounts routinely pay NOW drafts on demand, the statutes authorizing such accounts provide that the institutions may require the persons who present the drafts for payment to give notification to the institution in advance of withdrawal for a short period of time, such as thirty days.[163] Thus, although the NOW draft functions similarly to ordinary checks, the NOW draft does not fall within the definition of a "check" if it is regarded as not payable on demand.[164] It is not clear that the reserved right of the drawee institution to require advance notice before making payment would necessarily prevent the instrument from being payable on demand. The precise terms on the face of the instrument should be important to the resolution of this question.

Under some circumstances, the drawee institution's reserved right of prior notice may preclude the drawer-customer from asserting a claim against the drawee for wrongful dishonor of the instrument because invocation of the prior notice provision is not wrongful by the drawee. However, the holder of the NOW draft may have a cause of action against the drawer for dishonor when the terms of the instrument do not condition the holder's right to payment. Other interpretations, relying on the existence of the drawee's waiver of the notice requirement or analogizing to postdated checks, have been offered.[165] Sometimes the NOW draft is a "payable through" draft where it is to be presented for payment at a bank other than the thrift institution that holds the account. Although this is another difference between the NOW draft and a check, it does not affect whether the instrument should be regarded as payable on demand.

A note on its face stating that the draft is payable on demand should not be construed as an installment obligation payable at a definite time simply because the lender and borrower have agreed to a separate payment schedule. The payment schedule merely clarifies how the debt should be paid, assuming no demand for payment in full is made by the holder of the note. *Rogers v. Security Bank of Manchester* adopted this interpretation for a demand note that contained a separate payment schedule in the note itself.[166]

In *Kersten v. Continental Bank*, the court held that a promissory note stating it was payable "on demand, if no demand in 90 days" should not be viewed as a

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[163] See discussion at ¶ 19.02[2]. In Board of Governors v. Dimension Fin. Corp., 474 US 361, 368 (1986), the Supreme Court discussed NOW accounts and observed that they were not demand deposits because of the institution's legal right to require notification in advance of withdrawal.

[164] See Pennsylvania Bankers Ass'n. v. Secretary of Banking, 481 Pa, 332, 392 A2d 1319 (1978). See generally H. Bailey, Brady on Bank Checks, ¶ 1.22 (6th ed. 1987).

[165] See H. Bailey, Brady on Bank Checks, ¶ 1.22 (6th ed. 1987).

[166] 658 F2d 638, 639 (8th Cir. 1981).

demand instrument that was a matured debt.[167] In the court's view, the instrument required the holder to make a demand for payment if the obligation was to mature prior to the ninety days stated.[168] In another case, the promissory note stated that it was payable "on demand and if no demand be made, then principal and interest is payable in monthly installments of. . . ." The court concluded, after referring to other documents executed as part of the same transaction, that the note should be construed to be an installment note, not a note that was payable on demand.[169]

The status of a time certificate of deposit was considered in *Yahn & McDonnell, Inc. v. Farmers Bank of Delaware.*[170] A party trying to collect on the certificate of deposit from the issuing bank had acquired it after its stated date. The bank defended against the claim on the ground that the holder of the certificate could not be a holder in due course because he had acquired the certificate after it was overdue. The trial court agreed with this contention, ruling that either the certificate had matured on its stated date or that the certificate became a demand instrument after the stated date and acquisition more than a reasonable length of time after its issue is notice to the acquirer that it is overdue. The court of appeals required the district court to further explore the facts surrounding the issuance and acquisition of the certificate. The appellate court believed that the pre-UCC law and UCC § 3-122, which provides that the statute of limitations does not begin to run with respect to a certificate of deposit until a demand for payment has been made, might require treating the certificate of deposit differently than other negotiable instruments payable on

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[167] 129 Ariz. 44, 49-50, 628 P2d 592, 597-598 (Ct. App. 1981).

[168] Id. See UCC § 3-109(1) comment 4. A note dated July 30, 1976, stating that it was payable "on demand or if no demand be made January 31, 1977," was not a demand note as to which the statute of limitations began to run on the date of its making, but was a note due on January 31, 1977. Loomis v. Republic Nat'l Bank of Dallas, 653 SW2d 75, 77 (Tex. Ct. App. 1983).

The cause of action on a certificate of deposit accrues upon demand for payment. This occurs when the instrument is presented, and there is a refusal to pay. Garcia v. Chase Manhattan Bank, 735 F2d 645, 648 (2d Cir. 1984). See also Yahn & McDonnell, Inc. v. Farmers Bank of Del., 708 F2d 104 (3d Cir. 1983).

[169] Reese v. First Mo. Bank & Trust Co. of Creve Coeur, 664 SW2d 530, 531, 536–537 (Mo. Ct. App. 1983). In Seattle First Nat'l Bank v. Schreiber, 282 Or. 625–626, 580 P2d 1012–1013 (1978), a promissory note provided that it was payable "on demand but not later than 180 days." If the instrument was a note payable on demand, the cause of action accrued on the date of its issue, and the action was barred by the statute of limitations. If the note was payable at a definite time, the cause of action accrued on the maturity date, and the statute of limitations had not yet run. The court concluded that the language made the note ambiguous, and it was improper for the trial court to rule as a matter of law that it was a demand note. The court did not resolve the issue of the use of parol evidence to eliminate the ambiguity. See generally Hillis, "Negotiable Promissory Notes Containing Time and Demand Provisions: The Need for Consistent Interpretation," 19 Ga. L. Rev. 717 (1985).

[170] Yahn & McDonnell, Inc. v. Farmers Bank of Del., 708 F2d 104, 107–109 (3d Cir. 1983).

demand. Referring to the official comments, the court pointed out that banking custom is that such certificates are held for a considerable period of time and often are held for a period beyond the statute of limitations.

[g] Payable at a Definite Time. Instruments are payable at a definite time when they are payable on or before a specific date.[171] An instrument also is payable at a definite time if it is payable "at a fixed period after a stated date" or "at a fixed period after sight."[172]

An instrument may be payable at a definite time "subject to any acceleration."[173] The comments explain that a note with such an acceleration clause is "no less certain than a note payable on demand."[174] Although an acceleration clause may be abused, this is not a problem that should destroy negotiability. Curbing abuse is addressed by the general provisions of the UCC on options to accelerate at will which require that such a power be exercised in good faith when there is a belief "that the prospect of payment or performance is impaired."[175] Although the exercise of an acceleration clause may not be known to a subsequent purchaser or holder of the instrument, the provisions on notice to purchasers and holders in due course provide that lack of notice of the acceleration will not impair the holder's status as a holder in due course.[176] Further, lack of notice would operate as an excuse for delay in presenting the instrument.[177] Acceleration clauses are further discussed in Chapter 24.

[h] Payable to Order or Bearer. One of the most important requirements of a negotiable instrument is that it be payable to order or to bearer.[178] Most non-negotiable instruments are quickly identified because of the absence of both of these clauses.

The common printed forms are "pay to the order of," "pay to X or order," "pay to bearer," "pay to X or bearer," and sometimes "pay to the order of X or bearer." The first two are order instruments;[179] all the others are bearer instruments.[180] Use of the words, "pay to cash," or the words, "pay to the order of cash," make the instrument payable to bearer.[181] The UCC is stricter than the

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[171] UCC § 3-109(1)(a).

[172] UCC § 3-109(1)(a), 3-109(1)(b).

[173] UCC § 3-109.

[174] UCC § 3-109, comment 4.

[175] UCC § 1-208. See UCC § 3-109, comment 4. Acceleration clauses are discussed in Chapter 24.

[176] UCC §§ 3-302, 3-304, 3-109 comment 4.

[177] UCC § 3-511(1).

[178] UCC § 3-104(1)(d).

[179] UCC § 3-110(1).

[180] UCC § 3-111.

[181] UCC § 3-111(c).

pre-UCC law about this element of negotiability. For example, the expression commonly found in certificates of deposit, "on return of this certificate properly endorsed," was usually construed as making the instrument payable to order.[182] The UCC provides for the opposite result.[183] Under the UCC, the terms of the instrument must say it is payable to order or use the other language specified by the UCC to make the instrument payable "to order" or "to bearer." Therefore, use of language "pay to X or his assignees" and "pay to X's assignees only" does not meet the requirements of negotiability under the UCC.[184]

Under the UCC, it has been held that checks made payable to the order of a "depository account," followed by a number, are order instruments and not bearer instruments. The court stated that such a designation of the payee does not fall within any of the categories mentioned in the UCC for bearer instruments.[185] A note not payable to order or to bearer is not a negotiable instrument, but such a note is not outside the scope of Article 3 of the UCC. If its terms do not preclude transfer and it is otherwise negotiable, the note is within Article 3.[186]

[i] Designation of Payee. The payee of an instrument must be specified with "reasonable certainty."[187] The payee may be the drawer or maker,[188] any person who is not the drawer or maker, two or more payees jointly, one or two of several payees, or the holder of an office for the time being.[189] For example, "pay to Jones and Smith" or "Jones or Smith" is sufficient designation. So also, instruments bearing "treasurer of the town of Framingham,"[190] "trustees of Crozier Memorial Funds," "executor of Brown's estate," can be cashed or indorsed by the person holding the indicated office at the time of the act, and are therefore sufficient designation of the payee.[191]

Instruments drawn or payable to the cashier or fiscal officer of a bank or corporation are deemed payable to the corporation and may be negotiated by the indorsement of that officer or of the corporation itself.[192]

"Pay to the order of . . . ." is an incomplete designation. Until it

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[182] See Forrest v. Safety Banking & Trust Co., 174 F 345 (3d Cir. 1909).

[183] UCC § 3-110(2), comment 5.

[184] UCC § 3-110(1).

[185] Frost Nat'l Bank v. Nicholas & Barrera, 500 SW2d 906, 910–911 (Tex. Civ. App. 1973).

[186] Carpenter v. Payette Valley Coop., Inc., 99 Idaho 143, 144–145, 578 P2d 1074, 1075–1076 (1978). See UCC § 3-805.

[187] UCC § 3-110(1).

[188] UCC §§ 3-110(1)(a), 3-110(1)(c).

[189] UCC § 3-110(1)(d), 3-110(1)(f).

[190] UCC § 3-110(1)(e).

[191] Id. See also UCC § 3-111, comment 2, which makes clear that such instruments are not payable to bearer—they are order instruments, although only the office is designated.

[192] UCC § 3-110(f).

is filled in, the instrument remains nonnegotiable.[193] Blank instruments are discussed at ¶ 20.09[2].

In cases where names are misspelled or where instruments are made payable to persons operating under a trade name, such instruments may be negotiated by the indorsement of the persons intended, either by using the name on the instrument or by using the true names.[194] The payor or transferee for value may require signature both in the form on the instrument and in the correct form to assure the authenticity of the signer and remove doubt as to the identity of the signer by subsequent holders.[195] Instruments payable to a partnership or an unincorporated body of persons, are payable to order and can be negotiated by anyone with authority to represent the partnership or body.[196]

[j] Drawee Must Be Certain. In the case of checks and drafts, the drawee of the instrument must be sufficiently designated so that he or she can be identified and located.[197] Thus, an instrument may be negotiable if drawn on a single firm, whether incorporated or not,[198] or on joint drawees.[199] The drawee must be a "person," but under the UCC definitions a person may be an individual or an organization and an organization is also broadly defined to include, as well as the customary associations, any "legal or commercial entity."[200]

[k] Instruments Not Payable to Order or to Bearer. In order for an instrument to be negotiable the instrument must by its terms be payable "to order" or "to bearer." The rules contained in the UCC that establish negotiability will apply in some cases, however, even though the specific language that is necessary for an instrument to be payable to order or to bearer does not appear. UCC § 3-805 provides that "this article applies to any instrument whose terms do not preclude transfer and which is otherwise negotiable within this article but which is not payable to order or to bearer, except that there can be no holder in due course of such an instrument." This provision is not intended to make ordinary contracts into instruments under Article 3 of the UCC. But the provision does permit the application of the general rules for negotiable instruments to writings

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[193] UCC § 3-115. The rules on joint and multiple payees are discussed at ¶ 15.01[3][d]. See also the discussion of joint accounts at ¶ 19.03[2]. Blank instruments are discussed at ¶ 20.09[2].

[194] UCC § 3-203.

[195] Id.

[196] UCC § 3-110(1)(g).

[197] UCC § 3-102(1)(b).

[198] UCC § 3-102(1)(b). See definition of "person" and "organization." UCC §§ 1-201(28), 1-201(30).

[199] UCC § 3-102(1)(b).

[200] UCC §§ 3-102(1)(b), 1-201(28), 1-201(30).

that are similar in form and that in practice are treated as if they were instruments.[201]

[l] Ambiguous Terms and Rules of Construction. The UCC contains a number of rules to encourage free circulation of negotiable instruments without resort to parol evidence. These rules are set out as follows:

> § 3-118. Ambiguous Terms and Rules of Construction.
>
> The following rules apply to every instrument:
>
> (a) Where there is doubt whether the instrument is a draft or a note the holder may treat it as either. A draft drawn on the drawer is effective as a note.
>
> (b) Handwritten terms control typewritten and printed terms, and typewritten control printed.
>
> (c) Words control figures except that if the words are ambiguous figures control.
>
> (d) Unless otherwise specified a provision for interest means interest at the judgment rate at the place of payment from the date of the instrument, or if it is undated from the date of issue.
>
> (e) Unless the instrument otherwise specifies two or more persons who sign as maker, acceptor or drawer or indorser and as a part of the same transaction are jointly and severally liable even though the instrument contains such words as "I promise to pay."
>
> (f) Unless otherwise specified consent to extension authorizes a single extension for not longer than the original period. A consent to extension, expressed in the instrument, is binding on secondary parties and accommodation makers. A holder may not exercise his option to extend an instrument over the objection of a maker or acceptor or other party who in accordance with Section 3-604 tenders full payment when the instrument is due.

Carelessly drawn instruments sometimes contain differences between the amount stated by the words of the instrument and the amount stated in the figures. In one case, a note was filled in so that the amount was stated as "nineteen hundred eight hundred ninety six and 01/100" in one place and "$19,896.01" in another. The court found the note was for the latter amount.[202] Although the rule in UCC § 9-318(c) provides that words control figures unless the words are ambiguous, the court was able to determine reasonably from the circumstances that the amount was as stated in the figures.

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[201] UCC § 3-805, comment.

[202] Wall v. East Tex. Teachers Credit Union, 533 SW2d 918 (Tex. 1976).

¶ 14.05 DOCUMENTS OF TITLE AND SECURITIES

The chief types of negotiable paper other than negotiable instruments that are payable in money fall into two broad classifications: documents of title and investment securities. If they are documents of title, such as bills of lading and warehouse receipts, they are covered by Article 7 of the UCC. If they are securities that are traded on exchanges or in the "over the counter" market, they are covered by Article 8 of the UCC.[203] Corporate bonds also will usually fall within the UCC's coverage of securities.[204]

Although commodity paper may take almost any form, it usually appears in two standard types: the warehouse receipt issued by warehouses; and the bill of lading issued by carriers such as trucks, railroads, and ships. The negotiability of bills of lading is also affected by a federal statute,[205] which covers all shipments in interstate commerce, from any state or territory, or shipments from any state or territory to a foreign country.[206] This act is similar to Article 7 of the UCC, which would apply to purely intrastate transactions.

[1] Documents of Title

Documents of title, or commodity paper, as they are sometimes called, fall into two definite classes: negotiable and nonnegotiable. The *nonnegotiable* bill of lading or ocean freight bill is known as a *straight* bill,[207] whereas the *negotiable* one is called an *order* bill.[208] Warehouse receipts also are either negotiable or nonnegotiable, but are not referred to as "straight" or "order" receipts.[209]

The nonnegotiable document of title is simply a specialized form of receipt for the goods given by the carrier or warehouse.[210] The definition of "document of title" specifically includes a bill of lading, dock warrant, dock receipt, warehouse receipt, or order for the delivery of goods.[211] The definition also includes:

> Any other document which in the regular course of business or financing is treated as adequately evidencing that the person in possession of it is entitled to receive, hold, and dispose of the document and the goods it covers. To be a document of title a document must purport to be issued by

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[203] UCC § 8-102(1)(a), comment 2.

[204] UCC § 8-102.

[205] 49 USC app. §§ 81-124 (1982), known as the Pomerene Bills of Lading Act.

[206] 49 USC app. § 81 (1982).

[207] 49 USC app. § 82 (1982); UCC § 7-104.

[208] 49 USC app. § 83 (1982); UCC § 7-104.

[209] UCC § 7-104.

[210] 49 USC app. § 109 (1982); UCC §§ 7-102, 7-104. A nonnegotiable document of title such as a bill of lading can pass rights to the goods it covers by transfer. When a straight bill is transferred, the transferee has the right to notify the carrier to hold the goods for him in accordance with the duties of the contract owed to the transferor at the time of notification. See UCC § 7-504.

[211] UCC § 1-201(15).

or addressed to a bailee and purport to cover goods in the bailee's possession which are either identified or are fungible portions of an identified mass.[212]

When a document of title is in a form to be negotiable, transfer of the document carries with it the transfer of important rights in the goods represented by the document. As a result, negotiable bills and warehouse receipts not only embody shipping or storage contracts, but also serve important functions in security transactions because the paper itself carries title to the goods identified.[213]

[a] Negotiability of Documents of Title. When a negotiable document of title is *duly negotiated* to a bona fide purchaser, such a purchaser gets title to the document in much the same manner as does the holder in due course of a negotiable instrument.[214] Title to the document also carries title to the goods,[215] with the exception that the true owner (or one having a legal interest from whom the goods were stolen or who lost them and had nothing to do with issuing the document) does not lose his or her original title or interest.[216]

The term "duly negotiated" is a term of art under the UCC.[217] In order for a document of title to be duly negotiated or for there to be a due negotiation, the document first must be transferred with proper indorsements. A negotiation occurs when the document of title runs to the order of a named person and is negotiated by that person's indorsement and delivery. When the document of title is one that by its terms runs to bearer, it is negotiated by delivery alone. An order document of title can be indorsed in blank, thereby making it run to "bearer" and capable of further negotiation by delivery alone. Alternatively, an order document of title may be indorsed to a particular person, and when this is done the document runs to the order of that person and can be further negotiated only by that person's indorsement and delivery.[218] These rules on how a document of title is negotiated parallel those for negotiable instruments that are discussed in Chapter 15.

As described previously, in order for a document of title to be *duly negotiated*, a proper negotiation must occur, in addition to the satisfaction of the following requirements. The document must be negotiated "to a holder who purchases it in good faith without notice of any defense against or claim to it on the part of any person and for value, unless it is established that the negotiation

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[212] Id.

[213] 49 USC § 111 (1982); UCC §§ 7-501, 7-502, 7-503, 7-504.

[214] UCC § 7-502(1)(a).

[215] UCC § 7-502(1)(b).

[216] UCC § 7-503. There are also certain other exceptions to the rule that title to the document carries title to the goods.

[217] UCC § 7-501(4).

[218] UCC § 7-501(1), 7-501(2), 7-501(3).

is not in the regular course of business or financing or involves receiving the document in settlement or payment of a money obligation."[219]

As a result of the due negotiation requirement, a holder of a document of title by due negotiation is analogous to the holder in due course of a negotiable instrument. The holder by due negotiation must meet a test not required of the holder in due course, however. A holder by due negotiation must take the instrument "in the regular course of business or financing." The comments to UCC § 7-501 explain the reasons for this additional requirement. It imposes the duty of the transferee of a document of title of asking first if the transferor is "a person with whom it is reasonable to deal as having full powers."[220] The comment explains that "in regard to documents of title the only holder whose possession appears, commercially, to be in order is almost invariably a person in the trade. No commercial purpose is served by allowing a tramp or a professor to 'duly negotiate' an order bill of lading for hides or cotton not his own, and since such a transfer is obviously not in the regular course of business, it is excluded from the scope of the protection of subsection (4)."[221] A second question also must be answered satisfactorily for a due negotiation to occur. The question is whether the transaction is "one which is normally proper to pass full rights without inquiry, even though the transferor himself may not have such rights to pass, and even though he may be acting in breach of duty." The purpose of this aspect of the requirement is to limit the "effective wrongful disposition to transactions whose protection will really further trade."[222]

Once a document of title has been transferred by due negotiation, the holder acquires good title to the document, title to the goods, all rights based on agency or estoppel to obtain the goods, and the direct obligation of the issuer of the document to hold the goods or deliver them according to the terms of the document free of any defense or claim by the issuer except those expressly permitted by the UCC.[223] As a result of the provisions, a person who acquires a document by due negotiation may obtain a good title to the goods represented by the document although the transfer of the document was in breach of duty or occurred as the result of fraud, misrepresentation, mistake, loss, theft, conversion, or other wrongful conduct.[224] The holder by due negotiation gets good title to the goods even though the goods may have previously been sold or transferred to some other third person.[225]

In some circumstances, a holder by due negotiation will not obtain good title to the goods represented by the document. This situation occurs when the original owner of the goods cannot be held responsible for having introduced the

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[219] UCC § 7-501(4).

[220] UCC § 7-501, comment 1.

[221] Id.

[222] Id.

[223] UCC § 7-502.

[224] UCC § 7-502(2).

[225] Id.

goods into the stream of commerce so that a document of title could issue covering them. The UCC provides that a document of title will confer no rights in goods against a person who owns the goods or had a perfected security interest in the goods (in both cases before the document of title issued covering the goods) and who did not do any of the following: (1) deliver the goods or entrust the goods to a person who was given "actual or apparent authority" to ship, store, or sell the goods or had a special power under the UCC to dispose of the goods; (2) entrust any document of title covering the goods to a person who is either the bailor of the goods or the nominee of the bailor and who had actual or apparent authority with respect to the goods as above; (3) acquiesced in the procurement by the bailor or his nominee of any document of title.[226]

As a result of these provisions, in the case where goods are stolen from an owner, the thief obtains a document of title covering the goods and then duly negotiates the document to a purchaser, the purchaser who takes by due negotiation will not obtain title to the goods. There could be no showing that the owner had delivered or entrusted the goods or any document of title covering the goods to the thief, nor could it be shown that the owner had acquiesced in the thief's procuring the document of title on the goods. However, where an owner of goods entrusts possession of the goods to a person who is in the position of having apparent authority to ship or store or sell the goods, if that person acts beyond the scope of his authority and obtains a document of title and *duly* negotiates it to a purchaser, such a purchaser will obtain a good title to the goods.[227]

When a document of title is transferred under circumstances where there is no due negotiation, the transferee of the document acquires only the title and rights that his transferor had or had actual authority to convey.[228] As a result, if the transferee obtained the document of title from a thief or one who transferred it fraudulently, the transferee will not obtain good title to the goods.[229]

The formal requisites of negotiable and nonnegotiable documents are not complex. Under the UCC, a document of title is negotiable if the goods are to be delivered "to bearer" or "to the order of a named person."[230] All other documents of title are not negotiable.

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[226] UCC § 7-503(1).

[227] When a thief steals a negotiable document of title which is in bearer form and duly negotiates it to a purchaser, the purchaser should obtain a good title to the document and to the goods. This is an obvious purpose of UCC § 7-502(2) ("even though any person has been deprived of possession of the document by . . . theft . . ."). It is possible to read UCC § 7-503(1) as leading to a contrary conclusion because it is difficult to find that the owner has delivered or entrusted or acquiesced as required by that section. Nevertheless, it is believed that the intent of Section 7-502(2) and the analogy to negotiation of bearer negotiable instruments under similar circumstances should prevail and entitle the holder by due negotiation to protection.

[228] UCC § 7-504(1).

[229] Id.

[230] UCC § 7-104. See also 49 USC app. § 83 (1982).

[b] Liability of Bailee for Loss or Damage to or Failure to Deliver Goods. A carrier or warehouseman who issues a negotiable document of title is under the usual liability of the shipper or bailee of goods. In addition, by making the document negotiable, that individual undertakes to deliver the goods to the holder of the document at the *completion of the shipment* or the storage.[231] Bills of lading are sometimes issued in sets providing that in case the first is not presented, the second will carry the rights. The second contains similar provisions in case of nonpresentment of the first. In these situations, the carrier is required to perform the contract on behalf of the person *first presenting any one* of the set of bills. This practice originated in transactions that involved overseas transportation with great risk of loss or delay of the documents.[232] The bills were usually sent by different routes in order to make sure that the consignee received at least one copy. Railroads are prohibited from issuing bills in sets for inland shipments.[233]

The carrier or warehouse is liable to deliver the goods to the holder of the document of title, and discharges his liability if he does so in good faith.[234] If the bailee can show that the bailee delivered the goods to a person who had a right to the goods that was better than the holder of the document of title, such a delivery will excuse the bailee from failing to deliver to the holder.[235] When the holder has acquired the document of title by due negotiation, as seen earlier, in few circumstances will another person have a better title to the goods than the holder.

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[231] 49 USC app. § 89 (1982); UCC § 7-403. Where a warehouse releases goods under the purported authorization of the holder of the original receipt without production of this original and it turns out that the authorization was forged, the warehouse remains liable. Turner v. Scobey Moving & Storage Co., 515 SW2d 253, 255–256 (Tex. 1974).

[232] See UCC § 7-304(1) and comment.

[233] See 49 USC app. § 84 (1982); UCC § 7-304.

[234] UCC §§ 7-403, 7-404. "Under New York law, a warehouse that fails to provide an explanation for its failure to return stored property is liable for conversion." Under UCC § 7-204, a warehouse may limit its liability by agreement in some cases, but it cannot limit its liability for its own conversion. Colgate Palmolive Co. v. S/S Dart Canada, 724 F2d 313, 317 (2d Cir. 1983), cert. denied, 466 US 963 (1984).

A bailee is prima facie liable to the bailor under the law of Tennessee for negligence when the property was delivered to the bailee in good condition, the property was not returned in accordance with the contract or returned in a damaged condition, and the loss or damage was not due to the inherent nature of the property. Irving Pulp & Paper, Ltd. v. Dunbar Transfer & Storage Co., 732 F2d 511, 515 (6th Cir. 1984).

Under Section 22 of the Pomerene Bill of Lading Act (codified at 49 USC app. § 84 (1982)), a carrier is liable to the holder of an order bill of lading for damages caused by the failure to deliver the goods described in the bill of lading. In Industria Nacional Del Papel, Ca. v. M/V "Albert F.," 730 F2d 622, 624–625 (11th Cir.), cert. denied, 469 US 1037 (1984), the ship delivered worthless wastepaper instead of the soft wood pulp described in the bill. The court held the carrier liable for nondelivery and further held that the statement in the bill of lading, "particulars furnished by shipper," did not relieve the carrier of liability.

[235] UCC §§ 7-403(1)(a), 7-403(3).

When a nonnegotiable document of title is involved, the bailee must make delivery of the goods to the person entitled to delivery under the terms of the document of title or in accordance with written delivery instructions given to the bailee by the person entitled to the goods under the non-negotiable document.[236] Failure to deliver the goods to the person entitled to the goods will make the bailee liable to the person entitled to delivery.

Under certain circumstances, carriers may avoid liability for loss caused as a result of the misdescription of goods in the bill of lading or failure of the goods to be received for shipment when the carrier makes a proper notation on the bill of lading and the notation is a truthful one.[237] Similarly, a warehouse may avoid liability for nonreceipt or misdescription of the goods by appropriate notation on the warehouse receipt when the notation is truthful.[238]

The UCC permits a bailee to avoid liability for failing to deliver to the holder or other person entitled under the document when there is a "lawful excuse."[239] One court has held that a warehouse has a lawful excuse for not delivering goods to the person entitled to them under UCC § 7-403 when the warehouse files an interpleader action that brings all of the claimants to the goods under the jurisdiction of the court.[240]

Tyrone Pacific International, Inc. v. M.V. Eurychili[241] involved an action against the issuer of a bill of lading for wrongful refusal to issue a bill of lading for goods shipped by ocean vessel. The carrier refused to issue the bill of lading because the shipper failed to pay disputed freight charges. The shipper eventually paid the charges to obtain the bill of lading and then brought suit for conversion. The court held that no action for conversion had been established because the shipper had not demonstrated either that the bill of lading had declined in value during the period of its detention by the carrier or that the shipper had lost an opportunity to sell it.

In a case decided before the UCC became effective, the court held a warehouse liable for failure to deliver goods because the bailee did not prove that it was not responsible for the inability to return the goods. In this case, the goods were stored at the bailee's warehouse from 1953 until 1973, when the plaintiff demanded their return. The warehouse responded that the property was destroyed along with the warehouse in a fire and also introduced evidence that the warehouse was in an area subject to repeated fires and robberies. The court held that there was a presumption of negligence when the bailee failed to

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[236] UCC § 7-403(4).

[237] UCC § 7-301.

[238] UCC § 7-203.

[239] UCC § 7-403(1)(g).

[240] Corrigan Dispatch Co. v. Casa Guzman, 696 F2d 359, 362 (5th Cir. 1983).

[241] 658 F2d 664, 666–667 (9th Cir. 1981).

redeliver the bailed property. Because the bailee had not established the actual facts of the fire or how the goods were destroyed, it was responsible to the plaintiff. The court also refused to give effect to a term limiting the warehouse's liability contained in the warehouse receipt, because the plaintiff had not signed the receipt and the warehouse had failed to prove the plaintiff had "actual knowledge of the limitation of liability provision." The court imposed the standard of actual knowledge because of the social policy against enforcing contract provisions exculpating professionals from liability for negligence in dealing with nonprofessionals.[242]

In *Preston v. United States*,[243] the court considered the rights of persons who had stored grain that was commingled in a warehouse. The United States, which held warehouse receipts for some of the grain in the warehouse, withdrew the full amount it was entitled to under its receipts although it knew the warehouse had less than the amount of grain that should have been on hand. The court held the government liable in conversion under the Federal Torts Claim Act to other holders of warehouse receipts because the government knowingly took more than its pro rata share of the grain. The existence of the conversion depended upon the application of Article 7 of the UCC. Under UCC § 7-207(2) fungible goods commingled in a warehouse are owned in common and the depositors of the goods are treated as tenants in common. The UCC does not set out rights of tenants in common, so the court looked to the common law which imposes a duty of good faith in transactions between joint tenants. Under the common law, one joint tenant could claim only its pro rata share when a shortage exists.[244] Any clause in a warehouse agreement purporting to exculpate the warehouseman from a duty of reasonable care is ineffective and contrary to the UCC.[245]

[c] Carrier's or Warehouseman's Lien. A carrier or warehouseman has a lien on the goods to cover freight and other charges. This lien gives the right to hold the goods as security for the payment. In cases where the goods are covered by documents of title, the warehouse or carrier may enforce the lien for storage or freight on the goods covered. As is the case with certain purchases for value of negotiable bills and holders by due negotiation of warehouse receipts, the bailee can assert a lien for *other* charges only when the charges appear on the face of the

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[242] Griffin v. Nationwide Moving & Storage Co., 187 Conn. 405, 446 A2d 799, 805 (1982).

[243] 696 F2d 528, 536, 539 (7th Cir. 1982), reh'g denied, 709 F2d 488 (1983) (the court clarified the formula for calculating the damages recoverable in its decision on rehearing).

[244] See United States v. Luther, 225 F2d 499 (10th Cir. 1955), cert. denied, 350 US 947 (1956).

[245] UCC §§ 7-202(3), 7-204(1); Kimberly-Clark Corp. v. Lake Warehouse Div. of Lake Erie Rolling Mill, Inc., 47 App. Div. 2d 492, 375 NYS2d 918, 921–922 (1975).

document.[246] In addition to the right to hold the goods until the charges are paid, the warehouse has the power to foreclose the lien by selling the goods at a special sale after first giving proper notice to the parties involved.[247] In cases of perishable goods or hazardous goods, the UCC gives a warehouse special powers to sell the goods quickly without having to follow all of the normal procedures, but even in these cases there must be notice to persons who claim an interest in the goods.[248] The lienor must be engaged in the warehouse business in order to assert a lien under Section 7-209 of the UCC.[249]

[2] Investment Securities

The laws governing the transfer of rights represented by investment securities such as corporate stock and bonds have been codified partially in the UCC's Article 8 on investment securities. Although the UCC, in states where it has been adopted, supposedly repeals the Uniform Stock Transfer Act,[250] it should be noted that the UCC may not apply to all stocks, bonds, and corporate securities, but only to those "commonly dealt in upon securities exchanges or markets or commonly recognized . . . as a medium for investment,"[251] or "of a type" so traded although the particular security issue may not be.[252] Although this category covers most investment paper that comes to banks, other state laws deal with interests in corporations and their property. The UCC Article 8 applies only to certain limited aspects of rights in investment securities related to their

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[246] 49 USC app. § 105 (1982); UCC §§ 7-209, 7-307.

[247] UCC §§ 7-210, 7-308.

[248] UCC § 7-206(3). There is no comparable emergency provision in the UCC for carriers. See UCC § 7-308.

[249] In a Florida case, the plaintiff asked the defendant to pick up the contents of his house and store them pending notification of an address to which they would be shipped. No such notification was given, and after more than two months, the defendant mailed a notice to the address the plaintiff had given, but the letter was returned. The defendant sold the goods to satisfy its lien for their storage but did not advertise the sale as required by Section 677.210 of the Florida statute. To the plaintiff's action for conversion of the goods, the defendant pleaded that it was not a warehouse, but a carrier. The court held that a carrier may also be a warehouse. Suddath Moving & Storage Co. v. Roure, 276 So. 2d 549–550 (Fla. Dist. Ct. App. 1973).

[250] UCC § 10-102.

[251] UCC § 8-102(1)(a)(ii). See generally Annot., "What Is A Security Under U.C.C. Art. 8," 11 ALR4th 1036 (1982).

[252] UCC § 8-102(1)(a)(ii). This obviously includes securities that would not actually be on sale in regular markets, but they may be like those that are. Thus, forged U.S. Treasury bills are investment securities as defined by Section 8-102 of the UCC. Brannon v. First Nat'l Bank of Atlanta, 137 Ga. App. 275, 277, 223 SE2d 473, 475 (1976). See also Morgan Guar. Trust Co. v. Third Nat'l Bank, 529 F2d 1141 (1st Cir. 1976); Colin v. Penn Cent. Nat'l Bank, 404 F. Supp. 638 (ED Pa. 1975), aff'd without opinion 554 F2d 512 (3d Cir. 1976).

transfer. A substantial body of other state and federal law remains relevant to other aspects of rights relating to investment securities transactions.[253]

[a] Investment Securities Under the Pre-1977 UCC. Article 8 of the pre-1977 UCC covers not only stocks and bonds, but also interim certificates, equipment trust certificates, warrants for either money or property, and any other sort of paper commonly dealt with in security markets[254] that is one of a class or series of instruments evidencing participation or other interest in property or in an enterprise or that is an evidence of an obligation of the issuer.[255]

Under the pre-1977 UCC, securities are divided into two classes, "registered form" and "bearer form,"[256] and all securities are considered negotiable instruments.[257] The registered form is a security that specifies a person entitled to it and the transfer of which may be registered.[258] It may include stocks, bonds, and other instruments when in the proper form. A security is in the "bearer form" when its original terms run to bearer,[259] and such a security is negotiable by delivery.[260] An indorsement on a security in bearer form may give notice of an adverse claim, but an indorsement is a concept that normally applies only to registered securities.[261] Similarly, an indorsement in blank on the back of a security in "registered form" does not change its nature but makes the certificate itself negotiable by delivery until it is again specially indorsed.[262] The issuer of the registered security is entitled to regard the person who is registered on the books of the issuer as the owner.[263] The transfer of a security in "registered form" without a necessary indorsement gives the transferee only the rights of an assignee until he or she enforces his or her right to indorsement.[264]

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[253] UCC § 8-101 comment. Article 8 was extensively amended in 1977. When this book discusses the pre-1977 official version of Article 8, citation is to the UCC (1972 Original Text). When the current version, adopted in 1977, is discussed, the citation is simply to the UCC without specifying the 1977 Official Text.

[254] UCC § 8-102 & comment (1972 Official Text). See also UCC § 8-102, comment 2.

[255] UCC § 8-102 & comment (1972 Official Text).

[256] UCC §§ 8-102(1)(c), 8-102(1)(d) (1972 Official Text).

[257] UCC § 8-105(1) (1972 Official Text).

[258] UCC §§ 8-101 comment, 8-102(1)(c) (1972 Official Text).

[259] UCC § 8-102(1)(d) (1972 Official Text). Thus, a security is not in "bearer form" when it is originally in registered form and then indorsed to bearer. Id.

[260] UCC §§ 8-102(1)(d), 8-302 (1972 Official Text).

[261] UCC § 8-310 and comment (1972 Official Text).

[262] UCC §§ 8-302, 8-308(2) (1972 Official Text).

[263] UCC §§ 8-102(1)(c), 8-207 (1972 Official Text).

[264] UCC § 8-307 (1972 Official Text).

[b] Investment Securities Under the UCC—1977 Amendments and Uncertificated Securities. Article 8 of the UCC was amended in 1977 to broaden its scope to cover securities that are not represented by a tangible, paper certificate or document, but consist only of an interest registered on the books of the company.[265] The rules governing negotiable securities represented by a certificate remain basically unchanged. These securities, which are negotiable, are called "certificated securities" and include both registered and bearer forms as provided in the original Article 8.[266] Interests in a business or obligations of the issuer that are not represented by an instrument may be classified as "uncertificated securities" when they meet the Article 8 definition of such interests. This requires, among other characteristics, that the security be "of a type commonly dealt in on securities exchanges or markets," be registered on the books of the issuer or an agent of the issuer, and be part of a class or series of such interests.[267] Uncertificated securities are not negotiable, because they are not represented by the instrument, and statements or notices sent by an issuer of uncertificated securities are not negotiable instruments either and are not certificated securities.[268] It is possible to be a bona fide purchaser of both certificated and uncertificated securities.[269]

The transfer and pledge of both certificated and uncertificated securities are discussed in Chapter 22.

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[265] UCC App. I, § 8-101, Reasons for 1977 Change (1972 Official Text). Some states have not adopted these amendments yet. See Table 14-1, ¶ 14.01[2], for a list of the jurisdictions that have enacted the 1977 Article 8 amendments.

[266] UCC §§ 8-102, 8-105.

[267] UCC § 8-102(1)(b) and comment.

[268] UCC § 8-105.

[269] UCC § 8-302(1).

15

Rights and Liabilities of Parties to Commercial Paper

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¶ 15.01 TRANSFER AND NEGOTIATION OF COMMERCIAL PAPER

Commercial paper is a specialized form of property that through commercial custom and the development of the law has come to be recognized as property that must be readily transferable to fulfill its commercial purposes. The ease with which commercial paper may be transferred and the willingness of commercial parties to accept the transfer of such paper depends in part on the rights and liabilities that attach to parties to the paper and pass to transferees. To evaluate these rights and liabilities, a brief look at the rules that apply to the transfer of property generally is helpful.

[1] Transfer of Property Generally

An essential attribute of the ownership of property of all types is the ability to transfer ownership to another person. Whether the property is goods, contract rights, real property, or claims based upon legal rights against other parties, the ability to transfer or "alienate" rights in such property is important. How property is transferred or conveyed depends upon the type of property involved. Every state has statutes that deal with the transfer of land or interests in real

property which require the completion of various formalities in order to accomplish a valid transfer. To convey real property, the grantor typically must use a deed that satisfies certain formal requirements of the law of the state in which the land is located. Other specialized types of property may have rules peculiar to that property. For example, procedures for the transfer of interests in investment securities, such as shares of stock or corporate bonds, are set forth in the laws pertaining to such property. Some property may be regulated under legal regimes for which there are procedures for recording or filing notice of ownership interests in the property, as is the case with federal copyrights and patents. Further, there are legal systems for recognizing security interests in personal property that have centralized filing systems, as well as procedures for noting ownership and security interests on certificates of title or for registering those interests with federal authorities.[1]

Ordinarily, the transfer of title to goods is an uncomplicated affair that may be accomplished by simple delivery of the goods with the intention to pass title. Even these simple transactions may become complex when the transferor attempts to retain control by reserving title for security purposes, to make the passage of title conditional for other purposes, or to make the transfer of title effective on death.[2] When a bailee has possession of goods with title in another person, there are additional complications in determining to whom the bailee may deliver the goods, who has the right to compel the bailee to perform, and how interests in the goods held by the bailee may be transferred. While this discussion does not attempt to restate the law on the transfer of title to property generally, the focus of this chapter is on the transfer of interests in commercial paper.

Generally, a person to whom an interest in property has been transferred, the transferee, acquires no better rights than the rights the transferor had the authority to transfer. In a corollary rule, a transferor generally has or had the authority to transfer whatever rights in the property the transferor has. This latter rule must be limited to the extent the law will recognize as valid restraints that prior owners of property create on the ability of subsequent owners to transfer interests in the property. As might be expected of a commercially-oriented statute, the Uniform Commercial Code takes a general posture favoring the transferability of property. In Article 9, the UCC provides that a "debtor's right in collateral may be voluntarily or involuntarily transferred . . . notwithstanding a provision in the security agreement prohibiting any transfer or making the transfer constitute a default."[3] The UCC also recognizes a policy of free transferability with respect to negotiable instruments in providing that

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[1] For further discussion of perfection of security interests, see Chapter 22.

[2] For a good discussion of the general rules applicable to the transfer of ownership interests in personal property, see R. Brown, Personal Property (W. Rauschenbush ed. 3d ed. 1975).

[3] UCC § 9-311.

the transfer of a negotiable instrument generally vests in the transferee "such rights as the transferor has therein" with certain exceptions to prevent fraud.[4]

In certain circumstances, the law recognizes greater rights in the transferee than in the transferor of the property possessed. Buyers in the ordinary course of business of goods, for example, who meet the standards set forth in UCC § 2-403, obtain a good title to the goods although their seller's title may have been deficient.[5]

When a contract right is transferred or assigned, the general rule is that the rights of the assignee remain subject to the terms of the contract between the obligor and the assignor of the contract and any defense or claim arising from that contract. The UCC contains a provision on the assignments of "accounts." In the UCC terminology, the obligor is referred to as an "account debtor."[6] The UCC provision with respect to assignments adopts the general rule stated previously, but permits an account debtor by agreement with the assignor in the contract to give an assignee rights greater than those held by the assignor.[7] The relevant provision states as follows:

> (1) Unless an account debtor has made an enforceable agreement not to assert defenses or claims arising out of a sale as provided in Section 9-206 the rights of an assignee are subject to
>
> (a) all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom; and
>
> (b) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives notification of the assignment.
>
> (2) So far as the right to payment or a part thereof under an assigned contract has not been fully earned by performance, and notwithstanding

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[4] UCC § 3-201(1). See generally Annot., Beane, "Rights of Drawers, Banks and Holders in Bank Checks and Other Cash Equivalents," 19 Tulsa LJ 612 (1984).

[5] UCC § 2-403(2). For a good description of the rules applicable to good faith purchase of goods, see R. Nordstrom, The Law of Sales 511–525 (2d ed. 1970); G. Wallach, The Law of Sales Under the Uniform Commercial Code §§ 7.04(1), 7.04(2) (Supp. 1987); J. White & R. Summers, Uniform Commercial Code 140–146, 776–777 (2d ed. 1980).

[6] An account debtor is a person who is "obligated on an account, chattel paper or general intangible;" UCC § 9-105(1)(a). An account is broadly defined to mean "any right to payment for goods sold or leased or for services rendered that is not evidenced by an instrument or a chattel paper, whether or not it has been earned by performance." General intangibles is a term that refers to "any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, and money." UCC § 9-106. Chattel paper is defined as a writing that evidences both "a monetary obligation and a security interest in or a lease of specific goods. . . ." UCC § 9-105(1)(b). Thus, an account debtor is obligated on a broad range of different types of obligations.

[7] UCC § 9-318(1). For a statement of the general rule as applied to all contracts generally, see Restatement (Second) of Contracts § 336 (1979).

notification of the assignment, any modification of or substitution for the contract made in good faith and in accordance with reasonable commercial standards is effective against an assignee unless the account debtor has otherwise agreed but the assignee acquires corresponding rights under the modified or substituted contract. The assignment may provide that such modification or substitution is a breach by the assignor.

(3) The account debtor is authorized to pay the assignor until the account debtor receives notification that the amount due or to become due has been assigned and that payment is to be made to the assignee. A notification which does not reasonably identify the rights assigned is ineffective. If requested by the account debtor, the assignee must seasonably furnish reasonable proof that the assignment has been made and unless he does so the account debtor may pay the assignor.

(4) A term in any contract between an account debtor and an assignor is ineffective if it prohibits assignment of an account or prohibits creation of a security interest in a general intangible for money due or to become due or requires the account debtor's consent to such assignment or security interest.[8]

With respect to commercial paper, persons who qualify as holders in due course obtain greater rights to the instrument than those possessed by their transferors. Chapter 16 of this handbook discusses the holder in due course doctrine and the various limitations that have been ingrafted upon it. As previously discussed in Chapter 14, holders by due negotiation of documents of title may acquire rights superior to those of their transferors. Similar rules exist to protect bona fide purchasers of investment securities.[9]

[2] Transfer of Negotiable Instruments

In discussing the transfer of negotiable instruments, a distinction must be drawn between transfer and negotiation. When the transfer meets the formalities required for "negotiation," the transferee of the instrument becomes a "holder" and acquires the special rights attaching to that status under Articles 3 and 4.[10] A negotiation occurs only when the instrument is transferred in the proper manner. It requires delivery, plus any necessary indorsement of the instrument.[11] For delivery of the instrument to occur, there must be a "voluntary transfer of possession" of the physical instrument.[12] Where an indorsement is

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[8] UCC § 9-318.

[9] UCC § 8-307.

[10] UCC § 3-202(1). See also UCC § 1-201(20).

[11] UCC § 3-202(1).

[12] UCC § 1-201(14).

necessary, it must be made by a holder of the instrument, or one acting on behalf of the holder, by a signature on the instrument.[13]

An instrument, like other property, can be transferred without being negotiated. Rights will pass to the transferee although the transfer is not by negotiation. The UCC states: "Transfer of an instrument vests in the transferee such rights as the transferor has therein . . . ."[14] When an instrument has been transferred for value, if it is not payable to bearer, the transferee has the right to require the indorsement of the transferor so as to make the transferee a holder by negotiation.[15] However, until the proper indorsements are obtained, there will be no negotiation and "there is no presumption that the transferee is the owner."[16]

A transferee who does not take by negotiation cannot be a "holder" and so cannot qualify as a holder in due course. However, because a transferor can transfer all the rights that the transferor has, if the transferor is a holder in due course in his or her own right, the transferee will acquire those rights. This is discussed in Chapter 16.

Whether an indorsement is necessary in order to transfer a negotiable instrument by negotiation depends upon the character of the negotiable instrument. If the instrument is payable to "bearer," it may be negotiated by delivery alone. Subsequently, if the instrument is specially indorsed to be payable to a particular person, the instrument in that form may be further negotiated only by *both* delivery and indorsement.[17] When the instrument is issued in a form such that it is payable to "order," it can only be negotiated by delivery plus whatever indorsements are necessary.[18] If the instrument is indorsed in "blank," the instrument becomes payable to bearer and may be further negotiated by delivery alone until it subsequently becomes specially indorsed to be payable to order.[19] Thus, the form of indorsement, whether a special indorsement or an indorsement in blank, will determine whether the instrument will be regarded as "order" paper or "bearer" paper for purposes of further negotiation.

Unless the holder of an instrument is a holder in due course, the holder will take the instrument subject to defenses of nondelivery or delivery for a special purpose.[20] Delivery is generally defined in the UCC as any "voluntary transfer of possession," and an instrument is "issued" when it is first delivered.[21] Thus, in a

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[13] UCC § 3-202(2).

[14] UCC § 3-201(1). There are exceptions so that a transferee who has been a party to fraud or illegality cannot obtain better rights by laundering the instrument through a subsequent holder in due course. Id.

[15] UCC § 3-201(3).

[16] Id.

[17] UCC § 3-204(1).

[18] UCC § 3-202(1).

[19] UCC § 3-204(2).

[20] UCC § 3-306(c).

[21] UCC §§ 1-201(14), 3-102(1)(a).

1985 Wisconsin case in which the decedent had made a promissory note to the payee but had retained it among his personal papers, there was no delivery of the note. The payee could not enforce the obligation although the decedent had sent the payee a letter informing the payee of the existence of the note payable to him.[22]

[3] Indorsements

Negotiable instruments are commonly transferred by delivery and indorsement written on the instrument. To be effective under the UCC, the indorsement must be on the instrument itself or on a paper firmly attached to it.[23]

To be valid, the indorsement must transfer the entire instrument.[24] If part of the instrument has been paid, the indorsement must transfer the entire remaining unpaid amount.[25] When an indorsement attempts to split up the instrument and transfer a part to person *A* and another part to person *B*, the indorsement will not be effective to negotiate the instrument. Such action may operate as an assignment of parts of the instrument to the persons designated and may be enforceable as an assignment by them.[26] Because no negotiation would occur, the assignees could not qualify as holders in due course. A partial assignment differs from a security interest in an instrument. An instrument can be negotiated to a party who holds the entire instrument as security for a debt. The secured party must take care to be sure the formalities of delivery and indorsement necessary for negotiation are met; otherwise, the secured party will have only the rights of a transferee.[27]

An indorsement may be made by an agent or representative.[28] According to the comments to the UCC, the power to sign for another person "may be implied in law or in fact, or it may rest merely upon apparent authority."[29] Proving that the signature is authorized and therefore binding upon the principal is merely a

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[22] Vesely v. Security First Nat'l Bank, 128 Wis. 2d 246, 381 NW2d 593 (Ct. App. 1985).

[23] UCC § 3-202(2); Lamson v. Commercial Credit Corp., 187 Colo. 382, 531 P2d 966 (1975); Estrada v. River Oaks Bank & Trust Co., 550 SW2d 719 (Tex. Civ. App. 1977).

[24] UCC § 3-202(3).

[25] Id.

[26] Id. & comment 4.

[27] See UCC § 3-201(2).

[28] UCC § 3-403(1).

[29] UCC § 3-403, comment 1. When a lawyer exceeded the authority granted by his clients and indorsed checks for deposit into his personal account, rather than into the client's account, the indorsement was not effective because it was not authorized. The lawyer's conduct amounted to conversion of the client's property. The depositary bank was also liable for conversion because it paid the proceeds of the check to the lawyer. Levy v. First Pa. Bank, 338 Pa. Super. 73, 487 A2d 857 (1985).

matter of establishing the authority of the agent "as in other cases of representation." The drafters of the UCC indicate that parol evidence should be admissible to prove or deny the existence of the representative relationship.[30]

In a case before the New York Court of Appeals, the general and managing partner of a partnership indorsed a note to the bank. The partner exceeded his actual authority and negotiated the note for his own benefit, rather than for that of the partnership. The court held that although the bank might have behaved more prudently by investigating the notes offered to it, it had no obligation to investigate. The partner had *apparent* authority to transfer the note; therefore, the bank acted in good faith because the test of good faith is not whether the bank ought to have known or should have inquired, but whether the bank actually knew of some fact which should have prevented the bank from taking the note. Having acted in good faith, the bank qualified as a holder in due course that could enforce the notes notwithstanding the unauthorized transfer of them by the general partner.[31] An agent who indorses commercial paper should be careful to indorse it in a representative capacity so that the agent will not be personally liable for payment of the paper.[32]

[a] Types of Indorsements. The most common forms of indorsements that appear on negotiable instruments are the blank and the special indorsement. Indorsements may also be restrictive, qualified, or conditional.[33]

[i] Blank Indorsement. The blank indorsement is a transfer of the instrument by simply signing the name of the payee or the indorsee without further words.[34] Paper with such an indorsement is thereafter transferable by delivery and payable to bearer. Any holder desiring to make an instrument with a blank indorsement one that is payable to order may do so by writing above the

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[30] UCC § 3-403, comment 1.

[31] Chemical Bank of Rochester v. Haskell, 51 NY2d 85. 411 NE2d 1339, 432 NYS2d 478 (1980). Apparent authority cannot be created by the conduct of the person whose authority is in question. Confederated Welding & Safety Supply, Inc. v. Bank of the Mid-South, 458 So2d 1370 (La. Ct. App. 1984), cert. denied, 462 So2d 1264 (1985). The court held it was unreasonable to rely on the appearance of authority created by the president of the company himself. "It is well-established that the mere fact that an employee has managerial status and is in charge of the company's office does not entitle third persons to assume that he had the authority to execute or indorse negotiable paper belonging to his employer." In Grosberg v. Michigan Nat'l Bank of Oakland, 420 Mich. 707, 362 NW2d 715 (1984), the court interpreted Section 9 of the Uniform Partnership Act as conferring authority on one partner, as a matter of law, to indorse checks of the partnership that are payable to other partners. According to the court, the act gave a partner implied authority to indorse all incoming checks to the partnership.

[32] See UCC §§ 3-403(2), 3-403(3); see generally ¶ 15.04.

[33] UCC §§ 3-204, 3-414, 8-308(2). Under the UCC the term "restrictive indorsement" includes a conditional indorsement. UCC § 3-205.

[34] UCC §§ 3-204(2).

signature of the blank indorsee the holder's own name or the name of the person desired together with additional words, such as "pay to the order of" or "pay to," which indicate that the check is payable to the person designated.[35] Alternatively, the holder may specially indorse the instrument, which will allow the instrument to be further negotiated only with the indorsement of the special indorser. After the instrument has been specially indorsed, it no longer is bearer paper, and subsequently can be negotiated only with the indorsement of the person named.

[ii] Special indorsement. A special indorsement indicates the person to whom or to whose order the instrument is to be paid. After being so indorsed, the instrument can be further negotiated only by the indorsement of the special indorsee.[36] The special indorsement controls even when the instrument originally was issued as bearer paper; indorsement by the special indorsee is necessary to further negotiate the instrument.[37] Where an instrument originally payable to order has been indorsed in blank, making it a bearer instrument, a subsequent special indorsement controls and thereafter the indorsement of the special indorsee is necessary to further negotiation.[38]

The most common forms of special indorsement are "pay to *X*" or "pay to the order of *X*." Such expressions as "I hereby transfer my rights to *X*"[39] and "I hereby assign to *X*" have caused some conflict among the pre-Code cases.[40] The UCC makes clear that the addition of the words of assignment does not change the character of the indorsement.[41] Under the UCC, words of assignment, guaranty, or limitation of liability do not keep signatures from being effective as indorsements.

Generally where doubt exists as to the capacity in which a person signs an instrument, that person will be regarded as an indorser, unless he or she clearly indicates his intention to be bound in some other capacity.[42] Such an intention

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[35] UCC §§ 3-204(3), 8-308(2).

[36] UCC § 3-204(1).

[37] Id. The rule is different for bearer *securities*. Special indorsements of bearer securities do not prevent further negotiation; they merely serve to give notice of possible adverse claims to the securities so indorsed. UCC §§ 1-201(5), 8-304, 8-310, comment 1. Cf. UCC 8-308(2). The pre-UCC negotiable instruments law treated bearer instruments as remaining bearer paper notwithstanding any special indorsement. See F. Beutel, Beutel's Brannon Negotiable Instruments Law at 628 (7th ed. 1948).

[38] UCC § 3-204(1).

[39] Copeland v. Burke, 59 Okla. 219, 158 P 1162 (1916). Contra, Gale v. Mayhew, 161 Mich. 95, 125 NW 781 (1910).

[40] See Annot., "Indorsement in Form of Assignment Held Qualified Indorsement," 81 Banking LJ 447 (1964); Note, "Negotiable Instruments-Assignments as Indorsements Without Recourse," 10 NCL Rev. 306 (1932); "Effect of Assignment Indorsed on Back of Commercial Paper," 44 ALR 1353 (1926).

[41] UCC §§ 3-202(4), 8-308(1).

[42] UCC § 3-402 & comment.

may be expressed in appropriate words or indicated by the position on the instrument of the name of the indorsing party. The indorsement of an instrument to "cashier" or other fiscal officer of a bank or corporation is a special indorsement to the bank or corporation, and the instrument can be negotiated further either by the indorsement of the cashier or fiscal officer or by the bank or corporation itself.[43]

[iii] Indorsement without recourse. A qualified indorsement is a transfer of title to the instrument by which the indorser indicates his or her desire to limit his liability. Such an indorsement is commonly made by adding over the signature such words as "without recourse."[44] Such a qualification may be added to any type of indorsement. Its effect upon the liability of the indorser is discussed in the section that follows.

[iv] Restrictive indorsements. Restrictive indorsements are of four types. The first type, which purports to prohibit further negotiation of the instrument, can be made by adding to the signature of the indorser such an expression as "pay *X* only."[45] The second type vests title in trust for a third person and is created by such expressions as "pay to *X* in trust for *Y*,"[46] or "pay First Metropolitan Bank for account of *Y*."[47] The third type of restrictive indorsement, one that is very common in banking, is an indorsement that signifies a purpose of deposit or collection, and which may be made by adding to the indorsement the expression "for collection"[48] or "pay any bank."[49] Restrictive indorsements also include a fourth classification called "conditional" indorsements.

The UCC establishes certain general rules for all types of restrictive indorsements. No restrictive indorsement, regardless of its character, "prevents further transfer or negotiation of the instrument." However, the restrictive indorsement may give notice to certain parties and may impose requirements on subsequent parties that must be satisfied. In general, however, banks in the collecting process, including the payor bank, will not be affected by any restrictive indorsement on an instrument as long as the bank is not the depository bank.[50] Because banks must process checks rapidly and in bulk, it is reasonable to relieve all banks, except the first bank in which the item is deposited, from having to examine the chain of indorsements.

When the restrictive indorsement indicates that the instrument has been indorsed for purposes of deposit or collection, the transferee must "pay or apply

[43] UCC § 3-117 comment.

[44] UCC § 3-414.

[45] UCC § 3-205(b).

[46] UCC § 3-205(d).

[47] Id.

[48] UCC § 3-205(c).

[49] Id.

[50] UCC § 3-206(2).

any value given by him for on the security of the instrument consistently with the indorsement. . . ."[51] By making payment consistent with the indorsement, the transferee becomes a holder for value and may qualify as a holder in due course by satisfying the other holder in due course criteria. Thus, a depository institution that ignores a "for deposit" indorsement cannot be a holder for value; and therefore will not be a holder in due course and will be liable to the owner of the instrument for having paid it in a manner not consistent with the terms of the restrictive indorsement.[52] A similar rule applies when the indorsement is a "conditional" indorsement.[53] When the indorsement is in trust or otherwise for the benefit of another person, the first taker under such an indorsement "must pay or apply any value given by him for or on the security of the instrument consistently with the indorsement. . . ."[54] To the extent that the payment is consistent with the indorsement, the taker becomes a holder for value and possibly in due course. A subsequent holder for value is not on notice or otherwise affected by a conditional indorsement "unless he has knowledge that a fiduciary or other person has negotiated the instrument in any transaction for his own benefit or otherwise in breach of duty. . . ."[55]

[v] Conditional indorsements. Any kind of indorsement may be made conditional by adding words indicating that the instrument is to be transferred or paid only on some condition contained therein.[56] For example, "on arrival of the ship *Swallow*,"[57] or "This indorsement is made subject to all conditions of a separate contract"[58] are types of conditions. A conditional indorsement does not destroy negotiability of the instrument.[59] Payor banks that are not depositary banks are not given notice or otherwise affected by a conditional indorsement.[60] Intermediary banks likewise are under no duty as a result of a conditional indorsement.[61] A payor bank may properly pay the holder of an instrument bearing a restrictive indorsement so long as the payor bank is not the depositary bank.[62] Restrictive indorsements should be distinguished from mere directions

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[51] UCC § 3-206(3).

[52] Id.

[53] Id.

[54] UCC § 3-206(4).

[55] Id.

[56] The UCC classifies such indorsements as restrictive. UCC § 3-205(a).

[57] D. Smout, Chalmers on Bills of Exchange 116 (13th ed. 1964).

[58] Randles v. Gully, 128 Okla. 220, 262 P 201 (1927).

[59] UCC § 3-206 (1).

[60] UCC § 3-206(2).

[61] UCC § 3-206(3).

[62] UCC §§ 3-206(2), 3-603(1)(b). See also the discussion of notice to a bank from memoranda on a check at ¶ 21.03.

or notations written on checks, which indicate the disposition of the proceeds or the source of the account.

[b] Rights and Duties of Restrictive Indorsees. Restrictive indorsements do not prevent further negotiation of the paper, even where the indorsement specifically tries to prohibit further negotiation.[63] A bank is not bound by restrictive indorsements unless the bank is the first bank to whom the item is given for collection or is the transferee of the person who restrictively indorsed.[64]

In the case of restrictive indorsements that are indorsements in trust, are for collection or deposit, or are conditional, the first indorsee under the restrictive indorsement and the party required to pay (when the payor is not a bank) must conform to the terms of the indorsement or be liable to the person for whose benefit the indorsement was made.[65] Insofar as the indorsee does conform, that indorsee may become a holder in due course of the restrictively indorsed paper, cutting off defenses of previous parties.[66] When the indorsement is in trust or for the benefit of the indorser or another person, a person who is a holder for value after the first taker under the indorsement is "neither given notice nor otherwise affected" by the restrictive endorsement "unless he has knowledge that a fiduciary or other person has negotiated in any transaction for his own benefit or otherwise in breach of duties. . . ."[67] Thus, actual notice of breach of fiduciary duties by subsequent holders will remain significant. In the case of indorsements that are classified either as conditional indorsements or as indorsements for collection or deposit, any transferee other than a bank is bound to pay or apply any value given consistently with the terms of the indorsement.[68] The first bank that receives the instrument for deposit will be on notice from the terms of the indorsement and under the obligation to pay value consistently with the terms of the indorsement. Subsequent intermediary banks and the payor bank (when the payor is not the same bank as the depositary bank) are free from any effects as a result of the terms of the restrictive indorsement.[69]

To illustrate these rules, consider a check that the payee (P) indorses "for deposit" and deposits at Bank *A* where *P* has an account. Bank *A* forwards the

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[63] UCC § 3-206(1).

[64] UCC § 3-206(2) provides: "An intermediary bank, or a payor bank which is not the depositary bank, is neither given notice nor otherwise affected by a restrictive indorsement of any person . . ."; UCC § 4-205(2) states: "An intermediary bank, or payor bank which is not a depositary bank, is neither given notice nor otherwise affected by a restrictive indorsement of any person except the bank's immediate transferor." See also UCC §§ 3-206(3), 3-206(4), 3-603.

[65] UCC §§ 3-206(4), 3-603(1)(b).

[66] UCC §§ 3-206(3), 3-206(4) & comment 4.

[67] UCC § 3-206(4).

[68] UCC § 3-206(3).

[69] UCC §§ 3-206(2), 3-206(3).

check for collection to Bank *B* which, in turn, sends the check to Bank *C* for payment. Bank *A* is obligated to *P* to honor the restrictive indorsement and credit the funds to *P*'s account. Banks *B* and *C* do not have any responsibility to see that *P*'s account is properly credited. If a thief (*T*) should steal the check from Bank *A* and then take it to Bank *C* for payment or for deposit to some account of *T* at Bank *C*, in this situation Bank *C* is on notice of the restrictive indorsement because the check got outside the bank collection process when it was stolen and Bank *C* is now the first bank in the collection process when *T* attempts to obtain payment. If Bank *C* pays the check to *T*, Bank *C* will be liable to *P* for making a payment that is inconsistent with the restrictive indorsement. For additional discussion of problems involving miscredited proceeds and restrictive indorsements, see Chapter 20.

[c] Bank's Power to Supply Missing Indorsement. Under UCC § 4-205(1), banks may supply missing indorsements of their customers, which are needed to establish title to an item, unless there is an express statement on the item that requires the customer's indorsement, such as "payee's indorsement required."[70] The bank must note on the instrument that the customer's account was credited. However, the authority given under UCC § 4-205(1) to a depository bank to supply the missing indorsement of its customer does not extend to supplying the missing indorsement of a non-customer joint payee on the check. The bank's authority extends only to parties who are customers of the bank.[71]

In a New York case, the court held that a party could be a customer of the bank for the purpose of allowing the bank to supply the party's missing indorsement although the party had no account at the bank.[72] The person became the bank's customer when the bank agreed to collect the check for him.[73] Although the argument was made that the bank should be viewed as the purchaser of the check for its own account and not as an agent for collection, the court reasoned that the UCC expressed a policy in Section 4-201 to avoid deciding cases on the basis of agency or owner status.[74]

[d] Transferees of Instruments With Missing Indorsement. The effect of transferring an instrument without indorsement is similar in all types of negotiable paper. If the instrument is payable to bearer or indorsed in blank, such a transfer, which is made by mere delivery of the paper, constitutes a negotiation,

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[70] UCC § 4-205. See generally Annot.; Kreig, "The Missing Signature as an Unauthorized Signature of the Customer: The Debate Continues," 103 Banking LJ 542 (1986).

[71] Krump Constr., Inc. v. First Nat'l Bank of Nev., 98 Nev. 590, 655 P2d 524 (1982).

[72] Marine Midland Bank, N.A. v. Price, Miller, Evans and Flowers, 57 NY2d 220, 441 NE2d 1083, 455 NYS2d 565 (1982).

[73] See UCC § 4-104(e).

[74] For further discussion of this case, see ¶ 20.07.

and a person taking the instrument under these circumstances is a "holder" and may be a holder in due course by satisfying the additional criteria for that status.[75]

If the instrument is payable to the order of a particular person, indorsed specially, or contains some type of restrictive or conditional indorsement, the manual delivery without indorsement confers upon the transferee such title as the transferor had in the instrument. If the transfer is for value, it gives the transferee the right to have the indorsement of the transferor.[76] This right is to an unqualified indorsement and may be enforced in court,[77] but until such an indorsement is actually placed on the instrument, the transferee is a mere assignee of title to the paper and cannot sue as a holder in due course.[78]

A person to whom a negotiable instrument has been transferred without a necessary indorsement is classified as a "transferee" by the UCC.[79] Although such a person is not a holder of the instrument and therefore can never become a holder in due course as long as the indorsement is missing, such a person has rights as a transferee. Most importantly, the transferee acquires all of the rights that his or her transferor had in the instrument.[80] The transferee may bring suit

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[75] UCC § 3-202. See ¶ 15.01[3][a][i].

[76] UCC § 3-201(3).

[77] Id.

[78] UCC § 3-201. For a case in which the court found that the transfer of a check without an indorsement was an assignment so that the obligor, who had constructive notice of the assignment, lost any control or power to revoke payment of the funds, see Security State Bank v. Morlock, 355 NW2d 441 (Minn. Ct. App. 1984). The general differences between ordinary transfers of property and negotiation are discussed at ¶ 15.01.

[79] UCC § 3-201. A person who does not have possession of a check cannot be a holder and, thus, lacks standing to enforce payment of the check under UCC § 3-301 even though he may be the beneficial owner of the instrument. If the person can establish status as a transferee of the check, he may enforce the instrument under UCC § 3-201 which gives a transferee the rights of his transferor, but an assignment of rights to the check without physical transfer of possession is not sufficient to constitute a "delivery" or "transfer" under this section. Locks v. North Towne Nat'l Bank, 115 Ill. App. 2d 729, 451 NE2d 19 (1983). There may be some circumstances where physical possession of the instrument by an agent would constitute constructive possession by the beneficial owner. 451 NE2d at 19.

[80] UCC § 3-201. The transferee cannot obtain greater rights than his transferor had. If the transferor lacked title to the check, his transferee would not have good title either. For an example of a case where the court held that all subsequent transfers could not become holders of the instrument due to the missing necessary indorsement, see O'Mara Enters., Inc. v. Mellon Bank, 601 F. Supp. 565 (WD Pa. 1985). In *O'Mara Enterprises*, the court said that no transferee could become a holder out of the chain of title, even though there was an indorsement by the missing indorsee, after the check had been restrictively indorsed for deposit. See Brown v. Bell, 291 Ark. 116, 722 SW2d 592 (1987). The owner of a note payable to order can transfer his ownership interest by making a gift of the note even though he fails to indorse it.

to obtain payment of the instrument, although the transferee does not have the benefit of the special presumptions established by the UCC for holders.[81]

Because the relationship between the bank and its customer is contractual and requires the bank to obey the orders of its customer on checks drawn against the customer's account, a check made payable jointly to named payees is not properly payable unless both of the named payees indorse the check.[82] If the bank fails to obtain both signatures, the customer may require the bank to recredit the account. It is not necessary, according to one court, for the customer to prove actual damages before being entitled to have the account recredited.[83]

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[81] UCC § 3-201. Pay Center Inc. v. Milton, 632 P2d 642 (Colo. Ct. App. 1981). In Fore v. Bles, 149 Ariz. 603, 721 P2d 151 (Ct. App. 1986), the court recognized the rights of a party who was not a holder. When Fore and Bles divorced, the court determined that Fore had an interest of $52,500.00 in a note for $133,431.44 under Arizona community property laws because it was obtained for a loan of community funds. The maker of the note was a firm named ISSI, and Bles was the payee. The divorce decree awarded Fore a share of "the loan repayments due the community from ISSI" without specifically referring to the note. The note was payable to Bles, on demand, and had neither been indorsed nor physically transferred to Fore. Fore sued ISSI, naming Bles as an involuntary plaintiff, to collect on her interest in the note, ISSI defended on the grounds that Fore lacked standing to sue for payment of the note because she was neither a holder nor a transferee of the note. According to ISSI, only the holder could enforce the note. The court ruled for Fore. (It should be noted that the judgment provided for Bles to present the note to ISSI for partial cancellation.) According to the court, Fore was not a holder but had obtained the rights of a holder as a transferee under UCC § 3-201. Thus, she could sue on the note in her own name because she became a transferee through the Arizona community property laws. Having been awarded a beneficial interest in the note on dissolution of the marital community, she gained the right to exercise exclusive control over her separate property under the community property laws. Recognizing an exclusive right in Bles to enforce the note would violate this principle. Also, it would encourage collusion between the maker and the payee to deny enforcement rights to Fore. See Vance v. Vance, 124 Ariz. 1, 601 P2d 605 (1979) (an uncooperative payee could not prevent a co-payee from suing on a note).

[82] UCC § 3-116 provides that when an instrument is payable to the order of two or more persons, all of them must act in order to negotiate, discharge, or enforce the instrument. See also American Nat'l Bank & Trust Co. v. St. Joseph Valley Bank, 180 Ind. App. 546, 389 NE2d 379 (1979). See generally Note, "Drawers: Check for Missing Endorsement on Joint Payee Checks," 32 Mercer L. Rev. 407 (1980).

[83] Cincinnati Ins. Co. v. First Nat'l Bank of Akron, 63 Ohio St. 2d 220, 407 NE2d 519, 17 Ohio Op. 3d 136 (1980). See C.H. Sanders Constr. Co. v. Bankers Trust Co., 123 AD2d 251, 506 NYS 2d 58 (1986). A check named two payees using the word "and" plus a mark that might be interpreted as a virgule between the two payees' names. The court held that the check was ambiguous as to whether both payees needed to indorse. To protect the interest of both payees, who were not responsible for writing the check, the court ruled that the check should be deemed to be payable jointly. However, as the action was brought by the drawer, if the drawee bank could establish that the drawer received value for the check, the drawee bank would have a defense of unjust enrichment.

In *Puckett v. South East Plaza Bank*,[84] the court upheld the right of one joint payee to recover from a bank that cashed a draft in which she and another were named as joint payees without requiring her signature. The plaintiff's signature was forged. The court further held that the plaintiff could maintain the action without making the other joint payee a party to the lawsuit because he was not an indispensable party to the action.

Instruments payable to more than one person must be examined to determine whether they are payable in the alternative or payable to all of them.[85] When the instrument is payable in the alternative, it is payable to "any one of them" and any one of the persons to whom it is payable who has possession of the instrument may negotiate, discharge, or enforce it.[86] On the other hand, if the instrument is not payable in the alternative, then it must be regarded as payable to all of them and the instrument "may be negotiated, discharged, or enforced only by all of them."[87] An instrument payable to "*A* or *B*" is payable in the alternative to either *A* or *B*. An instrument payable to "*A* and *B*" is payable to both of the parties.[88] As the comment to the UCC recognizes, although an instrument is payable to more than one person and requires all of those persons to take action to negotiate or enforce the instrument, "one may of course be authorized to sign for the other. . . ." or to give consent to actions by the other.[89] A signature may be made by an agent, and the UCC incorporates the traditional rules of agency where authority may be established not only in cases of an express grant of authority to the agent but also in cases where authority "may be implied in law or in fact, or it may rest merely upon apparent authority."[90]

Sometimes an instrument is ambiguous as to whether it is payable to two or more persons in the alternative or is payable to all of them jointly. In a common situation, a slant or virgule is inserted between two names as in an instrument payable "to *A/B*." It has been held that a check made payable to two persons with a slant between the two names may be paid on the indorsement of either one of the payees. The slant, or virgule, is the equivalent of "or" rather than "and."[91]

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[84] 620 P2d 461 (Okla. Ct. App. 1980). See also Quintana v. Allstate Ins. Co., 378 NW2d 40 (Minn. Ct. App. 1985), holding that an insurance draft was converted when the insurance company paid the draft over the forged endorsement of one of the two joint payees on the instrument.

[85] UCC § 3-116.

[86] UCC § 3-116(a).

[87] UCC § 3-116(b).

[88] UCC § 3-116 & comment.

[89] Id.

[90] UCC § 3-403 & comment 1; see also UCC § 3-404 & comment 1. For further discussion of rules of agency, see ¶¶ 18.04, 19.04, 20.08.

[91] See Dynalectron Corp. v. Equitable Trust Co., 704 F2d 737 (4th Cir. 1983); Ryland Group Inc. v. Gwinnette Co. Bank, 151 Ga. App. 148, 259 SE2d 152 (1979); Miron Rapid-Mix Concrete Corp. v. Bank Hapoalim, 105 Misc. 2d 630, 432 NYS2d 776 (Sup.

The obligor on a promissory note that is payable to two or more payees jointly (and not alternatively) must make payment to all of the joint payees. Payment made to only one of them will leave the obligor liable to the remaining payees.[92] Of course, one joint payee may be authorized by the other joint payees to act on behalf of all of them. Also, a joint payee may indorse the instrument and transfer his or her interest to another person, including one who was also a joint payee, and that person will have the status of a holder if all necessary indorsements are obtained.

In another case, one joint payee, Cook, sued the depositary bank and the drawee bank for conversion of a check on which he was a joint payee with American General. The plaintiff claimed that the banks paid the check notwithstanding that his indorsement had been forged. Cook knew his indorsement had been forged but delayed for ten months in giving notice. The banks argued that Cook's delay in notifying them amounted to either a ratification of the forged indorsement or an estoppel from challenging the authenticity of the indorsement. The court held that ratification of a forged signature is usually a question of fact. The court then stated, "We find that ten months is a substantial delay raising an inference of ratification sufficient to warrant that this issue be submitted to the trier of fact. However, although urged to do so by the banks, we are unwilling to find as a matter of law that this delay by itself constitutes a ratification which entitles the banks to judgment in their favor."[93] The court further held that whether Cook was estopped from claiming the indorsement was unauthorized was a question of fact. Moreover, if the banks failed to exercise due care in paying the check, they could not assert estoppel as a defense.

Finally, although a check must be delivered in order for a payee to have a conversion claim against a bank for payment of the check on a forged indorsement, delivery of this check did occur. The drawer delivered the check to the other payee. Delivery to one joint payee may constitute constructive delivery as to all payees. Although Cook knew that the check had been delivered to the payee who committed the forgery, Cook's ratification of the delivery of the check to such payee did not constitute a ratification of the forgery.

The depositary bank's failure to authenticate Cook's signature as a joint payee did not, as a matter of law, constitute failure to act in a commercially

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Ct. 1980). A comment to UCC § 3-116 states that an instrument payable to "A and/or B," is to be regarded as "payable in the alternative to A, or to B, or to A and B together. . . ."

[92] Concepcion v. Tojeiro, 457 So2d 553 (Fla. Dist. Ct. App. 1984). Although a certificate of deposit payable in the *alternative* to multiple parties required an indorsement prior to payment according to its terms, the bank was not liable in conversion for paying the proceeds to one of the named payees without an indorsement because a properly payable party received the proceeds. Gray v. Bertrand, 723 SW2d 957 (Tex. 1987). See generally H. Bailey, Brady on Bank Checks, ¶ 7.13 (6th ed. 1987 and Cum. Supp.).

[93] Cook v. Great W. Bank, 141 Ariz. 80, 85, 685 P2d 145, 150 (Ct. App. 1984).

reasonable manner. In this case, the indorsements appeared proper on their face; the joint payee, who was a customer of the bank, deposited the check to his own account, and the indorsement of the depositing payee was authentic. Whether the bank acted in a commercially reasonable manner was a question of fact to be resolved in an evidentiary hearing.[94]

[e] Limitation of Indorsees' Rights by Separate Contract. Although a holder in due course of a negotiable instrument takes the instrument free from any conditions imposed by a separate written agreement of which the holder is not aware,[95] the parties among themselves may make any indorsement or transfer subject to contract arrangements. Under this rule every indorsement or other contract on a negotiable instrument may be shown to have been conditional or for a special purpose only and not for the purpose of transferring property in the instrument.[96] For example, an indorsement or even the original instrument may have been delivered or made as part of a larger contract that shows the transfer was a pledge as collateral security for a loan.[97] But oral agreements that contradict the nature of the indorsement are of doubtful enforceability, although the UCC itself "does not attempt to state general rules as to when an instrument may be varied or affected by parol evidence. . . ."[98]

¶ 15.02 LIABILITY OF PARTIES ON NEGOTIABLE INSTRUMENTS

When a person deals in commercial paper, three types of liabilities may arise. Firstly, a person may become liable on the contract that is evidenced by the paper itself, which usually is called liability on the instrument. Secondly, a person may become subject to liability arising from the circumstances surrounding the transfer of the paper. Under the UCC, a person who transfers a negotiable instrument or who presents it for payment or acceptance automatically makes certain warranties which, if broken, create warranty liability. Thirdly, the person

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[94] Id.

[95] UCC § 3-119(1).

[96] UCC § 3-119. This section permits a separate *written agreement* to modify the terms of a negotiable instrument as between the obligor and his "immediate obligee" and transferees who are not holders in due course.

[97] Pre-UCC law was similar. The authorities are collected in F. Beutel, Beutel's Brannon Negotiable Instruments Law at 366 (7th ed. 1948).

[98] UCC § 3-119, comment 1. See also UCC § 3-118, comment 1, which expresses a policy that except for "reformation of the instrument," there should not be resort to parol evidence to show the parties to an instrument intended terms contrary to those stated in the instrument. The general subject of when a writing or other agreement may modify or affect the terms of a negotiable instrument is discussed in ¶¶ 14.04[2][b], 16.05.

who becomes a party to a negotiable instrument may have obligations that derive from a larger contract, of which the transfer of the commercial paper is only part of the performance. One common example is the transfer of a check given in payment of a debt.

The UCC treats liability on the instrument as liability in contract.[99] The contract may be evidenced by the written terms of the agreement the party has signed, or by additional words added to the indorsement. In other cases, as when one signs a blank negotiable instrument, the liability may be furnished by rules of law giving consequence to the signature and its position on the paper. It is, however, a clear rule of law that no one is liable on negotiable paper unless his or her signature appears thereon.[100]

The fundamental rule of liability in negotiable instruments law is that no person is liable on a negotiable instrument unless that person has signed it.[101] Of course, one can become bound by the signature of another when the person signing is an agent with express, implied, or apparent authority to bind the person whose name is signed. A person also may be estopped or otherwise precluded from denying that the signature on an instrument is his or her authorized signature.[102] In *Sommerville Technical Services v. United States,*[103] the court reaffirmed that a party is not liable on an instrument unless his or her signature appears. In this case, the court held that the United States could not be liable on a promissory note that it had neither signed nor ratified.

Signing a negotiable instrument carries important legal consequences. The signature is the basis for liability on the instrument.[104] Unless the instrument clearly shows the capacity in which it is made, the signer will have liability as an indorser.[105]

[1] Primary and Secondary Liability

The two types of liabilities on negotiable instruments are known as primary and secondary liability. The person primarily liable is the one who, according to the terms of the contract, has a direct obligation to pay without the holder having to first present the instrument to another party. Most other parties are second-

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[99] See UCC §§ 3-413, 3-414, 3-415.

[100] UCC § 3-401. See National Bank of Bossier City v. Fornea, 272 So2d 411, cert. denied, 273 So2d 297 (La. Ct. App. 1973), arising under the Louisiana Negotiable Instruments Law.

[101] UCC § 3-401(1).

[102] See UCC §§ 3-404, 3-405, 3-406.

[103] 640 F2d 1276 (Ct. Cl. 1981).

[104] UCC § 3-401. See UCC §§ 3-413, 3-414, 3-415.

[105] UCC § 3-402.

arily liable.[106] The maker of a note or of a certificate of deposit and the acceptor of a draft are all primarily liable. The drawer of a check or draft and any indorser are usually considered secondarily liable.[107]

[2] Liability of Maker and Acceptors

The UCC uses the term "maker" in a technical way to refer only to the obligor on an instrument that contains a promise to pay, such as a "note."[108] When the instrument is a draft or a check, the person who draws the draft or who issues the check is a "drawer," not a "maker." This distinction is important because a maker has primary legal liability, whereas a drawer has secondary liability.[109] Therefore, to hold a drawer liable when the instrument is dishonored, the holder must show that the instrument has been properly presented and notice of dishonor given.[110] The UCC requires presentment and notice of dishonor for charging secondary parties, such as drawers and indorsers.[111] The maker of or the person promising to pay a note or a certificate of deposit is required to perform according to the terms of the promise. No presentation of the paper at maturity is necessary to hold the maker of a note.[112] When the maker has signed a demand instrument, although no presentment is necessary to hold the maker liable and the cause of action against the maker accrues as of the date of the instrument or, when no date is stated, on the date of issue, it may be advisable to make a demand for payment nevertheless. Under the UCC, unless the note provides otherwise, interest on the unpaid obligation will run at the rate

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[106] UCC § 3-102(1)(d). Sometimes the capacity in which a person signs a negotiable instrument is ambiguous. The UCC supplies special rules to resolve this ambiguity. Under UCC § 3-402, a signature is an indorsement "unless the instrument clearly indicates" that it is made in some other capacity. Custom and usage may supply the needed explanation as when the position of the signature indicates the individual has signed as a maker or drawer. UCC § 3-402 comment; Huron County Banking Co. v. Knallay, 22 Ohio App. 3d 110, 489 NE2d 1049 (1984). The position of party's signature on the lower right-hand corner of a note indicates an intent to sign as a maker, not an indorser. There also are rules for when a signature should be treated in a representative capacity. UCC § 3-403, discussed in ¶ 15.04. Similar ambiguities sometimes arise over signatures that are claimed to be for accommodation. See ¶ 15.06.

[107] UCC § 3-102(d).

[108] UCC §§ 3-104(1)(a), 3-413(1), 3-413(2).

[109] UCC § 3-413.

[110] The rules on presentment and notice of dishonor are discussed in Chapter 21.

[111] UCC § 3-501. There are certain situations where presentment and notice of dishonor are excused. See the discussion in ¶¶ 21.10, 21.11.

[112] UCC § 3-413(1), 3-501. See also UCC § 3-122 on the time when a cause of action accrues.

provided for judgments from the time that a demand is made on the maker, acceptor, or other primary obligor.[113]

The same rules apply to the liability of an acceptor. An acceptor is a person, on whom a draft or a check is drawn, who has agreed to be liable for paying the instrument by signing it.[114] Accepting a check is called certification, and the liability certification creates is similar in all respects to accepting a draft.[115] The drawee of a check or a draft is not liable on the instrument unless and until he or she accepts it.[116] Thus, the term "acceptor" is also a term of art used by the UCC to refer to a drawee who has become liable by signing the draft or check.

Under the UCC, to be liable as an acceptor, the drawee must write the acceptance on the draft.[117] Liability may be created by other acts, but such liability will be based on theories of contract or tort and will not be based on any contract obligation of the drawee on the instrument.[118]

The UCC expressly provides that a draft is not an assignment.[119] Because of this rule, a drawee such as a payor bank on a check may not become liable to pay a draft upon notification that the drawer has issued an order to pay a specified person. If the drawee were viewed as a bailee holding property belonging to its customer, the drawer, the drawee would become liable to parties to whom the drawer had transferred that property when the drawee received notice of the transfer. The same consequences would attach if the drawer were to be treated as having made an assignment of rights the drawer had for payment from the drawee. In modern banking operations, a payor bank must rapidly process payment of numerous checks each day, and the recognition of bank liability whenever the bank had notice of its customer's check would require the bank to make difficult judgments before deciding what checks should be paid from the customer's account, and would erode the efficiency of the system. The UCC avoids these problems by making clear that a draft "does not of itself operate as

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[113] UCC §§ 3-122(1), 3-122(4).

[114] UCC §§ 3-410, 3-413(1).

[115] UCC § 3-411.

[116] UCC §§ 3-409, 3-411(2).

[117] UCC § 3-410(1) comment. In W.B. Farms v. Fremont Nat'l Bank & Trust Co., 756 F2d 663 (8th Cir. 1985), the court enforced a drawee's oral promise to pay a check. The payee's bank had called the payor bank and obtained an oral agreement that the payor bank would pay the check when the drawer had sufficient funds in his account. Although the account subsequently received enough funds to pay the check, the payor bank did not pay it. Reasoning that the UCC permits parties to enter into private contracts to govern their relationships, the court permitted the issues of the existence and terms of the agreement to be submitted to a jury for decision.

[118] See UCC § 3-409(2) & comment 3; UCC § 3-410, comment 3, which states: "nothing in this section is intended to eliminate any liability of the drawee in contract, tort, or otherwise arising from the separate writing or any other obligation or representation, as provided in § 3-409."

[119] UCC § 3-409(1).

an assignment of any funds in the hands of the drawee available for its payment . . ." and there is no liability on the part of the drawee until the drawee accepts the instrument, which, as noted previously, requires the drawee's own signature.[120] Although a draft does not operate as an assignment "of itself," it is possible for the drawer to have made an assignment. The provision does not prohibit assignments of funds held by drawees. The assignment may "appear from other facts, and particularly from other agreements, expressed or implied; and when the intent to assign is clear the check may be the means by which the assignment is effected."[121] Moreover, the UCC does not prohibit a drawee from becoming liable to the holder for breach of an agreement that drawee has made to accept the instrument, and the drawee "may be liable in tort or upon any other basis because of his representation that he has accepted, or that he intends to accept."[122]

[3] Acceptance

The common form of acceptance is to write across the face of the instrument such words as "accepted" or "certified" followed by the signature of the drawee. However, any words are sufficient to hold the drawee as an acceptor, if they do not express a negative answer to the order to pay. For example, "good," together with a signature is sufficient; "kiss my foot" is not.[123] In fact, the signature alone of the drawee is a sufficient acceptance.[124]

When the holder is entitled to an acceptance, the holder is entitled to have it made on the face of the draft or check, and failure to give it constitutes a dishonor, which then establishes a right to recourse against prior indorsers and the drawer.[125]

An incomplete, dishonored, or overdue bill may be accepted under the UCC by a signed writing on the instrument.[126] Because the writing must be on the instrument, it is impossible under the UCC to accept nonexistent paper or drafts before they are drawn. Such promises are binding in favor of later purchasers under the UCC, only if they meet the requirements of letters of credit under Article 5[127] or are enforceable under general tort or contract theories because of the representation made to accept the instrument, as discussed earlier.

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[120] Id.

[121] UCC § 3-409, comment 1.

[122] UCC § 3-409(2), comment 3.

[123] UCC § 3-410, comment 4.

[124] UCC § 3-401(1).

[125] UCC §§ 3-501(1)(a), 3-507(1)(a). A bank is not obligated to certify a check. UCC § 3-411(2). See also ¶¶ 15.05[5], 21.10[8].

[126] UCC § 3-410(2).

[127] UCC §§ 5-103(1)(a), 5-102(2), 5-102(3).

With one exception, any expression in an acceptance that varies the terms of the draft gives the holder of the draft the rights to refuse the acceptance and to treat the draft as dishonored.[128] The only exception is that an acceptance may be conditioned upon payment "at any particular bank or place in the United States" unless the acceptance goes further and states that the draft "is to be paid only at such bank or place."[129] However, when an acceptance is conditioned upon making payment at a bank in the United States, the draft must be presented at the bank so designated.[130] Acceptances that vary the terms of the draft include acceptances that are conditional, are for part of the amount, are for payment at a different time than that provided in the draft, and "any other engagement changing the essential terms of the draft."[131] When the holder of the draft refuses an acceptance that has varied the terms of the draft, the drawee "is entitled to have his acceptance cancelled."[132] Alternatively, the holder may agree to the acceptance. If the holder agrees, any indorser and drawer who do not "affirmatively assent" to the variance are discharged from liability on the instrument.[133]

Following are some examples in which acceptance is "qualified" so that the terms of the draft are varied. A partial acceptance of the amount of the draft is qualified. Thus, accepting a $500 draft for an amount not over $200 would be a qualified acceptance.[134] It is common to indicate a place of payment on a draft, but this does not qualify the acceptance. If the acceptance is to pay at a particular place only, it is qualified. For example, "pay at First National Bank of Brownsville" is unqualified, but "pay at the Second National Bank only" is qualified.[135] Any limitation or change in the time of payment is also a qualified acceptance. For example, "accepted to be paid as soon as proceeds of hardware are available" is qualified. In addition, an acceptance of a sight draft to be paid in sixty days would be qualified.[136]

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[128] UCC § 3-412(1).

[129] UCC § 3-412(2).

[130] UCC §§ 3-412, comment 3, 3-504(4) & comment 4.

[131] UCC § 3-412, comment 1.

[132] UCC § 3-412(1).

[133] UCC § 3-412(3). A lessee forwarded a certified check to the lessor for rent due. The check contained the following language on the reverse: "Acceptance and Indorsement of this check constitutes a full and final settlement between lessor and lessee with regard to any obligation by lessee to lessor under lease. . . ." The lessor had the check certified but did not indorse it. The court held that the lessor's having the check certified constituted an acceptance under the terms specified in the check even though the lessor failed to sign or indorse the check. The lessor received payment and the lessee was released. Kersh v. Manis Wholesale Co., 135 Ga. App. 943, 219 SE2d 604 (1975).

[134] UCC § 3-412.

[135] UCC § 3-412(2).

[136] UCC § 3-412.

A general acceptance of a draft that is not a check does not change the liability of the drawer and prior indorsers, but the certification of a check may affect the liability of prior parties.[137] When the holder of a check obtains certification of the check, the certification discharges the drawer and prior indorsers in the same manner as if the check had been paid fully.[138] But, when the drawer of a check is the person who presents it for certification, the drawer is not discharged from liability.[139]

[4] Indorser's Liability

Indorsers are secondarily liable. An indorser is liable to all subsequent holders to pay the face amount of an instrument, if it is dishonored by the person primarily liable.[140] In the case of drafts, the indorser who, before acceptance, indorses a draft that is entitled to be presented for acceptance also undertakes that the draft will be accepted and paid. If the drawee fails either to accept or pay, the indorser must pay the instrument.[141] The liability is conditioned upon proper presentment of the paper at maturity and notice of dishonor,[142] the formal requirements for which are discussed in Chapter 21. If these formalities are not met, or if they are not timely, the indorser's liability is discharged.[143] In absence of liability on the instrument based on dishonor, the indorser is under no obligation other than liability for breach of warranty and any liability based on the underlying obligation for which the instrument was given. The indorser's liability based on warranty arises at the time of delivery of the paper and attaches without any notice of dishonor. Liability on the underlying obligation, of course, depends on the terms of the agreement or obligation. Warranty liability is discussed later in this chapter, as is the relationship between liability on a negotiable instrument and liability on the underlying obligation.

In absence of agreement to the contrary, the indorsers are liable to each other in the order in which their signatures appear on the paper.[144] Thus, if a check has been made payable to *A*, indorsed by *A* to *B*, indorsed by *B* to *C*, indorsed by *C* and presented for payment but dishonored by the drawee bank, *C* may recover against any of the prior indorsers, either *A* or *B*, and also has a right to recover directly from the drawer of the check. If *C* chooses to recover from

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[137] UCC § 3-411.

[138] Id.

[139] UCC § 3-411(2). See also ¶ 15.05[5] on accepted drafts and certified checks.

[140] UCC § 3-414(1).

[141] UCC §§ 3-414(1), 3-501(1), 3-507.

[142] UCC § 3-414(1).

[143] UCC §§ 3-501(1)(b), 3-502.

[144] Wilson v. Turner, 29 NC App. 101, 223 SE2d 539, cert. denied, 290 NC 311, 225 SE2d 832 (1976).

indorser *B*, *B* in turn may recover either from *A* or from the drawer. Once the drawer has been called upon to pay, there can be no recourse against any of the indorsers, *A*, *B*, or *C*, because the liability of the indorsers is discharged by the payment of the drawer.[145] The procedures for giving notice of dishonor and establishing liability in these cases are discussed in Chapter 21.

The indorser's conditional liability does not apply to indorsers who indorse "without recourse."[146]

[5] Drawer's Liability

The liability of a drawer on a draft is similar to that of an indorser, except that the drawer does not have further recourse on the instrument against anyone.[147] The drawer undertakes that upon presentation the instrument will be accepted, or paid, or both, and that given proper notice of dishonor the drawer will pay the amount of the instrument to any holder or subsequent indorser who may be compelled to pay it.[148]

Although the drawer's liability depends on proper presentment and notice of dishonor, the drawer usually cannot avoid liability even if the presentment or notice is delayed beyond the time when it was due.[149] The drawer is discharged only to the extent that the delay caused the drawer loss of funds to cover the draft because the bank on which the draft was drawn became insolvent.[150] To avoid liability in this limited situation, the drawer must assign his or her rights against the insolvent bank for payment of the check to the holder. In limited situations in which protest is necessary, however, any delay in making it results in a complete discharge of the drawer.[151] (These problems are discussed in greater detail in Chapter 21.) Otherwise, the drawer is required to pay drafts on default of the drawee.[152]

A drawer is also precluded from denying to subsequent parties or to the indorsee the existence of the payee and the payee's capacity to indorse.[153] For example, if the drawer made a check payable to an unlicensed corporation without power to contract, and the proper corporate officer subsequently indorsed it, the drawer would not be able to deny the power of the corporation to

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[145] UCC § 3-601(3).

[146] UCC § 3-414(1).

[147] Compare UCC § 3-413(2) with UCC § 3-414(1).

[148] UCC § 3-413(2).

[149] UCC § 3-502.

[150] Id.

[151] Id.

[152] UCC §§ 3-413(2), 3-501, 3-502. See Beutel, "The Liability of Secondary Parties Under the Uniform Commercial Code, Drawers and Indorsers," 1 Rut.-Cam. L. Rev. 15 (1969).

[153] UCC § 3-413(3).

transfer the instrument. However, the drawer does not guarantee the genuineness of the payee's indorsement and can set up forgery where it exists, so long as there is no basis for finding that the drawer is estopped or precluded.[154]

Under UCC Section 3-307, signatures on negotiable instruments are presumed to be "genuine or authorized." *After signatures on the instrument are* established as genuine or authorized, the holder of the instrument is entitled to recover on it unless the defendant establishes a defense. Thus, when the holder produces a check and sues to recover against the drawer, the holder is entitled to recover unless the drawer establishes a defense. The holder may obtain summary judgment against the drawer if the defendant drawer does not allege facts sufficient to constitute a defense to the suit on the instrument.[155] A drawer may disclaim the contract liability of a drawer by expressly drawing "without recourse."[156]

¶ 15.03 LIABILITY IN WARRANTY FOR TRANSFER AND PRESENTMENT OF NEGOTIABLE INSTRUMENTS

There are warranties that attach when a person transfers a negotiable instrument or presents it for payment or acceptance. The UCC contains separate warranty rules, depending on whether the instrument is one that is being transferred or presented by a customer or collecting bank, in which case the rules in Article 4 control,[157] or whether the instrument is being transferred or presented by any other person, in which case Article 3 rules apply.[158] The rules, however, are essentially the same in either case. The following explanation will focus on the general rule in UCC § 3-417. Significant differences in UCC § 4-207 with respect to the warranties made by customers and collecting banks will be noted.

[1] Presentment Versus Transfer Warranties

There are two different categories of warranties. Firstly, some warranties are made by a person who obtains payment or acceptance of an instrument.

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[154] *UCC §§ 3-413(3), 3-404, 3-405, 3-406. See generally ¶¶ 20.01, 20.08.*

[155] Sawgrass Builders, Inc. v. Realty Co-op, Inc., 172 Ga. App. 324, 323 SE2d 243 (1984). Where a note was signed by one asserting to be the attorney in fact for the defendants, the presumption of genuineness of the signatures as those of defendants applies (UCC § 9-307(1)), and defendants have to produce some evidence to challenge the authority of the signature. Until this was done, UCC § 3-403(1), which requires plaintiff to prove the authority of the agent, did not apply. Bowers v. Winitzki, 83 Or. App. 169, 730 P2d 1253 (1986).

[156] *UCC § 3-413(2). For a discussion of the relationship of the drawer's liability on the* instrument to that on the underlying obligation for which it was given, see ¶ 15.07.

[157] UCC § 4-207.

[158] UCC § 3-417.

Secondly, a different group of warranties is made by a person who transfers an instrument and receives consideration. A distinction is thus drawn between presenting an instrument for payment or acceptance and transferring an instrument. The two groups of warranties are dissimilar. This distinction is intentional in order to implement, among other policies, that policy expressed in the historic case of *Price v. Neal.*[159]

The full text of the various warranties is set forth as follows:

Warranties on Presentment and Transfer

(1) Any person who obtains payment or acceptance and any prior transferor warrants to a person who in good faith pays or accepts that

(a) he has a good title to the instrument or is authorized to obtain payment or acceptance on behalf of one who has a good title; and

(b) he has no knowledge that the signature of the maker or drawer is unauthorized, except that this warranty is not given by a holder in due course acting in good faith

(i) to a maker with respect to the maker's own signature; or

(ii) to a drawer with respect to the drawer's own signature, whether or not the drawer is also the drawee; or

(iii) to an acceptor of a draft if the holder in due course took the draft after the acceptance or obtained the acceptance without knowledge that the drawer's signature was unauthorized; and

(c) the instrument has not been materially altered, except that this warranty is not given by a holder in due course acting in good faith

(i) to the maker of a note; or

(ii) to the drawer of a draft whether or not the drawer is also the drawee; or

(iii) to the acceptor of a draft with respect to an alteration made prior to the acceptance if the holder in due course took the draft after the acceptance, even though the acceptance provided "payable as originally drawn" or equivalent terms; or

(iv) to the acceptor of a draft with respect to an alteration made after the acceptance.

(2) Any person who transfers an instrument and receives consideration warrants to his transferee and if the transfer is by indorsement to any subsequent holder who takes the instrument in good faith that

(a) he has a good title to the instrument or is authorized to obtain payment or acceptance on behalf of one who has a good title and the transfer is otherwise rightful; and

(b) all signatures are genuine or authorized; and

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[159] See generally UCC § 3-417 & comments; UCC § 3-418 & comments; UCC § 4-207 & comments. For a discussion of the rule of *Price v. Neal,* see ¶ 20.08.

(c) the instrument has not been materially altered; and

(d) no defense of any party is good against him; and

(e) he has no knowledge of any insolvency proceeding instituted with respect to the maker or acceptor or the drawer of an unaccepted instrument.

(3) By transferring "without recourse" the transferor limits the obligation in subsection (2) (d) to a warranty that he has no knowledge of such a defense.[160]

The presentment warranties, which are made by the person who obtains payment or acceptance and also by any prior transferor of the instrument, run to the party who pays or accepts the instrument.[161] Thus, such a payor or acceptor, who acts in good faith, may charge the presenting party or any prior transferor of the instrument with liability for breach of warranty in an appropriate case. The three basic warranties are (1) a warranty of good title to the instrument; (2) a warranty of no knowledge that the signature of the maker or drawer is unauthorized; and (3) a warranty that the instrument has not been materially altered. As previously indicated, these warranties are the UCC's basic scheme for allocating liability in cases where an instrument has been altered or bears a forged signature. When the warranty has been breached, the payor or acceptor may recover against earlier parties who transferred or presented the instrument such that the liability may come to rest on the party who took the instrument from the person who made the alteration or unauthorized signature. In certain situations, the payor or acceptor may not recover for breach of warranty because of special exceptions carved out from the basic warranties. For example, the warranty that the instrument has not been materially altered is not given by a holder in due course acting in good faith to the acceptor of a draft as to an alteration made after the acceptance because the acceptor should have known of the state of the instrument at the time the acceptance was made.[162] Similarly, the warranty is not made to the acceptor of a draft with respect to an alteration made before the draft was accepted, if the holder of the instrument took the draft after the acceptance, and this exception applies even though the acceptance may state it is "payable as originally drawn." The reason for this exception is to avoid uncertainty as to the state of the instrument in the hands of the innocent holder.[163]

The warranty of good title is intended to be more limited than the warranties contained in the group of warranties made by transferors of an instrument. This was done deliberately to preserve the rule in *Price v. Neal* that a drawee who pays an instrument with a forged drawer's signature is deemed to know the

[160] UCC § 3-417.

[161] UCC § 3-417(1).

[162] UCC § 3-417 & comment 5.

[163] UCC § 3-417, comment 5.

signature of the drawer and cannot recover against an innocent holder.[184]

The transfer warranties are broader in scope than are the presentment warranties. Any person who transfers an instrument and obtains consideration for it makes warranties to his or her immediate transferee. Moreover, if the transfer of the instrument is by indorsement, the transferor makes the warranties to any subsequent holder who takes the instrument in good faith.[185] There are five basic transfer warranties: (1) the warranty of good title to the instrument; (2) the warranty that all signatures are genuine or authorized; (3) the warranty that the instrument has not been materially altered; (4) the warranty that no defense of any party is good against the transferor; and (5) the warranty that the transferor "has no knowledge of any insolvency proceeding instituted with respect to the maker or acceptor or the drawer of an unaccepted instrument." Thus, if a holder of an instrument is required to take up an instrument because it has an unauthorized signature or was altered or for some other reason amounting to a breach of warranty, the holder will have recourse against the holder's immediate transferor and prior indorsers for breach of warranty. This shifts the liability back to the party who dealt with the person who committed the alterations or unauthorized signature. It then becomes the risk of that party to collect from the wrongdoer.

When an indorser transfers an instrument with an indorsement expressly made "without recourse," the indorser disclaims the indorser's contract liability on the instrument, as discussed earlier, but may not eliminate liability for breach of the transfer warranties. A "without recourse" indorsement limits only one transfer warranty (so that there is no defense of any party that is good against the transferor). It converts that warranty to the more limited warranty that the transferor "has no knowledge of such a defense."[186] The section on customer and collecting bank has no comparable provision; thus, the "without recourse" indorsement does not limit the warranty made to a collecting bank.[187]

[2] Warranties of Customers and Collecting Banks

The warranty rules that customers and collecting banks make differ somewhat from the general Article 3 warranties made by presenters and transferors.

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[184] UCC §§ 3-417 & comment 4, 4-207 & comments, 3-418 & comments. See the discussion at ¶ 20.08.

[185] UCC §§ 3-417(2), 4-207(2). The warranties run to *subsequent* transferees. Thus, the warranties made by a collecting bank under UCC §§ 3-417(2)(b) and 4-207(2)(b) include the warranty that the signatures on the check are authorized but this warranty does not run to the payee of the instrument. Matco Tools Corp. v. Pontiac State Bank, 614 F. Supp. 1059 (ED Mich. 1985).

[186] UCC § 3-417(3).

[187] UCC § 4-207(2).

As in the case of the general warranty rules, a division exists between the warranties that a customer or collecting bank makes to a payor bank or "other payor who in good faith pays or accepts . . ." and warranties made by a customer and collecting bank in transferring the item for a "settlement or other consideration" to a transferee or any subsequent collecting bank.[168] In the case of the Article 4 warranties, warranties are made regardless of any lack of indorsement or words of guarantee or warranty.[169] An additional transfer warranty provides: "Each customer and collecting bank so transferring an item and receiving a settlement or other consideration engages that upon dishonor and any necessary notice of dishonor and protest he will take up the item." This warranty is comparable in form to the contract of an indorser. Because the warranty will be made regardless of whether the instrument has been indorsed, each customer and collecting bank will have the liability of an indorser although they have not specifically indorsed the instrument.[170] As this language refers to customers and collecting banks that "so transfer" an item, the warranty should be similar to the transfer warranties generally in running only to the "transferee and to any subsequent collecting bank . . ."[171]

The provisions in the Article 4 warranties also limit the liability of the customer or collecting bank for breach of warranty to the "consideration received . . . plus finance charges and expenses related to the item, if any."[172] The provisions also require that a claim for breach of warranty be made within a reasonable time after the person claiming "learns of the breach." Failure to make a timely claim results in the discharge of the person liable for breach of warranty to the extent of any loss caused by delay in making the claim.[173]

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[168] Compare UCC § 4-207(1) with UCC § 4-207(2).

[169] UCC § 4-207(3).

[170] Chilson v. Capital Bank of Miami, 10 Kan. App. 2d 111, 692 P2d 406 (1984), aff'd, 237 Kan. 442, 701 P2d 903 (1985), held that the three-year statute of limitations, which applies to suits for breach of implied warranties, governed a suit for breach of warranties against a collecting bank that had stamped on the check "prior indorsements guaranteed." The court declined to apply the five-year statute of limitations that is applicable to the breach of written contracts.

[171] UCC § 4-207(2).

[172] UCC § 4-207(3). The damages referred to include "expenses related to the item." The comment indicates this should be read broadly so that they may include "ordinary collecting expenses and in appropriate cases could also include such expenses as attorney's fees." UCC § 4-207, comment 5.

[173] UCC § 4-207(4). It has been held that the payor bank may not recover from a collecting bank, for breach of warranty of presentment, when payment has been obtained on a check with a forged indorsement if the proceeds of the forged check reached the intended payee. The court held that it would be inequitable to allow the payor bank to recover because the payor bank had suffered no damage from the forgery. Banker's Trust of S.C. v. South Carolina Nat'l Bank of Charleston, 284 SC 238, 325 SE2d 81 (Ct. App. 1985).

The parties between themselves may limit the liability in warranty by a special contract.[174] Such a contract should be in writing and should state clearly the warranties that are intended to be released; otherwise all warranties mentioned earlier apply automatically upon the transfer of the paper without further agreement. Banks only warrant their good faith and authority when collecting documentary drafts.[175]

¶ 15.04 LIABILITY OF AGENTS AND REPRESENTATIVES

[1] Rules Regarding Liability

When a person signs as an agent or representative of another party, such as an officer for a corporation or a trustee on behalf of a beneficiary, two questions arise. The first question is whether the agent's signature will bind the principal on whose behalf the agent signed. The second question is whether the agent will have any personal liability on the instrument as a result of the signature. The UCC deals with both of these issues.

The general rule of liability on negotiable instruments is that no person is liable unless the person signs the instrument.[176] A signature of a person may be made by an agent, and the general rules of agency and establishing such agency will apply.[177] The principal may be bound because the agent will be deemed to have express authority, authority implied as a matter of law, or apparent authority.[178] Although the text of the UCC is not clear on the point, the comments indicate that a principal will not be liable on a negotiable instrument signed by an agent, even when the agent has authority to sign, unless the principal is named on the instrument.[179]

The second question, as to the liability of the agent, also is addressed by the UCC. This is a more complex legal issue and depends on the circumstances presented. The UCC provision is as follows:

Signature by Authorized Representative

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[174] UCC § 3-417 & comment 1; UCC § 4-207.

[175] UCC § 7-508.

[176] UCC § 3-401.

[177] UCC § 3-403(1). See also UCC § 3-404 & comment 1.

[178] "The power to sign for another may be an express authority, or it may be implied in law or in fact, or it may rest merely upon apparent authority. It may be established as in other cases of representation, and when relevant parol evidence is admissible to prove or to deny it." UCC § 3-403, comment 1.

[179] UCC § 3-403, comment 2; the principal is not liable "unless the instrument names him and clearly shows that the signature is made on his behalf."

> (1) A signature may be made by an agent or other representative, and his authority to make it may be established as in other cases of representation. No particular form of appointment is necessary to establish such authority.
>
> (2) An authorized representative who signs his own name to an instrument
>
> (a) is personally obligated if the instrument neither names the person represented nor shows that the representative signed in a representative capacity;
>
> (b) except as otherwise established between the immediate parties, is personally obligated if the instrument names the person represented but does not show that the representative signed in a representative capacity, or if the instrument does not name the person represented but does show that the representative signed in a representative capacity.
>
> (3) Except as otherwise established the name of an organization preceded or followed by the name and office of an authorized individual is a signature made in a representative capacity.[180]

The UCC thus sets forth three circumstances in which the agent will be personally obligated on the instrument, even where the agent is acting as an authorized representative: (1) when the instrument does not name the person represented and also does not show the agent signed in a representative capacity; (2) when the name of the person represented appears on the instrument but the signature of the agent does not show that the agent signed in a representative capacity; and (3) when the instrument does not show the name of the person represented but it does show that the agent's signature was in a representative capacity. In situations (2) and (3), as between the immediate parties, the agent is permitted to establish that the agent signed the instrument in a representative capacity. The agent has no such opportunity to explain the ambiguity in the instrument as against any other party. When the agent signs the instrument showing that the signature is as the representative of another person, the agent will not be liable so long as the signature is authorized.[181]

An authorized agent would not be liable on the following signatures: "Jones & Co., by Smith, agent" or "Jones & Co., by Smith, president," "Jones & Co., per Smith, agent" or similar designation, and "Smith, agent for Jones & Co." In these situations, the agent, if properly authorized, would not be liable on the instrument. The signature not only indicates that it is made by a representative,

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[180] UCC § 3-403.

[181] UCC § 3-404(1). An unauthorized signature operates as the signature of the unauthorized signer. Id. Because the principal is not liable on the instrument unless the instrument names him or her (see supra note 179) and the agent who signs as a representative may not be personally liable under situation (3) in the text, there may be the bizarre result that no one is liable on the instrument under the literal application of these rules.

but it also shows the person who is represented as required by the UCC.[182] When the agent signs a negotiable instrument without authorization from the principal, the agent is personally liable on the obligation regardless of the form in which the agent signs.[183]

The greatest difficulty has come in cases falling under the second circumstance, in which the instrument names the person represented but fails to show that the signature on the instrument was made in a representative capacity. The problem frequently arises in the use of checks where there is a preprinted corporate name but the check is signed by an officer without indication that the signature was made in a representative capacity. A legal issue also may arise as to whether a negotiable instrument has been made payable to a party personally or is payable to the person the party represents. The UCC has provisions dealing with this issue.[184]

[2] Case Examples

A rich body of case law deals with the problem of signatures by agents and other representatives. This section presents cases that illustrate the rules discussed earlier.

[a] Principal's Name Missing. When a principal's name does not appear on an instrument signed by an agent whose signature did not disclose that he or she signed as agent but only signed individually, the principal is not liable on that instrument, even when the payee knew when the instrument was issued that it was intended to be the obligation of one who did not sign.[185]

When an agent signs a negotiable instrument with his own name, without indicating that he is signing as an agent or as a representative and does not name the person who is the principal, the agent will be personally liable on the

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[182] UCC § 3-403. See generally Holland, "Corporate Officers Beware—Your Signature on a Negotiable Instrument May Be Hazardous to Your Economic Health," 13 Ind. L. Rev. 893 (1980); Annot., "Construction and Application of UCC § 3-403(2) Dealing with Personal Liability of Authorized Representative Who Signs Negotiable Instrument in His Own Name," 97 ALR3d 798 (1980); Annot., "Admissibility of Parol Evidence to Show Whether Guaranty of Corporation's Obligations Was Signed in Officer's Representative or Individual Capacity," 70 ALR3d 1276 (1976). See also Annot., "Personal Liability of Officers or Directors of Corporation on Corporate Checks Issued Against Insufficient Funds," 47 ALR3d 1250 (1973).

[183] UCC § 3-404(1); see Restatement (Second) of Agency § 324 (1958).

[184] UCC § 3-117. These provisions are discussed at ¶ 14.04[2][*l*].

[185] Ness v. Greater Ariz. Realty, Inc., 21 Ariz. App. 231, 517 P2d 1278 (1974), which quoted part of UCC § 3-401, comment 1. The case involved a note, but the rule applies with regard to a check signed by an individual that does not disclose the name of a purported principal for whom the alleged agent is signing.

instrument.[186] Although the agent in fact may be acting as an agent, he may not introduce parol evidence to prove the agency status.[187] This rule was followed in *Gainok v. Featherson*,[188] where a person who signed a promissory note with her own name was prevented from attempting to show by parol evidence that she had signed in a representative capacity. The court followed this rule, even though the person seeking to recover on the note was the original payee with whom the defendant had dealt.[189]

[b] Agent Fails to Sign in a Manner That Shows Agency Status. When an agent acting with authority signs an instrument without indicating that the signature is as a representative, but the instrument contains a printed corporate or other business name, courts have come to the conclusion in some cases that the instrument should be treated as if the printing on the instrument showed that the signature of the agent had been made as a representative of the organization. The result of taking this view is that, as long as the signature is within the scope of the agent's authority, the agent does not have personal liability and the organization named has the sole liability on the instrument. The cases are in conflict on this point, but there appears to be a greater willingness to recognize the signature as made in a representative capacity when the instrument is a printed corporate check than when the instrument is a promissory note. Some of the cases dealing with this situation are described later.

The Iowa Supreme Court has held that a person who signed a check in the lower right-hand corner with his personal name, without indicating that the

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[186] UCC § 3-402(2)(a).

[187] UCC § 3-403, comment 3 ("parol evidence is inadmissible under subsection (2)(a) to disestablish his obligation"). When a corporate officer signs a note using only his name, and the name of the corporation does not appear on the note, parol evidence is not admissible to prove that the parties intended the signature to be in a representative capacity. If the name of the corporation appears on the instrument, then the signature is ambiguous and UCC § 3-403(2)(b) permits the presentation of extrinsic evidence to clarify the parties' intent if the dispute is between the immediate parties. However, when the corporate name does not appear, and there is no indication of a signature in a representative capacity, there is no ambiguity, and extrinsic evidence cannot be admitted to show that it was signed in a representative capacity. Mid-America Real Estate & Inv. Corp. v. Lund, 353 NW2d 286 (ND 1984).

In some cases, there can be a threshold issue of whether the check contains a statement of the name of the principal represented. (As previously indicated, the check must contain both the name of the principal and that of the representative in order for there to be an ambiguity under UCC § 3-403(b)(2) that would permit the introduction of parol evidence to establish that the check had been signed in a representative capacity.) In one case, the court held that a check imprinted with the legend "Thrifty Liquors" was not effective to name the corporation, "Thrifty Liquors, Inc." In re Turner, 49 Bankr. 231 (Bankr. D. Mass. 1985).

[188] 131 Ariz. 421, 641 P2d 909 (Ct. App. 1982).

[189] The same result was reached in Bradley v. Romeo, 716 P2d 227 (Nev. 1986).

signature was made as a representative of the corporation for which the person was an officer, should be treated as a personal signature for which the person signing was personally liable. The check contained the printed name of the corporation in the upper left-hand corner, but the court said that this was not enough to raise an issue of fact as to the representative nature of the signature. Thus, although the UCC in § 3-403(2) allows the *immediate parties* to a transaction to show that a check was signed in a representative rather than a personal capacity, the failure of the drawer of the check to introduce further evidence that it was intended as a corporate check required the court to direct summary judgment for the payee. The check was given to the payee in payment for some 325,000 hot dog buns that the drawer ordered for concession stands in Iowa in anticipation of the visit of the Pope. When only 300 buns were sold, the drawer stopped payment on the check and this prompted the suit by the payee.[190]

Arizona has followed the rule that the representative nature of a signature on a check can be shown by the use of a preprinted check with a corporate name printed on it. J.M. Cook signed the check without indicating that she was the treasurer of the corporation, Arizona Auto Auction. The check contained the name and address of the corporation printed at the top and the name, Arizona Auto Auction, printed immediately above the signature line on the lower right-hand corner. In a suit asserting personal liability of Cook on the check, the court held that the instrument should be regarded as a corporate obligation. If a promissory note had been involved, the result might have been different. Unlike the practice of requiring a personal obligation on a corporate promissory note, it would be "most unusual," the court found, to demand the individual obligation of an officer on corporate checks. Consequently, the court thought it not likely that any confusion existed as to who was liable on the check. Moreover, testimony indicated that the bank treated the check as a corporate obligation and acted consistently with this expectation by first obtaining a judgment against the corporation.[191]

In another case, certain checks were signed with the name of a corporation followed by the names of two individuals, with each individual signature preceded by the word "by" and followed by the words "authorized signature." The court held that only the corporation was liable on the checks and that one of the signing individuals who was sued on the checks was not personally liable.[192]

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[190] Colonial Baking Co. of Des Moines v. Dowie, 330 NW2d 279 (Iowa 1983).

[191] Valley Nat'l Bank, Sunnymead v. Cook, 136 Ariz. 232, 665 P2d 576 (Ct. App. 1983). The Arizona court followed the rule stated in Pollin v. Mindy Mfg. Co., 211 Pa. Super. 87, 236 A2d 542 (1967). See also Kovash v. McCloskey, 386 NW2d 32 (ND 1986).

[192] Southeastern Fin. Corp. v. Smith, 397 F. Supp. 649 (Ala. 1975), rev'd on other grounds, 542 F2d 279 (5th Cir. 1976), where the court indicated that the checks basically fell within the rule of § 3-404(3) of the UCC and that any person seeing such checks would regard them as only the obligation of the corporation and not of any individual signer, who clearly signed as an agent. The court also indicated that the individual signer should

However, in a situation where a note neither named the person represented nor showed that the signature was given in a representative capacity, the word "by" preceding the signature on the face of the note did not alone show that he had signed in a representative capacity.[193]

Where a check was issued bearing the name of an incorporated travel agency, signed by the president of that organization who indicated neither title nor representative status on the check, the court held that the payee (described as an "immediate party"), who knew when the check was taken that the president had signed as an officer of the corporate drawer, could not enforce payment of the check against the president individually when the check was dishonored because of insufficient funds in the corporate account.[194]

When a check was issued by a company whose name appeared as signatory, followed by the signature of two individuals without any title or other indication that they signed in a representative capacity, the court held in a suit against one of the two individuals (whose signature was affixed by a check-writing machine) that such individual was not liable. The court said that it was clear from the evidence adduced that the individual intended to sign only in a representative capacity, and that the payee (who was suing on the check) knew of this intention, evidence to that effect not being disputed by the payee.[195] Note that the action was between immediate parties. In a case involving a check bearing on the left-hand side the printed name of an organization, where the check was signed by an individual who did not add a title or other indication of representative capacity, it was held that the jury should decide whether the individual signer was personally liable, and with the jury having held for liability there was said to be nothing in the evidence to justify a conclusion as a matter of law that the individual had signed in a representative capacity.[196]

Where a check bore the printed name "Cessna Ranch" together with an address and telephone number in the lower left-hand corner, but was signed by an individual who failed to include any title or other indication of representative capacity along with his signature, the court found that the bank, which had taken

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not be liable under an Alabama "bad check" law conferring civil liability on one who issued a worthless check.

[193] Giacalone v. Bernstein, 348 So2d 679 (Fla. Dist. Ct. App.), cert. denied, 354 So2d 980 (1977); see UCC § 3-403(2).

[194] Viajes Iberia, S.A. v. Dougherty, 87 SD 591, 212 NW2d 656 (1973).

[195] Speer v. Friedland, 276 So2d 84 (Fla. Dist. Ct. App. 1973).

[196] Carleton Ford, Inc. v. Oste, 1 Mass. App. 819, 295 NE2d 402 (1973). See Griffin v. Ellinger, 530 SW2d 329 (Tex. Ct. App. 1975), aff'd, 538 SW2d 97 (1976), held that an individual signer of the check, who did not indicate his title, had the burden of showing by evidence an understanding that he was not to be held personally liable by the payee. The mere facts that the identity of the corporate principal was printed on the upper left-hand part of the checks involved and that there had been previous instances where the payee had taken checks signed by other officers of the corporation were not considered enough to negate personal liability.

the check on deposit from the payee and had permitted a partial withdrawal of the proceeds, was entitled to the extent of the withdrawal to hold the signer personally liable. Since the bank was not an "immediate party," the court said that the signer could not introduce evidence of any agreement between the payee and the signer as to the capacity in which the check was signed.[197]

A company president who signed a corporate check without adding his title or indicating his representative capacity was held personally liable when the check failed to clear.[198] This may occur when the check is not imprinted with the firm name.[199] Absence of "by" or "for" renders an individual signer of a corporate obligation liable therefor.[200] Where a corporate president signed a note of the firm receiving proceeds, absence of the corporation's signature on the note precluded its liability thereon under Section 3-401 of the UCC, which provides that no one is liable on an instrument unless his signature appears thereon.[201]

A corporation owed money for delivery of merchandise on open account. The creditor demanded a "personal note" from the president and secretary of the debtor "as a condition to continued business." A note was executed bearing the typed name of the corporation, followed by the signatures of the two officers, without any indication that they had signed in a representative capacity. It was held that the evidence in the case sustained a holding that the two individuals had signed in a personal capacity and were therefore personally liable. The UCC permits it to be established between the "immediate parties" that the signatures were made in a representative capacity, where the principal is named. As the signatures did not show "representative capacity," the court held that the burden of proof was on the individuals to show affirmatively an understanding with the payee that they were not personally liable. Such a burden was not met in this instance.[202]

In *Berryfast, Inc. v. Zeinfeld*, the court held the individual signatures on a promissory note were made in a representative capacity although the signatures did not make clear that the parties were signing as representatives.[203] The note

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[197] American Exch. Bank v. Cessna, 386 F. Supp. 494 (ND Okla. 1974).

[198] Griffen v. Ellinger, 19 UCC Rep. Serv. (Callaghan) 587 (Tex. 1976).

[199] A.J. Jackson Chevrolet v. Oxley, 564 P2d 633 (Okla. 1977).

[200] Rotuba Extruders, Inc. v. Coppes, 25 UCC Rep. Serv. (Callaghan) 765 (NY 1978).

[201] Weubke v. Richardson & Sons, Inc., 265 NW2d 571 (Wis. 1978).

[202] Fanning v. Hembree Oil Co., 245 Ark. 825, 434 SW2d 822 (1968). The action was by the payee of the note against one of the individuals who had signed without including his title. The court observed that the note would have had little value if it had been merely the note of the corporation alone, and further observed that the individual was the most literate of all the persons involved in the transaction. For other cases where parol evidence was admitted to show representative capacity between "immediate parties," see Sullivan County Wholesalers, Inc. v. Sullivan County Dorms, 59 AD2d 628, 398 NYS2d 180 (1977); Medley Hardwoods, Inc. v. Novy, 346 So2d 1224 (Fla. Dist. Ct. App. 1977).

[203] 714 F2d 826 (8th Cir. 1983). For an example of a case where a note contained both a corporate signature and the signature of an officer without an indication that the officer

simply had the name of the corporation with lines for signatures of two individuals below. In a suit brought by the payee against the makers of the note, the court held that the trial court was entitled to find the makers were not personally liable in view of the previous dealings of the parties where notes were signed that clearly indicated the signers were liable personally as well as in their capacity as representatives of the company. The court did not discuss UCC § 3-403, but said that any doubts concerning the signatures could be resolved against the payee who drafted the note.

In dicta, a court indicated that the maker of a note may be able to establish against someone other than a holder in due course that his signature on the note was intended to be in a representative capacity. By doing so, the maker of the note avoids personal liability by proving that the note was incomplete and should have been completed to show that the signature was in a representative capacity. In this case, the defense failed because there was no evidence to establish that the signature was in a representative capacity.[204]

¶ 15.05 BANK'S LIABILITY ON NEGOTIABLE INSTRUMENTS GENERALLY

Banks use various types of commercial paper in making remittances and for other transactions. The liability of the bank on such instruments is the same as that of other parties. It will not be liable unless it has signed the instrument; the nature of the liability depends on the capacity in which the bank signs the instrument. The bank may be a drawer, acceptor, maker, or indorser of a negotiable instrument; its liability will be the same as other parties who sign instruments in these capacities.

The holders of paper on which the bank is obligated, whether they are holders in due course or not, are simply general creditors of the bank. In the absence of special circumstances, holders in due course have no greater claim

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had signed in a representative capacity and the court concluded that the officer would be liable personally, see United Fasteners, Inc. v. First State Bank of Crossett, 286 Ark. 202, 691 SW2d 126 (1985). In Kordick v. Merchants Nat'l Bank & Trust Co., 496 NE2d 119 (Ind. Ct. App. 1986), defendant, who was president of the corporation, signed a continuing guaranty with bank for the corporation's obligations. He signed the document using the title, "President." When the bank moved to enforce the guaranty against the defendant personally, he could not escape liability for having signed in a representative capacity under UCC § 3-403(3). Although the document identified the organization and the signer's office, UCC § 3-403(3) does not apply to "guaranty" agreements, but only to Article 3 paper; thus, the court affirmed a finding by the court below of personal liability. See also Cleveland Chemical Co. of Ark. v. Keller, 19 Ark. App. 7, 716 SW2d 204 (1986) (person who signed a guarantee for obligations of the Keller Chemical Co. in the form, "KELLER CHEM. CO., By: /s/ M.G. Keller," was personally liable.

[204] Hill v. Consumer Nat'l Bank, 482 So2d 1124 (Miss. 1986).

against the bank because they hold a cashier's check or certificate of deposit than any other creditors, and they do not take precedence in insolvency over general creditors.[205] The scope of federal deposit insurance on such items is discussed in Chapter 11. The UCC contains a provision that gives a preference in insolvency to certain bank customers who have not received a final settlement from a collecting bank,[206] but this provision does not prevail over the federal law applicable to both bankruptcy and the regulation of national banks.[207]

[1] Certificates of Deposit

A certificate of deposit may be either negotiable or nonnegotiable. A negotiable certificate of deposit is simply defined by the UCC as a writing that complies with the other requirements of the UCC for negotiability and that constitutes "an acknowledgement by a bank or receipt of money with an engagement to repay it."[208] The certificate must state that it is payable to order or to bearer and meet the other requirements of negotiability.[209]

[2] Cashier's Checks

The UCC does not specifically define "cashier's check." General banking usage defines a cashier's check as a draft drawn by the bank upon itself. The bank is both drawer and drawee. Because the bank has signed the instrument as a drawer, it has a liability on the check as a drawer. The effect of drawing the draft on itself, however, is to make the bank primarily liable for paying it. Therefore, under the UCC, the holder of this instrument may treat it as the equivalent of a note made by the bank and may hold the bank liable as a maker without need for presentment.[210] Problems involving attempts to stop payment on cashiers' checks are discussed in Chapter 20.

A bank that issues a cashier's check normally must honor the check because the issuance by the bank constitutes a contractual obligation to pay. The bank is liable because it has signed the instrument. Sometimes a court will say the bank's obligation is that of an acceptor; when the bank issued the cashier's check, the bank had accepted the check in advance. A more straight forward analysis holds the bank liable for signing the check as a drawer.[211] There is little legal significance in whether the bank's obligation is as an acceptor or a drawer. In either

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[205] See Chapter 10.

[206] UCC § 4-214(4).

[207] See Jennings v. United States Fidelity & Guar. Co., 294 US 216 (1935).

[208] UCC § 3-104(2)(c).

[209] See Thomas v. Estate of Eubanks, 358 So2d 709 (Miss. 1978).

[210] UCC § 3-118(a).

[211] UCC § 3-417.

event, when the check is procured from the bank through fraud, the bank has a valid defense entitling it to refuse payment. Participation in a check kiting scheme constitutes fraud.[212]

One court held that a bank had to pay cashier's checks that had been stolen from the bank while blank and unsigned. The court reasoned that the bank could be viewed as having been negligent in allowing the checks to get out of its possession. Because cashier's checks are regarded as the equivalent of cash and the banks that issue them encourage this attitude, the court concluded that it would not be unfair to impose a duty on the bank to protect innocent third parties by securing the blank cashier's checks and, thus, minimizing the risk of forgery.[213]

A payor bank that issues a cashier's check payable to joint payees may recover against a collecting bank when one of the joint payee's indorsements is forged. Undrr UCC § 4-207(1), the collecting bank automatically warrants to the payor that the indorsements are good and that the bank is collecting the check for the rightful owner of the instrument. Both of these warranties are broken when one of the joint payee's signatures is forged. Prior payment to the payor bank for the cashier's check from the remitter does not constitute a previous payment to the bank that precludes it from recovering against the collecting bank for breach of these warranties. Recovery by the bank does not amount to a windfall because the bank remains liable to pay the cashier's check when it is properly indorsed, and the bank also may be liable to the true owner of the check for conversion by paying one other than the true owner over a forged indorsement.[214]

[3] Money Orders

Many of the instruments that are called money orders are simply drafts drawn by the bank either on itself or on a correspondent. When the money order is drawn on the bank itself, it has the same legal status as the cashier's check.[215] If the money order is drawn on another bank, it has the same legal effect as a draft. In either case, to be negotiable, it must meet the essential requirements of negotiability under the UCC. On these so-called bank money orders, the bank signs the instrument as the drawer. It will, therefore, be liable to the holder of the instrument as a drawer or, in the case of the money order drawn on itself, in the same fashion as when it draws a cashier's check.

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[212] Banco di Roma v. Merchants Bank, 92 AD2d 42. 459 NYS2d 592 (1983).

[213] Savemart, Inc. v. Bowery Sav. Bank, 117 Misc. 2d 947, 461 NYS2d 144 (1982).

[214] Valley Bank & Trust Co. v. Zions First Nat'l Bank, 656 P2d 425 (Utah 1982).

[215] See Rose Check Cashing Serv. v. Chemical Bank N.Y. Trust Co., 40 Misc. 2d 995, 244 NYS2d 474 (1963), aff'd, 43 Misc. 2d 679, 252 NYS2d 100 (1964). See also H. Bailey, "Bank Personal Money Orders as Bank Obligations," 81 Banking LJ 669 (1964); Note, "Bank Money Order is Obligation of Bank," 82 Banking LJ 73 (1965).

In some cases, banks allow customers themselves to draw money orders against the bank. The customer pays the bank in advance for the face amount of the money order and is issued an instrument that has blanks for the customer to sign, for the insertion of the name of the payee, and for the date. When the blanks are filled in, the instrument becomes a negotiable instrument if it is payable to order or to bearer and has the other essential requirements for negotiability. The "personal money order" should have the same effect as an ordinary check drawn on the bank. The bank has not signed the money order and, therefore, under the UCC would not be liable on it. However, the case law is not consistent on this point. A number of courts have taken the view that the personal money order is like a personal check, and is not a bank obligation.[216] Other states have taken the view that the money order resembles a bank obligation.[217] Some courts have confused the issue by finding a signature by the bank when probably none was intended.[218] The cases often reflect the view that the holder of a money order is different from the holder of a personal check and should be able to rely on payment by the issuer. Because the UCC does not recognize money orders as such, the rights of the parties are not clear.

In a case involving an American Express money order, the court held that the money order was analogous to a personal check.[219] Under the court's analysis, American Express, the issuer of the money order, was the drawee. The

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[216] See Garden Check Cashing Service v. First Nat'l City Bank, 25 AD2d 137, 267 NYS2d 698 (1966), aff'd per curiam 18 NY2d 941, 223 NE2d 566, 277 NYS2d 141 (1966); Thompson v. Lake County Nat'l Bank, 47 Ohio App. 2d 249, 353 NE2d 895 (1975); Krom v. Chemical Bank N.Y. Trust Co., 38 AD2d 871, 329 NYS2d 91 (1972).

[217] Thompson Poultry, Inc. v. First Nat'l Bank, 199 Neb. 8, 255 NW2d 856 (1977); Bank of El Paso v. Powell, 550 SW2d 383 (Tex. Ct. App. 1977). See generally H. Bailey, Brady on Bank Checks § 1.21 (6th ed. 1987) (hereinafter Brady on Bank Checks); Bank of Niles v. American State Bank, 14 Ill. App. 3d 729, 303 NE2d 186 (1973) (the court did not discuss the form of the instrument involved or whether it had been signed by the issuing bank).

[218] See Sequoyah State Bank v. Union Nat'l Bank, 274 Ark. 1, 621 SW2d 683 (1981), where the court held that the printed name of the bank on a money order constituted a signature, thereby making the bank liable. Another court reasoned that, although a bank did not sign a given money order, the bank was liable on the money order by reason of an implied representation that it would accept the money order when properly presented to the bank. Graybar Elec. Co., 39 UCC Rep. Serv. (Callaghan) at 1721 (Mun. Ct. Mass. App. Ct. 1984). Thus, the bank's liability is not on the instrument itself but on the failure to honor the duly presented items in accordance with the bank's implied representation. Furthermore, when a customer pays for a money order, those funds are not on general deposit with the bank such that there is a relationship of debtor and creditor between the bank and its depositor. The court held that cash paid for the issuance of a money order is not placed on general deposit. Rather, it is deposited only in payment for the instrument. The depositor retains no right to the funds paid, and so the bank does not have the right to set off against such deposits other obligations the purchaser may have to the bank.

[219] Sony Corp. of Am. v. American Express Co., 115 Misc. 2d 1060, 455 NYS2d 227 (Civ. Ct. 1982).

purchaser of the money order was the drawer. The money order contained a printed statement that the instrument was not a traveler's check and should not be cashed for strangers, that the issuer reserved the right to refuse payment if the instrument was raised, altered, or stolen, or signatures were forged. A thief stole the instrument while it was in the mail, forged the payee's indorsement, and obtained payment. The court held that the payee had an action for conversion against the drawee, American Express, under UCC § 3-419(1)(c). The court also held that the payee should be viewed as the assignee of the drawer and therefore as a successor to the drawer's right to recover from the drawee, American Express, for paying an instrument that was not properly payable because of the forged indorsement. In this case, the money order was payable through a bank, for the court held that the bank was not liable because it was not the payor.

A federal district court has held that a personal money order should be treated like a personal check because it does not become an obligation of the bank until the bank signs it. Following this analogy to the personal check, the court held that a customer who purchases the money order has the same right to stop payment as does the drawer of a personal check under UCC § 4-403. The court said that personal money orders are "bills of exchange drawn on a bank payable on demand from funds deposited by the purchaser thereof."[220]

[4] Traveler's Checks

Traveler's checks are instruments that are purchased from a bank or other organization, such as the American Express Company; it is contemplated that the purchaser will sign at the time of purchase and then will countersign at the time the instrument is cashed. Use of this procedure permits the party who cashes the traveler's check to compare the signatures, thereby giving protection against taking a stolen instrument. The exact nature of a traveler's check as a negotiable instrument is subject to some question. The UCC does not recognize the traveler's check as a separate form of negotiable instrument. But the traveler's check may be classified as a draft drawn by the issuing company or bank upon itself. The issuing company can be viewed as having signed the instrument since its name usually will appear on the instrument, and it will be the issuing party. Under this approach, the issuing company would be liable on the traveler's check when it comes in the hands of someone who can claim to be a holder, which could occur when blank traveler's checks are stolen, signed by the thief, countersigned, and transferred to someone who takes them in good faith and for value. It could also occur when the original purchaser countersigns the traveler's checks, and they are then stolen and transferred to a good faith purchaser for value. However, if the original purchaser has signed the traveler's check but not

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[220] United Apparel Distrib., Inc. v. Chase Manhattan Bank, 548 F. Supp. 672 (SDNY 1982).

countersigned it and if the instrument is subsequently stolen and the countersignature forged, the forgery could be viewed as analogous to a forged indorsement. Under this approach, the purchaser would not acquire title to the instrument and could not enforce the liability of the issuer.[221]

In a case that involved international fraud where over 150 $1,000 traveler's checks were involved, the plaintiff sued Thomas Cook, Inc., the company that originally sold the traveler's checks, demanding payment. The plaintiff claimed to be a holder in due course, having obtained the traveler's checks from the individual who acquired the checks from Thomas Cook. When the traveler's checks were purchased, the customer signed them and left the place for the counter signature blank, as is proper procedure. Subsequently, the customer reported the checks as stolen and was reimbursed by Thomas Cook. Later, in Greece, an individual with the traveler's checks obtained payment from the plaintiff. The plaintiff claimed that before making payment, he checked with local banks to determine if there were any problems with Thomas Cook traveler's checks bearing serial numbers of the checks in question. Upon receiving information that these offices had no knowledge of any problems, he purchased the checks. When the traveler's checks were eventually presented for payment, Thomas Cook refused to pay them, and the plaintiff brought suit, claiming to be a holder in due course. The court held that the traveler's checks were negotiable instruments but negotiation required a counter signature on the checks. Since the counter signature was a forgery, there was no negotiation and, thus, the plaintiff could not be a holder in due course. Had the counter signature been an authorized signature, a negotiation would have occurred and the traveler's checks would have been negotiable instruments, payable to bearer. Although Thomas Cook guarantees the payment of its traveler's checks when the acceptor of the checks has the individual presenting them countersign the checks in the presence of the acceptor, the court denied recovery on Thomas Cook's guarantee because the court did not believe they were signed in the presence of the plaintiff.[222]

In another case against Thomas Cook, the plaintiff sought to recover for traveler's checks sold by Thomas Cook that the plaintiff claimed to own. The plaintiff argued a right to recover as the owner under UCC § 3-804, which gives the owner of a lost or stolen instrument the right to payment. In this case, two groups of checks were involved. The first group constituted checks sold directly by Thomas Cook to the plaintiff who had signed these checks at the time of issue. As to these checks, Thomas Cook indemnified the plaintiff for the loss. The second group of checks, however, had been purchased by the plaintiff from a street broker in Iran. These traveler's checks had not been completed by any

[221] See generally Brady on Bank Checks, supra note 217, at ¶ 26.4. See generally Annot., "Rights of One Who Acquires Lost or Stolen Traveler's Checks," 42 ALR3d 846 (1972).

[222] Xanthopoulos v. Thomas Cook, Inc., 629 F. Supp. 164 (SDNY 1985).

identifying signature. The court held that, without this signature, the traveler's checks were not instruments nor negotiable instruments under the UCC, and therefore no action could be brought under UCC § 3-804.[223]

[5] Accepted Drafts and Certified Checks

[a] Obligations of Acceptance or Certification. Under the UCC, acceptance of a draft is the drawee's signed engagement to honor the draft. The acceptance must be written on the draft and may consist of the drawee's signature alone.[224] A draft may still be accepted, however, even though it has not been signed by the drawer, is incomplete, is overdue, or has been dishonored.[225] When a bank certifies a check, it constitutes an acceptance.[226] A bank has no obligation to certify a check.[227]

In *Galaxy Boat Manufacturing Co. v. East End State Bank*, the court followed the rule that a bank does not become liable upon a check until it accepts it in writing.[228] The seller of small recreational boats had sold boats to the buyer over a period of time under an arrangement in which the seller would call the buyer's bank to determine if funds were available to pay checks given by the buyer in payment for the boats. Under this procedure, the bank then would call the buyer to determine that the buyer had ordered the boat and, after confirmation, would inform the seller that the check would be honored upon delivery of the boat. They followed this practice for over a year until the bank refused to pay one check because the buyer had stopped payment. In a suit by the seller against the bank, the seller argued that the bank should be bound by its oral promise to pay the check under the procedures the parties had established. The court rejected this argument, holding that under UCC §§ 3-409 and 3-410 the drawee bank does not become liable upon a check until the bank accepts the check in writing.

After a bank that has issued a letter of credit accepts drafts drawn under the letter of credit, the bank's customer on the letter of credit cannot enjoin payment of the drafts. Under UCC § 4-303(1)(a), once the drafts have been accepted, the legal process can no longer be used to suspend the bank's duty to pay. In the view of one court, this provision overrides § 5-114(2)(b), which carves out limited circumstances as to when the customer may enjoin the issuing bank from paying under a letter of credit, because of fraud in the underlying transaction.[229]

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[223] Thomas C. Cook, Inc. v. Rowhanian, 700 SW2d 672 (Tex. Ct. App. 1985).

[224] UCC § 3-410.

[225] UCC § 3-410(2).

[226] UCC § 3-411.

[227] UCC § 3-411(2).

[228] 641 SW2d 584 (Tex. Ct. App. 1982).

[229] First Commercial Bank v. Gotham Originals, Inc., 64 NY2d 287, 475 NE2d 1255, 486 NYS2d 715 (1985).

When a bank accepts a draft, the draft becomes the primary liability of the bank—all other parties continue to be secondarily liable. But when a holder obtains the certification of a check, the parties prior to such holder, including the drawer, are entirely discharged by the certification.[230] When, however, the drawer has the check certified, the drawer is not discharged, but remains secondarily liable. Under the UCC, discharge of prior parties occurs only when a *holder* procures certification.[231] A bank that has certified a check becomes primarily liable upon it in a manner similar to its liability upon its own cashier's check.

A drawer loses the right to stop payment after a check has been certified.[232] The drawer may prevent the bank from paying the check either by supplying adequate indemnity or by enjoining payment in a legal action.[233] Also, the certifying bank may be able to elect to refuse payment so that its customer, who is claiming a right to the check, may assert that claim in any litigation brought by the holder of the check against the bank. But if the bank is sued on the certification, the bank cannot defend the suit on the theory that the customer has the better claim to it (except in cases of theft or where there is a restrictive indorsement) even against one who is not a holder in due course.[234] The customer must enter the litigation and assert the claim directly. In any event, if the check is in the hands of a holder in due course, that holder will have a title to the check, which is superior to the claim of the customer.[235] If the adverse claimant to the check neither puts up satisfactory indemnity nor obtains an injunction against the bank, the bank is free to pay the check without fear of double liability—as long as the bank does not make a bad faith payment to a holder who acquired the check by theft or through a thief, and as long as payment is not inconsistent with the terms of a restrictive indorsement.[236]

[b] Certifying or Accepting Forged or Altered Paper. A bank's acceptance of an instrument is an engagement to pay that instrument according to its terms at the time of the acceptance.[237] Thus, on the one hand, if an alteration raises the amount of the check or draft before acceptance or certification, the bank has engaged to pay the check or draft in the raised amount. On the other hand, if the instrument is altered after the bank accepts it, the normal rules on alteration apply. The bank will be discharged from its liability if it is a material alteration, unless the instrument is in the hands of a holder in due course. A holder in due

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[230] UCC § 3-411. See Windsor, "The Certified Check," 81 Banking LJ 480 (1964).

[231] UCC § 3-411(1).

[232] UCC §§ 4-403(1), 4-303(1)(a).

[233] UCC § 3-603. See discussion at ¶ 20.05[2], 20.05[3].

[234] UCC § 3-306(d).

[235] UCC § 3-305(1).

[236] UCC § 3-603.

[237] UCC § 3-413(1).

course will be able to enforce the instrument according to its original tenor at the time the bank accepted the instrument.[238]

A bank that certifies a check on which the drawer's signature is forged is liable on its certification. The certification or acceptance is final in favor of a holder in due course or other person who has relied on it in good faith.[239] The only exception to the finality of the acceptance under the preceding rule is for breach of warranty when the instrument is presented to the bank for acceptance or payment. There is no breach of warranty when a check with a forged drawer's signature is presented as the only warranty made in this situation is that the holder has a good title. There is no warranty that the drawer's signature is genuine.[240] A warranty is made that the presenter has "no knowledge" the signature is unauthorized.[241] The bank will not be liable on its certification to one who has taken the instrument after the forgery of an indorsement that is necessary to title, because persons who present an instrument to the bank for acceptance or payment warrant to the bank that they have good title.[242] A bank that makes a good faith payment of an altered check is entitled to charge the account of its customer according to the original terms of the instrument.[243]

Whenever the drawee accepts a draft with conditions or qualifications, the holder is entitled to refuse the acceptance and to treat the draft as dishonored.[244] If this happens, the drawee is entitled to have the acceptance cancelled.[245] The UCC states that this result obtains whenever the proffered acceptance "in any manner varies the draft as presented."[246] The drafters of the UCC intended this rule to cover all situations involving "conditional acceptances, acceptances for part of the amount, acceptances to pay at a different time" and to any other engagement that changes the essential terms of the draft.[247] Under this view, language placed on certified checks stating that the check is "certified as originally issued" may be viewed as a qualified acceptance that the holder is entitled to treat as a dishonor of the instrument.

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[238] UCC §§ 3-407(2), 3-407(3).

[239] UCC § 3-418.

[240] UCC §§ 3-417(1), 4-207(1). See Mortimer Agency, Inc. v. Underwriters Trust Co., 73 Misc. 2d 970, 341 NYS2d 75 (Civ. Ct. 1973) (holding that the certifying bank could not recover from the collection bank for breach of warranty when the check had a forged drawer's signature).

[241] UCC §§ 3-417(1)(b), 4-207(1)(b). There are certain exceptions to even this warranty which are not relevant in this example.

[242] UCC § 3-417(1)(a).

[243] UCC § 4-401(2)(a).

[244] UCC § 3-412(1).

[245] Id.

[246] Id.

[247] UCC § 3-412, comment 1.

[c] Mistaken Certification. When a bank has certified a check by mistake, either because of the state of the holder's account or for other reasons, the mistake is no defense against subsequent holders in due course or others who have changed their positions on account of the certification.[248]

¶ 15.06 SURETIES AND ACCOMMODATION PARTIES

It is common in lending transactions for a creditor to require that the debtor supply security or other assurances for the debtor's performance of the obligation. When the security for the obligation takes the form of an interest in personal property or fixtures, the arrangement creates a security interest under Article 9 of the UCC.[249] These transactions are discussed in Chapters 22–24. The parties also may structure the transaction to give the creditor the promise of a third party or parties that the debtor will perform. Such an assurance may be part of a transaction in which the debtor also gives the creditor a security interest in collateral to secure the obligation, or it may be part of a transaction that involves no security interest in personal property or fixtures.

The relationship that is created when a third party promises a creditor that an obligation owed by another will be satisfied has been specially recognized in the law. The relationship created is one of suretyship. It always involves three parties: (1) the principal who is the person who has the principal obligation to the creditor;[250] (2) a creditor who is the person to whom the principal owes the obligation and also is the person to whom the surety has a duty;[251] and (3) the surety who is the person who has an obligation to the creditor but who should be freed from that obligation by the principal's performance of the principal's obligation to the creditor.[252] In the simple example in which Dora borrows money from the bank in a loan transaction and Sally guarantees the repayment of the loan by Dora in order to induce the bank to make the loan, the bank is the creditor, Dora is the principal, and Sally is the surety. The Restatement defines the suretyship relationship as one "which exists where one person has under-

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[248] UCC § 3-418. See Rockland Trust Co. v. Southshore Nat'l Bank, 366 Mass. 74, 314 NE2d 438 (1974).

[249] UCC § 1-201(37).

[250] The Restatement of Security § 82, comment c (1941) defines the principal as "the person who, in the solution of the rights and duties of the parties, should bear the ultimate burden unless excused for some reason personal to himself."

[251] "The creditor is the person to whom the surety is bound and to whom the principal is under an obligation or other duty," It can include a person who is entitled to satisfaction for a tort as well as a person who is the obligee of a contract. Restatement of Security § 82, comment d (1941).

[252] "The surety is the person who is bound on an obligation from which another, by the discharge of a duty, should relieve him." Restatement of Security § 82, comment b (1941).

taken an obligation and another person is also under an obligation or other duty to the obligee, who is entitled to but one performance, and as between the two who are bound, one rather than the other should perform."[253] Thus, a surety is not a co-obligor. As between the surety and the principal, the principal is the party who should perform the obligation.[254]

Although efforts are sometimes made to distinguish between "suretyship" and "guaranty," the search for a distinction is elusive and usage is not always uniform. The Restatement of Security uses the terms "guaranty" and "suretyship" interchangeably; it also uses the term "guarantor" as a synonym for "surety."[255] Although the Restatement uses the terms interchangeably, state or federal statutes may assign different meanings to the particular terms; therefore, care should be employed when the application of a statute is involved. In the UCC, the drafters used the term "accommodation party" and avoided use in the statutory language of the traditional terms "surety" or "guarantor." The comments make clear, however, that "an accommodation party is always a surety (which includes a guarantor). . . ."[256] An accommodation party is a special type of surety because an accommodation party has always signed a negotiable instrument. The UCC defines an accommodation party as "one who signs the instrument in any capacity for the purpose of lending his name to another party to it.[257]

The UCC negotiable instruments provisions apply to suretyship relations only when an accommodation party exists. If a person is a surety but is not a party to a negotiable instrument by having signed the instrument, the UCC will not apply; instead, the general law of suretyship will govern.[258] This handbook is primarily concerned with transactions involving accommodation parties. It is not possible to escape some consideration of the general law of suretyship in this context because the UCC provisions are limited and do not spell out all the

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[253] Restatement of Security § 82 (1941).

[254] Although suretyship arrangements are commonly used in credit transactions to give the creditor assurance the debtor will repay the obligation, the transaction is not a security arrangement within Article 9 of the UCC. As indicated above, a security interest is an interest in "personal property or fixtures." UCC § 1-201(27). The Restatement of Security (1941), however, includes suretyship among the subjects it treats.

[255] Restatement of Security § 82, comment g (1941).

[256] UCC § 3-415, comment 1.

[257] UCC § 3-415(1). Notwithstanding their rule, an accommodation party who signed two promissory notes as an accommodation was held liable on two notes he had not signed which were executed as replacements in substitution of the original notes. The court held the renewal did not extinguish or change the original debt. Estate of Williams, 109 Ill. App. 3d 828, 832-833, 441 NE2d 412, 416-417 (1982). See the discussion of renewal notes in Chapter 24.

[258] See UCC §§ 3-415, 3-416, 3-606. See generally Brennan & Burdick, "Does the Guarantor Guarantee? Lender, Beware!" 11 Seton Hall L. Rev. 353 (1981); Annot., "Conflict of Laws: What Governs Validity and Construction of Written Guaranty," 72 ALR3d 1180 (1976).

details of the legal relationships an accommodation party has to others who are parties or have rights in the instrument. In such cases, it may be necessary to resort to general principles of law to supplement the UCC.[259] In so doing, some caution is in order. The general body of suretyship law is old and some of its distinctions are being reconsidered.[260] On some points, there is considerable diversity of views among the states. Furthermore, although the Restatement of Security, published in 1941, is a respected source of authority, it is not a current statement of the law.

[1] The Rights of an Accommodation Party Against the Principal

Under the UCC, an accommodation party is a type of surety.[261] Such a party must be a person who signs a negotiable instrument and who does so "for the purpose of lending his name to another party to it."[262] As a result, an accommodation party has two legal capacities. Firstly, the accommodation party is a party to the negotiable instrument who undertakes liability on the instrument. The UCC is clear that this liability may be in "any capacity" and so the accommodation party may be one who has signed as a maker, indorser, acceptor, or other party. The capacity in which the accommodation party has signed will determine the liability the accommodation party has to those who have an interest in the instrument.[263] Secondly, the accommodation party is someone who has signed in order to benefit another party to the instrument by the signature. Because of this relationship, the accommodation party has the right to recover on the instrument against the principal if the accommodation party is called upon to pay.[264] Further, regardless of the capacity on the instrument in which the accommodation party signed, the accommodation party is not liable to the person the accommodation party accommodated.[265]

As a result of these rules, one may be an accommodation party although the relationship indicated on the face of the instrument may not indicate such fact. Using the example of the loan to Dora presented earlier, if a promissory note were used in the loan transaction, one way to structure the transaction would be for both Dora and Sally to sign the note as comakers with the bank as payee. If this is done, although Sally has signed in the capacity of a maker, her signature was to accommodate Dora; thus, Sally is an accommodation party and Dora is

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[259] UCC § 1-103.

[260] See generally J. White and R. Summer, Uniform Commercial Code §§ 516–519 (2d ed. 1980).

[261] UCC § 3-415, comment 1.

[262] UCC § 3-415(1).

[263] UCC § 3-415(2) & comment 1. These obligations are discussed in ¶ 15.06[2] infra.

[264] UCC § 3-415(5).

[265] Id. The party accommodated is the principal.

the accommodated party in the UCC parlance. Assuming such a relationship is established, if Sally is required to pay the bank, Sally will have a right of recourse for reimbursement from Dora. Moreover, if Dora pays the note to the bank, Dora has no recourse against Sally. Although the general rule is that co-obligors on a contract, such as comakers of a note, ordinarily have a right of contribution from each other for their proportionate liability on the obligation,[266] because Sally is an accommodation party she does not have the legal rights and duties of a co-obligor so far as concerns her relationship to Dora. As an accommodation party, Sally has no liability to Dora.[267]

The transaction could be structured in other ways as well without changing the relationship between Sally and Dora. Dora could be the maker of the note, with Sally as the payee and indorser, and the bank could be the indorsee. In such a case, the relationship between Sally and Dora remains the same. If Sally is required to pay, Sally has a right of recourse on the instrument against Dora. Dora has no recourse against Sally either as a result of their suretyship relation or from the capacity in which they have signed the instrument since a maker does not have recourse against an indorser. Another alternative might be to have Sally sign as maker of the note, with Dora as the payee and indorser, and bank as indorsee from Dora. The relationship between Dora and Sally still does not change. Sally has a right of recourse against Dora if Sally pays the note. Dora has no right of recourse against Sally because, notwithstanding the usual rule that allows an indorser to recover from the maker of the note, Sally signed to accommodate Dora. Finally, another manner of structuring the transaction might be to have Dora sign as maker with the note payable to bank but prior to delivering the note to the bank Sally signs as an indorser. The relationship between Sally and Dora is the same as indicated earlier. In this case, Sally's signature as indorser is irregular because it is out of the chain of indorsements. Normally, the bank as payee would indorse the instrument before other parties. Because the indorsement of Sally is not in the chain of title, the indorsement "is notice of its accommodation character."[268] Although this does not affect the relationship between Dora and Sally, the notice to subsequent parties may be important in determining whether Sally may raise certain defenses against them.[269]

Under general suretyship law, a surety has three types of rights against the principal. Firstly, after the surety has paid the debt, the surety may go against the

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[266] The UCC contains no provision incorporating this principle but, presumably, it would apply as a result of UCC § 1-103.

[267] UCC § 3-415(5).

[268] UCC § 3-415(4).

[269] This is discussed in ¶ 15.06[3]. It is important to note that the discussion above concerns the rights and duties between Dora and Sally. The capacity in which Sally signs is important so far as her liability is concerned to subsequent parties. This is discussed in ¶ 15.06[2].

principal debtor and require the principal to repay the surety. This right is known as reimbursement. Secondly, the surety has a right of subrogation. After paying the debt, the surety succeeds to the rights the creditor had against the principal debtor as well as any rights the creditor had in collateral securing the obligation. The surety need not rely on this right of subrogation, but may use any other remedy to achieve reimbursement.[270] Thirdly, the surety has a right known as exoneration. Exoneration entitles the surety to require that the debtor pay the creditor to prevent the creditor from suing the surety.[271]

The UCC does not spell out the rights of an accommodation party in detail. As indicated in the preceding discussion, the UCC gives an accommodation party a right of recourse "on the instrument" against the party accommodated.[272] The comments suggest that this is intended to incorporate the general rights of subrogation to the rights of the holder of the instrument who is paid.[273]

Sometimes the face of an instrument does not indicate that a party has signed for accommodation. It is not necessary that any magic language be used to be an accommodation party. The UCC does not address what must be shown in order to establish that one is an accommodation party, but it does indicate that as between the asserted accommodation party and another person who does not qualify as a holder in due course who took the instrument without notice of the accommodation, the nature of the signature as being for accommodation "may be shown by oral proof."[274] It is not necessary to show that the accommodation

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[270] Anna Nat'l Bank v. Wingate, 63 Ill. App. 3d 676, 678, 381 NE2d 19, 21 (1978).

[271] For a general description of these principles see Restatement of Security §§ 103, 104, 112, 141 (1941).

[272] UCC § 3-415(5).

[273] UCC § 3-415, comment 5. See also UCC § 3-603(2) which would make an accommodation party who pays an instrument and obtains possession of it a transferee of the party who was paid. See generally Lindsey v. Zeller, 10 Kan. App. 2d 4, 690 P2d 394 (1984), which recognizes an accommodation maker has a right of subrogation against other makers under Section 3-415(5).

[274] UCC § 3-415(3). See generally Annot., "Who Is Accommodation Party Under UCC § 3-415," 90 ALR3d 342 (1979); Noble, "The 'Surety' and Article 3: A New Identity for an Old Friend?" 19 Duq. L. Rev. 245 (1981); Wladis, "UCC Article 3 Suretyship and the Holder in Due Course: Requiem for the Good Samaritan," 70 Geo. LJ 975 (1982).

See Capital Bank v. Bernstein, 1 UCC Rep. Serv. 2d (Callaghan) 1597 (DDC 1986). Suit was brought in federal district court of District of Columbia against Eve Bernstein, the wife of one of several men who borrowed funds from plaintiff. Eve signed the note along with her husband. She moved to dismiss for lack of personal jurisdiction since she lived in Maryland, had no personal or telephone contact with plaintiff, and had executed the note in Maryland. The court held for defendant, as due process would prohibit asserting personal jurisdiction in D.C. given the lack of contacts. The court then transferred the case to Maryland.

In El-Ce Storms Trust v. Svetahor, 724 P2d 704, 707–708 (Mont. 1986), a wife was treated as an accommodation party when she signed a note for the purpose of enabling her husband to obtain a loan for his business and did not receive any direct personal benefit

party did not receive any consideration, although this may be a factor to show that the signature was for the benefit of someone else.[275] In some cases, an issue of who has been accommodated may arise. Because the UCC rules alter the rights of recourse between the accommodation party and the party accommodated, it is important to know not only whether a person is acting as a surety but also who is the principal for whom the surety is making the accommodation.[276]

[2] The Obligation of an Accommodation Party to Pay

An accommodation party may sign a negotiable instrument for accommodation in different capacities—as maker, indorser, acceptor, or otherwise. When the transaction is one in which the instrument has been taken for value, the accommodation party will be liable to those who have rights on the instrument according to the capacity in which the accommodation party has signed.[277] Thus, if the accommodation party has signed as an indorser, he or she will be liable as an indorser; likewise, if the signature is as the maker of a note, there will be liability as the maker of a note. Whether the holder who is enforcing the instrument must first make a prior presentment and demand for payment upon the party who has been accommodated simply depends on the capacity in which the accommodation party signed the instrument. The normal rules of liability of parties to negotiable instruments apply. When it is necessary for a presentment, notice of dishonor, and so forth to occur in order to hold an indorser, the same procedures must be followed to hold an accommodation party who has signed as an indorser. When the accommodation party has signed as a maker, however, no prior resort to the principal is required.[278] These rules apply even though the person who has taken the instrument knows that the party has signed for accommodation.[279]

An accommodation party may add language to a signature indicating "payment guaranteed" or "collection guaranteed" or the like. This language may affect the undertaking of the accommodation party. "Payment guaranteed" indicates that if the instrument is not paid when it is due, the signer "will pay it

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although her signature was without limitation. Her status as an accommodation party could be implied from the circumstances.

[275] UCC § 3-415, comment 2.

[276] See Fithian v. Jamar, 286 Md. 161, 410 A2d 569 (1979), for an illustration of a situation where some parties were sureties for some of the other parties to an instrument but not to all of them. For an interesting case where the possibility of circular liability existed as a result of application of the rules on liability of accommodation parties, see Belmont County Nat'l Bank v. Onyx Coal Co., 350 SE2d 552 (W. Va. 1986).

[277] UCC § 3-415(2).

[278] See UCC § 3-415, comment 1.

[279] UCC § 3-415(2).

according to its tenor without resort of the holder to any other party."[280] When the language used is "collection guaranteed," the signer agrees to pay "only after the holder has reduced his claim against the maker or acceptor to judgment and execution has been returned unsatisfied" or the primary obligor is insolvent or otherwise obviously unable to pay.[281] When language of guaranty is used that does not specify whether it is a guaranty of payment or collection, it is construed as a guaranty of payment.[282] When such language appears with the name of a person who has signed in a capacity as primary obligor, such as maker or acceptor, the language gives rise to a presumption that the signature is for accommodation so long as there are others primarily liable on the instrument.[283] By using words of guaranty, the signer waives the necessity of any "presentment, notice of dishonor and protest."[284] Such words, accompanying an indorsement, do not limit the character of the signature as an indorsement.[285] Although the language of guarantee may not be in sufficient detail to satisfy a general statute of frauds requirement that guarantees for the debts of another must be in writing, a special statute of frauds rule allows a guaranty written on an instrument to be enforceable notwithstanding.[286] A specific guaranty does not accompany the debt when the obligation is transferred, since it runs in favor of a named creditor only; conversely, a general guaranty runs with the obligation. Under the UCC, words of guaranty without specific limitation give rise to an obligation to pay that runs to the holder.[287]

One court applied the rules on a guarantor's obligation to modify the liability the parties would have had based on the capacity in which they signed a note. Three individuals guaranteed promissory notes executed by the county Democratic committee by indorsing the notes to the bank. The notes, which were dated May 3, 1967, were payable on demand. In 1977, the committee ceased making payments, and, in January of 1980, the bank demanded payment from the individuals. When the individuals refused, the bank brought suit against them in July 1981. The individual guarantors asserted that the suit was barred by the statute of limitations because the action had not been commenced within six years from the date of the note, May 3, 1967. If the guarantors were treated as indorsers, the cause of action would not accrue until after the holder of

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[280] UCC § 3-416(1). See generally Annot., "Construction and Effects of UCC § 3-416, Governing Guaranty Contracts," 10 ALR4th 897 (1981).

[281] UCC § 3-416(2).

[282] UCC § 3-416(3).

[283] UCC § 3-416(4).

[284] UCC § 3-416(5).

[285] UCC § 3-202(4).

[286] UCC § 3-416(6).

[287] FinanceAmerica Private Brands, Inc. v. Harvey E. Hall, Inc., 380 A2d 1377, 1380 (Del. Super. Ct. 1977). See generally, Hawkland, "Liability of Accommodation Parties Under Article 3 of the Uniform Commercial Code," 25 Prac. Law. 35 (1979).

the note had made a demand for payment and given notice of dishonor. If this were the case, the suit would have been timely.[288] The court held that the status of the guarantors was analogous to that of the maker of the note, not an indorser, because UCC § 3-416(1) provides that a guarantor waives presentment, notice of dishonor, and protest. Because the individual guarantor's liability was that of a comaker, the cause of action accrued on the date of the instrument, May 3, 1967, and the statute of limitations had expired.[289]

Persons who sign as an accommodation party sometimes attempt to defend an action on the instrument against them on the grounds that there was no consideration for their signature. The UCC rejects this as a defense in cases where there is sufficient consideration to support the transaction in which the instrument was given. Under this view, consideration for the transaction between the party who was accommodated and the person who took the instrument is enough. The comments to the UCC support this view by indicating that "the obligation of the accommodation party is supported by any consideration for which the instrument is taken before it is due."[290]

The principle that an accommodation party is liable on the instrument even when the party does not personally receive any consideration was followed in a West Virginia case. Two individuals served as accommodation makers of a note signed by a corporation. Although the individuals did not personally receive any consideration, the court said that their liability "is supported by the consideration which flows from the creditor to the principal debtor and the fact that no consideration flowed directly to the accommodation indorser [guarantor] is irrelevant."[291]

[3] Defenses to Payment of an Accommodation Party

Under general suretyship law, when a surety is called upon by the creditor to pay, there are two types of defenses that might be interposed if the circumstances

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[288] See UCC § 3-122(3).

[289] Bank of N.Y. v. Bersani, 90 AD2d 302, 305, 457 NYS2d 142, 145 (1982).

[290] UCC § 3-415(2), comment 3. The language of the section refers to an instrument that has been taken for "value" before it is due, but the comment refers to the existence of consideration for the transaction involving the party accommodated. There may be some cases where an instrument is taken for value, as in the case where it is taken as security for an antecedent debt, UCC § 3-303, but there would be no consideration in a traditional sense. It is the intention of the UCC, as reflected in the comments, to make consideration unnecessary when an instrument is taken as security for an antecedent obligation. UCC § 3-408. It is not intended that an accommodation party could claim the lack of consideration in such a case as a defense to the accommodation party's obligation. See UCC § 3-415, comment 3, stating that the language used in Section 3-415 (2) is intended to make the obligation of the accommodation party consistent with the policies as to antecedent obligations as consideration in Section 3-408.

[291] Pitrolo v. Community Bank & Trust, 298 SE2d 853, 856–857 (W. Va. 1982).

warrant it. The first type of defense is that relating to the principal debtor's duty to perform the obligation to the creditor. For example, when the creditor commits breach of contract such that the principal debtor does not have a duty under the contract to pay the obligation, the failure of consideration should be a defense available to the surety, as well.[292] Not all circumstances in which the principal may avoid payment should excuse the surety, however. For example, the lack of capacity of the principal to enter into the contract is not a defense that is generally available to the surety against the creditor.[293] The second type of defense is that relating to the surety's status as a surety. Four classic situations frequently present themselves in various contexts. The first situation arises when the creditor takes action to release the principal from liability. The second is the situation where the creditor modifies the contract with the principal. The third is where the creditor enters into a binding agreement with the principal to extend the time for payment by the principal. The fourth is where the creditor takes an action that injures or reduces the value of security held by the creditor for the principal's obligation. In all four of these cases, the circumstances may warrant discharge of the surety from liability.[294] In the first three situations mentioned, discharge of the surety may be avoided if the creditor obtains the consent of the surety or makes an express reservation of rights against the surety.

The UCC provides for certain suretyship-type defenses in UCC § 3-606. Although this section by its terms is not limited to accommodation parties, it primarily applies to cases in which accommodation parties claim that a discharge has occurred as a result of actions taken by the holder of the instrument. This section provides that there may be a discharge of an accommodation party when the holder (1) "releases or agrees not to sue any person against whom the party has to the knowledge of the holder a right of recourse . . .;" (2) "agrees to suspend the right to enforce against such person [a person against whom the party has a right of recourse as indicated above] the instrument or collateral . . .;" (3) "otherwise discharges such person [the party against whom there was a right

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[292] See Restatement of Security § 126 (1941). This section gives the surety a defense when there is a "material failure of performance by the creditor" which was not justified by conduct of the principal.

[293] See Restatement of Security § 125 (1941). See generally J. White & R. Summers, Uniform Commercial Code 531–535 (2d ed. 1980).

[294] See Restatement of Security §§ 122, 128, 129, 132 (1941). The exact circumstances under which a discharge may occur may vary, and it is important to note that the restatement view is not followed by all courts, particularly with respect to modifications of the contract between the creditor and principal which are not injurious to the surety. One court has held that UCC § 3-606(1), which gives guarantors to a negotiable instrument a discharge when certain events occur, does not apply to a guaranty agreement that is separate from the note itself. The separate writing is not part of a negotiable instrument and is governed by common law rules rather than the UCC. Gregoire v. Lowndes Bank, 342 SE2d 264, 267 (W. Va. 1986).

of recourse as above] . . .;"[295] or (4) "unjustifiably impairs any collateral for the instrument given by or on behalf of the party [who is claiming the discharge] or any person against whom he [the party claiming a discharge] has a right of recourse."[296] In all of these cases, the holder can avoid the discharge by obtaining the express consent of the accommodation party. The holder also can avoid a discharge in the first three of the situations by making an "express reservation of rights" against the accommodation party.[297]

The express reservation of rights provided in the section is intended to state the generally accepted rule in suretyship situations. When the holder of the instrument (the creditor) makes an express reservation of rights as part of any arrangement with the principal debtor that modifies the debtor's obligation or suspends enforcement of the instrument, the holder preserves all the rights the holder had against the accommodation party as of the time when the instrument originally was due. It also results in preserving the rights of the accommodation party to pay the instrument as of that time and the rights of the accommodation party to recourse against others.[298] The express reservation need not be communicated to the accommodation party under the generally accepted view as to reservation of rights.[299] Additionally, the comments support the view that an accommodation party may give consent to such actions by the holder of the instrument in advance, and the consent may be incorporated in the instrument itself. Thus, a term in the note may indicate that the parties signing for accommodation have waived an objection to the types of actions referred to earlier by the holder of the instrument.[300]

The availability to an accommodation party of discharges based upon the party's status as an accommodation party, such as the discharges based upon release of the principal, extending time, or impairing collateral, may depend on notice to the holder of the instrument that the party signed for accommodation. Such defenses are not available against a holder in due course who has no notice that the party signed for accommodation. Oral proof cannot be admitted to show the signature was for accommodation. Thus, the holder in due course will be able

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[295] UCC § 3-606(1)(a).

[296] UCC § 3-606(1)(b). See generally Annot., "Who Is a Party Discharged on Negotiable Instrument to Extent of Holder's Unjustifiable Impairment of Collateral, Under U.C.C. § 3-606(1)(b)," 93 ALR3d 1283 (1979).

[297] UCC § 3-606(1)(a).

[298] UCC § 3-606(2).

[299] See e.g. Restatement of Security §§ 122, 129 (1941).

[300] UCC § 3-606, comment 2 states that: "Consent may be given in advance, and is commonly incorporated in the instrument; or it may be given afterward. It requires no consideration, and operates as a waiver of the consenting party's right to claim his own discharge." For a case upholding the waiver by guarantors on a promissory note of their rights against a secured party in the event of failure to secure collateral, see Continental Bank & Trust Co. v. Utah Sec. Mortgage, Inc., 701 P2d 1095, 1098 (Utah 1985).

to enforce the instrument against the signer based on the capacity in which the instrument was signed, as maker, indorser, acceptor, or whatever capacity, as long as the holder in due course took without notice of the accommodation.[301]

A conflict in the case law exists on whether the maker of a note will be discharged from liability on the note when a holder impairs collateral given by the maker to secure the note. Although UCC § 3-606 provides for discharge of the liability of a party when the holder impairs any collateral "given by or on behalf of the party or any person against whom he has a right of recourse," some courts have held this defense is available only to someone who is in a position of a surety on the instrument. Because a maker of a note is primarily liable on that obligation and has no recourse against other parties (except comakers) the maker is not like a surety whose risks are increased whenever the surety's (accommodation party's) recourse against the collateral or other persons is impaired.[302] Following this rule, a court held that a comaker of a note was not able to raise as a defense that a secured party impaired collateral given by another comaker to secure the note. In the view of the court, comakers have only a right of contribution among themselves and are not subrogated to the rights that the payee may have against other comakers. Although one of the comakers may have been released, that release does not result in the release of the other comakers.[303] In a case in which a comaker of a note signed as an accommodation party, a court granted a discharge from liability on the instrument where the holder had been found to have unjustifiably impaired the collateral securing the instrument. The court reasoned that UCC § 3-606 was an intentional expansion of the defense based on impairment of collateral to include parties who were comakers in an accommodation capacity. Distinguishing the situation from one in which the signer was an ordinary comaker of the note, the court stated that the ordinary, not for accommodation comaker, would not be able to assert the defense.[304]

[4] Accommodation Parties in Consumer Transactions

Use of accommodation parties and guarantors also may raise other implications under special rules regulating consumer credit practices. Among the regu-

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[301] UCC § 3-415(3). As discussed previously, when the accommodation party has signed as an indorser outside the regular chain of indorsements, this will be notice that the signature is one for accommodation. UCC § 3-415(4).

[302] United States v. Vahlco Corp., 720 F2d 885, 890 (5th Cir. 1983). Although a maker may not be entitled to a discharge of liability, the maker may have rights against the secured party based on the UCC rules which place duties on a secured party who is in possession of collateral.

[303] In re I.A. Durbin, Inc., 49 Bankr. 528, 531–532 (Bankr. SD Fla. 1985), aff'd, 62 Bankr. 139 (Bankr. SD Fla. 1986). See also El-Ce Storms Trust v. Svetahor, 724 P2d 704, 706–707 (Mont. 1986) following the rule that an ordinary maker cannot raise the defense of impairment of collateral as constituting grounds for discharge.

[304] FDIC v. Blue Rock Shopping Ctr., Inc. 766 F2d 744, 749–750 (3d Cir. 1985).

lations that need to be taken into account are the Federal Trade Commission's credit practice rules.[305] The credit practice rules make it a deceptive act or practice to misrepresent the nature or extent of cosigner liability to any person in a consumer credit transaction. They also make it an unfair act or practice for a lender or an installment seller to obligate a cosigner without providing certain disclosures and information to the cosigner of the nature of the liability being assumed. A disclosure document, containing a statement describing the nature of the legal liability the cosigner will assume, must be given to the cosigner. The rule defines a cosigner as "a natural person who renders himself or herself liable for the obligation of another person without compensation."[306]

¶ 15.07 DISCHARGE OF LIABILITY

Parties who are liable on a negotiable instrument are released or discharged from that liability under a number of circumstances, usually by payment of the instrument. Any person who is liable on a check, note or other negotiable instrument may end that liability by paying the holder.[307]

When the drawer of a check or the maker of a note pays the instrument, the liability of all the indorsers on the instrument is discharged because when a person having no recourse on the instrument against other parties pays the instrument, the liability of all parties to the instrument is discharged.[308] The UCC rule is broader than simply discharge by payment and the same result follows regardless of the reason for the discharge. The liability of other parties to the instrument is discharged whenever a party who has "no right of action or recourse on the instrument" "reacquires the instrument in his own right; or is discharged under any provision . . ." of Article 9, except as specifically limited in the section on impairment of recourse or collateral.[309]

[305] 16 CFR § 444.3 (1988).

[306] 16 CFR § 444.1(k) (1987). There are certain exclusions, as for spouses whose signatures may be needed to perfect a security interest under state law.

[307] UCC § 3-603(1).

[308] UCC § 3-601(3).

[309] Id. See Yahn & McDonnell, Inc. v. Farmers Bank. 708 F2d 104 (3d Cir. 1983). A bank paid the proceeds of a certificate of deposit to a person other than the holder of the certificate of deposit or the payee named on the certificate. The court held this did not constitute payment to the holder, and the bank could not rely upon its action as a defense when the holder sued to obtain payment. However, the court indicated that if the claimant was not a holder in due course, then the bank might have defenses against the holder. Because the holder of the CD had a series of transactions with the party whom the bank had paid, the court left several issues open for further exploration. Assuming the bank had a claim for reimbursement from the party the bank paid, could this claim be asserted as an offset or defense to the action by the holder? Did a defense of unjust enrichment exist

In circumstances that involve an accommodation party, the accommodation party has recourse on the instrument against the party who has been accommodated. The party accommodated has no recourse on the instrument against the accommodation party because as between these two persons the party accommodated is the principal debtor and should pay.[310] Thus, a payment by the party accommodated will discharge all parties when the accommodated party has recourse against no one. Discharge of the accommodation party, however, will not result in a discharge of all parties to the instrument because the accommodation party always has recourse on the instrument.[311]

Discharge may occur through actions other than payment. One method is through the intentional cancellation of an instrument. This may occur by marking the face of the instrument in a manner that indicates that the holder has canceled it. The holder's mutilation or destruction of the instrument or the party's signature will be effective when done with the intent to cancel. The holder also may discharge a party by renunciation of rights in a signed writing delivered to, or by surrender of the instrument to, the party to be discharged.[312] No consideration is needed to make the discharge valid—it may be a gift. Problems sometimes arise when a note is canceled and a new renewal note is executed. These and related issues are discussed in Chapter 24. A holder may discharge a party by striking through a signature, such as an indorsement.

Other provisions that may give rise to a discharge of liability include the following:

- Discharge by tender of payment;[313]
- Impairment of right of recourse of collateral;[314]
- Reacquisition of the instrument by a prior party;[315]
- Fraudulent and material alteration;[316]

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because the holder, through the various transactions, in effect received the benefit of the bank's payment?

[310] See UCC § 3-601(3), comment 4.

[311] Id.

[312] UCC § 3-605.

[313] UCC § 3-604. When full payment is tendered to a holder, the party is discharged to the extent of subsequent liability for interest, costs, and attorney fees. A refusal of the tender by the holder results in a discharge of any party who has a right of recourse against the party making the tender. In the case of a maker or acceptor on an instrument that is other than an instrument payable on demand, a formal offer to pay is not necessary. Being able and ready to pay at every place of payment specified in the instrument is equivalent to a tender. Id.

[314] UCC § 3-606. This is discussed in ¶ 15.06.

[315] UCC § 3-208. This may produce a discharge of intervening parties.

[316] UCC § 3-407. This is discussed in ¶ 20.09.

- Certification of a check;[317]
- Acceptance varying a draft;[318] and
- Delay in presentment or notice of dishonor or protest.[319]

These circumstances are not exclusive. A party may be discharged from liability "by any other act or agreement" with the party which would "discharge his simple contract for the payment of money."[320]

A relationship exists between a party's liability on an instrument and the party's liability on the underlying obligation for which the instrument was given. When a person is discharged from liability on the instrument for whatever reason, that person's liability on the underlying obligation is automatically discharged.[321] For example, where *D* gives *P* a check that *P* indorses to *X* to pay for goods, any action that discharges *P* as an indorser will also discharge *P* from the obligation to pay *X* for the goods for which the check was given. As discussed in Chapter 21, delay in presentment of the check for payment or in giving notice of the dishonor of the check are circumstances that may cause a discharge of *P*'s liability as an indorser.

Although a party may be discharged from liability on the instrument, the discharge is treated like any other defense so far as the rights of a holder in due course are concerned. If the instrument remains in circulation and is in the possession of a holder in due course who did not have notice of the discharge when the holder in due course took the instrument, the discharge is not effective as against the holder in due course.[322] Because of this rule, it is essential that one who pays an instrument insist that the instrument be produced, so that the fact of payment may be noted upon the instrument when the payment is a partial payment, and so that the instrument will be surrendered to the payor and notation of payment made on it when payment is made in full.[323] Otherwise, the continued circulation of the instrument may lead to its purchase by a holder in due course, who will be entitled to payment notwithstanding the prior payment by the party who claimed to have been discharged.

Although a holder may take an instrument with notice that one of the parties to the instrument has been discharged, the holder will not be prevented from being a holder in due course and from enforcing the instrument against other

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[317] UCC § 3-411. This may result in the discharge of the drawer and prior indorsers when a holder obtains the certification.

[318] UCC § 3-412.

[319] UCC § 3-502. This is discussed in Chapter 21.

[320] UCC § 3-601(2).

[321] UCC § 3-802(1). For further discussion of the relationship between a party's liability on an instrument and on the underlying obligation for which the instrument was given, see ¶ 21.03[2].

[322] UCC § 3-602.

[323] UCC § 3-505(1)(d).

parties so long as there is no notice that the others have been discharged.[324] Of course, notice that the maker of a note has been discharged would be notice that all indorsers also were discharged because the maker has no recourse on the instrument against any other party to it, as discussed earlier. But notice to the holder that one of several indorsers has been discharged normally would not be notice that any other indorser or maker had been discharged, because the indorser does have recourse on the instrument against prior indorsers and the maker, and so the discharge of the indorser does not cause a discharge of the other parties.

¶ 15.08 HANDLING OF INSTRUMENTS INVOLVING A FIDUCIARY

In many situations, a bank will handle a check or other negotiable instrument in which a fiduciary is involved. Although the UCC has special rules to deal with such circumstances, the UCC does not define "fiduciary." A bank may be involved with a fiduciary when the bank purchases, collects or pays a negotiable instrument. A fiduciary relationship exists, under general legal principles, whenever an agent acts on behalf of a principal, an officer acts on behalf of an organization, or a trustee acts on behalf of a beneficiary. The Uniform Fiduciaries Act defines a fiduciary to include "a trustee under any trust, expressed, implied, resulting or constructive, executor, administrator, guardian, conservator, curator, receiver, trustee in bankruptcy, assignee for the benefit of creditors, partner, agent, officer of a corporation, public or private, public officer, or any other person acting in a fiduciary capacity for any person, trust, or estate."[325] A person may include an organization as well as an individual. Given this definition, on many occasions a fiduciary will be the drawer of the check, a payee or indorsee of an instrument, or will be acting on behalf of a principal to whom the instrument is payable.

[1] UCC Provisions Relating to Fiduciaries

The UCC treatment of transactions that involve fiduciaries is not elaborate. An extensive body of common law and statutory law was developed prior to the UCC.[326] Some of the prior law will be relevant under the UCC because of the

[324] UCC §§ 3-601, 3-602 & comment.

[325] Uniform Fiduciaries Act § 1(1), 7A ULA 395–396 (1985).

[326] See G. Bogert & G. Bogert, The Law Of Trusts And Trustees §§ 901–912 (2d ed. rev. 1982); Restatement (Second) of Trusts §§ 321, 324 (1959); Uniform Fiduciaries Act, 7A ULA 395–426 (1985). See generally Brady on Bank Checks Ch. 13 (2d ed. 1987).

incorporation of general principles of law where the specific provisions of the UCC have not displaced such law.[327]

A number of provisions in the UCC are relevant in considering problems related to fiduciaries. Among the most important of these rules is that a purchaser of an instrument will have notice of a claim against the instrument and, therefore, cannot be a holder in due course when the purchaser "has knowledge that a fiduciary has negotiated the instrument in payment of or as security for his own debt or in any transaction for his own benefit or otherwise in breach of duty."[328] This provision requires that the purchaser have both knowledge that the person concerned is a fiduciary and knowledge that the circumstances amount to a breach of duty by or personal benefit to the fiduciary. Merely knowing that a person who negotiated the instrument "is or was a fiduciary" is not enough to give the purchaser notice of a defense or claim.[329] According to the comments to the section, the purchaser is entitled to assume that a fiduciary is acting properly, and as long as there is no notice of a breach, the comment states that "the purchaser may pay cash into the hands of the fiduciary without notice of any breach of the obligation."[330]

The UCC distinction between knowledge of a breach of duty and only knowing that a person is a fiduciary is critical. When the purchaser of a check or a note does not have notice of a defense or claim and qualifies as a holder in due course, the purchaser takes free from the claims of any person, including a beneficiary who was injured by a fiduciary's breach of obligation. On the other hand, when the purchaser has notice of the breach of obligation and, thus, cannot qualify as a holder in due course, the purchaser takes the instrument subject to the claims of other parties, such as the wronged beneficiary.[331]

Additionally, the UCC rules on payment of an instrument permit one to make payment to the holder, although a third party asserts claims to the instrument, so long as the provisions on restrictive indorsements are not violated and it is not a bad faith payment to one who acquired the instrument through a thief.[332]

When an instrument is restrictively indorsed to a person, the UCC provisions on restrictive indorsements require payment to be made consistently with that indorsement. Although an agent or other fiduciary may transfer the instrument to the bank, where the instrument is indorsed restrictively for deposit to the account of the principal, the depositary bank will be required to act consis-

[327] UCC § 1-103.

[328] UCC § 3-304(2).

[329] UCC § 3-304(4)(e).

[330] UCC § 3-304, comment 5.

[331] UCC §§ 3-305, 3-306. See discussion at ¶¶ 16.02[1], 16.03.

[332] See discussion of these rules at ¶ 20.05[2].

tently with the directions in the indorsement.[333] Similarly, if the indorsement provides that the instrument has been transferred for the benefit or use of the indorser or of another person, the first transferee under the indorsement also is required to pay any value given consistently with the indorsement.[334] Additionally, the UCC provisions dealing with forged and unauthorized signatures apply in cases in which the agent or fiduciary lacks authority to issue, transfer, or obtain payment of the instruments in question. These rules may give rise to actions by the principal based upon conversion, and to the application of the UCC preclusion policies in circumstances in which the principal should be bound by the conduct of the agent because of the principal's own negligent conduct or other basis for an estoppel.[335]

The problems discussed in this chapter involve circumstances in which a fiduciary otherwise has authority to transfer or to issue or obtain payment of an instrument on behalf of his or her beneficiary, but has engaged in a transaction that breaches the duty owed to the principal. Thus, one common thread in these circumstances is the question of when a person handling an instrument should be charged with notice that a fiduciary, who was involved with the instrument, has acted in breach of the fiduciary's duties. Two general principles of trust law are relevant. Firstly, so long as a person acts in good faith to pay or transfer to a fiduciary money or other property that the fiduciary has authority to receive, the person will not be viewed as responsible for a subsequent misapplication of the funds or property by the fiduciary.[336] This principle applies only when the fiduciary has authority to receive the money. Secondly, a person will be liable when the person participates with a trustee in a breach of trust. As explained in a leading treatise, this wrong occurs when the person engages in conduct that assists the trustee in the breach of trust and the person has knowledge or may legally be charged with the knowledge that the transaction amounted to a breach of trust.[337] When will a purchaser or payor of an instrument to a fiduciary be viewed as participating in a breach of trust by the fiduciary? Although the body of law is extensive, the answers to this critical question remain unclear. A bank dealing with a fiduciary should exercise caution.

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[333] UCC § 3-206(3).

[334] UCC §§ 3-205(d), 3-206(4). There is a provision like the holder in due course notice provision that states that when there is an instrument that has been indorsed for the benefit of a person, "a later holder for value is neither given notice nor otherwise affected by such restrictive indorsement unless he has knowledge that a fiduciary or other person has negotiated the instrument in any transaction for his own benefit or otherwise in breach of duty (subsection (2) of § 3-304)." UCC § 3-206(4).

[335] See discussion at ¶ 20.08.

[336] Uniform Fiduciaries Act § 2, 7A ULA 401 (1985).

[337] G. Bogert & G. Bogert, The Law of Trusts and Trustees § 901 at 257–259 (2d ed. rev. 1982).

The law relating to fiduciaries' handling of negotiable instruments is affected in some states not only by the UCC, but also by the Uniform Fiduciaries Act. A number of jurisdictions have adopted the Uniform Fiduciaries Act of 1922.[338] All of these state enactments predate the UCC by a considerable period of time, but the UCC did not repeal the Uniform Fiduciaries Act. Thus, in those jurisdictions where the Uniform Fiduciaries Act is in effect, courts need to harmonize the more detailed rules of the Uniform Fiduciaries Act with the policies of the UCC and to decide what effect the subsequent adoption of the UCC had on the continuing force of the policies in the Uniform Fiduciaries Act.

The UCC provisions apply smoothly in many of the situations that involve fiduciaries. For example, suppose *D* issues a check drawn on Bank *B* that is payable to "*F* as trustee for *B*," *F* indorses it to *X*, *X* in turn transfers it to Bank *A*, and Bank *A* presents it to Bank *B* for payment. Although Bank *A* may have notice from the manner in which the check designates the payee that a person who was a fiduciary, *F*, negotiated the check, there is no notice from the circumstances that *F* negotiated the instrument for personal benefit or in breach of duty. Bank *A* can qualify as a holder in due course. Any claim to the instrument of *B* based upon breach of fiduciary duty by *F* will not be effective against Bank *A*, which has the rights of a holder in due course.[339] The negotiation of the instrument by *F* is effective, although *F* breached his or her duty to *B* by negotiating it in this particular transaction.[340] Likewise, when Bank *B* pays the check, the payment will be to a holder, the payment will not violate the rules on restrictive indorsements, and so Bank *B* may properly pay the check to Bank *A* notwithstanding notice of the claim of *B* unless *B* takes the legal action required to enjoin payment.[341] If *B* does sue, and litigation ensues between *B*, Bank *A*, and Bank *B* over who has the superior right to the proceeds of the check, Bank *A* will prevail because it took the check free from all claims to it by anyone, when it took the check as a holder in due course. The same reasoning and result should follow for a check that is issued by *F* as trustee for *B*, on an account of *B*'s in Bank *B*, and which is payable to *X*, then transferred, and paid as previously. Thus, in most cases, the UCC permits persons, including banks, who purchase or pay instruments to do so although a fiduciary may have been involved in the issue or transfer, so long as the person who purchases or pays has no knowledge of breach of duty by the fiduciary. This furthers the policy of permitting checks to be

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[338] Twenty-five jurisdictions have adopted the act. They are Alabama, Arizona, Colorado, District of Columbia, Hawaii, Idaho, Illinois, Indiana, Louisiana, Maryland, Minnesota, Missouri, Nevada, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Dakota, Tennessee, Utah, Virgin Islands, Wisconsin, Wyoming. Uniform Fiduciaries Act, 7A ULA 391 (1985).

[339] These rules follow from the provisions on notice and indorsement, UCC §§ 3-206(4), 3-304(4).

[340] UCC § 3-207(1)(d).

[341] UCC § 3-603.

handled rapidly without inquiry into extrinsic circumstances to determine the validity of the instrument.

The more difficult situations are those in which the purchaser or payor has dealt directly with the fiduciary. In the two previous examples, *X* dealt directly with *F* and knew that *F* was a fiduciary. If that is all *X* knew, then, under the UCC, *X* may qualify as a holder in due course, but *X* cannot have that status if *X* knew that the transaction involved a breach of *F*'s duties as a fiduciary. There are a number of possible situations. In the first situation, the check is payable to the fiduciary as such, either because the instrument names "*F* as fiduciary for *B*" as the payee or it was indorsed to "*F* as fiduciary for *B*." *F* then transfers the check to Bank *A*, which applies the check to settle a personal obligation of *F* with the bank, or which credits the check to a personal account of *F* with the bank, or which credits the check to an account at Bank *A* in the name of "*F* as fiduciary for *B*." The second set of situations involves checks or other instruments issued by *F* as a fiduciary for *B* drawing against funds in a fiduciary account or an account beneficially owned by *B*. The check may be payable to "*F*" personally or to "*F* as fiduciary for *B*." The check may be payable directly to a third party, such as a check payable to Bank *A*. The third set of circumstances arises when fiduciary funds are deposited into an account maintained by the fiduciary in the depository bank and *F* subsequently withdraws the funds for personal benefit in breach of trust. In this scenario, *F* may deposit the fund to a personal account of "*F*" or to an account maintained in the name of "*F* as a fiduciary for *B*."

The UCC does not address these circumstances separately, but rather leaves the solution to an application of the general principles on notice to a holder in due course and when payment is proper. The Uniform Fiduciaries Act contains a set of elaborate separate rules that distinguish between various of these types of transactions on the theory that the forms of some of them may constitute notice of breach of duty. These provisions of the Uniform Fiduciaries Act may continue to have some effect, notwithstanding the enactment of the UCC, because a comment to the UCC indicates that the policies of the Uniform Fiduciaries Act, at least in part, are followed by the UCC.[342]

[2] Uniform Fiduciaries Act Provisions

Section 4 of the Uniform Fiduciaries Act deals with transfer of negotiable instruments by a fiduciary.[343] It provides that an indorsee who takes an instrument from a fiduciary that was payable or indorsed to the fiduciary as such is not bound to inquire whether the fiduciary is committing a breach of his or her obligations, and is not chargeable with notice that the fiduciary is committing a

[342] See UCC § 3-304, comment 5, indicating that the provisions in Section 3-304(2) follow Section 6 of the Uniform Fiduciaries Act.

[343] See Uniform Fiduciaries Act § 4, 7A ULA 405 (1985).

breach of the fiduciary's obligations unless the purchaser takes the instrument "with actual knowledge of such breach or with knowledge of such facts that his action in taking the instrument amounts to bad faith." The same rule applies when an instrument payable to or indorsed to the principal is indorsed by a fiduciary for the principal. (This applies only when the fiduciary has authority to indorse the instrument for the principal). An example of a check falling under this rule of Section 4 of the Uniform Fiduciaries Act is one drawn by *D*, payable to *P*, which *P* then indorses specially "to *F* as fiduciary for *B*" and which *F* then indorses to *X* or to Bank *A*. Another example is a check drawn as above, but specially indorsed by *P* to "*B*" and which *F* then indorses "*F*, as agent for *B*" to *X* or to Bank *A*. When the transferee (*X* or Bank *A* in the previous examples) has actual knowledge that the fiduciary is transferring the instrument in payment or security of a personal debt of the fiduciary or for other personal benefit, the transferee is liable to the principal if there is in fact a breach of the obligation owed to the principal by the fiduciary in transferring the instrument. Under this view, the form of the instrument that makes clear it is payable to *F* in a fiduciary capacity is regarded as sufficient to give notice of a breach of duty by *F* in using the instrument to gain a personal benefit, although the transferee does not have actual knowledge that the transaction in fact constitutes a breach.

Section 5 of the Uniform Fiduciaries Act deals with checks drawn by a fiduciary in that capacity and payable to third persons.[344] An example would be a check payable to *X* as payee and written by "*F* as trustee for *B*," drawn on a trust account with Bank *B* where *F* is the trustee and *B* is the beneficiary of the account. Once again, the payee is not under any obligation to inquire, and is not placed on notice of any breach by the fiduciary of obligations owed to the principal, unless the payee takes the instrument with actual knowledge or knowledge of facts amounting to bad faith. However, when the payee of the instrument is a personal creditor of the fiduciary, and the instrument is delivered to the creditor to pay for a debt that the creditor knows is a personal debt of the fiduciary or knows is otherwise known to be for the personal benefit of the fiduciary, the payee is liable to the principal where the fiduciary has in fact breached an obligation owed to the principal.

Section 6 of the Uniform Fiduciaries Act deals with checks drawn by a fiduciary as such, and payable to a fiduciary personally.[345] These would include a check drawn by "*F* as fiduciary for *B*" on a fiduciary account where the payee is "*F*." In such cases, the transferee "is not bound to inquire whether the fiduciary is committing a breach of his obligation as fiduciary in transferring the instrument, and is not chargeable with notice that the fiduciary is committing a breach of his obligation as fiduciary" unless the transferee has actual knowledge of the

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[344] See Uniform Fiduciaries Act § 5, 7A ULA 406–407 (1985).

[345] It also includes checks drawn by "*F* as fiduciary for *B*" which are payable to *P* and subsequently transferred by *P*. See Uniform Fiduciaries Act § 6, 7A ULA 410 (1985).

breach or such knowledge as amounts to bad faith. A comment to the UCC indicates that the UCC incorporates the notice concept of this section.[346]

The drafters of the Uniform Fiduciaries Act stated that the rules in Sections 4–6 were intended to permit one to take an instrument without any duty of inquiry, and assuming any fiduciary has acted properly as long as the instrument is not taken "in a transaction known by the taker to be for the personal benefit of the fiduciary."[347] The Uniform Fiduciaries Act takes the position that this presumption that the transaction is proper should be rebuttable only by proof that the person who took the instrument either had actual knowledge that the transaction was improper or acted in bad faith under a subjective definition of bad faith.[348] When the person taking the instrument knows that the fiduciary is using it to obtain a personal benefit, the drafters distinguish between the types of cases in Section 4, in which the taker knows that *F* is using an instrument payable to "*F* as fiduciary for *B*" for personal gain, and the types in Section 5, in which the taker is a payee who knows "*F* as fiduciary for *B*" has drawn a check to obtain a personal benefit, from the cases in Section 6, where "*F* as fiduciary for *B*" has drawn a check payable to "*F*" and then transferred it for personal benefit. The Uniform Fiduciaries Act finds a "strong presumption that the fiduciary is acting improperly" in the Sections 4–5 cases, but no such presumption in Section 6 cases because the fiduciary may have been entitled to be paid from the funds of the principal.[349] The UCC, in a comment to the notice provisions in Section 3-304, states that it "follows the policy of Section 6 of the Uniform Fiduciaries Act, and specifies the same elements as notice of improper conduct of a fiduciary."[350] The UCC comments are silent as to whether the UCC also incorporates the policies in Uniform Fiduciaries Act §§ 4, 5 & 7.

Section 7 of the Uniform Fiduciaries Act covers deposits made in the name of the fiduciary in the capacity as a fiduciary.[351] These situations would include deposits of cash or instruments by "*F* as fiduciary for *B*." In these cases, when the fiduciary draws a check on the account, using the same name as fiduciary with which the deposit was made, the bank has authority to pay the check and has no liability to the principal for breach of the fiduciary's authority in drawing the check, unless the bank has actual knowledge of a breach of obligation or such facts as amount to bad faith. When the fiduciary draws such a check payable to the drawee bank itself in payment for a personal debt of the fiduciary, the bank is liable to the principal if the transaction constitutes a breach of the fiduciary's obligation.

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[346] UCC § 3-304(2), comment 5.

[347] Uniform Fiduciaries Act § 6, comment 1, 7A ULA 410–411 (1985).

[348] Id.

[349] Uniform Fiduciaries Act § 6, comment 2, 7A ULA 411 (1985).

[350] UCC § 3-304, comment 5.

[351] See Uniform Fiduciaries Act § 7, 7A ULA 413 (1985).

Section 8 of the Uniform Fiduciaries Act deals with accounts in the name of the principal.[352] When a fiduciary with authority to draw checks on the account does so, Section 8 applies. This section follows the same rules as contained in Section 7 for deposits in the name of the fiduciary as such. The bank may pay unless it has actual knowledge of a breach by *F*, except that when *F* makes the check payable to the drawee bank itself for a personal debt of *F* to the bank, the bank will be liable to the principal if there is a breach of duty in fact.

Section 9 of the Uniform Fiduciaries Act covers deposits in the fiduciary's personal account at the bank.[353] When the fiduciary makes a deposit to a personal account of checks that indicate that they were drawn by the fiduciary as a fiduciary or were payable to the fiduciary in the capacity as a fiduciary or were checks in the name of the principal, or the deposit otherwise consists of fiduciary funds, "the bank receiving such deposit is not bound to inquire whether the fiduciary is committing . . . [by the deposit] a breach of his obligation as fiduciary . . ." as long as the bank does not have actual knowledge that *F* has breached his duty and has not acted in bad faith. Further, the bank may pay out the deposit on the personal check of the fiduciary without liability to the principal, so long as the bank does not pay the check having either actual knowledge the fiduciary had breached a duty owed the principal or knowledge of such facts that the payment of the check amounted to bad faith.[354]

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[352] See Uniform Fiduciaries Act § 8, 7A ULA 415 (1985).

[353] See Uniform Fiduciaries Act § 9, 7A ULA 417 (1985).

[354] The provision of the Uniform Fiduciaries Act that allows a bank to make payment to a fiduciary who deposits the funds in a personal account as long as the bank does not know the fiduciary is breaching his duty was held not to apply in Arvada Hardwood Floor Co. v. James. 638 P2d 828, 830 (Colo. Ct. App. 1981). The court said the provision could not apply because the depositor was not a fiduciary and did not have authority to indorse the checks.

In Boutros v. Riggs Nat'l Bank, 655 F2d 1257, 1259 (DC Cir. 1981), a bank claimed the protection of Section 2 of the Uniform Fiduciaries Act which provides that "a person who in good faith pays or transfers to a fiduciary money . . . which the fiduciary as such is authorized to receive, is not responsible for the proper application thereof by the fiduciary." The bank permitted a person it claimed was its customer's agent to make withdrawals from the customer's account. The court held that this provision of the Uniform Fiduciaries Act excusing good faith payment to a fiduciary applies only when the payor deals with someone it knows is a fiduciary. In this case, there were disputed issues of fact as to whether the person who made the withdrawals in fact was authorized to make them and as to whether at the time of the withdrawals the bank knew he was authorized to act for its customer.

The provision of the Uniform Fiduciaries Act that relieves banks of any duty to inquire whether a fiduciary is acting contrary to his obligations as a fiduciary was examined in Levy v. First Pa. Bank, 338 Pa. Super. 73, 487 A2d 857 (1985). The court said that cases under the Uniform Fiduciaries Act that held that a bank was relieved of any duty of inquiry into whether a fiduciary's indorsement was within the scope of the fiduciary's authority did not apply to a case where the bank did not know it was dealing with a fiduciary. In the latter case, the bank is liable in conversion for paying over an

[3] Problems in Determining When There Is Knowledge of a Breach of Fiduciary Duty

Although the Uniform Fiduciaries Act draws distinctions based on the different types of transactions, commentators have questioned the significance of the distinctions. One leading authority notes the distinction in the act between checks on a fiduciary account payable to a bank that are delivered to the bank in payment of a personal debt of the fiduciary and cases where persons other than banks are the indorsees, transferees, and payees. The authority disagrees that in the former circumstances the form of the transaction alone is enough to give notice that the bank is participating in a breach of the fiduciary's duty, while in the second set of cases the form of the transaction does not show a breach.[355] This same authority suggests that whether the bank takes a check drawn by "*F* as fiduciary for *B*" which is either payable to the bank, or payable to "*F*" personally and indorsed by *F* to the bank, or where the bank receives cash known to be proceeds of a check drawn by the fiduciary as such to the fiduciary personally, or the bank accepts a check payable to *F* as a fiduciary, which the fiduciary has indorsed to the bank, strong evidence suggests that the trustee has personally benefited from the transaction and this should be enough to give actual knowledge to the bank of a breach of *F*'s obligation or is at least knowledge of facts sufficient to amount to bad faith.[356] But the views stated by this authority do not square in all cases with the policies in the UCC, which indicate that the existence of notice of breach of the obligation of a fiduciary is not to be based on knowing a fiduciary was involved in the transaction unless there is knowledge of additional circumstances showing personal benefit to the fiduciary or breach of obligation to the principal.

In the case where there is a check drawn by *D* on Bank *B* payable to "*F* as fiduciary for *B*," then indorsed by *F* to Bank *A* to pay *F*'s personal debt at the bank, this should be a circumstance in which the bank could be viewed as having actual knowledge that fiduciary funds were used to pay a personal debt of the fiduciary. The bank would then be prevented from being a holder in due course, and the principal's claim to the proceeds based upon the bank's participation in the breach of trust would not be cut off.

Although a similar result would appear to be appropriate when the fiduciary deposited the same check (one payable to "*F* as fiduciary for *B*") to the fiduci-

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unauthorized indorsement of a check. The Uniform Fiduciaries Act does not apply, in the court's view, because that Act is designed to shield banks from negligence only when they know that the party before them is acting for another. The objective of the Uniform Fiduciaries Act was to make transactions "between banks and known fiduciaries easier and faster" and not to make risk-free transactions with persons not known to be fiduciaries.

[355] G. Bogert & G. Bogert, The Law of Trusts and Trustees § 904 at 286 (2d ed. rev. 1982).

[356] Id.

ary's personal account at Bank *A*, there is authority to the contrary. In one case, a father was the guardian of an account established for his son. The father received a $14,000 check made payable to him as guardian for the son. The father took the check, deposited it to his personal account at the bank, and retained $4,800 in cash, which the father subsequently spent on an automobile. The father used the remaining amount in the account for personal expenditures in violation of the fiduciary responsibility owed to the son. The court held that the bank had no liability for the father's conduct. It did not have to inquire of the father whether negotiation of the check was within the father's authority as a fiduciary. The court said:

> In general, a bank may assume that a person acting as a fiduciary will apply entrusted funds to the proper purposes and will adhere to the conditions of the appointment.... A bank is not in the normal course required to conduct an investigation to protect funds from possible misappropriation by a fiduciary, unless there are facts—not here present—indicating misappropriation....[357]

On the other hand, another court held that when a bank receives a check for deposit that has been made payable to a guardian in the person's capacity as a guardian, the bank must place the check in a guardianship account or be held accountable for notice that the individual is violating the fiduciary duty owed as guardian, by depositing the check into a personal account.[358] The Restatement of Trusts takes the position that although a bank knows a fiduciary has deposited trust funds into a personal account at the bank, the bank does not have a duty of inquiry as to whether there has been a breach of trust in making the deposit, and the bank is not liable for participation in the breach of trust absent further circumstances known to the bank indicating that the trustee is committing a breach of trust.[359] The Restatement would apply the same rule if the fiduciary has drawn the check as a fiduciary on a fiduciary account and deposited the check in the fiduciary's personal account.[360] The rule in the UCC does not give a clear answer to the case where funds payable to a fiduciary as such are deposited to the fiduciary's personal account. The issue is whether the depositary bank

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[357] Knox v. Columbia Banking Fed. Sav. & Loan Ass'n. 64 NY2d 434, 436–437, 488 NYS2d 146, 148–149, 477 NE2d 448, 450–451 (1985).

[358] Smith v. Olympic Bank, 103 Wash. 2d 418, 421–422, 693 P2d 92, 95–96 (1985). See also Canyon Lake Bank v. New Braunfels Utilities, 638 SW2d 944 (Tex. Ct. App. 1982), where the bank was liable when it allowed a trustee to take proceeds from a maturing certificate of deposit in the name of the trustee and deposit the proceeds into a personal account at the same bank.

[359] Restatement (Second) of Trusts § 324, comment d (1959).

[360] Id.

knows the fiduciary was engaged in a "transaction for . . . [the fiduciary's] own benefit or otherwise in breach of duty."[361]

When a fiduciary draws a check as fiduciary on a fiduciary account, if the check is used to pay a personal debt of the fiduciary or otherwise for personal benefit, under what circumstances might the bank that takes such a check for a personal obligation of the fiduciary be viewed as having notice of breach of obligation? The Uniform Fiduciaries Act § 5, as noted earlier, makes a check drawn by a fiduciary payable directly to the personal creditor, under circumstances where the payee knows it is for the personal benefit of the fiduciary, a transaction in which the creditor is liable if there was a breach of fiduciary obligation in fact. However, when the fiduciary deposits such a check to a personal account of the fiduciary, under Section 9 of the Uniform Fiduciaries Act, the bank has no duty to inquire and will not be liable for paying out the deposit on the personal check of the fiduciary unless the bank has actual knowledge that there is a breach of the fiduciary's obligation in making the deposit or in drawing the check or there is sufficient knowledge to amount to bad faith.

The Uniform Fiduciaries Act attempts to distinguish between the bank as depository and the bank as creditor. When the bank is a depository, it is liable only when it has actual knowledge or acts in bad faith, but when the bank receives payment as a creditor from the fiduciary for a personal debt of the fiduciary, the act treats the bank in the same manner as the act treats other creditors whom a fiduciary pays. The bank as creditor will be liable when it deals with a fiduciary in these circumstances who in fact breaches the fiduciary obligation owed to the principal.[362] However, in some cases checks drawn by a corporation payable to a bank were deposited by an officer in a personal account or the officer obtained cash from the bank for the check, and the bank was liable for paying the proceeds improperly.[363]

Given the varying views of what constitutes notice of a breach of fiduciary duty or when funds are being used by a fiduciary in violation of the obligations owed to the principal, banks should use great care in dealing with fiduciaries. The notice provisions in UCC § 3-304 are susceptible to different interpretations because the language of UCC § 3-304(2) makes knowledge that a fiduciary has negotiated an instrument as payment for the fiduciary's own debt or in a transaction for the fiduciary's own benefit, sufficient information to constitute notice of a claim or defense without indicating clearly whether the transferee must also know that use of the check for personal gain constituted a breach of fiduciary duty. The section ends with the phrase "or otherwise in breach of duty," which could be read as assuming the circumstances where the instrument

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[361] UCC § 3-304(2).

[362] Uniform Fiduciaries Act § 9, comment 6, 7A ULA 418 (1985).

[363] See discussion at ¶¶ 20.07 and 20.08 of miscredited proceeds and checks with unauthorized signatures. See generally Brady on Bank Checks ¶¶ 13.3–13.4 (6th ed. 1987).

was used in payment of a personal debt or for personal benefit also are circumstances where there was knowledge that the use in that manner constituted a breach of fiduciary duty. Given the ambiguity in the UCC provisions, courts may be expected to deal with cases as they are presented and to continue to draw on the pre-UCC law for help in resolving them. As seen in the previous discussion, if the pre-UCC law reflected in the Uniform Fiduciaries Act is relevant and continues, in some circumstances knowledge that a fiduciary has gained personally will be sufficient to give notice of breach of duty although there is no knowledge a breach in fact occurred.

The issues under the UCC are somewhat different when the bank is a payor, rather than a transferee, because then the relevant section is UCC § 3-603, not the holder in due course provisions. Under the provisions governing payment of instruments, notice of the claim of another party is not decisive because the payor bank is free to pay the holder so long as it does not violate the rules concerning restrictive indorsements. With the strong pre-UCC background, in which payment to a fiduciary with knowledge of the breach of a fiduciary obligation creates liability for the payor, it may be questioned whether the UCC payment provision in Section 3-603 will be interpreted to insulate payors from their traditional liability.

16

Holders in Due Course

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¶ 16.01 HOLDER IN DUE COURSE REQUIREMENTS

Under the Uniform Commercial Code, a holder in due course is a person who has acquired an interest in a negotiable instrument in a way that gives the person a special status like that of a bona fide purchaser of other property. The UCC gives a holder in due course many special rights, including an ownership interest in the instrument that is free from the claims of other parties and the ability to enforce the liability of parties to the instrument free from many defenses. To become a holder in due course, a person must meet the formal requirements set forth in the UCC. Articles 3 and 4 contain an elaborate network of provisions that bear on who can become a holder in due course and what such a person must do in order to acquire such status. Although these provisions are in part a codification of prior negotiable instruments law, they go beyond that law both in scope and detail and they substantively change prior doctrine.

Four requirements must be met in order to obtain the status of a holder in due course:

1. The person must be a "holder" of a negotiable instrument;
2. The person must take the instrument for value;
3. The person must take the instrument in good faith; and
4. The person must take the instrument without notice that it is overdue or has been dishonored or that any person has any defense against or claim to it.[1]

Although a holder in due course enjoys special rights and privileges, both federal and state law have dramatically cut back the availability of holder in due course rights in consumer credit transactions.[2]

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[1] UCC § 3-302.

[2] See discussion of the Federal Trade Commission Holder in Due Course Rule and other measures affecting holder in due course rights infra ¶ 16.06.

[1] The Holder Requirement

The UCC requires a holder in due course to be a "holder."[3] To become a holder, the person must take the instrument by negotiation, which means that the instrument must be properly delivered and transferred with any necessary indorsement, as discussed in Chapter 15. A person who is a transferee of an instrument and who meets the other requirements for being a holder in due course may become a holder by obtaining the missing indorsements on the instrument.[4] Such a person does not become a holder, and so cannot qualify as a holder in due course, until the necessary indorsements are obtained.

A person can be a holder in due course only by being in possession of a negotiable instrument either directly or through an agent who is acting on behalf of the holder.[5] If an instrument fails in any respect to meet the requirements for being a negotiable instrument, the transferee cannot claim status as a holder in due course. (The requirements for negotiability are discussed in Chapter 14.) If the instrument is not "payable to order or to bearer," the UCC is clear that there can be no holder in due course of such an instrument.[6] Because of the requirement that the instrument be negotiable, a common defense to a claim by a purported holder in due course is to attack the instrument as not meeting the formal requirements for negotiability.

The transferee of a negotiable instrument acquires the rights of the transferor through a "shelter" principle that permits the transferor to pass on the rights the transferor enjoyed.[7] The transferee thus "steps into the shoes" of the transferor and receives whatever rights the transferor possessed, but the transferee acquires no greater status or rights than the transferor had.

[2] Taking Without Notice of Defects or Defenses

The UCC requires that a holder in due course be an innocent purchaser, unaware of troubles in the transaction or in the instrument for which it was given. The key section states that the holder must take the instrument "without notice that it is overdue or has been dishonored or of any defense against or

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[3] UCC § 3-302(1) ("A holder in due course is a holder who takes the instrument (a) for value; and (b) in good faith; and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person"). All UCC citations are to the 1978 official text unless otherwise noted.

[4] UCC § 3-201(3).

[5] UCC § 3-302(1) on the requirements for being a holder in due course refers to being a "holder who takes the instrument . . . ." Instrument is defined to be a negotiable instrument. UCC § 3-102. The possession requirement flows from the definition of negotiation as requiring the delivery of an instrument. UCC § 3-202(1). In order to have a delivery, there must be a "voluntary transfer of possession." UCC § 1-201(14).

[6] UCC § 3-805.

[7] The "shelter" principle is discussed in ¶ 16.04.

claim to it on the part of any person."[8] Under this provision there are four types of problems of which the holder must have no notice at the time of "taking" the instrument. The holder must have no notice that (1) the instrument is overdue; (2) the instrument has been dishonored; (3) someone who is obligated on the instrument has a defense to the liability on the instrument; and (4) some person claims an interest in the instrument.[9]

The first two situations do not present many difficulties. What constitutes dishonor is discussed in Chapter 21 and ordinarily there will be no great difficulty in ascertaining that an instrument has been dishonored or when the person receives notice of such facts. Under this requirement, one who takes a check knowing it has been refused payment for insufficient funds, for example, cannot be a holder in due course. Likewise, when a time draft has been presented for acceptance and the drawee has refused acceptance, a subsequent holder with notice of such refusal would have notice of dishonor and could not qualify as a holder in due course.[10]

The UCC itself contains several rules to help determine when an instrument is overdue. It provides that a purchaser has notice that an instrument is overdue if the purchaser "has reason to know" any of the following:

> (a) that any part of the principal amount is overdue or that there is an uncured default in payment of another instrument of the same series; or
>
> (b) that acceleration of the instrument has been made; or
>
> (c) that he is taking a demand instrument after demand has been made or more than a reasonable length of time after its issue. A reasonable time for a check drawn and payable within the states and territories of the United States and the District of Columbia is presumed to be thirty days.[11]

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[8] UCC § 3-302(1)(c). See generally Annot., "What Constitutes Taking Instrument in Good Faith and Without Notice of Informities or Defenses to Support Holder in Due Course Status Under UCC § 3-302," 36 ALR 4th 212 (1985).

[9] UCC § 3-302(1)(c).

[10] See generally Annotation, "What Constitutes, Under the Uniform Negotiable Instrument Law or Commercial Code, a Reasonable Time for Taking a Demand Instrument, so as to Support the Taker's Status as Holder in Due Course," 10 ALR 3d 1199 (1966). The UCC requirement that a holder in due course take the instrument without knowledge that it is overdue has important consequences for loan guarantee arrangements. For example, in one case, the United States acquired promissory notes under its loan guarantee program for HUD home improvement loans. After the maker of the notes defaulted in payment, the bank that held the notes (the original payee) assigned the instruments to the United States. In a suit by the United States against the maker of the notes for payment, the court held the United States could not claim to be a holder in due course because it took the notes after default had occurred and, therefore, with knowledge that the notes were overdue. United States v. Gray, 552 F. Supp. 943, 945 (N.D. Ill. 1982).

[11] UCC § 3-304(3). The choice of the language "reason to know" is significant. The UCC distinguishes between actual knowledge and reason to know as discussed later in this section. See UCC § 1-201(25).

It is important to note that although an instrument may be overdue, a holder will not be precluded from becoming a holder in due course if the holder took the instrument without notice that it was overdue.[12]

The UCC policy with respect to checks is significant. If the holder takes a check more than thirty days after its date of issue, it is presumed that the check is overdue. Ordinarily, since the check will be dated, there will be notice from the face of the instrument to the holder and the holder will not be able to qualify as a holder in due course. Antedating or postdating an instrument, by itself, does not make an instrument overdue. The fact that an instrument is antedated or postdated does not give notice to the purchaser that a defense or claim to the instrument exists.[13]

Most of the difficulties arise in connection with the requirement that the holder take without notice of a claim or defense. Before considering what will amount to notice of a claim or defense, attention should be given to the definition of notice in the UCC, which is carefully and deliberately drawn.

[a] Definition of "Notice." There are different possible qualities of notice, and the legal system is not always consistent in how it uses the term. At one extreme, notice can mean actual knowledge that a fact exists. At another extreme, notice can mean facts or circumstances that could be discovered by a search by a diligent party in official records. This latter type of notice is sometimes referred to as constructive notice. The UCC holder in due course provisions take an intermediate view. Actual knowledge of the existence of a defense or claim to the instrument disables a person from being a holder in due course under the UCC.[14] But the provisions go further, defining notice as including something that exists when a person has "received a notice or notification of it"[15] or when a person "from all the facts and circumstances known to him at the time in question . . . has reason to know that it exists."[16] Thus, a "reason to know" standard is appropriate in deciding whether a person has taken an instrument with notice of a defense or claim. The UCC does not go so far as to say that constructive notice from official records is sufficient to give notice to a holder in due course.[17]

[b] What Constitutes Notice of a Claim or Defense. Sometimes the appearance of the instrument itself is so irregular that a taker will be placed on notice

[12] UCC § 3-304 comment 7.

[13] UCC § 3-304(4).

[14] The term notice includes "actual knowledge." UCC § 1-201(25)(a).

[15] UCC § 1-201(25)(b).

[16] UCC § 1-201(25)(c).

[17] UCC § 3-304(5).

that something may be wrong.[18] Thus, there is notice of a claim or defense if "the instrument is so incomplete, bears such visible evidence of forgery or alteration, or is otherwise so irregular as to call into question its validity, terms or ownership or to create an ambiguity as to the party to pay . . . ."[19]

In addition, the purchaser will have notice of a claim or defense when the purchaser has notice "that the obligation of any party is voidable in whole or in part, or that all parties have been discharged."[20] Under this rule, if the taker knows that one party, such as an indorser, has been discharged, that knowledge will not preclude the taker from becoming a holder in due course. If the taker knows that all parties have been discharged, as in the case where the instrument had previously been paid, the taker cannot be a holder in due course.[21]

One situation that has created difficulties involves instruments issued or negotiated by fiduciaries. The UCC draws a distinction between notice that a fiduciary has negotiated an instrument for personal benefit or otherwise in breach of duty and notice only that the person negotiating the instrument is or was a fiduciary. Knowing that the person is a fiduciary is not notice that the fiduciary has breached his or her obligations to the beneficiary because the holder is entitled to assume the fiduciary is acting properly.[22]

To assist in determining when there is notice of a claim or defense, the UCC specifies that certain circumstances do not by themselves give a purchaser of an instrument notice of a defense or claim:

> (4) Knowledge of the following facts does not of itself give the purchaser notice of a defense or claim
>
> (a) that the instrument is antedated or postdated;
>
> (b) that it was issued or negotiated in return for an executory promise or accompanied by a separate agreement, unless the purchaser has notice that a defense or claim has arisen from the terms thereof;
>
> (c) that any party has signed for accommodation;
>
> (d) that an incomplete instrument has been completed, unless the purchaser has notice of any improper completion;
>
> (e) that any person negotiating the instrument is or was a fiduciary;
>
> (f) that there has been default in payment of interest on the instrument or in payment of any other instrument, except one of the same series.

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[18] First Nat'l Bank v. Otto Huber & Sons, Inc., 394 F. Supp. 1284 (DSD 1975) (the note was open to two interpretations of when it was due, and so gave notice of a defect in the instrument).

[19] UCC § 3-304(1)(a).

[20] UCC § 3-304(1)(b).

[21] UCC § 3-304, comment 4.

[22] UCC §§ 3-304(2), 3-304(4)(e) & comment 5. For a detailed discussion of transactions involving fiduciaries who use negotiable instruments, see ¶ 15.08.

(5) The filing or recording of a document does not of itself constitute notice within the provisions of this Article to a person who would otherwise be a holder in due course.[23]

For the notice to be effective to prevent a taker from being a holder in due course, it "must be received at such time and in such manner as to give a reasonable opportunity to act on it."[24] When a purchaser acquires an instrument and meets all the requirements for being a holder in due course at the time the instrument is acquired, later notice of facts that would constitute notice of a defense or claim will not prevent the purchaser from being a holder in due course. There is an ambiguity when a purchaser takes possession of an instrument in good faith and without notice but later has notice of a claim or defense before giving all the value that was agreed upon for the purchase of the instrument. Is this notice too late because it has come after the purchaser has *taken* the instrument? The UCC's policy on value indicates that one becomes a holder in due course only to the extent that "the agreed consideration has been performed . . . ."[25] This policy suggests that the holder who has notice after taking the instrument but before all value is given becomes a holder in due course only to the extent that value is given prior to the notice, but the question is not clearly answered by the UCC.

Knowledge that the person giving a check has a bad financial record, has overdrawn the account, or might otherwise generally be considered a bad risk does not in itself preclude the person taking the check from being a holder in due course.[26] Similarly, no notice of a claim or defense has been found when a bank takes for deposit a check from a payee-depositor and permits withdrawal of credit before the check is collected even though the depositor's account balance is low or has been previously overdrawn or even when the bank knows that its depositor is experiencing financial problems and has overdrawn the account.[27] Circumstances that are grounds for suspicion and conjecture only are not enough, as was held in a case in which a purchaser of traveler's checks acquired them outside the normal commercial market and at a different price than would be customary.[28]

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[23] UCC §§ 3-304(4)-3-304(5). When there will be notice of a defense from the existence of a separate writing or other agreement is discussed infra ¶ 16.05.

[24] UCC § 3-304(6).

[25] UCC § 3-303(a).

[26] St. Cloud Nat'l Bank & Trust Co. v. Sobania Constr. Co., 302 Minn. 71, 73, 224 NW2d 746, 748, (1974), which held that the depository bank could recover on the check from the drawer, who had stopped payment.

[27] Commerce Bank v. Edco Fin. Serv., 379 F. Supp. 293, 294 (ED Mo. 1974), aff'd per curiam 503 F2d 1047 (8th Cir. 1975) (holding that the depository bank could recover from the drawer who had stopped payment on the checks that had been deposited).

[28] Sendery v. American Express Co., 16 UCC Rep. Serv. (Callaghan) 753, 755 (NY Sup. Ct. 1975) (the court held this was not enough to give notice the checks were stolen).

Whether a transferee of a negotiable instrument has notice of a defense to the instrument before taking it usually will be a question of fact for a jury to decide. In *First National State Bank v. Reliance Electric Co.*,[29] the court upheld a jury finding that a bank took an assignment of an equipment lease from its borrower with notice that the borrower had not delivered the equipment to the lessee. Because the lease contained a waiver of defense clause, the bank claimed to have had a status equivalent to that of a holder in due course.[30] In upholding the jury's finding, the court precluded the bank from being in the position of a holder in due course, because the bank knew, from its past dealings with the borrower, that the borrower was in financial difficulty and was following a practice of borrowing against equipment leases for undelivered equipment. When the bank received the loan lease documents for the transaction at issue in the case, there was nothing in them to indicate that the equipment covered by the lease had been delivered. The court said, "[T]he documents in themselves were sufficient to put a sophisticated lender with knowledge of [the borrower's] marketing practices on notice that delivery of the equipment to the lessee was to be made sometime in the future."[31] The UCC expressly states that knowledge that a promise in a contract has not been performed is not, by itself, notice of a defense under the contract. There must be reason to know a breach exists.[32] The

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See also Gutekunst v. Continental Ins. Co., 486 F2d 194, 196 (2d Cir. 1973); Mid-Continent Nat'l Bank v. Bank of Independence, 523 SW2d 569, 573-74 (Mo. Ct. App. 1975).

[29] 668 F2d 725 (3d Cir. 1981).

[30] See UCC § 9-206. See also ¶ 15.01[1] for a discussion of assignments of accounts and contractual waivers of defenses.

[31] 668 F2d at 730. A bank in Israel claimed to be a holder in due course of notes made by a buyer of diamonds in California who gave the notes to a diamond dealer, who in turn indorsed the notes to the bank. The court held that the involvement of the bank in the underlying transaction for the export of the diamonds raised the issue of whether the bank had "dealt with" the buyer in such fashion that the bank could not be a holder in due course. This was a question of fact that could not be resolved on summary judgment. The court said there also was an issue of whether the bank was aware of a custom in the diamond trade in Israel that allowed a buyer to return the diamonds and be discharged from any obligation to pay. This too constituted an issue of fact. The bank would have had notice of a defense if it had known that the underlying obligation for which the note was given was "voidable in whole or part." See UCC §§ 3-302(1), 3-304(1)(b). Additionally, the buyer claimed that the diamonds had been returned to the seller by sending the diamonds to the bank. If so, the bank might have had notice that the obligation of the buyer to pay had been discharged because of the Israeli custom. Finally, there was an issue of whether the bank had notice that an executory contract had not been duly performed. It was alleged that under Israeli law, only a bank can export diamonds. The bank, knowing the contract was executory, may have known that the diamonds were never delivered and that the buyer had a defense of failure of consideration. Barclays Discount Bank, Ltd. v. Levy, 743 F2d 722, 726-727 (9th Cir. 1984).

[32] UCC § 3-304(4).

UCC rule makes it difficult to find notice when the holder has taken the instrument *before* the breach of contract actually occurs.

It has been held that receipt of a postdated cashier's check does not constitute notice to the payee of a defense to the check. The bank that issued the check argued that the postdating should have indicated to the payee that the remitter, who obtained the check from the bank, did not have the funds to pay for it and, therefore, that the payee had notice of the bank's defense of lack of consideration for the check. Although the payee was sufficiently concerned about the postdating to call the bank and inquire about its validity, the court held that these circumstances did not constitute notice of a defense. Under the New York standard for notice, contrary to the uniform definition of notice in UCC § 1-201(25), there must be actual subjective knowledge that a defense exists.[33]

When the payee on checks in which the plaintiff bank had a security interest transferred those checks to the Internal Revenue Service (IRS) for payment of tax obligations, the IRS became a holder in due course. Therefore, the bank could not enforce its security interest against the IRS, and the IRS's action in taking the checks did not constitute conversion. Payment by means of third-party checks was not such a suspicious circumstance that the IRS was prevented from being a holder in due course.[34]

Notice to one joint payee of a defect in the instrument is not automatically imputed to the other payees because of their relationship as joint payees.[35]

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[33] Indyk v. Habib Bank, Ltd., 694 F2d 54, 56 (2d Cir. 1982). A 1985 case considered what constituted a notice of a defense. In Sundsvallsbanken v. Fondmetal, Inc., 624 F. Supp. 811 (SDNY 1985), the court pointed out that under UCC § 3-304(1)(b), there is notice of a defense if there is notice that the obligation is "voidable in whole or in part," which, as noted in UCC comment 3 to that section, was intended "to restrict the provision to notice of a defense which will permit any party to avoid his original obligation on the instrument, as distinguished from a set-off or counterclaim." Following this analysis, the court also pointed out that UCC § 3-302(1)(c), defining a holder in due course, refers to one who has taken the instrument without notice of any defense against or claim to "it," meaning the instrument in question as contrasted to some other agreement. The court thus concluded that notice of a defense relating to the underlying transaction, although possibly sufficient as the basis for a counterclaim, would not be notice of a defense against the instrument that would deprive the holder of status as a holder in due course. (The court did not consider further the extent to which a defense on the underlying transaction might give rise to a defense against the instrument based on failure of consideration or other breach of contract under UCC § 3-306.)

[34] Valley Nat'l Bank v. Porter, 705 F2d 1027, 1030 (8th Cir. 1983). In Taves v. Griebel, 363 NW2d 73, 75 (Minn. Ct. App. 1985), the court held that knowledge of a stop payment order does not constitute notice of a defense. The court said, "Failure to inquire why payment is stopped may be negligence and lack of diligence, but it is not notice of what he might discover."

[35] United States v. Mark Twain Bank, 771 F2d 361, 365 (8th Cir. 1985).

In *Stewart v. Thornton*,[36] the Arizona Supreme Court upheld a determination that a purchaser of a note given as part of a real estate transaction was not a holder in due course because of the deep discount on the note and the effect of the Federal Interstate Land Sales Full Disclosure Act, which gives the obligor forty-eight hours to rescind the transaction. The court said:

> In the instant case, the note was not purchased for full value. It was discounted one-third. That fact alone is sufficient to alert a prospective purchaser to a possible defense. Moreover, it was sold in the 48-hour period during which the purchaser of the property could have voided the purchase agreement. By examining the written sales agreement in possession of the seller of the note, Stewart could have ascertained that Mrs. Thornton had not inspected the lot or received a property report.... We think under these circumstances bad faith could have reasonably been inferred by the trial judge, and he could have concluded that Stewart was not a holder in due course within the meaning and intent of the UCC. To hold otherwise would open to rampant abuse the fraud which Congress's Act, Section 1703(b) seeks to prohibit.[37]

When an organization such as a bank or a corporation acquires the instrument, notice to the organization will occur as a result of information coming to the attention of the agents of the organization. If notice is given to the proper person in the organization, the organization is charged with that notice even when another person acting for the organization has no actual knowledge of such facts.[38] The law puts the burden on the organization to maintain "reasonable routines for communicating significant information to the person conducting the transaction. . . ."[39] The person conducting the transaction for the organization does not have to have actual knowledge of the matter. Under the UCC, the relevant individual will be deemed to have notice from the time when it should have been brought to the person's attention if proper diligence by the organiza-

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[36] 116 Ariz. 107, 568 P2d 414 (1977).

[37] Id. at 110, 568 P2d at 417.

[38] UCC § 1-201(27).

[39] Id. That section states:

> Notice, knowledge or a notice or notification received by an organization is effective for a particular transaction from the time when it is brought to the attention of the individual conducting that transaction, and in any event from the time when it would have been brought to his attention if the organization had exercised due diligence. An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.

tion had been used.[40] Similarly, notice is considered given when the person giving the notice takes the steps "as may be reasonably required to inform the other in ordinary course whether or not such other actually comes to know of it."[41]

There is an important qualification in the UCC's notice provisions. This is that "[t]he time and circumstances under which a notice or notification may cease to be effective are not determined by this Act."[42] Because of this qualification, there can be situations in which an individual has received notice but, due to the passage of time or other justification, the person subsequently is relieved from its effect.[43]

[3] Good Faith

A holder in due course must take the instrument in "good faith." Courts have long debated what constitutes good faith for purposes of being a holder in

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[40] Id. An organization is defined broadly to include "a corporation, government or governmental subdivision or agency, business trust, estate, trust, partnership or association, two or more persons having a joint or common interest, or any other legal or commercial entity." UCC § 1-201(28).

[41] UCC § 1-201(26). As a result, a person receives notice when the matter comes to his attention or when the notice "is duly delivered at the place of business through which the contract was made or at any other place held out by him as the place for receipt of such communications." See generally, Blum, "Notice to Holders in Due Course and Other Bona Fide Purchasers Under the Uniform Commercial Code," 22 BCL Rev. 203 (1981). In Bryen v. Krassner, 208 NJ Super. 639, 506 A2d 803, cert. denied, 105 NJ 583, 523 A2d 210 (1986), a trustee's knowledge precluded beneficiaries from status as holders in due course. Krassner made a promissory note payable to Kennedy Investors (KI). KI transferred the note to plaintiff, who was trustee for fifteen creditors of KI who had agreed to take the note in exchange for cancellation of the debts KI owed them. When plaintiff sued for payment of the note, Krassner defended by contending that he had been defrauded. Plaintiff countered this defense by asserting he had the rights of a holder in due course. The trial court combined the status of plaintiff trustee with the fifteen beneficiaries to find they collectively had status as a holder in due course. The appellate court reversed. The plaintiff trustee did not qualify as a holder in due course because he was in bad faith, had knowledge of defenses, and gave no value. The beneficiaries, although they had given value in good faith, were not holders. The court commented that any other ruling

> would thwart justice under the circumstances, if established, that the trustee knew that the beneficiaries were releasing credits of value against an entity in which he had a financial interest in exchange for a note subject to defenses of which they were unaware. It would conflict with the principal of trust law that a trustee is obligated to make full disclosure of all facts known to him respecting the trust which are material for the protection of the beneficiary's interests . . . .

506 A2d 804-805.

[42] UCC § 1-201(25). See First Nat'l Bank v. Fazzari, 10 NY2d 394, 223 NYS2d 483, 179 NE2d 493 (1961).

[43] Id. See UCC § 1-201, comment 25.

due course. Can one be a purchaser in good faith when the instrument is acquired under suspicious circumstances? What degree of care, if any, need be exercised by a purchaser before acquiring an instrument? The debate involving the resolution of questions such as these continues even though the UCC drafters deliberately chose to adopt a narrow definition of good faith for purposes of the holder in due course rules in Article 3. Good faith is defined simply as "honesty in fact in the conduct or transaction concerned."[44]

This definition contrasts sharply with the definition of good faith that the UCC imposes upon a merchant in Article 2 on the sales of goods. Good faith for a merchant requires not only honesty in fact but also "the observance of reasonable commercial standards of fair dealing in the trade."[45] In Article 3 on negotiable instruments, the absence of an objective standard like the merchant test was not accidental. At one time, the UCC contained a good faith standard for a holder in due course similar to the reasonable commercial standard required of a merchant in Article 2. The sponsors of the UCC deliberately eliminated this added test to restrict the standard to the present one of "honesty in fact."[46]

Although the test for good faith, thus, does not require the purchaser to conduct an investigation to determine whether a negotiable instrument is subject to outstanding claims or defenses, the purchaser cannot deliberately ignore facts that indicate problems in order to avoid obtaining knowledge of defenses or claims. As is apparent in the discussion of the cases that follows, courts struggle on where to draw the line between circumstances in which there is no duty to inquire and circumstances in which a calculated avoidance of becoming knowledgeable exists.

The fact that a bank teller took and cashed two checks of a corporation drawn on another bank, in violation of an internal rule of the cashing bank requiring the approval of the manager before cashing such checks, was held to make no difference in testing the good faith of the bank. All that was necessary was that the bank take the checks in simple good faith, for value, and without notice of any dishonor or of any defense or claim. When the bank met the "simple honesty" test, it could be a holder in due course and enforce payment of the checks against the drawer corporation, which had stopped payment.[47]

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[44] UCC § 1-201(19).

[45] UCC § 2-103(1)(b).

[46] The history is explained in E. Farnsworth and J. Honnold, Cases on Commercial Law 56-57 (4th ed. 1985). See UCC § 3-302(1)(b) (1952 ed.); 1956 recommendations of the Editorial Board for the Uniform Commercial Code, which gave as reason for the change that it was intended "to make clear that the doctrine of an objective standard of good faith exemplified by the case of Gill v. Cubitt, 3 B & C. 446 (1824), is not intended to be incorporated . . . " See generally Gillette, "Limitations on the Obligation of Good Faith," 1981 Duke LJ 619.

[47] Industrial Nat'l Bank v. Leo's Used Car Exch., Inc. 291 NE2d 603, 606 (1973), where the court declared that the subjective test, or that of "honesty in fact" was all that was required, in order to establish the good faith of the bank.

When a bank took a check from the payee, who was not a regular customer of the bank, and issued its own cashier's check to the payee in exchange for the check, the bank having first telephoned the payor bank to verify the account and the sufficiency of funds, it was held as a matter of law that the bank taking the check had acted in good faith and was a holder in due course. As a holder in due course, the bank was held entitled to enforce payment of the check against the drawer, who had stopped payment. The court noted that the act of stopping payment occurred after the first bank had telephoned the payor bank to verify the account and the sufficiency of funds.[48]

Under the "simple honesty" test of good faith, a stockbrokerage firm was not denied holder-in-due-course status merely because it took a check drawn by a corporation to the order of the brokerage firm as payee in satisfaction of a debt owed to the firm by an individual customer (who was the remitter of the check) for stock purchased by that individual customer for his own benefit.[49] However, when a bank has had an unusually close relationship with the assignor of a note, and there are other circumstances from which knowledge of the shaky nature of the assignor can be imputed to the bank, there is justification according to an Ohio court in finding that the bank has not taken the note in good faith. Thus, the bank is not entitled to the protection afforded a holder in due course.[50]

In cases in which unconscionable or unfair contracts have been practiced by payee-sellers, courts sometimes scrutinize the relationship between the sellers who have taken the paper and the finance companies or banks to whom the paper is transferred. When the purchaser of the paper has a close business connection with a fraudulent payee, some courts hold that the purchaser lacks the good faith necessary to be a holder in due course.[51]

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[48] Manufacturers & Traders Trust Co. v. Murphy, 369 F. Supp. 11–13 (WD Pa. 1974), which cited UCC § 3-302(1) and the definition of "good faith" as "honesty in fact" in UCC § 1-201(19).

[49] Eldon's Super Fresh Stores, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 296 Minn. 130, 133-134, 136, 207 NW2d.282, 285–286, 288 (1973). The court commented that there were no facts known by the broker that might attract the application of what is sometimes called the "red light" test, where in connection with the taking of an instrument, there are "danger signals" from which may be inferred the existence of a claim to the instrument on the part of another person. It appeared that the individual customer, an attorney-secretary of the corporation and an attorney for the president of the corporation, had improperly obtained and used the corporate check for his own purpose, but the brokerage firm had no knowledge of this.

[50] Security Cent. Nat'l Bank v. Williams, 52 Ohio App. 2d 175, 177, 368 NE2d 1264, 1266 (1976). A former employee of the bank was a sales representative of the assignor. The bank took a substantial number of notes from the assignor. The officer of the bank who had handled the notes resigned under pressure because of deals that presumably included this one. The court determined that the type of business the assignor conducted seemed to be almost inherently suspect.

[51] The Nevada Supreme Court applied the close business connection doctrine to a nonconsumer transaction in St. James v. Diversified Commercial Fin. Corp., 714 P2d

Failure to make inquiries that a reasonable man would make is not bad faith and does not constitute notice of a defense. The Louisiana Court of Appeals explained:

> The "reasonable man test" is not the standard to be applied in determining notice of a defense or good faith. Both determinations require a more subjective test, with the determination of good faith being totally subjective. *Corporacion Venezolana de Fomento v. Vintero Sales*, 452 F. Supp. 1108 (S.D.N.Y. 1978). The "reason to know" portion of the notice requirement guards against an intentional or willful ignorance.[52]

The court held that a holder who took an antedated promissory note did not have notice of a possible defense of lack of corporate authority. In the court's view, mere negligence or failure to make inquiries that a reasonable man would make do not amount to bad faith as long as the holder does not refuse to inquire in order to deliberately remain ignorant of facts that might disclose a defect in the transaction.[53]

A court upheld a jury determination that the purchaser of a $10,000 treasury bill in bearer form was not a holder in due course because she did not act in good faith. The purchaser, a tavern owner, had never purchased a treasury bill. She bought this bill from her accountant, a longtime friend, at a discount of $500 and after receiving advice from her banker that treasury bills were risky investments because anyone in possession could cash the security. The court held that the question of the purchaser's good faith was a matter for the jury to determine on the basis of its assessment of her credibility.[54]

179, 181 (Nev. 1986). The buyer entered into a transaction structured as a direct loan from the finance company, evidenced by a promissory note payable directly to the financer. Although a nonconsumer sale, the court followed the same reasoning as that used in Unico v. Owen, 50 NJ 101, 113, 232 A2d 405, 417 (1967), discussed infra ¶ 16.06, where the court ruled in a consumer financing deal that the financer's close connection to the deal should make the financer a participant in that transaction and therefore not someone entitled to be a holder in due course. The court also remarked that it saw no reason to limit the Federal Trade Commission holder in due course regulations to consumer transactions. Whether a close connection exists would be an issue of fact to be determined in each case. For earlier judicial development of the close connection doctrine, see Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 SW2d 260, 262 (1940); Mutual Fin. Co. v. Martin, 63 So. 2d 649, 653 (Fla. 1953). There is an additional discussion of this doctrine at ¶ 16.06.

[52] Republic of Tex. Sav. Ass'n v. First Republic Life Ins. Co., 417 So. 2d 1251, 1255 (La. Ct. App.), cert. denied, 422 So. 2d 161 (La. 1982).

[53] 417 So. 2d at 1256.

[54] McCarthy v. Kasperak, 3 Ohio App. 3d 206, 444 NE2d 472, 475 (1981). When a check that had been completed without authority was taken by a person under circumstances not in the ordinary course of business, and where the person was facing a $400,000 loss if payment was not obtained from the person delivering the check, a court concluded that the person was not a holder in due course. The person "either knew of the circum-

[4] Giving Value

A holder in due course must take the instrument "for value."[55] There is a special definition of value in the UCC. It is not the same as what constitutes "consideration" in the law of contracts. It is different from the *general definition* of value that the UCC follows and that may be applicable to other types of bona fide purchasers.[56]

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stances, or closed its eyes and in bad faith simply did not seek the truth in order to get its money." E. Bierhaus & Sons, Inc. v. Bowling, 486 NE2d 598, 605 (Ind. Ct. App. 1985).

In Banker's Trust Co. v. Crawford, 781 F2d 39, 41–43. (3d Cir. 1986), where Pennsylvania law was applied, the court concluded there was no duty to make an inquiry into the nature of the transaction when circumstances suggested the possibility of a defect or defense in the underlying transaction. The court stated the following:

> [T]here is no affirmative duty of inquiry on the part of one taking a negotiable instrument, and there is no constructive notice from the circumstances of the transaction, unless the circumstances are so strong that if ignored they will be deemed to establish bad faith on the part of the transferee.

781 F.2d at 45. The case involved a cashier's check that Crawford had sent to Chalfont Industries. Chalfont negotiated the check to Cutner Buick. Crawford became concerned about the check, obtained an order directing the issuing bank not to pay the check, and went personally to Chalfont's office to intercept the check, but a Chalfont employee falsely told him the check had not arrived after it had been indorsed over to Cutner Buick. A close relationship existed between Chalfont and Cutner Buick as the respective companies were owned by a father and son team, with the father supplying working capital, loans, and other financial assistance to the son's business. However, the district court found there was no evidence showing lack of good faith on the part of Cutner Buick in accepting the check and no knowledge on the part of Cutner Buick of the fraudulent activities of Chalfont employees. Cutner's failure to inquire into the circumstances of the check did not stem from an attempt to avoid knowledge of the underlying circumstances. The court also held that Pennsylvania did not recognize the "close connection" doctrine that would have identified Cutner Buick with the payee, Chalfont, who had been a party to the fraud.

Knowledge of a customer's financial difficulties did not prevent a bank from being a holder in due course in Corn Exchange Bank v. Tri-State Livestock Auction Co., 368 NW2d 596,600 (SD 1985). Elkton, the bank's customer, had an arrangement to buy cattle for Tri-State to sell at auction and had authority to write checks to pay for the cattle on the Tri-State account at a different bank. When Elkton had written checks in excess of $1 million, Tri-State told its bank not to pay the checks, and that bank notified Elkton's bank. Elkton's bank claimed to have advanced funds against these checks and brought suit for payment. Although the bank was aware of Elkton's financial difficulties, it did not intentionally remain ignorant of circumstances that would have disclosed defects in the transaction and had no reason to inquire more closely under the UCC standard for good faith of "honesty in fact."

[55] UCC § 3-302(1)(a). See generally Annot., "Who is Holder of Instrument for 'Value' Under UCC § 3-303," 97 ALR 3d 1114 (1980).

[56] UCC § 1-201(44); compare UCC § 2-403(1) on Good Faith Purchasers of Goods for Value with UCC §§ 3-302–3-303. Under the general definition in Section 1-201(44), value includes "any consideration sufficient to support a simple contract." This is not enough under the special definition for value for Article 3, which requires that the consideration be performed or other factors be present, as explained in this Section. Section 3-303(a).

Generally, there are three circumstances in which a holder gives value:

1. To the extent that the agreed consideration has been performed or that [the holder] acquires a security interest in or a lien on the instrument otherwise than by legal process;[57]
2. When the holder takes the instrument "in payment of or as security for an antecedent claim against any person whether or not the claim is due;"[58] or
3. When the holder takes the instrument by giving another "negotiable instrument for it or makes an irrevocable commitment to a third person."[59]

The value definition is significantly different from what constitutes ordinary consideration for a contract because value is given only to the extent that the consideration has been performed at the time the holder claims to be a holder for value. The UCC explains that "the underlying reason of policy is that when the purchaser learns of a defense against the instrument or of a defect in the title he is not required to enforce the instrument, but is free to rescind the transaction for a breach of the transferor's warranty....There is thus not the same necessity for giving [the purchaser] the status of a holder in due course, cutting off claims and defenses, as where he has actually paid value."[60]

Article 3 specifically provides that giving a negotiable instrument or an irrevocable commitment to a third party is value, as is payment of a prior debt.[61] Giving a negotiable instrument is value because there is always the potential for its being negotiated to a holder in due course. Although a holder takes the instrument for value "when he gives a negotiable instrument for it or makes an irrevocable commitment to a third person,"[62] this principle has been held to apply only when the commitment to the third person is made at the time the holder takes the instrument. If the commitment is made after the holder takes the instrument, no value is given and the holder cannot become a holder in due course.[63]

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[57] UCC § 3-303(a).

[58] UCC § 3-303(b).

[59] UCC § 3-303(c).

[60] UCC § 3-303, comment 3. The comment then gives as a common illustration "bank credit not drawn upon, which can be and is revoked when a claim or defense appears." See text discussion, later in this section, of bank credits as value. See generally Korzenik v. Supreme Radio, Inc., 347 Mass. 309, 197 NE2d 702 (1964); Saka v. Mann Theaters, 94 Nev. 137, 575 P2d 1335 (1978).

[61] UCC § 3-303(c), comment (5); Texaco State Bank v. Hullinger, 75 Ill. App. 2d 212, 214, 220 NE2d 248, 250 (1966).

[62] UCC § 3-303(c).

[63] Bennett v. United States Fidelity & Guar. Co., 19 NC App. 66, 68, 198 SE2d 33, 35, cert. denied 284 NC 121, 199 SE2d 659 (1973).

The fact that an instrument is acquired at a discount or less than face value does not, of itself, establish lack of value for purposes of determining whether a holder is a holder in due course.[64]

The concept of giving value in order to be a holder in due course must be distinguished from the requirement of consideration to support a contract. Although a holder may not have given value and therefore cannot be a holder in due course, it is still possible for the instrument to have been acquired in exchange for consideration, which creates enforceable contract rights. Failure of consideration can be a defense of a party to a negotiable instrument against someone who does not have the rights of a holder in due course. With a negotiable instrument, however, no additional consideration need be given when the instrument or an obligation as a party to an instrument is "given in payment of or as security for an antecedent obligation of any kind."[65]

Taking an instrument "in payment of or as security for" a prior debt is value. It has been held that a widow took certain cashier's checks for value and was a holder in due course when she took the checks in partial payment for loans she had made to a corporation of which she and her late husband had been the sole stockholders.[66] When a bank takes a check on another bank in exchange for its own cashier's check, it is a holder for value of the check it has taken. The act of issuing the cashier's check comprises both the giving of a negotiable instrument and the making of an "irrevocable commitment."[67]

In a Connecticut case, the court held that provisional credit made by a bank against one of its customers' overdrawn accounts constituted value although the credit entered was subject to a later withdrawal or reversal of credit by the plaintiff. The bank took the instrument in payment for an antecedent obligation and received a security interest in the item and its proceeds.[68]

A person who acquires a security interest in a note gives value to the extent of the security interest and can qualify as a holder in due course if the other requirements for holder-in-due-course status are satisfied.[69] However, attaching creditors and other parties who acquire a lien on the instrument by compulsory legal process do not give value and cannot become holders in due course.[70]

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[64] Illinois Valley Acceptance Corp. v. Woodard, 159 Ind. App. 50, 304 NE2d 859 (1973). But purchaser of an instrument at a "deep discount" may raise notice and good faith issues as discussed in ¶¶ 16.01[2], 16.01[3].

[65] UCC § 3-408.

[66] Bank of Lyons v. Schultz, 22 Ill. App. 3d 410, 417, 318 NE2d 52, 59 (1974).

[67] Manufacturers & Trader Trust Co. v. Murphy, 369 F. Supp. 11, 13 (WD Pa. 1974), which cited UCC § 3-303(c) in support of its holding. See Note, "Taking a Bank Money Order for Value Under UCC Section 3-303," 63 Minn. L. Rev. 983 (1979).

[68] Laurel Bank & Trust Co. v. City Nat'l Bank, 33 Conn. Supp. 641, 644, 365 A2d 1222, 1225 (1976).

[69] UCC § 3-303(a). Hollemon v. Murray, 666 P2d 1107, 1109 (Colo. Ct. App. 1982).

[70] UCC § 3-303(a) & comment 4.

A bank engaged in the collection of items may give value by giving credit to its customer for the item when special rules of the UCC are met. A bank gives value when it obtains a security interest in an item.[71] A bank obtains a security interest in an item that has been deposited in an account at the bank when the bank has given credit for the item and such credit "has been withdrawn or applied."[72] Thus, when the bank gives a provisional credit for a check that the customer has deposited but retains a right to revoke the credit and charge back, the bank does not have a security interest until the customer has withdrawn funds against such credit or the bank has taken action to "apply" the credit in some fashion. However, when the bank gives credit "available for withdrawal as of right," the bank has a security interest in the item to the extent of the credit whether or not the credit is drawn on or the bank has a right to charge back to the account of its customer.[73] It is generally believed that this latter provision would not apply to the ordinary case where a provisional credit is given to a deposited check pending the bank's collection of payment because this would not be a circumstance where the customer had a "withdrawal as of right."[74] The bank also has a security interest when it makes an advance to its customer "on or against the item."[75]

When a customer deposits a group of checks to the customer's account and the bank allows the customer to make a partial withdrawal against the provisional credit given for the deposit, the bank has obtained a security interest as a result of the credit withdrawn. This security interest exists in "all of the items" as well as in "any accompanying documents or the proceeds of either." This security interest continues in the item and the accompanying documents and proceeds as long as the bank is engaged in collection of the item and until the bank receives a final settlement for the item. When the bank receives a final settlement, the security interest in the item is realized.[76] The UCC follows an accounting method of credits first given are first withdrawn for purposes of deciding against what items the withdrawals are made.[77]

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[71] UCC § 4-209. See generally Note, "Bank Credit as Value in Article 4 of the Uniform Commercial Code," 1981 U. Ill. L. Rev. 395.

[72] UCC § 4-208(1)(a). The bank's security interest extends not only to the item but also to any documents which are taken that accompany the items (as when a documentary draft is being collected) as well as to the proceeds of the item and any documents. Id.

[73] UCC § 4-208(1)(b).

[74] See J. White & R. Summer, Uniform Commercial Code § 14-15 (2d ed. 1980). It is interesting to note that the customer obtains additional rights to withdrawal, not contemplated by the UCC, in the Expedited Funds Availability Act of 1987. See ¶ 20.11[1][b]. For a discussion of when funds are available for withdrawal as of right under the UCC, see ¶ 20.11[1][a].

[75] UCC § 4-208(1)(c).

[76] UCC § 4-208(3).

[77] UCC § 4-208(2).

Recognition of a depository bank or collecting bank as giving value as a result of giving bank credits for deposited items has broad implications. As long as the bank makes sure that there is a proper chain of indorsements and otherwise takes without notice of a defense or claim and in good faith, the bank is a holder in due course. This permits the bank to enforce the liability of prior parties such as indorsers and the drawer or maker free from defenses or claims if the check subsequently is not paid.[78]

The rules on bank credit as value have been applied in various cases. The following are illustrative. In *Lynnwood Sand & Gravel, Inc. v. Bank of Everett*,[79] the court held that a depository bank gave value when it applied the provisional credit, given for a check deposited by its customer, to reduce an existing overdraft in the customer's account. When the check was presented for payment to the payor bank (Bank of Everett), it refused to pay the check because of a stop payment order. The check was then returned to the depository bank, which subsequently presented it a second time. This time the Bank of Everett paid the check notwithstanding the stop payment order. When the drawer of the check sued the Bank of Everett for making a wrongful payment in violation of the stop payment order, the court held that the Bank of Everett was subrogated to the depository bank, which was a holder in due course. In *Friendly National Bank v. Farmers Insurance Group*,[80] the court held that a bank had given value for an insurance claims draft when it allowed its customer to draw checks against the amount the bank had provisionally credited to the customer's account.

In *European Asian Bank, A.G. v. G. Crohn & Co.*,[81] a bank gave credit to its customer for a bill of exchange that had been accepted by Crohn. After giving the credit, the bank applied it to satisfy an antecedent debt of the customer. The credit given was conditional on payment of the bill of exchange by Crohn, but the court held that such credit constituted value for the purpose of qualifying as a holder in due course. The bank could reverse the credit only if Crohn failed to pay the bill. This was different from giving a provisional credit, because the bank had "agreed to expose itself to the credit risk of the party obligated on the instrument taken in payment of the antecedent debts."

[5] Persons Who Cannot Qualify as Holders in Due Course

There are three categories of purchasers of instruments who cannot become holders in due course. A person who purchases an instrument at a judicial sale or gets it through legal process such as attachment or the like cannot be a holder in

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[78] The bank has an added advantage in that it may supply the indorsement of its customer as discussed previously. UCC § 4-205. See ¶ 15.01[3][c].

[79] 29 Wash. App. 686, 630 P2d 489 (1981).

[80] 630 P2d 318, 320 (Okla. 1981).

[81] 769 F2d 93, 97 (2d Cir. 1985).

due course.[82] A person who obtains a negotiable instrument by acquiring it "in taking over an estate" is not a holder in due course.[83] Finally, when an instrument is purchased "as part of a bulk transaction not in regular course of business of the transferor," the purchaser is not a holder in due course.[84] The policy underlying these exclusions is that such persons are merely successors in interest to the prior holder and should acquire no better rights than the prior holder. Under the shelter principle, discussed later in this chapter, the person acquiring an instrument in such manner succeeds to the rights of the predecessor transferor of the instrument. If the transferor was a holder in due course, the purchaser may succeed to that status.[85]

A bulk purchase, the comments suggest, would include situations where a new partnership purchases all the assets of a former partnership or where a corporation is reorganized and takes over in bulk the assets of a predecessor company.[86] The comments also state that the bulk purchase rule "has particular application to the purchase by one bank of a substantial part of the paper held by another bank which is threatened with insolvency and seeking to liquidate its assets."[87] The Federal Deposit Insurance Corporation may acquire holder-in-due-course status as a matter of federal law when it purchases assets in bulk of an insolvent bank notwithstanding the nonapplicability of the holder in due course rights granted by the UCC.[88]

¶ 16.02 RIGHTS OF A HOLDER IN DUE COURSE

A holder in due course under the UCC has a number of special rights and privileges that are not available to a person who does not qualify as a holder in due course. Perhaps the most significant rights of a holder in due course are to be free from the claims of other parties and to be free from certain defenses to the instrument of parties with whom the holder has not dealt.[89] Additionally, a holder in due course has special rights under numerous other provisions in the UCC. For example, payment to a holder in due course is final.[90] No discharge of

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[82] UCC § 3-302(a).

[83] UCC § 3-302(3)(b).

[84] UCC § 3-302(3)(c).

[85] UCC § 3-302, comment 3. The shelter principle is discussed in ¶ 16.04.

[86] UCC § 3-302, comment 3.

[87] Id.

[88] The FDIC's holder-in-due-course status is discussed at ¶ 10.02[5].

[89] UCC § 3-305.

[90] UCC § 3-418.

the liability of any party to a negotiable instrument is effective against a holder in due course who does not have notice of the discharge.[91]

[1] Freedom From Conflicting Claims

A holder in due course not only takes a negotiable instrument free from many defenses, the holder in due course also acquires ownership of the instrument free from "all claims to it on the part of any person."[92] This gives the holder in due course rights in the instrument that are free not only from others' claims of legal title to the instrument "but also from all liens, equities or claims of any other kind."[93] The holder in due course cuts off all conflicting claims including those based upon "rescission of a prior negotiation."[94] In *Bricks Unlimited Inc. v. Agee*,[95] this rule was applied to give a bank an ownership interest in a note free from the competing claim of a garnishing judgement creditor. Bricks Unlimited was a judgment creditor of the person who was the payee of the note. Bricks Unlimited garnished the debt represented by the note. After the garnishment, the payee transferred the note to the bank. The bank was not aware of the garnishment when it acquired the note. Because the bank had no notice of a claim or defense, it was a holder in due course and acquired the instrument free from the conflicting claim of the garnishing judgment creditor.

[2] Freedom From Defenses

The right of a holder in due course to be free from defenses as provided by the UCC is a bit more complex than the right to be free from claims of other persons. There are two reasons for this. Firstly, the holder in due course takes free from the defenses of certain persons only. The holder in due course takes free from "all defenses of any party to the instrument *with whom the holder has not dealt*. . . ."[96] Secondly, the holder in due course does not take free of certain defenses. The defenses that remain good against a holder in due course are often referred to as "real" defenses, whereas the defenses that a holder in due course may avoid are referred to as "personal" defenses.

[a] Defenses of Parties With Whom the Holder Has Dealt. Although the UCC allows a payee of an instrument to be a holder in due course,[97] it also

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[91] UCC § 3-601.

[92] UCC § 3-305(1). One who is not a holder in due course "takes the instrument subject to . . . all valid claims to it on the part of any person . . . "UCC § 3-306(a).

[93] UCC § 3-305, comment 2.

[94] Id.

[95] 672 F2d 1255 (5th Cir. 1982).

[96] UCC § 3-305(2).

[97] UCC § 3-302(2).

provides that a holder in due course does not take the instrument free from defenses of parties with whom the holder has dealt.[98] This requirement significantly limits the benefits of holder-in-due-course status for payees. In the typical case in which the payee deals directly with the drawer or maker, the payee takes the instrument subject to all defenses the drawer may have to it. Thus, one consequence of this rule is that the immediate parties to a transaction may choose to make payment using a negotiable instrument without altering their underlying rights and duties with respect to the transaction. In other cases, such as where the payee acquires a cashier's check from a remitter in a transaction where the payee's dealings have been with the remitter only, the payee may qualify as a holder in due course and take the instrument free from any defense the bank which drew the instrument might assert.[99] In this situation the payee has dealt with the remitter, but not with the bank that issued the cashier's check. These principles were followed in *Standard Finance Co. v. Ellis*,[100] to find that the payee of a promissory note who had loaned money to the maker of the note, which payee had been personally present when it was executed and had explained the terms and conditions of the note to the maker, took the note subject to any defenses available to the maker because the payee had "dealt" with the maker.[101]

Although a holder of a note may not be able to cut off the defenses of someone with whom the holder has dealt, there may be other principles of law relevant to whether a defense may be shown. When the defense is based on a

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[98] UCC § 3-305(2). A Louisiana court first held that although a payee of a note may be a holder in due course, it does not take the note free from the defenses of parties with whom the payee has dealt directly. In a confused opinion on rehearing, the court went on to say that the payee would not be a holder in due course if the payee had dealt directly with the maker of the note and the maker had a valid defense against the payee. But failure of consideration would not be a defense against a holder in due course even if the holder had dealt directly with the party asserting the defense. American Bank & Trust Co. v. Sunbelt Envtl. Sys., Inc., 451 So. 2d 1111, 1119 (La. Ct. App. 1984).

[99] UCC § 3-302, comment 2.

[100] 3 Haw. App. 614, 617, 657 P2d 1056, 1059 (1983).

[101] Compare A.C. Davenport & Son Co. v. United States, 703 F2d 266, 269 (7th Cir. 1983), where the court held qualified as a holder in due course, a subcontractor to whom the Government Services Administration (GSA) had sent a check. The check was a duplicate of checks previously issued to the contractor. who had failed to pay the subcontractor. The GSA then tried to back out of paying the check to the sub because it had failed to stop payment on the checks to the general contractor, who had become bankrupt. The court did not discuss whether GSA and the sub had "dealt" with each other. Nor did the court consider whether the subcontractor could be a "holder" of a check made payable to the general contractor. (The check was payable to the general contractor in care of the subcontractor for deposit in a special account from which only the subcontractor could withdraw.) For dubious dicta to the effect that the payee of a note would not be subject to the defense of failure of consideration even though a holder in due course, see American Bank & Trust Co. v. Sunbelt Envtl. Sys., Inc., 451 So. 2d 1111, 1119 (La. Ct. App. 1984).

separate agreement, the parol evidence rule may apply. The parol evidence rule limits the circumstances under which parol evidence may be admitted to vary the terms of a writing intended as a final and complete statement of an agreement. If the parol evidence rule applies, the evidence offered will not be admissible.[102]

In *Kovash v. McCloskey*,[103] the defendant was the plaintiff's attorney in a debt collection matter. The check was issued payable to the plaintiff and the defendant jointly; the defendant indorsed it to his client, the plaintiff, but the check was dishonored for insufficient funds when presented. In a suit on the check on the defendant's indorsement, the defendant raised the defense of lack of consideration because he had merely indorsed the check to transfer it to his client. The plaintiff tried to avoid the defense by claiming that he was a holder in due course and had not dealt with the defendant because he was not involved in the original transaction that gave rise to the issuance of the check. The court rejected this reasoning, holding that the plaintiff's taking the check from the defendant amounted to dealing with the person as contemplated in UCC § 3-305(2).

[b] Real and Personal Defenses. The UCC permits a holder in due course to take free of all defenses of any party to the instrument with whom the holder has not dealt except certain listed defenses. They are:

> (a) infancy, to the extent that it is a defense to a simple contract; and
> (b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and
> (c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and
> (d) discharge in insolvency proceedings; and
> (e) any other discharge of which the holder has notice when he takes the instrument.[104]

The foregoing enumerated defenses, which are valid even against a holder in due course, are often referred to as "real defenses." Other types of defenses, which are not effective against a holder in due course, are termed "personal defenses."

The rights of a holder in due course should be compared to the rights of one who is not a holder in due course. A person who is not a holder in due course takes the instrument subject to "all defenses of any party which would be

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[102] See infra ¶ 16.05 for a discussion on the relationship between the parol evidence rule and negotiable instruments.

[103] 386 NW2d 32 (ND 1986).

[104] UCC § 3-305(2).

available in an action on a simple contract. . . ."[105] These include defenses based upon failure of consideration, nonperformance of conditions precedent, nondelivery of the instrument or delivery for a special purpose, the instrument's being held as a result of theft, and the payment's being inconsistent with a restrictive indorsement.[106] The only defense that cannot be raised against a holder of an instrument who is not a holder in due course is a defense based upon "the claim of any third person to the instrument. . . ."[107] Thus, when the drawer of a check is sued by one who is not a holder in due course for payment of the check, the drawer cannot raise in defense that the payment properly should be made to a third party who is the real owner of the instrument. The third party must be a party to the litigation and raise the defense for himself or herself.[108]

[c] Categories of Real Defenses. The five categories of real defenses that are good against even a holder in due course are as follows.

[i] Incapacity. Two types of incapacity which can be a defense against a holder in due course are infancy, when it is a defense to a simple contract, and other incapacity, when it makes an obligation "a nullity."[109] The UCC does not define when infancy is available as a defense, but leaves it as a matter to be determined by the general law of the jurisdiction on when an infant can avoid contracts.[110]

The incapacity of an individual, such as an incapacity based upon being a minor, does not prevent an instrument from being transferred. The infant or other person with the incapacity may be able in an appropriate case to rescind the transaction or to have another equitable remedy imposed (such as imposing a constructive trust on proceeds) to prevent the proceeds of the transaction from being misapplied contrary to the local law, but such remedies cannot be exercised against a "subsequent holder in due course."[111] Otherwise, negotiation "is effective to transfer the instrument" even though it is made by an infant or other person who lacks capacity.[112] Although the holder in due course who acquires the instrument cannot sue an infant and hold such person to an obligation on the instrument when the defense of infancy is a real defense, the holder in due course does have rights on the instrument against other parties such as indorsers who

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[105] UCC § 3-306(b).

[106] UCC § 3-306.

[107] UCC § 3-306(d).

[108] UCC § 3-306 & comment 5. See UCC § 3-603. The claims of third parties to the instrument are discussed in ¶¶ 16.03, 20.05[2].

[109] UCC § 3-305(2)(a), (b).

[110] UCC § 3-305, comment 4.

[111] UCC § 3-207. It is not clear what is meant by a *subsequent* holder in due course.

[112] UCC § 3-207(1).

are not incapacitated. An infant or other party under incapacity may have a right to rescind the transaction and recover the instrument except to the extent that the UCC protects a holder in due course. Because the holder in due course takes an instrument free from the claims of any person, the claim of the incapacitated party to the instrument based on his or her right to rescind will not be good against the holder in due course. "Against him [the holder in due course] there can be no rescission or other remedy, even though the prior negotiation may have been fraudulent or illegal in its essence and entirely void."[113]

The UCC provision stating that any other incapacity that makes the obligation on the instrument a nullity is a real defense is a rule intended to cover situations such as "mental incompetence, guardianship, ultra vires acts or lack of corporate capacity to do business, any remaining incapacity of married women, or any other incapacity apart from infancy."[114] In this type of incapacity, it is expected the disability will be based upon local statutes. The UCC intends to draw a distinction between local laws that render the obligation "entirely null and void," in which case the defense is good against a holder in due course, and laws whose effect "is merely to render the obligation voidable at the election of the obligor," in which case a holder in due course will take free of the defense.[115] This may involve tricky problems of interpreting the legislative intent.

[ii] **Duress or illegality.** Duress or illegality in the transaction can be a defense against a holder in due course when the local law provides that under such circumstances the obligation is a *nullity*. The same distinction is drawn between obligations that are a nullity and obligations that are merely voidable as just discussed. Examples given by the drafters include statutes making gambling or usurious contracts illegal. Whether such transactions make the obligation null and void or only voidable is up to the particular jurisdiction to determine. Likewise, duress in entering into an obligation may create a defense that is good against a holder in due course. The drafters give the example of an instrument that a person has signed at the point of a gun. But all duress may not have the same consequences. Other threatened action, although wrongful and giving rise to legal remedies against the person who made the threats, may not be deemed so oppressive that the transaction is a "nullity."[116]

Illegality is often recognized when the transaction involves a gambling debt. In *First State Bank v. Spencer*, the defendant gave the bank a note for a loan to

[113] UCC § 3-207 comment 5.

[114] UCC § 3-305 comment 5.

[115] Id.

[116] UCC § 3-305, comment 6. See also Williamsen v. Jernberg, 99 Ill. App. 2d 371, 373–374, 240 NE2d 758, 760–761 (1968); Bank of Niles v. American State Bank, 14 Ill. App. 3d 729, 734, 303 NE2d 186, 191 (1973). See generally Note, "UCC § 3-305(2)(b): What Degrees of Duress?" 21 S. Tex. LJ 37 (1980).

pay a gambling debt.[117] Ordinarily, a bank can recover on such a loan, notwithstanding that the proceeds are used to pay a prior gambling debt. This general rule does not apply, however, when the lender is a participant in the illegal transaction. In *Spencer*, the court held that the bank should be treated as if it were involved in the illegal transaction because the defendant owed the gambling debt to the chairman of the board of the bank, the purpose of the loan was to permit the bank officer to recover the debt, and the bank officers handling the transaction were aware that the proceeds of the loan were to be used for payment of this debt.[118]

Another frequently encountered problem involves the defense of usury. The laws that control the amount of interest that may be charged for various credit transactions are complex, vary enormously from state to state, and are affected by federal legislation when consumers and financial institutions are concerned. The effect of these laws when a person charges interest in violation of them varies greatly. The UCC does not determine when an obligor such as the maker on a promissory note that is usurious may raise the violation of the interest controls as a defense against a holder in due course seeking payment of the note. As in the other cases of illegality, the UCC treats usury as "primarily a matter of local concern and local policy" that is best left to local law.[119] The UCC recognizes the defense as one that is good against a holder in due course if the local law regards the illegality as enough "to make the obligation entirely null and void," but cuts off the defense when the consequence of the illegality is that the obligation is only voidable or otherwise something less than "null and void." However, even when the defense is one that a holder in due course can avoid, if the instrument gives notice of the existence of the illegality on its face, as may occur when the rate of interest is excessive, the holder takes the instrument with notice of the illegality and therefore does not qualify as a holder in due course.[120]

[iii] **Fraudulent misrepresentation of the nature of the instrument.** There is a special form of misrepresentation that provides the signer of a negotiable instrument with a defense against even a holder in due course. If the misrepresentation is what is sometimes referred to as "fraud in the essence or fraud in the factum," it is a defense that the obligor can raise against a holder in due course. The misrepresentation must be such that it "has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowl-

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[117] 7 Kan. App. 2d 147, 150–151, 638 P2d 379, 382-383 (1981).

[118] See generally Annot., "Fraud in the Inducement and Fraud in the Factum as Defenses Under UCC § 3-305 Against Holder in Due Course," 78 ALR3d 1020 (1977). The parol evidence rule does not bar oral testimony by the maker of a promissory note that he was fraudulently induced to sign the note. Pinken v. Frank, 704 F2d 1019, 1022 (8th Cir. 1983).

[119] UCC § 3-305, comment 6.

[120] See UCC § 3-304(1)(b).

edge of its character or its essential terms. . . ."[121] The example given in the comments is misrepresentation that tricks the signer into signing a negotiable instrument by making the signer believe the document is an innocuous paper of some other type.[122] Under this rule, it is not enough for the signer to establish misrepresentation that deceived the signer as to the nature of the instrument. The signer also must show that it occurred under circumstances where the signer had no "reasonable opportunity to obtain knowledge" of what the transaction was about. The comment indicates that the determination of whether a reasonable opportunity existed requires an exploration of all the facts and circumstances, such as the person's "intelligence, education and business experience; his ability to read or to understand English, the representations made to him and his reason to rely on them or to have confidence in the person making them; the presence or absence of any third person who might read or explain the instrument to him, or any other possibility of obtaining independent information; and the apparent necessity, or lack of it, for acting without delay."[123]

[iv] **Discharge in insolvency proceedings.** When a person who has liability on a negotiable instrument has been discharged in insolvency proceedings of any kind, the person has no liability on the obligation discharged by those proceedings, and the discharge may be raised even as against a holder in due course.[124]

[v] **Other discharges when the holder has notice.** A number of circumstances may create a discharge of the liability of a person on a negotiable instrument.[125] Although a holder may have notice that one or more parties to a negotiable instrument have been discharged, notice of such discharge does not prevent the holder from being a holder in due course.[126] The holder may still have recourse against parties on the instrument who are not discharged or of whom the holder does not have notice of the discharge. If the holder has notice that the obligations of all the parties to the instrument have been discharged,

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[121] UCC § 3-305(2)(c).

[122] UCC § 3-305, comment 7.

[123] UCC § 3-305, comment 7. See, e.g., FDIC v. Culver, 640 F. Supp. 725, 730 (D. Kan. 1986), where the court concluded the defendant could not raise the defense of fraud against a holder in due course where he had signed a blank note and claimed not to have known what he had signed because the terms were left blank. The court quoted approvingly from an 1884 case that one who has the ability to read and understand that the document is a note but who signs it on the assurance that it is a different instrument is negligent as a matter of law. The 1884 case cited was Ort v. Fowler, 31 Kan. 478, 2 Pac. 580 (1884).

[124] UCC § 3-305(2)(d).

[125] See UCC § 3-601, which lists nine different provisions in Article 3 as well as a general principle of discharge whenever the law would recognize the act or agreement as sufficient to discharge a "simple contract for the payment of money." See also ¶ 15.07.

[126] UCC §§ 3-305, comment 9, 3-304(1)(b).

however, the UCC provides that the holder cannot be a holder in due course.[127] Clearly, a distinction is being drawn between certain defenses which may result in a discharge of a party from liability on the instrument and other types of defenses. This is because a holder takes an instrument with notice of a claim or defense when he or she takes it with notice "that the obligation of any party is voidable in whole or in part" but, as indicated earlier, is not precluded from being a holder in due course as a result of notice of discharge of a party unless he or she takes it with notice that all parties have been discharged.[128]

A holder in due course may have rights based on other principles of law as well. The holder in due course, of course, has all rights that a holder would have to enforce the obligations of parties to the instrument. The holder in due course also may have rights based upon general principles of contract, tort, agency or other law.[129] One case said a holder in due course could bring an action based upon negligence against the issuing bank on a certificate of deposit when the bank attempted to pay the certificate without requiring its production and surrender. The court reasoned:

> Moreover, since an action in negligence is separate and distinct from any claim based on the instrument or the underlying contract, we do not believe that the allocation of rights created by the holder in due course doctrine presents such a comprehensive remedial scheme as to supplant a negligence action.... Accordingly, we find that the Code does not bar a claim based on a theory of negligence.[130]

Failure of consideration is not a defense to payment of a note, even against one who is not a holder in due course, when the note was given to secure a prior debt (referred to as an antecedent obligation in the UCC).[131]

¶ 16.03 RIGHTS OF A HOLDER WHO IS NOT A HOLDER IN DUE COURSE

A holder may have valuable rights to enforce a negotiable instrument even though the holder does not qualify as a holder in due course. As previously discussed, the obligor on a negotiable instrument has an obligation to pay that

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[127] UCC § 3-304(1)(b).

[128] Id. The reference to obligations that are "voidable" is a deliberate choice of language, according to Comment 3, and is intended to distinguish notice of a defense which does preclude holder-in-due-course status from notice of a setoff or counterclaim. UCC § 3-304 comment 3.

[129] See UCC § 1-103

[130] Yahn & McDonnell, Inc. v. Farmers Bank, 708 F2d 104, 113 (3d Cir. 1983).

[131] UCC § 3-408. See also Bradley v. Romeo, 716 P.2d 227, 288 (Nev. 1986).

runs to the holder.[132] The holder is entitled to demand payment of the instrument, and the person obligated to pay may safely pay the holder notwithstanding that other third parties may have given notice of or asserted claims to the instrument.[133] The only exceptions to the ability to make payment to the holder are when the adverse claimant to the instrument takes action either by supplying an indemnity adequate to the payor or by obtaining an injunction from a court of competent jurisdiction over both the adverse claimant and the parties.[134] Otherwise, the payor may ignore the claims of other persons and pay the holder unless the circumstances are such that it (1) would be a payment in bad faith to a person who acquired the instrument by theft or through a thief or (2) is a payment by one other than an intermediary bank or a payor bank that is not a depository bank to a holder for a restrictively indorsed instrument and the payment is not consistent with the terms of the restrictive indorsement.[135] Further, if a holder brings suit to enforce a party's obligation on an instrument, apart from the two exceptions just given relating to theft and restrictive indorsement, the party obligated on the instrument is permitted to raise only his or her own defenses. "The claim of any third person to the instrument is not otherwise available as a defense to any party liable thereon unless the third person himself defends the action for such party."[136]

A holder also has the benefits of the presumptions and rules on burden of proof established for enforcing an obligation on a negotiable instrument. Firstly, signatures on a negotiable instrument are deemed to be admitted unless specifically denied in the pleadings.[137] When the validity or authority of a signature is placed in issue, the holder who is claiming under the signature has "the burden of establishing it . . . ." The holder is assisted in meeting this burden by a statutory presumption that a signature on a negotiable instrument is "genuine or authorized" unless the lawsuit is one which involves enforcement of the obligation of a purported signer who is dead or incompetent.[138] Burden of establishing under the UCC means "the burden of persuading the triers of fact that the existence of the fact is more probable than its non-existence."[139] Secondly, once the signatures on an instrument are established or are admitted as a result of the failure to deny the validity of the signature, the holder is entitled to recover on the obligation represented by the signature on the instrument by simply produc-

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[132] UCC §§ 3-413–3-414, 3-603. See discussion at ¶ 15.02.

[133] UCC § 3-603.

[134] UCC § 3-603(1).

[135] Id.

[136] UCC § 3-306(d).

[137] UCC § 3-307(1).

[138] Id.

[139] UCC § 1-201(8).

ing the instrument unless the party being charged establishes a defense.[140] The comments make clear that this rule is deliberately designed to permit a holder "to recover in the absence of any further evidence."[141] The comments also indicate that the intent is to place the burden on the defendant not only to establish the existence of a defense but to prove it by a "preponderance of the total evidence.[142] These presumptions and the benefit of the allocation of the burden of proof are rights that run only to a holder. A person who is not a holder but who has possession of an instrument is required to prove all aspects of the person's right to recover on the instrument.[143] Thirdly, if it is then shown by the defendant that a defense exists to the claim made by the holder, the holder has the burden of establishing that the holder or some person under whom the holder claims is in all respects a holder in due course.[144]

The person who is not a holder in due course takes the instrument subject to defenses of the person the holder seeks to charge with liability. These include an all-encompassing list of defenses:

1. All valid claims to the instrument;
2. All defenses available in a simple contract action;
3. Defenses based on failure of consideration;
4. Nonperformance of conditions precedent;
5. Nondelivery or delivery for a special purpose; and
6. Defenses related to acquisition of an instrument through theft or payment in a manner inconsistent with a restrictive indorsement.[145]

The reference to "all valid claims" is intended to be read broadly to include not only legal claims of ownership to the instrument but "all liens, equities, or other claims of right against the instrument or its proceeds."[146] Of course, the availability of defenses to an action on a negotiable instrument may be affected by the general rules in the UCC respecting the obligations of parties to negotiable instruments. For example, the UCC has special rules on when failure of consideration is a defense. Although it generally is a defense against any person who is not a holder in due course, it is not necessary for consideration to be given when

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[140] UCC § 3-307(2).

[141] UCC § 3-307, comment 2.

[142] Id.

[143] Id.

[144] UCC § 3-307(3).

[145] UCC § 3-306.

[146] UCC § 3-306, comment 2. Thus, equitable claims that might give rise to a right to rescind a transaction and recover the instrument or its proceeds would be viewed as a claim under this section. Id.

the instrument is taken in payment of or as security for an antecedent obligation, i.e., a prior debt.[147]

A person who does not have the status of a holder in due course takes the instrument subject to "all defenses of any party which would be available in an action on a simple contract."[148] The defenses available against one not a holder in due course may include setoff. In one case, the maker of a note had a claim against her husband under an indemnity agreement entered into with him during a divorce. The note was payable to the husband's company, which the court treated as being an alter ego of the husband for purposes of the rights and liabilities with respect to the instrument. The company negotiated the note after maturity to the holder. Because the maker could have set off her unrelated claims based on the indemnity agreement against her obligation on the note if payment had been demanded by her husband or the company (the payee), she was entitled to setoff against the holder not in due course as long as those claims arose prior to either notice of the transfer of the note or its actual negotiation to the holder.[149]

¶ 16.04 THE SHELTER PRINCIPLE—ACQUIRING THE RIGHTS OF A HOLDER IN DUE COURSE BY TRANSFER

When a check, note, or other negotiable instrument is transferred, the transferee acquires all the rights that the transferor had in the instrument.[150] The transferee obtains these rights even when the transfer does not qualify as a negotiation.[151] Therefore, when a check that is payable to the order of a named person is transferred by the payee to another party without indorsement, the party who acquires the check also acquires all the rights of the payee to enforce it even though the transfer does not constitute a negotiation.

When the transferor of the instrument is a holder in due course, the transferor's rights as a holder in due course are transferred. This is known as the shelter principle.[152] The UCC adopts this approach to assure the holder in due course a market for the paper that the person acquires.[153] There is a limitation to this principle, however. A transferee who has been a party to any fraud or

[147] UCC § 3-408.

[148] UCC § 3-306(b).

[149] Barrett v. Odom, Mays, & DeBuys, 453 So. 2d 729, 732–734 (Ala. 1984). A holder also took subject to setoff rights in Contrail Leasing Partners, Ltd. v. Executive Serv. Corp., 100 Nev. 545, 688 P2d 765, 768 (1984).

[150] UCC § 3-201.

[151] See UCC § 3-201(3).

[152] Id.

[153] Id.

illegality or who was a previous holder with notice of a defense or claim cannot use the shelter rule to acquire the rights of a holder in due course. These rules were applied in *Rozen v. North Carolina National Bank*,[154] to find that a transferee was not entitled to claim the rights that a previous holder of the instrument could have asserted. In this case Rozen, the transferee, sought to enforce a negotiable certificate of deposit. The bank that issued the certificate dishonored it because of a claimed right to set off a debt owed by the original holder of the certificate. Rozen could not be a holder in due course in his own right because he knew the certificate had been dishonored when he bought it; therefore, he argued that he succeeded to the holder in due course rights of his transferor, Manufacturers Hanover.[155] Rozen received the certificate of deposit from Manufacturers Hanover, who had acquired the certificate as part collateral for a loan. The court rested its conclusion on alternative grounds. Firstly, it said that Manufacturers Hanover was not Rozen's assignor, because Manufacturers Hanover was not the owner of the certificate—it only was a pledgee without the right to transfer the collateral. Secondly, the court held that the debt owed to Manufacturers Hanover for which the certificate was pledged had been paid and therefore any interest Manufacturers had in the certificate was terminated.

The shelter principle, which gives a transferee the rights of the transferor, is a rule that allows the transferee to "step into the shoes of" the transferor. It does not make the transferee a "holder" in the transferee's own right. If it did, the rules on negotiation would be undermined. Consider a check drawn payable to the order of *P*, which is issued to *P*. *P* then is a holder because *P* is in possession of an instrument issued to *P*.[156] When *P* transfers the instrument to *T* without indorsing it, there has been a transfer but not a negotiation.[157] Consequently, when *T* transfers the check to *X*, whether or not *T* indorses the check, *X* cannot be a holder as long as the indorsement of *P* is missing. Absent agreement to the contrary, as long as the transfer from *P* to *T* is for value, *T* has the right to obtain the indorsement of *P*, and when the indorsement is obtained, *T* becomes the holder of the instrument. Similarly, when *T* transfers the check to *X*, *X* may have the right to obtain the indorsement of *T*. Because *X* also succeeds to all of *T*'s rights in the instrument, *X* may also acquire the right that *T* has to obtain the indorsement of *P*. When *X* gets the indorsements of both *P* and *T*, *X* becomes a holder with all the rights of a holder.[158] Until *T* or *X* becomes a holder, even

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[154] 588 F2d 83 (4th Cir. 1978).

[155] Rozen also was closely connected to one of the original parties in the transaction, Allen Stein. Stein succeeded to ownership of the corporation that originally held the certificate and that was indebted to the issuing bank. Stein could not qualify as a holder in due course because of his role in these transactions. Stein engineered the assignment of the certificate to Rozen, who also happened to be Stein's brother-in-law.

[156] UCC § 3-202. See UCC § 1-201(20).

[157] UCC § 3-202. See discussion of negotiation in Chapter 15.

[158] UCC § 3-201(3).

though each may have taken the instrument in good faith, without notice of a claim or defense or that the instrument is overdue, and for value, neither can qualify as a holder in due course in his own right. This is true even though *P* may have been a holder. Although UCC § 3-201 gives *T* and *X* the rights of *P* who is a holder, it does not make either *T* or *X* a holder.[159]

¶ 16.05 DEFENSES TO THE INSTRUMENT BASED UPON SEPARATE CONDITIONS OR AGREEMENTS

An area of great confusion is the extent to which a party may impose conditions upon the obligation the party undertakes as a signer of a negotiable instrument based upon a separate agreement with the person to whom the instrument is given. A number of interrelated UCC provisions must be considered.

A holder in due course is not bound by any separate agreement of which the holder does not have notice.[160] Although a holder in due course has notice that an instrument was taken as part of a separate agreement or under circumstances in which a promise was made which is still executory or unperformed, the holder in due course is not regarded as having notice that a defense or claim exists as a result of those circumstances alone.[161] In order to have notice that disqualifies the holder from being a holder in due course, the holder must have notice of the actual existence of a defense or claim, such as a default in any promise or agreement relating to the instrument.[162] It is possible for a holder in due course to obtain notice of such a defense by examining the terms of a separate written agreement, as in the case in which the separate writing states that the instrument "is a sham and cannot be enforced. . . ."[163] Regardless of the existence of notice, a separate written agreement does not destroy the negotiability of an instrument that otherwise meets the requirements for negotiability.[164]

One who is not a holder in due course may be affected by a separate agreement. Two separate UCC provisions support this result. Firstly, UCC § 3-119(1) permits an instrument's terms to be "modified or affected" by a separate "written agreement executed as a part of the same transaction" determining the rights between "the obligor and his immediate obligee or any transferee. . . ."[165]

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[159] To the extent there is any contrary implication in Bowling Green, Inc. v. State Street Bank & Trust Co., 425 F2d 81 (1st Cir. 1970), it is submitted such suggestion does not reflect the policies of the UCC on transfer and negotiation.

[160] UCC §§ 3-119(1), 3-305(2).

[161] UCC § 3-304(4)(b).

[162] UCC § 3-304, comment 9.

[163] UCC § 3-119, comment 4.

[164] UCC § 3-119(2).

[165] UCC § 3-119(1).

Secondly, UCC § 3-306(c) on the rights of one who is not a holder in due course makes clear that a person who lacks holder-in-due-course rights takes an instrument subject to the defenses of "want or failure of consideration, nonperformance of any condition precedent, nondelivery or delivery for a special purpose. . . ."[166] Both of these sections establish a general rule that one who is not a holder in due course takes a negotiable instrument subject to conditions or other agreements validly entered into that limit or condition the obligation undertaken by parties to an instrument.

The availability of a defense based upon a separate agreement or condition is made more complex by considerations of when it is appropriate to use parol evidence to prove the existence of such a condition or agreement. UCC § 3-119 refers only to separate written agreements. UCC § 3-306 is not so limited, however. The comments to the UCC indicate that Article 3 should not be read as stating general rules "as to when an instrument may be varied or affected by parol evidence" except for certain specific rules of construction adopted by the UCC to avoid ambiguity as to the terms of an instrument.[167] Section 3-306, which makes the defenses of failure of consideration, nondelivery, or delivery for a special purpose available against one who is not a holder in due course, is silent in both its text and the official comments as to the use of parol evidence to establish such defenses. As between the immediate parties, some courts have permitted the use of parol evidence to show nonperformance of a condition precedent, lack of consideration, or other defenses to the instrument. Parol evidence has been allowed to show that the negotiable instrument is only part of an entire oral contract between the parties and does not represent the parties' complete agreement.[168] Courts also have enforced between the immediate parties conditions imposed on when a check could be presented for payment.[169] On the other hand numerous cases express reluctance to allow parties to contradict their obligations as parties to negotiable instruments that on their face are absolute and unconditional.[170] When the terms of the instrument are ambiguous,

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[166] UCC § 3-306(c).

[167] UCC § 3-119, comment 1, § 3-118 & comment 1.

[168] Scafidi v. Johnson, 420 So. 2d 1113, 1115 (La. 1982). See also Gulf States Fin. Corp. v. Airline Auto Sales, Inc., 248 La. 591, 593, 181 So. 2d 36, 38 (1965). In Participating Parts Assocs., Inc. v. Pylant, 460 So. 2d 1299, 1302 (Ala. Ct. App. 1984), the court enforced an agreement between the parties that the delivery of a check was conditional.

[169] Engelcke v. Stoehsler, 273 Or. 937, 940, 544 P2d 582, 585 (1975) (check conditioned on obtaining evidence of an insurance payment). See generally the discussion in H. Bailey, Brady on Bank Checks ¶ 5.6 (6th ed. 1987), which reviews the case law on conditional delivery.

[170] For a good general discussion of the application of parol evidence to commercial paper, see C. Weber and R. Speidel, Commercial Paper 88–98 (3d ed. 1982). In Brooks v. McCorkle, 174 Ga. App. 132-133, 329 SE2d 214-215, (1985), the court refused to permit the introduction of parol evidence to show that the terms of a promissory note were modified by oral conditions that were part of a larger transaction.

use of parol evidence to resolve the ambiguity serves a more traditional function.[171]

¶ 16.06 PRESERVATION OF CLAIMS AND DEFENSES IN CONSUMER TRANSACTIONS

Significant limitations exist to preclude application of holder in due course rules in consumer credit transactions as the result of action by the Federal Trade

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When an individual indorsed a check, she became liable as an indorser and could not claim that her indorsement was intended to be merely an assignment of her rights to the instrument, according to the ruling in another case. She claimed it was an assignment of her rights in the instrument to her husband because the assignment was provided for in a separation agreement that she had entered into with her husband. The court held that since she had not indorsed the check in a manner that indicated the recourse against her was limited, her liability was as an indorser and there was a negotiation of the instrument, not merely an assignment. The court recognized that UCC § 3-119(1) permits the terms of an instrument to be affected by other written agreements executed by the obligor and her immediate obligee, but the court declined to apply this section for reasons that were unclear. When the makers of the note refused to pay it and dishonored the instrument, the husband sued his former wife on her indorsement and recovery was allowed. Alves v. Baldaia, 14 Ohio App. 3d 187, 190-191, 470 NE2d 459, 462-463 (1984).

In another case, Nelson executed a guaranty contract for a debt that was owed by a corporation in which he had an interest. He claimed that he was not liable under the guaranty because the consideration for giving the guaranty was that the corporate obligation would be restructured by the lender, which had not been done. The court rejected the argument. It held that when a guaranty is given that is absolute on its face, it is an unconditional promise to pay that does not depend upon any condition. Moreover, parol evidence would not be admissible to contradict the language in the agreement that it was an unconditional promise to pay. Although the court's analysis indicated that the guaranty was given as security for an antecedent debt, no consideration is required when an instrument or obligation is given as security for an antecedent obligation. American Viking Contractors, Inc. v. Scribner Equip. Co., 745 F2d 1365 (11th Cir. 1984); UCC § 3-408. The same conclusion was reached in International Minerals & Chem. Corp. v. Matthews, 71 NC App. 209, 321 SE2d 545 (1984), review denied, 313 NC 330, 327 SE2d 890 (1985). See also First Nat'l City Bank v. Cooper, 50 AD2d 518, 375 NYS2d 118 (1975); Trustees of Tufts College v. Parlane Sportswear Co., 4 Mass. App. Ct. 783, 342 NE2d 727 (1976). The following cases did not permit the use of parol evidence to vary the terms of notes which appeared on their face to be complete and unconditional. Trustees of Tufts College v. Parlane Sportswear Co., 4 Mass. App. Ct. 783, 342 NE2d 727-728 (1976); Texas Export Dev. Corp. v. Schleder, 519 SW2d 134, 137 (Tex. Civ. App. 1974).

[171] In Banker's Credit Serv., Inc. v. Dorsch, 231 Va. 273-275, 343 SE2d 339, 340-341 (1986), the court allowed parol evidence. The defendant signed a note but added "without recourse per UCC § 3-413(2)." The court regarded the language as ambiguous because UCC § 3-413(2) uses the term "without recourse" only in the context of referring to a draft. The defendant was entitled to introduce correspondence showing that his liability was not personal but was limited to the land securing the note.

Commission. Before examining the FTC rule, it is useful to review how the holder in due course doctrine works in consumer transactions. When a consumer signs a negotiable note as part of a credit or purchase transaction, the transfer of the note to a person who qualifies as a holder in due course results in the consumer's being obligated to pay the note notwithstanding any legal claim the consumer may have had against the party to whom the note was originally given if the consumer's claim does not rise to the level of a "real defense," which is good even against a holder in due course.[172] For example, suppose a consumer who purchases an automobile from a used car dealer pays for the car in part by signing a negotiable promissory note. The dealer then discounts this note to a finance company. If the car is worthless, the consumer has a claim against the dealer for breach of warranty. In some cases, the consumer might even have a right to return the car and demand a refund. If the dealer sues the consumer for the purchase price, the consumer can set off against the dealer's claim the damages caused by dealer's breach of warranty. However, none of these rights can be exercised against the finance company to which the note was transferred if the finance company qualifies as a holder in due course.[173] A comparable result follows when the consumer signs a purchase agreement with the dealer that contains a clause providing that upon the assignment of the contract the consumer waives any defenses or claims which might be asserted against the original seller.

Because of the harsh results these rules have produced for consumers who generally were not in any position to bargain over the loss of these rights, there are now broad restrictions on the applicability of holder in due course and waiver of defense provisions in consumer transactions. Even before the enactment of special statutes dealing with this problem, courts were sensitive to protect consumers from these results. A leading case is *Unico v. Owen*,[174] in which the court held that an assignee of a note and sales agreement did not have holder-in-due-course status because the assignee was closely connected to the seller of the goods.[175] Today, many special consumer credit protection statutes deny holder-in-due-course status or comparable rights to creditors in consumer

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[172] See discussion supra ¶ 16.02.

[173] UCC § 3-305. See supra ¶ 16.02. See generally Geva, "Optimality and Preservation of Consumer Defenses—A Model for Reform," 31 Case W. Res. L. Rev. 51 (1980).

[174] 50 NJ 101, 232 A2d 405 (1967).

[175] For a general discussion of these problems, see Countryman, "The Holder In Due Course and Other Anachronisms in Consumer Credit," 52 Tex. L. Rev. 1 (1973); Kripke, "Consumer Credit Regulation: A Creditor-Oriented Viewpoint," 68 Colum. L. Rev. 445 (1968); Rohner, "Holder in Due Course in Consumer Transactions: Requiem, Revival, or Reformation?" 60 Cornell L. Rev. 503 (1975); Rosenthal, "Negotiability—Who Needs It?" 71 Colum. L. Rev. 375 (1971); Note, "Consumer Protection—The Role of Cutoff Devices in Consumer Financing," 1968 Wis. L. Rev. 505.

transactions.[176] Without doubt, however, the most far-reaching changes to the holder in due course doctrine were accomplished by the Federal Trade Commission. It has promulgated rules that effectively nullify the holder-in-due-course status of most consumer credit transactions. These rules are discussed in the following sections of this chapter.[177]

[1] Abolition of Holder in Due Course Status by FTC

The FTC rule on preservation of consumers' claims and defenses is simple in operation.[178] Any person who sells or leases goods or services to consumers must be sure that any consumer credit contract executed by the consumer in connection with the transaction contains a notice prescribed by the FTC.[179] Any consumer credit contract taken by the seller must contain the following:

NOTICE

> ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

When the seller accepts in payment the proceeds of any purchase money loan, the consumer credit contract must contain this notice:

> ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

The effect of placing this legend on the instrument is to incorporate this provision into the terms of the instrument. As a result, if the instrument otherwise would have been negotiable, the notice destroys negotiability because it makes

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[176] See, e.g., Uniform Consumer Credit Code § 3.307. See generally, Lawrence & Minan, "The Effect of Abrogating the Holder-in-Due-Course Doctrine on the Commercialization of Innovative Consumer Products," 64 BUL Rev. 325 (1984).

[177] The authority of the FTC to engage in this regulation is controversial. See J. White & R. Summers, Uniform Commercial Code § 14-8 (2d ed. 1980); Annot., "Validity, in Contract for Installment Sale of Consumer Goods, or Commercial Paper Given in Connection Therewith, or Provision Waiving, as Against Assignee, Defenses Good Against Seller," 39 ALR3d 518 (1971).

[178] 16 CFR § 433 (1988).

[179] 16 CFR § 433.2 (1988).

payment conditional upon the absence of a claim of defense.[180] It also nullifies any clause contained in the agreement that purports to waive the consumer's defenses and claims against the seller. Thus, without directly challenging the validity of state law, the FTC has effectively nullified it by requiring use of a notice that, under general contract principles and the UCC, operates to destroy holder-in-due-course status.[181]

[2] Transactions Covered by FTC Rule

For the FTC rule to apply, the transactions must involve a consumer who is acquiring goods or services for personal, family, or household use.[182] Any such transaction in which a "consumer credit contract" is used imposes obligations upon the seller to make sure that the contract contains the notice. A consumer credit contract is defined, inclusively, as "any instrument which evidences or embodies a debt" arising from a purchase money loan transaction or a financed sale.[183]

[a] Financed Sale and Purchase Money Loan. A financed sale is simply the extension of credit to a consumer in a way that comes within the definition of a credit sale under the Truth-in-Lending Act and Regulation Z.[184] When a seller of goods or services does business on credit, taking a consumer credit contract as part of the transaction, this constitutes a financed sale.

A purchase money loan, on the other hand, is "a cash advance which is received by a consumer" in return for a finance charge as defined in the Truth-in-Lending Act and Regulation Z. It must be used to purchase goods or services from a seller who refers consumers to the creditor making the advance or who is affiliated with the credit "by common control, contract, or business arrangement."[185] Thus, the purchase money loan involves an advance by a third-party creditor to a consumer who uses the proceeds to make a purchase of goods or services from the seller. The consumer credit contract is executed by the consumer and the creditor, but the seller has an obligation to make sure the contract contains the required notice. This follows from the provision in the regulation that prohibits the seller from accepting as payment for any consumer sale or

[180] UCC §§ 3-104(1)(b), 3-105(2).

[181] For the reflection of a similar policy to preserve consumer rights in the regulations applicable to the federally insured student loan program, see United States v. Griffin, 707 F2d 1477 (DC Cir. 1983).

[182] 16 CFR § 433.1(b) (1988).

[183] 16 CFR § 433.1(i) (1988).

[184] 16 CFR § 433.1(e) (1988).

[185] 16 CFR § 433.1(d) (1988).

lease the proceeds of a purchase money loan unless the consumer credit contract contains the required notice.[186]

The provisions of the rule, thus, cover arrangements between sellers and creditors where there is an extensive degree of cooperation in providing financing for the goods or services sold or leased by the seller. Under the terms of the regulation, the affiliation between seller and creditor need only be "by common control, contract, or business arrangement."[187] The contract can be oral or written, formal or informal, so long as it contemplates "cooperative or concerted activity" between the seller and the creditor in providing financing.[188]

[b] Impact of FTC Rule. The obligation to comply with the FTC rule by placing the appropriate notice on the consumer credit contract applies only to sellers. A seller is any individual, corporation, or other business organization "who, in the ordinary course of business, sells or leases goods or services to consumers."[189] Creditors have no duty to see that the notice appears on the contract.[190]

Although the rule's effect on creditors is indirect, it is still substantial. Any creditor who engages in discounting paper that arises from consumer transactions will be deprived of holder-in-due-course status as a result of the notice on the paper. Moreover, in most cases, the creditor will know that the paper it is discounting resulted from a consumer transaction just from the nature of the business of the assignor of the paper, regardless of whether the seller in fact properly put the notice on the paper. In such a case, it is probable that the creditor would be held to know that the FTC notice was required on the paper, and so the creditor may be viewed as lacking the good faith needed to be a holder in due course even when the legend is missing.[191]

If a creditor takes consumer paper governed by the FTC notice, any defense the consumer might have against the seller of the goods or services can also be asserted as a defense to payment to the creditor, assuming that the consumer has

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[186] 16 CFR § 433.2(b) (1988).

[187] 16 CFR § 433.1(d) (1988).

[188] 16 CFR § 433.1(f) (1988).

[189] 16 CFR § 433.1(a), (j) (1988).

[190] 40 Fed. Reg. 53,530 (1975). But the authority of the Federal Trade Commission does not extend to banks. See 15 USC § 45(a)(2) (1982). At an earlier time, the FTC proposed extending the rule to creditors through an amendment which would have made it an unfair or deceptive act or practice for a seller "or a creditor" to take a consumer credit contract in violation of the rule. After receiving additional information in 1977, 42 Fed. Reg. 52439 (1977), publishing a report, and requesting further public comment, 43 Fed. Reg. 54950 (1978), the Commission approved the amendment in substance, 44 Fed. Reg. 65771 (1979), but it was never put into effect.

[191] UCC § 3-302. See generally, J. White & R. Summers, Uniform Commercial Code, at 1143; Note, "The FTC's Preservation of Consumers' Claims and Defenses: Consumer Security or Consumer Fraud?" 11 Val. UL Rev. 263 (1977).

a valid defense against the seller arising from breach of warranty or other breach of contract. It is important to note that the FTC notice also makes the creditor subject to claims the consumer has against the seller. This provision may require a creditor to refund amounts to the consumer that the consumer has paid under the contract. The notice limits the extent of any claim that the debtor can assert against the creditor to "amounts paid by the debtor" under the contract. Although it is not clear from the language, this limitation could include amounts paid by the consumer under the contract to persons other than the creditor—for example, payments made to the seller before the contract was assigned and, perhaps, depending upon the wording of the contract, down payments made to the seller.

[c] Case Examples. The case law dealing with the FTC rule is not extensive. Several cases have considered what effect to give the notice when it is contained in a contract that is not a consumer contract. In *International Harvester Credit Corp. v. Hill*,[192] the court held that the holder of a commercial contract could be a holder in due course even though the document contained the FTC notice. In this case, the notice said it applied only if it was a consumer contract. A Florida appellate court reached a similar result in *First New England Financial Corp. v. Woffard*,[193] in which the notice said it did not apply if the amount financed exceeded $25,000 or the transaction was for commercial purposes. In *Jefferson Bank & Trust Co. v. Stamatiou*,[194] on the other hand, the court denied holder-in-due-course status because the FTC notice was in the contract, even though the purchase was for a commercial use. The court took the straightforward approach that the parties could govern their relationship by their contract and had done so by including the FTC notice.

When the FTC notice should have been used in a transaction, but the contract does not include it, one court has ruled that the holder may become a holder in due course.[195] In the court's view, the FTC might penalize the seller for violating its rule, but the violation did not affect the holder's status as a holder in due course. The case did not involve facts in which the bank that held the contract had been found to be a regular financer of the seller who should have known the paper needed the FTC notice.

When the consumer credit contract is transferred, the holder takes the contract as if it were in the hands of the transferor, subject to all the claims and defenses that the obligor had against the transferor. The FTC notice does not create any new claims or defenses, but simply puts the holder of the contract in

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[192] 496 F. Supp. 329, 332-333 (M.D. Tenn. 1979).

[193] 421 So. 2d 590, 593-594 (Fla. Dist. Ct. App. 1982).

[194] 384 So. 2d 388, 391 (La. 1980).

[195] Capital Bank & Trust Co. v. Lacey, 393 So. 2d 668-669 (La. 1980).

the shoes of the seller of the goods. If the buyer has a defense against the seller, it will be good against the holder.[196]

An interesting issue was presented in *Provident Bank v. Barnhart*,[197] in which the buyer purchased a car from the seller using a consumer credit contract with the FTC notice. Ten months later, because of complaints over defects in the car, the buyer and seller settled their dispute over the seller's warranty liability by letting the buyer trade in the original car on a new vehicle, obtaining a cancellation of the old indebtedness and entering into a new financing agreement for the new car. The seller failed to pay the plaintiff bank to whom the original contract had been assigned and became insolvent. When the plaintiff bank sued on the original consumer credit contract, the trial court gave the bank summary judgment. The appellate court ruled summary judgment was in error. There was a material question of fact as to whether the acquisition of the new car was a settlement of the buyer's warranty claims or was merely the purchase of a new car. If the latter, the plaintiff was entitled to judgment. If the transaction were a warranty settlement, the settlement would be a defense against the plaintiff. The court did not explore whether the settlement between the buyer and the seller could be conclusive of the existence of a defense against the plaintiff, nor did the court consider whether the seller could create a defense or claim for the buyer by conduct after the transfer of the consumer credit contract that would be effective against the bank because of the FTC notice.[198] Of course, if the buyer does not have a defense against the seller because of an effective waiver in the original sales agreement, the assignee of the contract is also entitled to the benefit of the waiver of the defense.[199]

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[196] United States v. Griffin, 707 F2d 1477, 1482 (DC Cir. 1983) (student loan; defenses against school lender good against government to whom loan transferred); Tinker v. De Maria Porsche Audi, Inc., 459 So. 2d 487, 492-493 (Fla. Dist. Ct. App. 1984), review denied, 471 So.2d 43 (Fla. 1985) (return of verdict against seller for fraud required setting aside as inconsistent a verdict for the financer for the balance owed on the contract); First Homestead Fed. Sav. & Loan Ass'n v. Boudreaux, 450 So. 2d 995, 996 (La. Ct. App. 1984) (arbitration clause in home improvement contract effective against financer); General Motors Acceptance Corp. v. Johnson, 426 So. 2d 691, 695 (La. Ct. App. 1982), cert. denied, 433 So. 2d 151 (La. 1983) (defense against seller of redhibitory defects available against seller's financer); Dartmouth Plan, Inc. v. Valle, 117 Misc. 2d 534-535, 458 NYS2d 848-849 (1983) (finance company could not enforce contract assigned by an unlicensed contractor because state law forbade the contractor from recovering); State v. Excel Management Servs., Inc., 111 Wis. 2d 479, 484-485, 331 NW2d 312, 316-317 (1983) (seller's violations of consumer credit code prohibitions against bait and switch tactics and misrepresentation constituted a defense that buyer could assert against the assignee of the contracts).

[197] 3 Ohio App. 3d 316, 445 NE2d 746 (1982).

[198] For a discussion of the general law on modifications by the obligor and assignor of contracts that have been assigned, see UCC § 9-318(2) and ¶ 22.07[1].

[199] Xerographic Supplies Corp. v. Hertz Commercial Leasing Corp., 386 So. 2d 299-300 (Fla. Dist. Ct. App. 1980) (buyer's waiver of certain warranties in the sales agreement

Some cases have presented situations in which the buyer, who was obligated on the consumer credit contract, was entitled to protection under state law as well as the protection flowing from the FTC notice. The cases have given the consumer-buyers the benefit of such protection.[200] In *Cooper v. Republicbank Garland*, the FTC notice and the state law on limitations of actions combined to allow the buyer to raise the seller's breach of warranties as a defense to an action by the bank to collect the unpaid balance on the buyer's contract, even though the statute of limitations barred the buyer from affirmatively recovering from the seller.[201]

[3] Preservation of Claims and Defenses Under the Uniform Consumer Credit Code

The pervasiveness of the FTC holder in due course rule makes much state legislation on this subject moot. The FTC rule, of course, does not purport to override any local law on the subject. Thus, local laws may provide additional rights and duties. Also, they may reach transactions not covered by the FTC rule. The Uniform Consumer Credit Code (UCCC) is a comprehensive attempt to deal with this subject. Drafted prior to the FTC rule, many of the purposes of the UCCC provisions have now been satisfied by the FTC rule. Nevertheless, the UCCC deserves consideration because of its attempt to deal comprehensively with the holder in due course problem.

The UCCC is the first attempt by a uniform law to eliminate the holder in due course. The first draft of the UCCC (1968 act) was promulgated by the National Conference of Commissioners on Uniform State Laws in 1968. The 1968 act was adopted by eight states.[202] The current version of the act, which was promulgated in 1974, varies substantially from the 1968 act.

The purpose of the UCCC is to abolish the holder in due course doctrine in consumer transactions.[203] The 1974 act contains four provisions that pertain to

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was enforceable by the assignee of the contract). For a discussion of the law relating to the assignment of accounts, see UCC § 9-318(2) and ¶ 22.07[1].

[200] Saporita v. Delco Corp., 104 Misc. 2d 527, 530, 428 NYS2d 581, 584 (1980) (extra recovery under state law could be obtained) (dicta); De La Fuente v. Homes Sav. Ass'n, 669 SW2d 137, 142, 146 (Tex. Ct. App. 1984) (failure to give notice under state credit code of subsequent negotiation of the buyer's note created liability for attorney's fees and other damages). See generally, Sovern, "Paradigm and Paradox in New York Consumer Credit Law: After Holder in Due Course," 6 Ann. Rev. Banking L. 119 (1987).

[201] 696 SW2d 629, 634 (Tex. Ct. App. 1985).

[202] See Hadak & Carter, "The Erosion of the Holder in Due Course Doctrine: Historical Perspective and Development," 9 UCCLJ 165 (1976). See also Notes, "Regulation Z and the UCCC: The Bewildering Maze of Credit Disclosure Provisions," 1979 BYUL Rev. 394; "Consumer Defenses and Financers as Holders in Due Course," 4 Conn. L. Rev. 83 (1971).

[203] UCCC § 3.307, comment (1974).

negotiability and the consumer: Section 3.307 deals with the holder in due course; Section 3.403 pertains to credit card transactions; Section 3.404 is concerned with the waiver of defenses clause; and Section 3.405 treats direct loans.

[a] Section 3.307: Use of Negotiable Instruments. Section 3.307 prohibits use of negotiable instruments for *credit* in consumer transactions:

> With respect to a consumer credit sale or consumer lease [except a sale or lease primarily for an agricultural purpose], the creditor may not take a negotiable instrument other than a check dated not later than ten days after its issuance as evidence of the obligation of the consumer.[204]

[b] Section 3.403: Credit Card Transactions. Section 3.403 extends the policy reflected in Section 3.307 against holder in due course rights to credit card transactions. It has two parts. Firstly, it subjects the issuer of a credit card to all the defenses and claims the cardholder may have against the original seller or lessor if the seller or lessor is "licensed, franchised, or permitted by the card issuer to do business under the trade name or designation of the card issuer or person related to the card issuer."[205] This makes the card issuer who, like oil companies or retail stores, permits others to sell products under the card issuer's name or trademark, subject to all claims and defenses of its cardholders that arise from the sale or lease of property or services by those authorized to do business. The liability extends "to the extent of the original amount owing" to the card issuer for the transaction related to the claim or defense.[206] Secondly, whether there is a relationship between the card issuer and the business that sold the goods, the credit card issuer will be subject to "all claims and defenses of a cardholder against the seller or lessor arising from the sale or lease of property or services pursuant to the credit card" if certain criteria are met.[207] These criteria are (1) the original amount owing to the card issuer with respect to the transaction in dispute must exceed fifty dollars, (2) the residence of the cardholder must be within 100 miles of where the transaction occurred or within the same state;[208] and (3) the cardholder must make a good-faith attempt to obtain satisfaction from the seller.[209] The credit card issuer is liable only for the amount owing at the time the issuer has notice of the claim or defense. Oral notice to the issuer is

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[204] UCCC § 3.307 (1974). See UCCC § § 1.301(12), 1.301(14) (1974) (consumer credit sale and consumer lease defined).

[205] UCCC § 3.403(2) (1974).

[206] Id.

[207] UCCC § 3.403(3) (1974).

[208] The phrase "in the same state" is optional.

[209] UCCC § 1.110(2) (1974) (good faith defined).

effective unless the issuer requests written confirmation and the buyer fails to give such written confirmation within the time required. The card issuer must give the cardholder at least fourteen days for the written confirmation. The cardholder can give notice of the claim or defense before attempting good faith settlement with the seller. Any agreement made between the cardholder and the card issuer to disclaim any of the provisions of Section 3.403 is unenforceable.[210]

[c] Section 3.404: Waiver of Defense Clauses. Section 3.404 eliminates the effect of a waiver of defenses clause, making all assignees in consumer credit sales or consumer leases subject to all claims and defenses of the consumer arising from the transaction. Section 3.404 also provides that even if the assignee has taken a negotiable instrument in violation of Section 3.307, such person is still subject to any claims and defenses the consumer as buyer or lessee may have against the seller or lessor. The assignee is liable only for the amount outstanding at the time the consumer gives notice to the assignee of the defenses or claims against the original seller or lessor. There are requirements similar to those discussed for Section 3.403 of good faith efforts at settlement and giving notice of the claim or defense, as well as a similar prohibition against waiver of the consumer's rights.

[d] Section 3.405: Availability of Claims and Defenses Against Lender. Section 3.405 subjects a lender, other than the issuer of a credit card, to all claims and defenses of a consumer against a seller or lessor with respect to the purchase or lease of property when the lender has made a consumer loan "to enable" the consumer to enter into the sale or lease transaction. When the criteria of this section are met, the lender will be subject to all the claims and defenses the consumer has against the particular seller or lessor with respect to the property or services in question.[211] For this liability to arise, a relationship must exist between the lender and the seller or lessor. The act specifies six ways in which the required relationship may be shown.

(a) The lender knows that the seller or lessor arranged for the extension of credit by the lender for a commission, brokerage, or referral fee;

(b) the lender is a person related to the seller or lessor, unless the relationship is remote or is not a factor in the transaction;

(c) The seller or lessor guarantees the loan or otherwise assumes the risk of loss by the lender upon the loan;

(d) The lender directly supplies the seller or lessor with the contract document used by the consumer to evidence the loan, and the seller or

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[210] Compare the federal rules on credit cards discussed in Chapter 18.

[211] UCCC § 3.405(1) (1974).

lessor has knowledge of the credit terms and participates in preparation of the document;

(e) The loan is conditioned upon the consumer's purchase or lease of the property or services from the particular seller or lessor, but the lender's payment of proceeds of the loan to the seller or lessor does not in itself establish that the loan was so conditioned; or

(f) The lender, before he makes the consumer loan, has knowledge or, from his course of dealing with a particular seller or lessor or his records, notice of substantial complaints by other buyers or lessees of the particular seller's or lessor's failure or refusal to perform his contracts with them and of the particular seller's or lessor's failure to remedy his defaults within a reasonable time after notice to him of the complaints.[212]

As in the previous provisions, the consumer must make a good faith attempt to settle and may hold the lender only to the extent of the amount owing to the lender at the time the lender obtains notice of the claim or defense. The procedures for giving notice are similar. The UCC prohibits waivers of a consumer's rights under this section.[213] There also is a procedure for determining what the amount owing to the lender is when the loan represents the consolidation of two or more loans or represents an open-end credit account.[214]

The UCCC provisions abolishing the holder in due course doctrine with respect to various consumer transactions have been influential in other legislation. Although the number of states that have adopted the UCCC is limited, and the states that have adopted the provisions have often incorporated nonuniform amendments and variations, the policies reflected in the UCCC on the holder in due course rules have gained widespread acceptance. The federal rule on claims and defenses in credit card transactions is patterned in great part after the UCCC. The federal credit card rule is discussed in Chapter 18.

[4] Other State and Federal Restrictions on Holder in Due Course Rights

There are many specialized consumer protection statutes. They are by no means uniform and, instead, vary greatly in the degree of protection afforded the consumer. Some states' statutes are limited to specific consumer transactions, such as home solicitation sales or other special transactions. A few states have special laws that abolish or sharply restrict the holder in due course doctrine. In view of the great variety of these statutes, banks should consult local counsel as to the possible existence of local laws affecting the rights of those who engage in the business of discounting or rediscounting consumer paper.

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[212] UCCC §§ 3.405(1)(a)–3.405(1)(f) (1974).

[213] UCCC §§ 3.405(2), 3.405(4) (1974).

[214] UCCC § 3.405(3) (1974).

There also are numerous federal consumer protection laws. Some of these are discussed in Chapter 26. Consumers have a right under federal law to assert claims and defenses in certain credit card transactions.[215] Also, an FTC rule that applies to door-to-door sales makes it an unfair trade practice for a seller in a door-to-door sale transaction to fail to give proper notice to the buyer that the transaction can be canceled if the buyer acts within three business days.[216] The FTC rule makes it an unfair trade practice to transfer any "note or other evidence of indebtedness to a finance company or other third party" before midnight of the fifth business day after the buyer signed the contract or purchased the goods and services.[217]

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[215] See discussions in Chapters 18 and 26.

[216] 16 CFR § 429.1 (1988).

[217] 16 CFR § 429.1(h) (1988).

17

Letters of Credit

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¶ 17.01 RIGHTS AND DUTIES OF PARTIES IN LETTER OF CREDIT TRANSACTIONS

The letter of credit first developed in sales transactions, particularly international sales, in which the seller of goods sought assurance of payment from an independent and reliable financial party before undertaking the expense and risks of shipping goods to a buyer who was unknown and located at a distant point. The usefulness of the letter of credit as a technique whereby commercial parties could shift credit and payment risks to financial institutions that were better equipped to assess credit risks, arrange for international payment through reliable channels, and obtain security for credit extended led to the expansion of the use of the letter of credit in other circumstances as well. As a result, the use of the so-called standby letter of credit for all sorts of commercial transactions has grown enormously. Regardless of the type of transaction, the basic underlying

law governing the rights and obligations of parties to a letter of credit transaction is the same.

A letter of credit is a written promise by the issuer of the credit to pay drafts or other demands for payment that comply with the terms of the credit.[1] No special form, other than that the credit must be in writing and signed by the issuer, is necessary to make the letter of credit binding upon the issuer.[2] A letter of credit may be issued by banks, individuals, or firms and may be conditional or unconditional, revocable or irrevocable.[3] The party issuing the letter of credit is liable to the person who is entitled to payment under the terms of the credit.[4]

The letter of credit thus involves at least three parties: the issuer, who is obligated to pay when the terms of the credit are satisfied; the customer, who requested the issuance of the credit and who usually is using the credit to satisfy an obligation to some third person related to a separate transaction; and the beneficiary, who is entitled to payment under the terms of the credit and whose right to payment is based upon some underlying business relationship with the customer.[5]

Other parties may become a part of the letter of credit transaction. Under the Uniform Commercial Code, the right to draw under a credit can be transferred or assigned when the credit is expressly designated as transferable or assignable.[6] When the credit states that it is nontransferable or nonassignable, the beneficiary may assign his or her right to the proceeds under the letter of credit. In such case, the assignee, in effect, obtains a security interest in the letter of credit.[7] Such an assignment of "proceeds" only does not transfer the right to perform under the letter of credit or to obtain payment.[8]

The obligation of the issuer may be "confirmed" by another party. For example, a New York bank might issue a letter of credit and a bank in California, where the beneficiary is located, might confirm the credit of the New York bank

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[1] See UCC § 5-103(1)(a). The UCC citations are to the West 1978 official text unless noted otherwise. See also Annot., "What is a Letter of Credit Under UCC §§ 5-102–5-103," 44 ALR4th 172 (1986); Farrar & Landau, "Letters of Credit," 40 Bus. Law. 1177 (1985); Kozolchyk, "Is Present Letter of Credit Law Up To Its Task?", 8 Geo. Mason L. Rev. 285 (1986); Rosenblith, "Modifying Letters of Credit: The Rules and the Reality," 19 UCC LJ 245 (1987).

[2] UCC § 5-104.

[3] UCC §§ 5-103, 5-106.

[4] UCC § 5-114(1). For a general discussion of rights involved, see J. Dolan, The Law of Letters of Credit: Commercial and Standby Credits (1984); L. Sarna, Letters of Credit: The Law and Current Practice (2d ed. 1986); J. White & R. Summers, Uniform Commercial Code § 18 (2d ed. 1980) (hereinafter White & Summers).

[5] UCC § 5-103. See also Harfield, "Who Does What to Whom: The Letter of Credit Mechanism," 17 UCCLJ 291 (1985).

[6] UCC § 5-116(1).

[7] UCC § 5-116.

[8] See UCC § 5-116, comments 1–3.

so as to give the beneficiary the advantages of being able to rely on the obligation of a local bank. When a bank confirms a credit, it becomes liable for payment of the credit. The UCC provides that a confirming bank engages either that it will itself honor the credit that has been issued or that the credit in fact will be honored by the issuer.[9] The confirmation must be in writing and signed by the confirming bank.[10] Confirmation of a credit is different from merely advising a party that a credit has been issued. Mere notification of the issuance of a credit will not make the bank liable to the beneficiary.[11]

The letter of credit obviously is a useful commercial instrument for assuring payment. It was first used extensively in international transactions in which great distances separated the sellers and the buyers of goods and both parties needed the assurance that could be obtained from a reliable bank that payment would be forthcoming upon proper performance of the underlying contract. The popularity of the letter of credit now extends to purely domestic transactions. A bank may be asked to issue a letter of credit to assure the performance of its customer under domestic sales contracts or other transactions. Letters of credit have been used as substitutes for performance bonds, deposits, and guarantees for the performance of other obligations.[12] One such example is the so-called standby letter of credit, which is issued by a bank to be drawn against only in the event of a default in some underlying contract by the bank's customer.

The letter of credit is a direct obligation of the issuing bank to the beneficiary.[13] With limited exceptions, the issuer must honor demands for payments or drafts drawn that comply with the terms of the credit regardless of whether the underlying contract between the customer and the beneficiary is properly performed.[14] This is because the letter of credit is designed to require payment by the issuer on the basis of the documents presented to the issuer. The standard definition of a letter of credit in the UCC makes it clear that a credit is a letter of credit when the issuer is a bank "if the credit requires a documentary draft or a documentary demand for payment."[15]

The UCC deliberately makes the definition of what constitutes a letter of credit within the scope of Article 5 of the UCC depend upon the nature of the

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[9] UCC § 5-103(1)(f).

[10] UCC § 5-104.

[11] UCC § 5-103(1)(d).

[12] See generally White & Summers, supra note 4, at § 18-1.

[13] UCC §§ 5-103(1)(a), 5-114(1). See generally, Dolan, "Letters of Credit, Article 5 Warranties, Fraud, and the Beneficiary's Certificate," 41 Bus. Law. 347 (1986).

[14] UCC § 5-114(1).

[15] UCC § 5-102(1)(a). Under the UCC, credits conspicuously designated as letters of credit are also treated as letters of credit, thus permitting a flexible definition of the instruments that will be subject to the UCC rules. UCC § 5-102(1)(c). It also applies when the issuer is not a bank if the "credit requires that the draft or demand for payment be accompanied by a document of title. . . ." UCC § 5-102(1)(b).

issuer of the credit. When the issuer is a bank, the policy of the UCC provision is to treat an engagement to pay as a letter of credit "whenever the promise to honor is conditioned on presentation of any piece of paper. . . ."[16] This follows from the definitions used for "documentary draft" and "documentary demand for payment." The UCC defines these as a draft or a demand "honor of which is conditioned upon the presentation of a document or documents." In turn, "document" is defined as "any paper including document of title, security, invoice, certificate, notice of default and the like."[17] Thus, the use of the term "document" with respect to letters of credit is different from and much broader than the definitions of document of title that are used in other articles to refer to bills of lading, warehouse receipts, and the like, as well as from the use of the term "document" in Article 9 on secured transactions, in which it is limited to referring to documents of title.[18]

[1] Scope of UCC Letter of Credit Provisions

The UCC applies to some, not all, letter of credit transactions. International transactions may be governed by other rules.[19] Even more important, New York, which is the home jurisdiction for a large number of banks that issue letters of credit, has added a provision to the UCC that states that the parties may by agreement, course of dealing, or usage of trade make the letter of credit subject to the Uniform Customs and Practices for Commercial Documentary Credits adopted by the International Chamber of Commerce rather than to the UCC.[20] Even when the UCC applies, the UCC makes it clear that it does not purport to codify all aspects of letters of credit. It takes the view that the law of letters of credit is still developing.[21] In this situation, usage of trade and the development of business practices with respect to letters of credit will be important in covering the areas that are not specifically covered by the UCC.[22]

The UCC expressly provides as follows:

> This Article deals with some but not all of the rules and concepts of letters of credit as such rules or concepts have developed prior to this act or may

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[16] UCC § 5-102, comment 1.

[17] UCC § 5-103(1)(b).

[18] UCC § 5-103, comment 2.

[19] For further discussion on international transactions, see ¶ 17.01[4].

[20] The version of UCC § 5-102 adopted by New York, as well as Alabama, Arizona, and Missouri, reads as follows: "Unless otherwise agreed, this Article 5 does not apply to a letter of credit or a credit if by its terms or by agreement, course of dealing or usage of trade such letter of credit or credit is subject in whole or in part to the Uniform Customs and Practice for Commercial Documentary Credits fixed by the Thirteenth or any subsequent Congress of the International Chamber of Commerce."

[21] UCC § 5-102, comment 2.

[22] See generally White & Summers, supra note 4, at § 18-3.

> hereafter develop. The fact that this Article states a rule does not by itself require, imply or negate application of the same or a converse rule to a situation not provided for or to a person not specified by this Article.[23]

The comment to the section just quoted indicates that the drafters believed that in some areas where the law was evolving, it would not be useful to attempt to codify rules that might stultify further development of the letter of credit. The drafters identified some of the important areas not covered by Article 5 as those that "revolve around the question of when documents in fact and in law do or do not comply with the terms of the credit."[24] The drafters offer the following advice in applying the article:

> The rules embodied in the Article can be viewed as those expressing the fundamental theories underlying letters of credit. For this reason the second sentence of subsection (3) makes explicit the court's power to apply a particular rule by analogy to cases not within its terms, or to refrain from doing so. Under § 1-102(1) such application is to follow the canon of liberal interpretation to promote underlying purposes and policies. Since the law of letters of credit is still developing, conscious use of that canon and attention to fundamental theory by the court are peculiarly appropriate.[25]

[2] Form of Letters of Credit

As indicated earlier in this chapter, a letter of credit must be in writing and must be signed by the issuer.[26] A telegram is a sufficient writing if it identifies the sender by an authorized authentication, which may be by a code.[27] No consideration is necessary to establish a credit or to enlarge it or otherwise modify its terms.[28]

Usually the letter of credit is a "documentary" credit that calls for payment against the presentation of specified documents. When the issuer is a bank, a letter of credit may call for payment against any type of document.[29] The document may be a bill of lading, which was the principal document called for in the traditional international letter of credit transaction, but also it can be a

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[23] UCC § 5-102(3).

[24] UCC § 5-102, comment 2. The comment also refers to minor matters such as "the absence of expiration dates and the effect of extending shipment but not expiration dates," which the article leaves to future adjudication. Id.

[25] UCC § 5-102, comment 2.

[26] UCC § 5-104(1).

[27] UCC § 5-104(2).

[28] UCC § 5-105.

[29] UCC § 5-102(1)(a). The definition of "document" is discussed in ¶ 17.01.

warehouse receipt, an inspection certificate, or a certificate of performance.[30] When the issuer is a party other than a bank, the credit will be viewed as a letter of credit when the documents are documents of title—bills of lading, warehouse receipts, and the like.[31]

The UCC also permits the parties to establish a letter of credit obligation that does not fall within the guidelines described earlier as long as the obligation conspicuously designates the credit as a letter of credit.[32] This permits the issuance of a "clean" letter of credit that does not condition payment upon presentation of documents and gives the parties flexibility in structuring letter of credit arrangements to meet their commercial needs.[33]

The letter of credit must be distinguished from guarantees, which are agreements to make advances and other arrangements.[34] The UCC provides that Article 5 on letters of credit does not apply to these other forms of transactions unless the requirements discussed earlier are satisfied.[35] Thus, at least in part, the form of the transaction will determine whether Article 5 governs. If it does, the legal consequences will be quite different from those that would apply if the transaction were treated as one of a simple guarantee or a third party beneficiary contract.[36]

A letter of credit may be either a "notation credit" or a "straight" letter of credit. The notation credit is used when it is expected that a number of separate payments will be made under the credit. Persons who receive drafts drawn against the credit from the beneficiary or otherwise pay the beneficiary on the strength of the credit are required to make a notation on the letter of credit as to the amount they have paid or drawn.[37] In this fashion, subsequent persons who deal with the beneficiary on the strength of the letter of credit will know the amount of credit that remains to be drawn against. Failure of the person to note the amount paid or drawn on the letter of credit makes the person liable in damages to the bank issuing the credit if any loss occurs as a result of the failure to make the notation.[38] An early example of this type of letter of credit was the

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[30] UCC § 5-102(1)(a) & comment 1. See New Jersey Bank v. Palladino, 77 NJ 33, 38–39, 389 A2d 454, 459–460 (1978), for a discussion of what writings constitute a sufficient documentary demand.

[31] UCC § 5-102(1)(b).

[32] UCC § 5-102(1)(c). "Credit" is defined by the UCC as "an engagement by a bank or other person made at the request of a customer and [otherwise within Article 5]... that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit." UCC § 5-103(1)(a).

[33] See UCC § 5-102, comment 1.

[34] See discussion at ¶ 17.01[3].

[35] UCC § 5-102(2).

[36] See ¶ 17.01[3].

[37] UCC §§ 5-108(1), 5-108(2).

[38] UCC § 5-108(2)(a).

traveler's letter of credit, which was given to a traveling purchaser who had a number of people from whom he expected to purchase goods.[39] When a notation letter of credit is used, the issuing bank may justifiably refuse to pay any drafts drawn against it until it receives evidence of notation on the letter of credit.[40]

Letters of credit may be either revocable or irrevocable, although usually the parties will want the credit to be in irrevocable form. If the letter is irrevocable, the issuer cannot revoke the credit or refuse to honor drafts after the credit has been sent to the customer or the beneficiary, or after authorized written advice of its issuance has been given to the beneficiary.[41] If the credit is revocable, the issuer may modify or revoke it without the consent of the customer or the beneficiary.[42] The letter of credit should state whether it is revocable or irrevocable. The UCC does not provide a rule for interpretation if the credit is silent on the matter.

[3] Letters of Credit Are Not Guarantees

A letter of credit in legal form is neither a guarantee nor a third party beneficiary contract. If it were, knowledge of the existence of defenses and claims in the underlying contract between the customer and the beneficiary might be available to the bank as issuer and justify the bank's refusing payment to the beneficiary. Under the letter of credit, the bank has a direct obligation to pay regardless of the underlying contract between the customer and the beneficiary as long as the documents presented satisfy the terms of the credit.[43]

The expanded role of the letter of credit gives rise to legal problems at times. Some of the transactions in which letters of credit are used closely resemble guarantee transactions. If the credit is characterized as a guarantee, the issuing bank could refuse payment because of defects in performance of the underlying contract; such a result destroys the fundamental understanding of the letter of credit as an obligation undertaken by the issuing bank that is independent of the underlying commercial contract. Also, it may result in complications for those depository institutions that are prohibited by banking regulations from guaranteeing their customers' obligations.[44] Litigation on the question of whether a

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[39] See UCC § 5-108, comment 2.

[40] UCC § 5-108(2)(b).

[41] UCC § 5-106. Language in a letter of credit stating that it shall "remain in force" was sufficient to make the letter of credit irrevocable for the period of time stated under the Uniform Customs and Practice for Documentary Credits. Conoco, Inc. v. Norwest Bank, 767 F2d 470–471 (8th Cir. 1985).

[42] UCC § 5-106.

[43] For further discussion of the bank's obligation to pay, see ¶ 17.02[2].

[44] See New Jersey Bank v. Palladino, 77 NJ 33, 37, 389 A2d 454, 458 (1978).

letter of credit constitutes a guarantee has been extensive, and the specific facts of each transaction must be carefully examined.[45]

From the bank's standpoint, questions may also arise as to whether letters of credit should be viewed as extensions of credit subject to loan limits, restrictions on loans to affiliates, and limitations on loans to single borrowers.[46]

[4] International Letters of Credit and the Uniform Customs

Since the UCC is the law of the state that enacts it, it does not apply to all aspects of international letters of credit. Here, the laws of many countries may be involved because the buyer, the seller of goods, and the financing banks may be located in different nations; therefore, usages of the trade may be the basis of the ultimate rules of law. These customs have been authoritatively collected by the International Chamber of Commerce in a document known as the Uniform

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[45] In FDIC v. Freudenfeld, 492 F. Supp. 763, 768 (ED Wis. 1980), the court held that a standby letter of credit issued by a national bank was not a bank guarantee that violated the provisions of the National Bank Act against national banks' guaranteeing debts. (See the discussion of the powers of national banks at ¶ 4.03[2][d].) The court further held that even if the bank violated the provision against guaranteeing debts by issuing the standby letter of credit, only the United States had standing to challenge the bank for its *ultra vires* action.

In another case, a federal district court upheld a program initiated by Citibank to provide standby credits to back the payment of municipal bonds. The insurance association challenged the program, contending that it amounted to selling insurance, an activity not permitted national banks, and that the program was an illegal bank guarantee. The court rejected these contentions, saying the credits were standby letters of credit. American Ins. Ass'n v. Clarke, 656 F. Supp. 404, 408–411 (DDC 1987).

See Bank of N.C. v. Rock Island Bank, 570 F2d 202 (7th Cir. 1978); Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 493 F2d 1285 (9th Cir. 1974); Dubuque Packing Co. v. Fitzgibbon, 599 P2d 440 (Okla. Ct. App. 1979); Republic Nat'l Bank v. Northwest Nat'l Bank, 566 SW2d 358 (Tex. Civ. App. 1978), rev'd on other grounds 578 SW2d 109 (Tex. 1978). See generally KMW Int'l v. Chase Manhattan Bank, 606 F2d 10 (2d Cir. 1979); Barclays Bank v. Mercantile Nat'l Bank, 481 F2d 1224 (5th Cir. 1973), cert. dismissed 414 US 1139 (1974); United Technologies Corp. v. Citibank, 469 F. Supp. 473 (SDNY 1979); American Bell Int'l v. Islamic Republic of Iran, 474 F. Supp. 420 (SDNY 1979). Examples of standby letters of credit may be found in National Surety Corp. v. Midland Bank & Trust Co., 408 F. Supp. 684 (DNJ 1976), rev'd 551 F2d 21 (3d Cir. 1977); Beathard v. Chicago Football Club, Inc., 419 F. Supp. 1133 (ND Ill. 1976); Prudential Ins. Co. v. Marquette Nat'l Bank, 419 F. Supp. 734 (D. Minn. 1976).

[46] Standby letters of credit are subject to the lending limitations of the National Bank Act for national banks. 12 USC § 84(c)(2) (1982); 12 CFR §§ 32.2(e), 32.3 (1988). See the discussion in ¶ 7.01[2]. See also International Dairy Queen, Inc. v. Bank of Wadley, 407 F. Supp. 1270, 1271 (MD Ala. 1976). See generally Arnold & Bransilver, "The Standby Letter of Credit," 10 UCCLJ 272 (1978); Verkuil, "Bank Solvency and Guaranty Letters of Credit," 25 Stan. L. Rev. 716 (1973).

Customs and Practices for Commercial Documentary Credits,[47] mentioned earlier in this chapter. Most standard forms used for letters of credit in international trade have a clause in the terms of the letter that refers to and incorporates the Uniform Customs. Although letters of credit under the Uniform Customs function similarly to those under the UCC, some differences exist. The Uniform Customs also may be evidence of trade usage, which can supplement the rules set out in the UCC.[48]

Although the Uniform Customs may apply, the UCC letter of credit provisions are not necessarily irrelevant. In areas in which the Uniform Customs do not supply an answer or where interpretation is required, a court may look to the UCC for a statement of policies and applicable law. Because the UCC represents the continuation of the development of rules of law pertaining to letters of credit that began many years prior to the UCC, this law should continue to be relevant in instances in which there is no conflict with the provisions of the Uniform Customs in the same way that the case law prior to the UCC was relevant to transactions under the Uniform Customs.[49]

¶ 17.02 OBLIGATIONS OF AN ISSUER OF A LETTER OF CREDIT

The issuer of a letter of credit has an obligation to its customer to make payment in accordance with the terms of the letter of credit. The issuer also has an obligation to the beneficiary of the letter of credit to make payment to the beneficiary when the beneficiary complies with the terms.

[1] Issuer's Obligation to Its Customer

A letter of credit will ordinarily be used to further a commercial contract between the issuing bank's customer and the beneficiary. The issuing bank has no responsibility for any performance of the underlying contract between the

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[47] See International Chamber of Commerce, Uniform Customs and Practice for Documentary Credits (rev. ed. 1983). See also Byrne, "The 1983 Revision of the Uniform Customs and Practice for Documentary Credits," 102 Banking LJ 151 (1985).

[48] See Gewolb, "The Law Applicable to International Letters of Credit," 11 Vill. L. Rev. 742 (1966). See also generally, Armstrong, "Letters of Credit in East-West Trade: Soviet Reception of Capitalist Custom," 17 Vand. J. Transnat'l L. 329 (1984); Flax-Davidson, "The ALADI Treaty and Letter of Credit Transactions in Latin America," 19 Int'l Law. 1303 (1985); Leacock, "Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions," 17 Vand. J. Transnat'l L. 885 (1984); Saunders, "Letters of Credit in International Transactions," 102 Banking LJ 361 (1985).

[49] See White & Summers, supra note 4, at § 18-3; United Bank Ltd. v. Cambridge Sporting Goods Corp., 41 NY2d 254, 258–260, 392 NYS2d 265, 269–271, 360 NE2d 943, 947–949 (1976).

customer and the beneficiary,[50] but it does have responsibility for examining the documents presented to ensure that they comply with the terms of the letter of credit. As against its customer, the issuing bank must act in good faith, observe general banking practices, and follow the terms of the letter of credit agreement.[51] The bank does not have to engage in any investigation of the performance of the underlying contract or inspect the goods that are represented by the documents, but it must carefully examine the documents to ascertain that "on their face they appear to comply with the terms of the credit".[52] Subject to a contrary agreement, the bank assumes no responsibility for the genuineness or falseness of documents that appear to the bank to be regular on their face, as long as the bank has no notice of irregularity.[53]

When drafts or other documents are sent for collection, the bank will not be responsible for the acts of other parties. If documents are lost in transit, the bank is not liable.[54]

The issuing bank may be liable to its customer for wrongfully dishonoring drafts drawn against the credit.[55] However, when a documentary draft or demand for payment under a letter of credit is made, the bank has until the third banking day after receipt of the documents to pay.[56] The delay will not constitute dishonor. If the person who presents the documents "expressly or impliedly" consents, the bank may delay payment further.

When the bank properly pays a draft under a letter of credit, it has a right to immediate reimbursement from its customer.[57] When the bank accepts a draft

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[50] UCC § 5-109(1). For a statement of this view in the law prior to the UCC, see Maurice O'Meara Co. v. National Park Bank, 239 NY 386, 389, 146 NE 636, 639 (1925).

[51] UCC § 5-109(1).

[52] UCC § 5-109(2). A bank that paid drafts drawn on an expired letter of credit was not entitled to recover from its customer for unjust enrichment. City Nat'l Bank v. Westland Towers Apartments, 152 Mich. App. 136, 139–140, 393 NW2d 554, 557–558 (1986), appeal denied, 428 Mich. 885 (1987).

[53] UCC § 5-109(2). See UCC § 5-114(2).

[54] UCC § 5-109(1)(b).

[55] UCC § 4-402. The issuer of a letter of credit may become liable for anticipatory breach, as well as for wrongful dishonor of drafts drawn under the letter of credit, when the issuer repudiates its obligation to pay and refuses to pay subsequently submitted drafts. Atari, Inc. v. Harris Trust & Sav. Bank, 599 F. Supp. 592, 599–600 (ND Ill. 1984), aff'd in part mem. & rev'd in part mem., 785 F2d 312 (7th Cir. 1986).

[56] UCC § 5-112.

[57] UCC § 5-114(3). In Northern Trust Co. v. Oxford Speaker Co., 109 Ill. App. 3d 433, 436–438, 440 NE2d 968, 971–973 (1982), the court held that the seller of goods who was to be paid in a documentary transaction arranged by the seller's bank could raise equitable defenses, such as waiver and estoppel, when the transaction broke down and the bank sought to recover from the seller. The bank sued its customer, the seller, as drawer of the draft and under the bank's right to charge back uncollected instruments to its customer. The court held that advice and assurances from the bank to the seller, which encouraged the seller, who was unfamiliar with documentary transactions, to enter the deal, raised

under the credit, it is entitled to be given funds for payment "not later than the day before maturity" of the acceptance.[58]

[2] Issuer's Obligation to Pay the Beneficiary

The issuing bank must honor drafts drawn against a letter of credit or other demands for payment when they comply with the terms of the credit.[59] As previously indicated, the bank's duty to pay arises when the terms of the documents presented on their face comply with the terms of the credit.[60] Apart from the exceptions discussed in the next subsection, the bank has no right to refuse payment to one otherwise entitled to payment on the grounds that the underlying contract for sale, or other contract, between the customer and the beneficiary has not been properly performed.[61]

Although these rules are easily stated, troublesome legal questions can arise as to whether there has been compliance with the terms of the credit. Some courts have applied a strict test.[62] Questions of waiver, estoppel, and cure can arise.[63]

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issues as to whether the bank should be estopped from claiming its right to repayment. By advising the seller that the seller's documentation complied with the terms of the letter of credit, an issue also arose of waiver of the bank's right to recover for losses caused by defects in the documentary arrangements.

[58] UCC § 5-114(3).

[59] UCC § 5-114(1).

[60] UCC §§ 5-109, 5-114(2).

[61] UCC § 5-114(1).

[62] See Marine Midland Grace Trust Co. v. Banco del Pais, S.A., 261 F. Supp. 884, 889 (SDNY 1966). See generally White & Summers, supra note 4, at § 18-6.

The strict approach was followed in Courtaulds N. Am., Inc. v. North Carolina Nat'l Bank, 528 F2d 802, 806 (4th Cir. 1975), where the court held that the bank should not have paid a letter of credit that provided that drafts presented for payment had to be accompanied by an invoice describing the goods as "100% acrylic yarn" when the invoice submitted only stated that the goods were "imported acrylic yarn" even though it could be determined from packing lists stapled to the invoice that the yarn was 100 percent acrylic. On the other hand, in Transamerica Delaval, Inc. v. Citibank, 545 F. Supp. 200, 204 (SDNY 1982), involving a dispute between the customer and the issuing bank over whether the bank's payment was wrongful, the court held that a standard of "substantial compliance" should prevail. In this case, the bank could proceed reasonably to determine what constituted compliance with the letter of credit because the bank's customer had failed to provide precise specifications.

The demand for payment by the beneficiary under a letter of credit must comply with the dates specified in the letter of credit. Where a letter provided that it expired on April 7, 1980, but the draft and accompanying documents drawn against the letter did not arrive until April 11, 1980, four days late, the issuing bank was justified in refusing to pay even though the draft had been sent prior to the expiration date and had been delayed in the mail. The court rejected the argument that the normal grounds for excusing delay in presenting negotiable instruments for payments should apply to letter of credit transactions. The court reasoned that the value of the letter of credit depended upon the ability of the issuer to

[a] Indemnities. Parties seeking payment under a letter of credit commonly offer indemnities when a question arises as to minor variations between the documents presented for payment and the terms of the letter of credit. The UCC recognizes the use of indemnities as an appropriate practice. For example, the sales provisions allow a seller to tender less than a full set of bills of lading in overseas shipment transactions without breaching the underlying sales contract by furnishing an indemnity.[64] Although such practice determines the rights between the buyer and the seller on their contract, it does not bind the bank that

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precisely assess its risk on the letter of credit by evaluating the letter's terms and specifying the conditions for payment. The court thus rejected the argument that UCC § 5-102 should be viewed as incorporating UCC § 3-511(1) in the general law governing letters of credit. Moreover, the court found that the Uniform Customs and Practices for Documentary Credits applied and that those rules expressed a policy of placing the risk of delays due to acts of God and other causes on the beneficiary, not the issuer, of the letter of credit. Consolidated Aluminum Corp. v. Bank of Va., 544 F. Supp. 386, 400–402 (D. Md. 1982), aff'd, 704 F2d 136 (4th Cir. 1983).

In Beckman Cotton Co. v. First Nat'l Bank, 34 UCC Rep. Serv. (Callaghan) 966, 969 (ND Ga. 1982), on the other hand, the court held that a bank issuing a letter of credit with an expiration date of Sunday, October 30, wrongfully dishonored drafts that were presented on Monday, October 31, when the beneficiary had called the bank in advance regarding presentment of the draft and a bank officer had consented to presentment on October 31.

When the terms of a letter of credit call for "full set clean on board bills of lading," the mode of shipment must be ocean shipment and transportation of the goods by air does not comply with the letter. "The issuer of a letter of credit should not be placed in the position of having to determine whether an unauthorized method of shipment is material." Board of Trade v. Swiss Credit Bank, 728 F2d 1241, 1243 (9th Cir. 1984).

An issuing bank wrongfully refused to pay a draft drawn under a letter of credit when the letter of credit required the draft to state "drawn under . . . Letter of Credit Number 105 . . . " and the draft stated "letter of Credit No. 105 . . . " (Changing "L" to "l" and "Number" to "No."). Tosco Corp. v. FDIC, 723 F2d 1242, 1247–1248 (6th Cir. 1983).

In Banque Paribas v. Hamilton Indus. Int'l, Inc., 767 F2d 380, 383 (7th Cir. 1985), the court determined that it was inappropriate to resolve on summary judgment whether the conditions required for payment of a standby letter of credit had been performed.

See also generally, Dolan, "Strict Compliance With Letters of Credit: Striking a Fair Balance," 102 Banking LJ 18 (1985); Notes, "Letters of Credit: The Role of Issuer Discretion in Determining Documentary Compliance," 53 Fordham L. Rev. 1519 (1985); "Letters of Credit: A Return to the Historical Documentary Compliance Standard," 46 U. Pitt. L. Rev. 457 (1985).

[63] For a case where the court held that the beneficiary was entitled to go to trial on the issue of whether a confirming bank under a letter of credit had waived strict compliance with the terms of the letter of credit, see Voest-Alpine Int'l Corp. v. Chase Manhattan Bank, 707 F2d 680, 685–686 (2d. Cir. 1983). The court noted that care must be taken in finding waiver because such a finding could jeopardize the bank's ability to obtain reimbursement from its customer.

[64] UCC § 2-323(2).

is obligated as the issuer of the letter of credit.[65] A bank is permitted to offer indemnities both for itself and for the benefit of another person in order to encourage the honor of a letter of credit, negotiation of drafts under a letter of credit, or reimbursement.[66] When such an indemnity agreement is made, unless it otherwise expressly provides, the agreement to indemnify is limited to "defects in the documents but not in the goods" and the agreement "expires at the end of ten business days following receipt of the documents by the ultimate customer" unless notice is sent before the expiration date.[67] This provision does not require any issuer to accept an offer of indemnity. The comments make clear that "[t]he question whether a particular banking usage may require honor of documentary drafts accompanied by indemnities for particular defects goes to the meaning of the terms of the credit and is beyond the scope of this section."[68]

There are three limited exceptions to the issuing bank's duty to pay when presented with documents that appear on their face to conform to the credit. These exceptions are (1) when the documents presented are not genuine or are invalid or there is no right to transfer them; (2) when the documents are forged or fraudulent; and (3) when there is "fraud in the transaction. . . ."[69] Even in these situations, the issuer must honor the drafts presented when they are presented by persons who are in the position of a holder in due course.[70] Moreover, the bank does not have to become embroiled in controversies with its customers over whether it should pay. If the bank acts in good faith, it is free to honor drafts drawn notwithstanding notification from the customer of fraud, forgery, or other defects until the customer enjoins payment in an appropriate court.[71]

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[65] UCC § 2-323, comment 2.

[66] UCC § 5-113(1).

[67] UCC § 5-113(2).

[68] UCC § 5-113, comment 4. The comment cites Dixon, Irmaos & Cia, Ltda. v. Chase Nat'l Bank, 144 F2d 759, 762 (2d Cir. 1944), cert. denied, 324 US 850 (1945), where the court found a banking usage to accept indemnities under certain circumstances. The comment states that a determination that applicable usage makes a demand for payment with an offer of indemnity one which complies with the terms of the credit is a decision that "rest[s] on the implications of the usage rather than on breach of the issuer's duty" under the UCC § 5-113, comment 4.

[69] UCC § 5-114(2).

[70] Id.

[71] UCC § 5-114(2)(b). Although the customer gives the issuing bank notice of fraud in the underlying transaction, the bank may pay drafts drawn on the letters of credit if it acts in good faith unless the customer obtains a court order enjoining payment under UCC § 5-114(2). W.O.A., Inc. v. City Nat'l Bank, 640 F. Supp. 1157, 1159 (WD Ark. 1986). See also Annot., "What Constitutes Fraud or Forgery Justifying Refusal to Honor, or Injunction Against Honoring Letter of Credit Under UCC § 5-114(1)(2)," 25 ALR4th 239 (1983); Rosenblith, "What Happens When Operations Go Wrong: Enjoining the Letter of Credit Transaction and Other Legal Strategems," 17 UCCLJ 307 (1985); Thorup, "Injunctions Against Payment of Standby Letters of Credit: How Can Banks Best Protect Themselves," 101 Banking LJ 6 (1984).

Needless to say, what constitutes "fraud in the transaction" is not always clear;[72] nor is it always clear what circumstances will bring the other exceptions into play. In these cases, if the bank acts in good faith, it may pay unless the customer obtains a court order enjoining the payment.

If the issuer of a letter of credit can refuse to pay the beneficiary of the letter on the ground that a breach of the underlying contract between the beneficiary and the customer has occurred, the usefulness of the letter of credit will be impaired. Beneficiaries will not be able to rely upon issuance of the letter as assurance of payment upon compliance with the terms of the letter.

[b] Relationship of Letter of Credit to the Underlying Contract. Although the issuance of a letter of credit does not, by itself, eliminate the rights that the parties to the underlying transaction may have based upon their contract, it does shift some of the risks and burdens. When a letter of credit is used as the method for payment under a contract for the sale of goods, the seller is assured that the risk of litigation over the adequacy of the seller's performance will be thrust upon the buyer, because the seller will get paid under the letter of credit and the buyer will be forced to pursue the seller to enforce the buyer's rights under the contract.[73] When problems arise, buyers and other customers who have procured

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[72] See Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 722, 31 NYS2d 631, 634 (Sup. Ct. 1941), which found fraud in a case where documents called for the shipment of bristles but the material shipped was rubbish. See also Note, "UCC—Letters of Credit and 'Fraud' in the Transaction," 60 Tul. L. Rev. 1088 (1986).

[73] Recovery from one who has fraudulently obtained payment of a letter of credit can be significant. When a person drew funds under a standby letter of credit without having a basis for believing that any amounts under the letter of credit were owed, the person was found liable for both fraud in falsely certifying that payment was owed and fraud in the transaction. This person was held liable for the payments received, as well as for substantial punitive damages. Emery-Waterhouse Co. v. Rhode Island Hosp. Trust Nat'l Bank, 757 F2d 399, 404–405, 408 (1st Cir. 1985). See also Note, "Letters of Credit Litigation—Bank Liability For Punitive Damages," 54 Fordham L. Rev. 905 (1986).

The plaintiff-customer arranged for a letter of credit to be issued in favor of a bank in Saudi Arabia as part of a contract with a Saudi refinery. When a dispute arose, the bank demanded payment under the letter of credit. The plaintiff sued to enjoin payment, claiming the demand was fraudulent. The court held that a preliminary injunction against payment was improper because there is no "irreparable injury where only money is at stake and where there is a satisfactory remedy at law. . . ." The parties had contracted for their disputes to be resolved under Saudi law, using Saudi arbitration. Moreover, suit could be brought in federal court to recover for any harm caused by the fraudulent demand for payment of the letter of credit. Under the contract, irreparable harm could not be posited on the buyer to obtain an unfair advantage using payment of the letter of credit; that advantage was already contemplated by the arrangements in the contract. The plaintiff also could not claim irreparable injury to its credit and business reputation from the payment of the letter of credit on the theory that obtaining letters of credit in the future would become more expensive. Failure to obtain an injunction should not reflect adversely on the plaintiff's reputation, because obtaining such an injunction is an

the issuance of a letter of credit sometimes seek to avoid this result by enjoining payment. UCC § 5-114(2) gives the customer a right to enjoin payment only in very limited circumstances. Nevertheless, an extensive case law dictates when it is proper to enjoin payment and how strict the standard for granting an injunction should be.[74]

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extraordinary remedy that is rarely granted. Foxboro Co. v. Arabian Am. Oil Co., 805 F2d 34, 36–37 (1st Cir. 1986).

[74] A court may enjoin payment under a letter of credit when there is fraud in the documentation required to be presented. In Griffin Co. v. First Nat'l Bank, 374 NW2d 768, 771 (Minn. Ct. App. 1985), the court held that fraudulent certification by the beneficiary of the letter, stating that funds drawn under the letter were due the beneficiary, would entitle the customer to enjoin payment to a person who was not a holder in due course. Furthermore, the court could enter a preliminary injunction to preserve the status quo pending determination of the circumstances.

Fraud in the transaction entitling a court to enjoin payment of a letter of credit under UCC § 5-114(2)(b) exists when the beneficiary has "no plausible or colorable basis under the contract to call for payment" of the letters. Itek Corp. v. First Nat'l Bank, 730 F2d 19, 25 (1st Cir. 1984). In *Itek* the Court held that the circumstances justified enjoining payment of a letter of credit to a bank in Iran. The letters of credit were given to reimburse the Iranian bank if it was called upon to make good on guarantees it had made on a contract. The court said that the plaintiff did not have an adequate remedy to sue to recover the money because that claim would have to be pursued in an Iranian court. The court then found fraud in the transaction. See also Verner, " 'Fraud in the Transaction': Intraworld Comes of Age in Itek," 14 Memphis St. UL Rev. 153 (1984).

In Wyle v. Bank Melli, 577 F. Supp. 1148, 1163–1166 (ND Cal. 1983), the court enjoined payment on a letter of credit that provided that payment would be made on a simple demand for payment by the beneficiary without requiring any proof of entitlement to payment. In this case the beneficiary was an Iranian bank. The court concluded that there was no basis that would justify paying under the letter of credit, so the demand for payment was fraudulent. However, this fraud involved the customer of the Iranian bank, not the bank itself. The court held that the Iranian bank should have known that the claim of its customer against it for payment was fraudulent, and that it therefore did not have the status of a holder in due course with respect to the claim it was presenting against the issuing bank for payment on the letter of credit. For another case where the court enjoined payment of a letter of credit because of fraud in the transaction, see Rockwell Int'l Sys., Inc. v. Citibank, 719 F2d 583 (2d Cir. 1983).

An intermediate appellate court in Louisiana concluded that the phrase "fraud in the transaction" contained in UCC § 5-114(2) refers to fraud in the letter of credit transaction between the issuing bank and the beneficiary of the letter of credit and not to the underlying transaction between the parties to the deal for which the letter was issued. Cromwell v. Commerce & Energy Bank, 450 So2d 1, 9 (La. Ct. App. 1984), aff'd in part & rev'd in part, 464 So2d 721 (La. 1985).

In Originala Petroleum Corp. v. Beta Fin. & Invs. Corp., 39 Bankr. 1003, 1015 (Bankr. ND Tex 1984), the court refused to enjoin payment under a letter of credit. The court believed the purpose of the letter of credit would be destroyed if any controversy regarding the validity of the underlying transaction could serve as grounds for the issuance of an injunction. 39 Bankr. at 1008.

In a case involving a standby letter of credit, the court held that the bank issuing the letter of credit breached its undertaking to pay by refusing to pay the beneficiary on

The court granted an injunction in *Harris Corp. v. National Iranian Radio & Television*.[75] The case involved radio transmitters the seller had sold to a buyer in Iran. The seller had been paid in advance but had given the buyer a standby letter of credit to guarantee performance of the contract. The seller was not able to perform the contract because of the Iranian revolution. The underlying contract between the buyer and the seller recognized this event as cause for termination of the seller's obligation, but the government of Iran demanded that the letter of credit be paid because of the non-performance of the seller. The court held that the buyer's action suggested a fraudulent effort to obtain an undeserved benefit from the seller because the buyer must have known that the failure to perform did not constitute a breach of contract. Having found fraud in the transaction, the court granted a preliminary injunction against payment. In California, on the other hand, a customer cannot enjoin payment of a letter of credit even on the ground of fraud.[76]

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ground of fraud. The opinion of the court contains a good discussion of the distinctions among fraud in the transaction (meaning the underlying commercial transaction between the customer and the beneficiary); fraud in the inducement (fraud that leads the bank to issue the letter of credit because of false representations made by the beneficiary); and fraud in the documents presented to the issuer of the credit in order to obtain payment. Tem-Tex Prods., Inc. v. Capital Bank & Trust Co., 623 F. Supp. 816, 821–822 (MD La. 1985), aff'd, 788 F2d 1563 (5th Cir. 1986).

Customers sued banks that issued letters of credit and the beneficiaries of the letters to enjoin payment of the credits for fraud in the underlying transaction. Because the plaintiffs and the issuing banks were adverse parties in this suit, there could be no jurisdiction based on diversity of citizenship unless there was complete diversity between the plaintiffs and the defendant banks. W.O.A., Inc. v. City Nat'l Bank, 640 F. Supp. 1157, 1159 (WD Ark. 1986).

See generally, Note, "Enjoining the Suicide Letter of Credit," 17 Willamette L. Rev. 253 (1980).

[75] 691 F2d 1344, 1356–1358 (11th Cir. 1982). See also Kimball & Sanders, "Preventing Wrongful Payment of Guarantee Letters of Credit—Lessons From Iran," 39 Bus. Law. 417 (1984).

[76] Agnew v. FDIC, 548 F. Supp. 1234, 1238 (ND Cal. 1982). The California version of UCC § 5-114 deletes the provision that "a court of appropriate jurisdiction may enjoin such honor" of a letter of credit for fraud, forgery, and the like. However, a California court has held that this section refers to the duty of the issuer of the letter of credit to honor payment demands. Under California law, it is possible to enjoin the beneficiary from attempting to draw under the credit. To do so, however, the complainant must show irreparable injury if the injunction is not granted. Mitsui Mfrs. Bank v. Texas Commerce Bank, 159 Cal. App. 3d 1051, 206 Cal. Rptr. 218, 222–223 (1984). In Wyle v. Bank Melli, 577 F. Supp. 1148, 1161 (ND Cal. 1983), the court followed a similar interpretation and suggested that an unusual case was presented when both the beneficiary was subject to jurisdiction before the court and the courts in Iran were closed to the American interests involved.

An Illinois court declined to draw a distinction between enjoining the issuer of a letter of credit from paying under the letter of credit and enjoining the beneficiary of the credit from drawing under the letter of credit. Jupiter Orrington Corp. v. Zweifel, 127 Ill. App.

A bank may become liable on a letter of credit by confirming a credit issued by another bank, under UCC § 5-107(2). In a case involving a letter of credit issued by a bank in Venezuela for a Venezuelan customer to pay for tires purchased from a seller in Louisiana, the liability of a confirming bank was at issue. A bank in Louisiana confirmed the letter of credit. In a suit against the confirming bank, the buyer claimed that the bank had failed to perform its duty of examining the documents required for payment under the credit. The court held that the confirming bank did not owe a duty of care to the buyer because the bank's duty ran to its customer, the issuing bank in Venezuela. The buyer's remedy, the court held, was against the issuing bank for its failure to exercise the proper standard of care.[77]

The customer's power to enjoin payment of a letter of credit for fraud in the underlying transaction ends once the issuing bank has accepted drafts drawn against the letter of credit, according to the New York Court of Appeals. UCC § 4-303 provides that the legal process cannot be used to affect the bank's duty to pay if the process comes after the bank has accepted the item. In the view of the court, this provision was entitled to prevail over Section 5-114(2)(b), which gave the customer a method of stopping payment when the customer could show fraud in the transaction.[78]

[3] Standby Letters of Credit

The preceding discussion does not expressly distinguish between the obligation to pay under the traditional letter of credit used in a sales transaction and the obligation to pay under the standby letter of credit. The issuer's obligation to pay when the demand meets the terms of the letter of credit is in form the same and is based upon the same legal authority in the UCC.[79] The function of the standby letter of credit, however, differs sharply from the traditional letter of credit. In the traditional letter of credit transaction, the buyer of the goods has arranged for the issuance of the credit. The issuer of the credit anticipates that the seller will draw on the credit. The issuer usually obtains a security interest in the goods as a result of having made an advance and of being in possession of

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3d 559, 562, 469 NE2d 590, 593 (1984). The court reasoned that permitting issuance of an injunction against the beneficiary to prevent the presentation of drafts against the credit "would be tantamount to allowing a party to accomplish indirectly that which he is forbidden to do directly."

[77] Auto Servicio San Ignacio, S.R.L. v. Compania Anonima Venezolana de Navegacion, 765 F2d 1306, 1308 (5th Cir. 1985).

[78] First Commercial Bank v. Gotham Originals, Inc., 64 NY2d 287, 292, 475 NE2d 1255, 1260, 486 NYS2d 715, 720 (1985).

[79] UCC § 5-114(1). See generally, Notes, "The Standby Letter of Credit: What It Is and How To Use It," 45 Mont. L. Rev. 71 (1984); "The Independence Rule in Standby Letters of Credit," 52 U. Chi. L. Rev. 218 (1985); "Standby Letters of Credit: Are They Insured Deposits?" 32 Wayne L. Rev. 1165 (1986).

documents of title that are turned over to the issuer when the seller presents the draft. The issuing bank will be reimbursed by the buyer in the normal course of business. As the buyer will have the goods for resale or other purposes, the buyer anticipates generating revenues as a result of the transaction that ultimately may be the source of reimbursement for the issuing bank.

The standby letter of credit transaction works differently from the traditional transaction. In the standby letter of credit transaction, the letter of credit is a backup that is available to one of the parties in the event that something goes wrong with the transaction. The standby letter of credit is an assurance of performance from the bank that issues the letter of credit when the contemplated performance of the underlying contract, whatever that might be, between the beneficiary of the credit and the beneficiary's counter party, who normally is the customer for whom the bank issued the letter of credit, fails. For example, in *Harris Corp.*,[80] the buyer paid the seller in advance. To ensure the seller's performance, the seller gave a standby letter of credit to the buyer. The buyer was entitled to draw on the credit if the seller failed to perform. Using a letter of credit in this way contemplates that the beneficiary will never draw against the letter of credit if the underlying contract is properly performed.

The problems in the *Harris Corp.* case also illustrate two of the risks with the standby letter of credit. The first is the risk of a demand for payment under the letter of credit that is fraudulent or that is made even though the beneficiary may not have a right under the underlying contract to make such a demand. Because the bank that issued the letter of credit will not be interested in determining whether the underlying contract has been performed as a condition to deciding when to pay under the letter of credit, the terms of the letter of credit will authorize payment when proper documents or certification are presented to the bank. In some cases, this documentation may be a simple demand for payment. In other cases, the terms of the letter of credit may require documents that include certification by third parties, such as an architect, of completed performance. The terms for payment that the parties stipulate in the letter of credit, thus, are critical. They may have an important bearing on the extent to which the customer who arranges the letter of credit will have to bear risks associated with the beneficiary making an improper demand or a demand that may be a matter of dispute between the parties because of disagreements that arise subsequently as to the performance of the underlying contract.

Second, when the beneficiary makes a demand under a standby letter of credit and the issuer pays, the risks of contracting for the underlying transaction are dramatically altered. The customer now must bring suit against the beneficiary if the customer believes that the beneficiary is liable for breach of the underlying contract or other obligations. Having given the standby letter of

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[80] Harris Corp. v. National Iranian Radio & Television, 691 F2d 1344, 1346–1349 (11th Cir. 1982). For further discussion of this case, see ¶ 17.02[2].

credit, the customer is no longer in the position of dealing with contract disputes by withholding performance of the underlying contract. Moreover, since the bank that pays on the standby letter of credit will look to its customer for reimbursement, the customer may be in the position of having expended substantial funds in the course of performing the underlying contract and having to also pay the bank to reimburse the issuer for payment to the beneficiary.

Because of risks such as these associated with the standby letter of credit, a substantial body of litigation addresses when a customer may enjoin payment under a letter of credit.[81] As indicated in the preceding subsection, a common contention is that making a demand for payment under a standby letter of credit when the beneficiary knows that the underlying contract does not entitle the beneficiary to obtain payment is a fraudulent demand that should be enjoinable under UCC § 5-114(2). This argument must be treated cautiously, however, because it involves the court in making a determination as to the performance of the underlying contract in the course of deciding whether to enjoin payment of the letter of credit. The purpose of the letter of credit, in its traditional role, is to assure payment without inquiry into issues relating to performance of the underlying contract unless there are circumstances so egregious as to amount to "fraud in the transaction."

¶ 17.03 DOCUMENTARY DRAFTS

A documentary draft under the UCC is any draft accompanied by documents that are to be delivered to the person designated in the draft upon compliance with the terms of the instrument.[82] The accompanying documents may be documents of title, securities, or "other papers."[83] The draft may be negotiable or nonnegotiable.[84] Frequently, the document that accompanies the draft will be a bill of lading, a warehouse receipt, or some other document of title. Typically, the drawer of the draft wants to delay transfer of the goods, represented by the bill of lading or the warehouse receipt, until the drawee pays or accepts the draft. To accomplish this, the drawer gives the draft and the accompanying document of title to a bank for collection. The bank will forward the documents through customary banking channels to another bank, which then will present the documents to the drawee for payment or acceptance according to the terms of the draft. When the drawee complies with the terms of the draft, by paying or by accepting it, the bank releases the bill of lading to the drawee and remits the payment or the accepted draft to the person entitled to it. This

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[81] A number of cases that consider when a customer may enjoin payment under a letter of credit are discussed in ¶ 17.02[2].

[82] UCC § 4-104(1)(f).

[83] Id.

[84] Id.

procedure gives the drawer the security of retaining control of the goods until the drawee pays or accepts, and it gives the drawee assurance of receiving control of the goods on payment. By using a documentary transaction, the parties have contracted to shift the normal allocation of risks in a contract for the sale of goods, because in agreeing to pay against documents, the buyer gives up the right to inspect the goods before payment.[85] This forces the buyer to pay first and bear the affirmative burden of litigating if the buyer objects to the seller's performance.[86]

When banks handle documentary drafts for collection, their rights and responsibilities are substantially the same as those involved in collecting checks and other instruments, as explained in the preceding paragraphs. A documentary draft is an instrument for the payment of money and so falls within the definition of an "item," collection of which is governed by the rules of the UCC.[87]

When a draft is drawn and secured by a bill of lading or other paper, it usually is only part of a larger contract covering the sale or transfer of the merchandise represented by the documents. The underlying contract has been made directly between the seller and the buyer of the merchandise.[88] The collect-

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[85] UCC §§ 2-310, 2-513. See also generally, Hawkland, "Documentary Transactions: New Solutions to Old Problems," 18 UCCLJ 291 (1986).

[86] In the usual documentary draft sales transaction, the buyer must pay the draft in order to get the documents necessary for obtaining delivery of the goods from the carrier or other bailee as explained earlier. Since the buyer has paid, when, after inspecting the goods, the buyer learns of defects in the goods or other grounds for objection to the seller's performance, the buyer will have to bring suit against the seller in a place where jurisdiction over the seller can be obtained to recover damages. In Vickers v. Mach. Warehouse & Sales Co., 111 Wash. 576, 191 P 869 (1920), a person in the position of such a buyer tried to attach the proceeds of a documentary draft that the buyer had paid while the proceeds were in the hands of the collecting banks. The buyer initiated suit for breach of contract against the seller in a local court, and brought the attachment proceedings to seize the payment and, presumably, to establish jurisdiction over the seller. The efforts were unsuccessful in this case because the court viewed the banks as having an ownership interest in the proceeds as a result of having made advances on the draft. A similar result would obtain under the UCC, which gives a collecting bank a security interest in an item "and any accompanying documents or the proceeds of either" when the bank gives credit that has been drawn against, gives a credit where withdrawal is available as of right, or makes an advance against the item. UCC §§ 4-208(1)(a), 4-208(1)(c). See discussion at ¶ 16.01[4]. To permit a buyer to use such an attachment procedure to obtain jurisdiction to litigate contract claims against the seller related to a documentary sales transaction would result in the reversal of the risks allocated by the contract, which called for the buyer to pay in advance against documents.

[87] UCC § 4-104(1)(g).

[88] The parties must specifically contract for terms that require payment by the buyer on the presentment of documents. Absent a contrary agreement, the buyer of goods has a right to inspect the goods before making payment. UCC §§ 2-310(b), 2-503(5), 2-513(1), 2-513(3)(b).

ing bank ordinarily has no notice of the terms of the deal between the buyer and the seller. In these circumstances, then, it is extremely important for the bank transferring or collecting such paper to follow carefully the instructions of the drawer of the draft and to properly transmit the papers to correspondent banks. The bank's failure to follow such instructions may result in breach of the underlying sales contract and liability for damages for failure to exercise the proper degree of care in handling the documentary draft.[89]

The way documents of title such as bills of lading and warehouse receipts operate to control the delivery and ownership of goods held by the bailee (such as the carrier or warehouse) is explained in Chapter 14.

[1] Bank's Duty to Present Draft and to Notify Customer of Nonpayment

When a bank takes a documentary draft for collection, it must either present the draft to the drawee for payment or acceptance or it must send the draft through collection channels so that it may be properly presented.[90] The bank must act promptly and use ordinary care in presenting the draft.[91] When the draft, or other set of instructions by the bank's customer, directs the bank to present the draft "on arrival" or "when goods arrive" (or when the documents use similar language), the bank may wait to present the draft until it believes that the goods have arrived.[92]

When the bank has presented a documentary draft and the draft has not been paid or accepted in due course, the bank has a duty to promptly notify its customer.[93] This duty is placed on the bank even when it has purchased the draft

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[89] UCC §§ 4-201, 4-202, 4-203. See UCC § 4-103 on the measure of liability.

[90] UCC § 4-501.

[91] UCC § 4-202. When a collecting bank delivered documents of title to the drawee without requiring the acceptance of the drawee as the collection instructions required, the collecting bank was liable to its customer for failure to do so. The individual signatures of the officers of the drawee did not constitute compliance with the instructions. The bank's liability was for failure to exercise ordinary care, UCC § 4-103(5), which includes "the amount of the item reduced by the amount which could not have been realized by the use of ordinary care" except that consequential damages can be recovered in cases of bad faith. The case presented a special damages issue, since the customer based the damages on its inability to recover on an insurance policy, and not on its inability to collect from the drawees. The court remanded the case to determine whether the customer's inability to collect on the insurance policy should be viewed as a direct loss that could be recovered because of the bank's lack of ordinary care or whether it should be treated as a consequential loss for which the customer must show that the bank acted in bad faith. Bar-Ram Irrigation Prods. v. Phenix-Girard Bank, 779 F2d 1501, 1503–1505 (11th Cir. 1986).

[92] UCC § 4-502.

[93] UCC § 4-501. By acting as agent in collecting the draft, the bank will have a fiduciary relationship to the owner of the draft under the view taken in Aimor Elec. Works, Ltd. v. Omaha Nat'l Bank, 727 F2d 688, 691–692 (8th Cir. 1984). See ¶ 17.03[2].

from the customer and is no longer acting as an agent for collection; this is so the customer can find out whether the underlying commercial transaction, for which the draft was given, is going through as planned.[94] When the draft calls for payment "on arrival," the drawee does not have any duty to pay or accept until the goods have actually arrived. The drawee's refusal to pay or accept will not constitute dishonor, but the bank must notify its customer of the refusal.[95] Having given this notification, the bank has no duty to present the draft a second time until it receives instructions to do so until it learns that the goods have arrived.[96]

[2] Bank's Responsibilities for the Documents and the Goods

The documents that accompany a documentary draft are usually a form of security for payment of the draft. In a typical transaction, the drawer will not want the bill of lading or other paper transferred to the drawee until the drawee has made payment or accepted the draft. It is the bank's duty to preserve the security when dealing with the paper. The bank should follow strictly the instructions of its customer as to release of the documents.[97] Unless otherwise instructed, when the terms of the draft require payment in three or fewer days after it is presented to the drawee, the bank should not release the documents to the drawee until after the draft is paid.[98] When the draft is payable more than three days after presentment, the bank must deliver the documents to the drawee on acceptance of the draft.[99] Releasing the underlying documents to the drawee without receiving payment or acceptance of the draft may result in a loss of the customer's security for the draft, and the bank will be liable for its lack of care in handling the documents.[100] In some cases, the drawee or purchaser of the underlying goods may have the right to inspect the goods before making payment.[101] Unless the bank is instructed otherwise, however, it must follow the rules stated here and not release the documents until there is proper payment or acceptance.

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[94] UCC § 4-501 & comment.

[95] UCC § 4-502.

[96] Id.

[97] UCC § 4-503.

[98] UCC § 4-503(a). See UCC § 2-514. A bank was liable for releasing documents when the buyer paid with an uncertified personal check in a pre-UCC case. Bunge v. First Nat'l Bank, 118 F2d 427, 429-430 (3d Cir. 1941). The UCC should provide the same result under Section 4-211(1)(d). Since the draft is drawn on a person, not on a bank, the collecting bank is authorized to take in settlement of the draft only "a cashier's check, certified check or other bank check or obligation." Section 4-211(1)(d).

[99] UCC § 4-503(a).

[100] UCC § 4-202.

[101] See UCC §§ 2-512, 2-513, 2-514.

The draft may designate a referee, with whom the bank may consult for instructions, in the event that the draft is dishonored by refusal either to pay or to accept.[102] The bank is not required to consult with the named referee, but if it does not, it must use diligence and good faith to discover the reason for the draft's dishonor; it then must notify its customer of the dishonor and of the results of its inquiry and must request further instructions.[103]

The presenting bank has no obligation with respect to the goods represented by the documents. The bank's only obligation is to follow "reasonable instructions seasonably received." In following such instructions, the bank has a right to be reimbursed for any expenses it may incur, as well as a right to prepayment or indemnity for its expenses.[104] When a bank has given timely notice of dishonor to its customer and has requested instructions, and the customer does not give the bank instructions within a reasonable time, the bank may "store, sell, or otherwise deal with the goods in any reasonable manner."[105] The bank will have a lien upon the goods, or upon their proceeds, for its expenses in storing or otherwise dealing with the goods.[106]

A transferor of a bill of lading or other document of title normally makes warranties to the transferee that the document is genuine and that the transferor does not know of any fact detracting from the document's validity or value.[107] When a collecting bank transfers a bill of lading or a document of title as part of a documentary transaction, however, the bank does not make these warranties, but warrants only that it is acting in good faith and that it has the necessary authority to transfer the documents.[108] In determining the scope of the bank's warranties, it makes no difference that the bank may have purchased the documentary draft or made advances against it.[109]

Documentary drafts are frequently drawn against letters of credit. When this occurs, additional responsibilities exist that are based on the obligations on the letter of credit.[110]

In *Aimor Electric Works, Ltd. v. Omaha National Bank*,[111] the court discussed the duties of a bank engaged in collecting documentary drafts. The bank acted as collecting bank for a Japanese seller, presenting drafts to the seller's American customer for ninety days' acceptance. The bank also loaned funds to

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[102] UCC § 4-503(b).

[103] Id.

[104] UCC § 4-503.

[105] UCC § 4-504(1).

[106] UCC § 4-504(2).

[107] UCC § 7-507.

[108] UCC § 7-508.

[109] Id.

[110] These additional responsibilities are discussed in ¶¶ 17.01–17.02.

[111] 727 F2d 688 (8th Cir. 1984).

the American customer to enable the customer to pay for some of the shipments. The loans were secured by the customer's accounts receivable, which the bank required to be specially deposited. When the bank's actions in applying the special deposit to reduce the outstanding loans caused the customer to lack funds to pay off outstanding drafts to the Japanese seller, the seller sued the bank. The seller claimed that the bank breached its fiduciary duty to disclose to the seller that it had a conflict of interest because of its secured interest in the proceeds of the buyer's accounts arising from the sale of the goods shipped. Although the court conceded that the bank's status as collecting agent created a fiduciary relationship to the seller, it held that the jury was adequately instructed on the point, and there was no error in its verdict for the bank.

¶ 17.04 LETTERS OF CREDIT AND BANKRUPTCY

When the issuer of a letter of credit becomes insolvent, the rights of the beneficiary to obtain payment may be challenged by creditors of the bank who oppose payment of the letter of credit on terms other than those similar to the rights of general creditors to share in the distribution of the assets of the bank. The UCC contains an insolvency provision that seeks to treat letter of credit transactions as "wash" transactions for purposes of insolvency on the theory that the bank is simply transmitting funds of its customer when payment is made to the beneficiary of the credit.[112] The UCC provision seeks to protect "any funds or collateral" that is given either after or before the insolvency occurs and that is given to pay drafts or demands under the credit or to serve as indemnity for such payment.[113] To the extent that the insolvent bank is holding any such funds or collateral, the persons entitled to draw under the letter of credit are given the right to be paid in preference to "depositors or other general creditors of the issuer or bank."[114] The UCC applies the same rule when no funds or collateral is given to the bank if a specific agreement has been made for the purpose of indemnifying the bank for payment of the credit that authorizes the bank to "charge a general or current account" with the bank.[115] These insolvency provisions expressly apply only in the cases of letters of credit where either a bank is the issuer and the credit requires a documentary draft or documentary demand or any person is the issuer and the credit requires the draft or demand for payment to be accompanied by a document of title such as a bill of lading.[116]

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[112] UCC § 5-117 & comment.

[113] UCC § 5-117(1)(a). If any part of the credit is unused, the person supplying the funds or collateral is entitled to its return. UCC § 5-117(1)(b).

[114] UCC § 5-117(1)(a).

[115] UCC § 5-117(1)(c).

[116] UCC §§ 5-117, 5-102.

As state law, the UCC cannot dictate what occurs in bankruptcy because that is a matter of federal law. The application of the federal bankruptcy law to letter of credit obligations is discussed in Chapter 25.

18

Alternative Payment Systems: Bank Cards, Credit Cards, and Electronic Fund Transfers

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¶ 18.01 ALTERNATIVE PAYMENT SYSTEMS GENERALLY

[1] Types of Transactions

With the availability of sophisticated electronic technology, financial institutions have been developing new techniques that aid their customers in transferring funds, paying third parties, and drawing upon lines of credit. These techniques offer the ability to move large sums of money rapidly and reliably to distant points and multiple transferees. In addition, they have created opportunities for cost savings by the depository institutions and payors who engage in mass processing of fund transfers, while at the same time they have made possible sophisticated programs of money management and control by the customers of institutions having this capability. Consumers may enjoy quick and convenient access to cash from savings and checking accounts and lines of credit. Merchants and suppliers of services to consumers may receive faster and more reliable payment with less costly processing of the payment instruments.

These alternative payment systems eliminate the physical transfer of paper checks and rely instead upon electronic transmission and data-processing equipment. The development of these systems is an ongoing process, but it is apparent that these developments have brought, and will continue to stimulate, substantial changes, not only in the way that depository institutions do business, but also in the regulatory framework affecting these transactions.

This handbook does not attempt to provide a detailed discussion of electronic fund transfer systems.[1] However, a number of systems are in operation, and these systems deserve brief mention.

[a] Check Truncation. Some banks have experimented with check truncation systems in which checks are retained at various points in the bank collection process, rather than being physically transferred to the payor bank and returned to the customer after payment. Check truncation is discussed further, later in this chapter.[2]

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[1] There are several good general sources on the various forms of electronic payment systems. The leading authority is N. Penney & D. Baker, The Law of Electronic Fund Transfer Systems (1980) (hereinafter Penney & Baker) and D. Baker & R. Brandel, The Law of Electronic Fund Transfer Systems (1987 Cum. Supp.) (hereinafter Baker & Brandel). See also M. Benfield & P. Alces, Commercial Paper and Alternative Payments Systems (1987); F. Miller & A. Harrell, The Law of Modern Payment Systems and Notes (1985); J. Vergari & V. Shue, Checks, Payments, and Electronic Banking (1986).

[2] See infra ¶ 18.05. See generally Penney & Baker, supra note 1, ¶ 2.01; Baker & Brandel, supra note 1, ¶ 2.01.

[b] Automated Clearinghouse Transactions. There are numerous automated clearinghouses (ACHs). These clearinghouses engage in clearing functions similar to those involved in payment by paper checks, except that the information is transferred electronically—usually on magnetic tape exchanged between member banks of the clearinghouse—but also by direct electronic communication. Although observers note that ACH transactions have not become as large in volume as was initially predicted, transfers through the ACH system are substantial. The Federal Reserve System too provides ACH services.

Authorities estimate that the ACH network handled between 600 million and 700 million transactions in 1985.[3] The federal government probably accounts for slightly more than half of the number of ACH transactions.[4] The value of ACH transactions in 1983 amounted to about $1.4 trillion for private transactions and $127.5 billion for government transactions.[5] Over 11,000 banks and over 4,000 thrifts are reported to be members in ACH associations.[6]

ACH transactions may include both credit and debit transactions. Credit transactions involve direct payments to the bank accounts of the persons entitled to payment. For example, a large employer may use ACH services to make payroll payments to employees through direct credits to the accounts of the employees at banks that are members of the ACH. Debit transactions also may take place through the ACH system. A person with a bank account in a bank that is a member of an ACH may authorize the bank in advance to transfer funds from the account to pay various recurring obligations, such as mortgage payments, insurance payments, and utility bills.

The ACH Associations have developed rules for their clearing operations. A national automated clearinghouse association (NACHA), formed in 1974, has developed rules for interregional electronic fund transfer.[7] These rules are enforceable as contracts between the members of the associations but cannot override the regulations of the Board of Governors under the Electronic Fund Transfer Act[8] or the general authority of the Board over payments systems.[9]

The federal government has a direct deposit program, in which Social Security and other benefit payments are credited directly to the accounts of payees through use of automated clearinghouses.[10] The federal government also makes payments through ACH networks for interest on government securities,

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[3] Baker & Brandel, supra note 1, ¶ 3.03[4] at S3-19.

[4] Id. at S 3-16.

[5] Id.

[6] Id. at S 3-18.

[7] See Penney & Baker, supra note 1, ¶ 3.03(3).

[8] The Electronic Fund Transfer Act is discussed *infra* ¶ *18.02*.

[9] See ¶ 14.01[3][c] for a discussion of the authority of the Board of Governors over electronic payment systems.

[10] See infra ¶ 18.05[6].

income tax refunds, payments to persons who do business with the federal government, payments to government employees, and many other circumstances.[11] The U.S. Treasury has adopted regulations governing the direct deposit program.[12] These federal regulations describe the procedures for making payments through the ACH method, the obligations of the participants in the transactions, and the liabilities of financial institutions to the U.S. government when payments are made to persons not entitled to receive the payments, as may occur when the recipients of payments are deceased or incompetent or when the beneficiaries of federal benefit payments are deceased.

The Board of Governors regulates transfers through ACH services offered by the Federal Reserve Banks, in its Regulation J and various operating circulars.[13]

[c] Book Entry Securities and Safekeeping Services. The Federal Reserve provides book entry securities services for the U.S. Treasury and for certain federal agencies. The Federal Reserve System also provides safekeeping services for depository institutions. A depository institution may arrange for its Federal Reserve bank to maintain custody of various U.S. agency securities, which may be held by the Federal Reserve bank for custodial purposes or for the purpose of collateralizing borrowings from the Federal Reserve or for deposits of public funds held by the institution. The Federal Reserve System will process transfers of securities and related payments. The Federal Reserve System may make securities transfers through electronic communications, through the Federal Reserve's wire transfer system. Many of these transactions may be initiated through on-line computer connections between the Federal Reserve bank and the participating depository institution.[14] Additionally, the ACH network is employed to credit interest and other payments related to these securities transactions directly to the bank accounts of the securities owners.

[d] Wire Transfers. Large dollar amount transfers also are made electronically. These transfers, for the most part, are made by large corporate parties and often are referred to as wire transfers, or wholesale wire transfers. Typically, they are transactions in which large amounts are involved and for which speed is important. Many of these transfers relate to transactions in U.S. government securi-

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[11] See generally Baker & Brandel, supra note 1, ¶ 5.02.

[12] 31 CFR pt. 210 (1988).

[13] 12 CFR pt. 210, subpt. B (1987).

[14] See generally Board of Governors of the Fed. Reserve Sys., The Federal Reserve System—Purposes and Functions 110–111 (1984); Board of Governors of the Fed. Reserve Sys., Annual Report 211–212 (1986). The U.S. Treasury has regulations governing the processing of transactions involving book entry securities. 31 CFR pt. 357 (1987).

ties. The Federal Reserve System provides such fund transfer services through its FedWire network. These operations are discussed in Chapter 3. Another network through which large dollar wire transfers may be made is known as CHIPS, which stands for Clearinghouse Interbank Payment System. CHIPS is operated by the New York Clearinghouse Association.[15] An international network for making electronic funds transfers of a similar nature is known as SWIFT, the Society for Worldwide International Financial Telecommunication.[16]

[e] Automated Teller Machines. Customers may make transfers of funds through noncheck transactions by use of an automated teller machine (ATM), which is linked to the customer's bank. The ATM may be part of a network established by the customer's own bank or it may be a part of an ATM system shared by a group of banks over which different banks' transactions may be processed. The operation of ATM networks raises various regulatory questions, including the application of laws restricting branch and interstate banking; these regulatory issues are discussed in Part 1 of this book.[17] Through the use of an ATM, a customer may be able to instruct its bank to make payments of obligations to the bank such as mortgage payments, to transfer funds between different accounts, to make deposits, to withdraw cash, and sometimes to make payments to third parties.

[f] Point of Sale Terminals. Payments to third-party vendors also may occur through point of sale (POS) terminals. In these systems, a terminal is located at a merchant's place of business, which enables the customer to obtain direct access electronically to his or her account at the bank in order to transfer funds from the customer's account to an account of the merchant.[18]

[g] Home Banking. Home banking systems are systems that permit customers to engage in banking transactions from their homes. Some such systems involve giving instructions to the bank through the customer's telephone. Other systems involve a more sophisticated array of services available through a computer terminal located in the customer's home.

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[15] See generally Penney & Baker, supra note 1, ¶ 9.04; Baker & Brandel, supra note 1, ¶ 9.04.

[16] See generally Penney & Baker, supra note 1, ¶ 9.05; Baker & Brandel, supra note 1, ¶ 9.05.

[17] See generally Penney & Baker, supra note 1, ¶ 6.01–6.04; Baker & Brandel, supra note 1, ¶ 6.01–6.04.

[18] See generally Penney & Baker, supra note 1 ¶ 7.01; Baker & Brandel, supra note 1, ¶ 7.01.

[h] **Credit Cards.** Payments through credit cards may or may not involve electronic processing and transfers of funds. Credit card transactions are discussed in this chapter because the law relating to credit card transactions frequently is important in consumer banking services that involve electronic fund transfers. A bank card may permit the cardholder to engage in a number of banking transactions that include both access to a credit line as well as access to a checking or other account that may be directly debited. Additionally, payment by credit card is in itself a significant method of consumer payment for goods and services.

Although the discussion in this section has treated the various types of alternative payment systems as if there were a clear separation between the processing of paper checks and the electronic transfer of funds, the distinction may become blurred as technological developments lead to the processing of check collection by electronic communication methods. As discussed previously in Chapter 14, the Board of Governors of the Federal Reserve System is under a mandate from Congress to develop a more efficient system for check collection, which utilizes electronic technology. In view of this mandate, it is reasonable to expect that substantial changes will occur in the traditional forms of handling check collections and payments. Some of the legal questions associated with these changes are discussed in this chapter.[19]

[2] Sources of Law

While there is no comprehensive regulation of electronic fund transfer systems comparable to that provided by Articles 3 and 4 of the Uniform Commercial Code for negotiable instruments and bank collections, efforts are underway to amend the UCC to provide for these new payment systems.[20] The UCC itself, in Articles 3 and 4, generally applies to "negotiable instruments" and "items," neither of which contemplates an electronically transmitted payment order.[21] Nevertheless, since the UCC provides the general framework of legal regulation for bank collection and payment, it will doubtless serve as a source of law, at least by analogy, for resolving problems associated with electronic fund transfers.[22]

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[19] See also the discussion of check truncation in ¶ 20.12[2].

[20] See discussion of efforts to amend the UCC at ¶ 14.01[2].

[21] See Bradford Trust Co. v. Texas Am. Bank, 790 F2d 407 (5th Cir. 1986). In Evra Corp. v. Swiss Bank Corp., 673 F2d 951, 955 (7th Cir.), cert. denied, 459 US 1017 (1982), the court said, "Maybe the language of Article 4 could be stretched to include electronic fund transfers, see section 4-102(2), but they were not in the contemplation of the draftsmen." See also Delbrueck & Co. v. Manufacturers Hanover Trust Co., 609 F2d 1047 (2d Cir. 1979).

[22] Bradford Trust Co. v. Texas Am. Bank, 790 F2d 407, 409 (5th Cir. 1986), followed this approach.

In 1978, Congress enacted the Electronic Fund Transfer Act. Although this act is not a comprehensive treatment of electronic fund transfers, it does provide guidelines for dealing with certain important problems. The federal act primarily applies to consumers, that is, natural persons, thus leaving a broad area of commercial transfers uncovered by the act.[23] *The act establishes disclosure* requirements and rules for documenting transactions. It also contains provisions for dealing with preauthorized transfers, resolving errors made by the financial institution, determining liability for unauthorized transfers and failure to make transfers as instructed, and distributing liability for malfunctioning systems that affect underlying customer obligations. These subjects are discussed in greater detail later in this chapter.

The Board of Governors of the Federal Reserve System has implemented the Electronic Fund Transfer Act with its Regulation E.[24] It also has promulgated an extensive Official Staff Commentary on the regulations, which gives specific answers to questions of interpretation of the act and its regulations.[25] In addition to Regulation E, the Board has adopted rules in its Regulation J to deal with other aspects of wire transfers.[26] Further Board regulation may be expected, as the Board adopts rules to carry out the mandates of Congress under the Competitive Equality Banking Act of 1987 to improve the efficiency of the nation's payment systems.[27] The Board also has issued other rules and policy statements relating to electronic transfers of various kinds. Some of the more significant statements include policies designed to reduce the risk of payment failure to the payments system and policies designed to eliminate float in payment transactions.

Additional federal statutes cover other aspects of electronic fund transfer transactions. When credit transactions are involved, federal consumer statutes, such as the Truth-in-Lending Act, may be relevant. States, too, may regulate electronic fund transfers, as long as the regulation is not inconsistent with the federal Act.[28] State law may afford consumers greater protection than the federal act.[29]

¶ 18.02 ELECTRONIC FUND TRANSFERS

The term "electronic fund transfer" often is used in a general sense to refer to any transaction with a financial institution in which debits or credits are made

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[23] 15 USC §§ 1693, 1693a(5) (1982).

[24] 12 CFR pt. 205 (1988).

[25] Id. at Supp. II.

[26] 12 CFR pt. 210, subpt. B (1988).

[27] See discussion at ¶ 14.01[3][c].

[28] 15 USC § 1693q (1982).

[29] Id.

to the accounts of customers and where data is communicated at least in part by some form of electronic media, without the processing of a paper instrument such as a check or deposit slip. In this general sense, the term may be used to refer to transactions at ATMs and POS terminals, ACH transfers, systems of check truncation, telephone payment arrangements, and large dollar wire transfers between corporate customers over FedWire, CHIPS, SWIFT, or other networks. This popular usage must be distinguished from the legal classifications created by the Electronic Fund Transfer Act. This act, discussed later, is limited in scope to only some of the types of transactions identified here.

[1] Scope of the Electronic Fund Transfer Act

For the purposes of the Electronic Fund Transfer Act, an electronic fund transfer is defined as a "transfer of funds, other than a transaction originated by check, draft, or similar paper instrument, which is initiated through an electronic terminal, telephonic instrument, or computer, or magnetic tape so as to order, instruct, or authorize a financial institution to debit or credit an account."[30] The definition thus does not reach the typical checking transaction that would be covered by the UCC. It also does not cover check truncation arrangements because these transactions are at least "originated by check."

The federal act further provides that the term "electronic fund transfer" is to be understood to include, but not be limited to, point of sale transfers, automated teller machine transactions, direct deposit or withdrawal of funds, and transfers initiated by telephone.[31] Under the definitions adopted by the act, the act covers the use of cash-dispensing machines, POS terminals, and ATMs, because all of these expressly qualify as electronic terminals.[32]

In 1984, the Board amended its Regulation E to add to the definition "all transfers resulting from debit card transactions, including those that do not involve an electronic terminal at the time of the transaction."[33] The act does not cover the following:

1. Check guarantee or authorization systems that do not directly debit or credit consumer's accounts;[34]
2. Fund transfers between depository institutions or Federal Reserve banks, other than ACH transfers of funds held at Federal Reserve banks

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[30] 15 USC § 1693a(6) (1982). The Board of Governors of the Federal Reserve System has issued regulations under the Electronic Fund Transfer Act, as well as interpretations of those regulations. 12 CFR pt. 205 (1988) (Regulation E); 12 CFR pt. 205, Supp. II (1988) (Official Staff Interpretations).

[31] 15 USC § 1693a(6) (1982).

[32] 15 USC § 1693a(7) (1982).

[33] 12 CFR § 205.2(g) (1988).

[34] 15 USC § 1693a(6)(A) (1982); 12 CFR § 205.3 (1988).

or other depository institutions and which are not "designed primarily to transfer funds on behalf of a consumer";[35] this exempts transfers over FedWire and similar networks used "primarily for transfers between financial institutions or between businesses."[36]

3. Transactions where the "primary purpose" is to buy or sell securities through registered or regulated broker-dealers;[37]
4. Automatic transfers between savings accounts and checking accounts under an agreement with a consumer in which the institution covers overdrafts or maintains a minimum balance in the consumer's demand deposit account;[38]
5. Transfers, initiated by a telephone conversation between a consumer and a financial institution, that are not undertaken pursuant to a prearranged plan in which periodic or recurring transfers are contemplated;[39]
6. Any trust account held by a financial institution under a bona fide trust agreement;[40]
7. Certain preauthorized transfers to small financial institutions.[41]

Regarding the exclusion for telephonic transfers of funds that are not made as part of a prearranged plan or agreement, the federal Court of Appeals for the Fifth Circuit has held that this exclusion from coverage means that a consumer account holder cannot sue a financial institution under the act for wrongfully charging the customer's account in response to a telephone instruction from a person other than the customer. Although the customer might have an action under state law for conversion or breach of contract based on the customer's deposit agreement with the institution, the customer was held to have no remedy under the Electronic Fund Transfer Act.[42]

The act applies to all financial institutions, state or federal, including banks, savings and loan associations, mutual savings banks, credit unions, or other institutions that hold consumer accounts.[43] It also includes anyone "who issues

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[35] 15 USC § 1693a(6)(B) (1982).

[36] 12 CFR § 205.3(b) (1988).

[37] 15 USC §§ 1693a(b), 1693a(c) (1982).

[38] Id at (6)(D).

[39] Id at (6)(E).

[40] 12 CFR § 205.3(f) (1988).

[41] 12 CFR § 205.3(g) (1988).

[42] Kashanchi v. Texas Commerce Medical Bank, 703 F2d 936, 942 (5th Cir. 1983). See also Abyaneh v. Merchants Bank, 670 F. Supp. 1298, 1300 (MD Pa. 1987), where the court held that a telephone call from a swindler, which initiated a wire transfer, was an exempt transaction so the true owner of the account had no remedy under the act.

[43] 15 USC § 1693a(8) (1982).

an access device and agrees with a consumer to provide electronic fund transfer services."[44] As previously indicated, the act applies to consumer transactions. A consumer is defined as a "natural person," and thus, does not include corporations, trusts, or other artificial entities.[45]

Although debit cards and other cards used to obtain access to a customer's account are covered by the Electronic Fund Transfer Act and the Board's regulation,[46] the Truth-in-Lending Act covers transactions involving credit cards.[47] When the same card provides access to a consumer's deposit account for the purposes of making debits or credits, and also allows the consumer to draw on a line of credit or other credit feature, the Electronic Fund Transfer Act and Regulation E will cover aspects of transactions that fall within the definition of an electronic fund transfer while the Truth-in-Lending Act and Regulation Z will cover those aspects relating to the credit feature.[48]

Even so, occasions will arise when it is unclear which body of law applies. The Board's staff has taken the position that when a combination credit card/access device is used to obtain unauthorized cash advances from a line of credit at an automated teller machine, the consumer liability provisions of Regulation Z under the Truth-in-Lending Act will apply, because the advances "do not involve a consumer asset account" so that there would not be an electronic fund transfer.[49] On the other hand, if the unauthorized transfers accomplished through the use of a combination card were from a checking account, which resulted in a cash advance from an overdraft line of credit, the Board's view is that Regulation E applies because the transfer was an electronic fund transfer. As the Board explains, "there was an extension of credit only as a consequence of the overdraft protection feature on the checking account."[50] However, if the same card is used to make unauthorized withdrawals from the checking account and the line of credit, separately, both Regulation E and Regulation Z will apply.[51]

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[44] 12 CFR § 205.2(i) (1988).

[45] 15 USC § 1693a(5) (1982).

[46] 15 USC § 1693a(6)(A) (1982); 12 CFR § 205.2(g) (1988). See generally Brandel & Olliff, "The EFT Act: A Primer," 30 Ohio St. LJ 531 (1979); Connors, "The Implementation of the Electronic Fund Transfer Act: An Update of Regulation E," 17 Wake Forest L. Rev. 329 (1981); Vergari, "Articles 3 and 4 of the Uniform Commercial Code in an Electronic Fund Transfer Environment," 17 San Diego L. Rev. 287 (1980); Notes, "EFT Act," 58 Or. L. Rev. 363 (1979); "Electronic Fund Transfers: Regulation E and the Right to Financial Privacy," 16 Gonzaga L. Rev. 313 (1981); Symposium, "Electronic Fund Transfers," 37 U. Pitt. L. Rev. 613 (1976).

[47] 12 CFR § 205.5(c) (1988).

[48] Id.

[49] 12 CFR pt. 205, Supp. II, § 205.6 ¶ 6-9 (1988).

[50] Id.

[51] Id.

[2] Error Resolution

The Electronic Fund Transfer Act establishes procedures to assist a consumer in obtaining an investigation, a review, and a resolution, by the account-holding financial institution, when the consumer believes that there has been an error in the statement of the consumer's account as a result of an electronic fund transfer transaction.[52] After the consumer notifies the institution of an alleged error, the institution has a duty to investigate to determine whether an error has occurred, and to report its findings to the customer within ten business days.[53] The institution may require that the customer give written confirmation of the alleged error if it notifies the customer of this requirement when the oral notice is given to the bank.[54] When the institution determines that an error occurred, it must correct the error within one business day after it comes to that determination, and such correction must include the crediting of interest when applicable.[55]

The financial institution may avoid the ten-day deadline by giving the consumer provisional credit for the amount claimed to be in error while it completes its investigation. Under this approach, the investigation must be concluded within forty-five days, but the customer must have full use of the funds provisionally credited under this procedure.[56] When the financial institution concludes that there was no error, it must deliver a written explanation of its finding to the consumer within three business days after it has concluded its investigation.[57]

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[52] 15 USC § 1693f (1982).

[53] 15 USC § 1693(f)(a) (1982).

[54] Id.

[55] 15 USC § 1693f(b) (1982).

[56] 15 USC § 1693f(c) (1982).

[57] 15 USC § 1693f(d) (1982). Bank's customer notified bank that she believed an error had been made in transfers from her account to pay monthly premiums on a life insurance policy under a preauthorized transfer plan. On two occasions the bank transferred funds, although the transfer created overdrafts in the customer's account. A bank officer checked the complaint, determined that no error had been made (because although the bank made two transfers in October, one of those was for the previous month's payment), and telephoned the customer with an explanation of the matter. The customer treated the matter as unresolved and brought suit against the bank under the Electronic Fund Transfer Act. The court held that although no error occurred with respect to the customer's checking account, the bank violated Section 908(d) of the act, which requires that the financial institution investigate and "deliver or mail to consumer an explanation of its findings" at the end of its investigation, and inform the customer of her right to obtain copies of the documents on which the bank relied. Oral notification is not sufficient. There was no indication of bad faith on the part of any party so the treble damage provisions did not apply. Although the act requires finding civil liability, the court noted that the customer may well have benefited from the bank's action as the bank paid the premium although it had no obligation to cover her overdraft. This situation could be one for the district court to exercise its discretion to award only nominal damages and a

The financial institution will be liable to the consumer for treble damages if a court finds that the financial institution has (1) knowingly and willfully concluded that the consumer's account was not in error when it was unreasonable to draw this conclusion from the evidence available; (2) failed to credit the consumer's account provisionally within the ten-day period mentioned; and (3) either did not make a good-faith investigation of the error or did not have a reasonable basis for believing that the account was not in error.[58]

Errors subject to this resolution procedure include unauthorized electronic fund transfers, incorrect electronic fund transfers to or from the consumer's account, omissions from the consumer's statement of electronic fund transfers affecting the account, computational errors, receipt of incorrect amounts of money from an electronic terminal, consumer requests for information or clarification about an electronic fund transfer, and other errors prescribed by regulations of the Board of Governors of the Federal Reserve System.[59] Because unauthorized transfers are errors, the financial institution has a duty to investigate them, as it does in the case of other errors. Although the act could be clearer in this matter, it appears that when the financial institution determines that an unauthorized transfer has been made, the institution does not have to recredit the account if it can sustain the burden of proving that the consumer was liable for the amount of the unauthorized transfer.[60]

Error resolution procedures are provided under the Truth-in-Lending Act, as well. When an electronic fund transfer also involves an extension of credit under an agreement whereby the financial institution extends credit to cover an overdraft in the consumer's account or to maintain a minimum balance in a consumer's account, the Board's regulations specify that the error resolution procedures under the Electronic Fund Transfer Act shall govern, rather than those under the Truth-in-Lending Act.[61]

[3] Failure to Execute a Transfer or Stop Transfer Order Properly

The Electronic Fund Transfer Act makes a financial institution liable for failing to transfer funds in some circumstances that are comparable to those in which a bank wrongfully dishonors a check.[62] The act makes a financial institution liable "for all damages proximately caused by . . . the financial institution's failure to make an electronic fund transfer, in accordance with the terms and

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reasonable attorney's fee to mitigate the results of strict liability for a "technical and nondamaging violation." Bisbey v. DC Nat'l Bank, 793 F2d 315, 317–318 (DC Cir. 1986).

[58] 15 USC § 1693f(e) (1982).

[59] 15 USC § 1693f(f) (1982).

[60] 15 USC § 1693f(b) (1982).

[61] 12 CFR § 205.11(i) (1988).

[62] 15 USC § 1693h(a)(2) (1982).

conditions of an account, in the correct amount or in a timely manner when properly instructed to do so by the consumer . . . "[63] The institution is not liable, however, if the consumer's account has insufficient funds, if there is an encumbrance or effective legal process that restricts transfers from the account, if the transfer exceeds the credit limit established for the account, if an electronic terminal lacks sufficient cash to complete the transaction, or otherwise as provided by the Board's regulations.[64]

The financial institution will be liable under the federal act in other situations as well, such as when the institution (1) fails to make an electronic fund transfer, because it has previously failed to credit a deposit of funds to the consumer's account that would have provided sufficient funds for the transfer[65] (this provision is broad enough to cover failure to credit deposits which are made by means other than electronic fund transfers) or (2) fails to stop payment on a preauthorized transfer from the consumer's account, which the consumer properly instructed the institution not to pay.[66]

Unlike the rules for wrongful dishonor in the UCC, the financial institution has an absolute defense to liability, if it can show that its failure resulted from circumstances beyond its control, and that it exercised reasonable diligence or that the failure was caused by a technical malfunction known to the consumer at the time of attempting to initiate the electronic fund transfer.[67] When the institution makes an unintentional good faith error, the act, consistent with the UCC provisions on wrongful dishonor, limits the liability of the institution to "actual damages proved."[68]

[4] Preauthorized Transfers and Stop Payment Rights

It is necessary under the Electronic Fund Transfer Act for preauthorized transfers *from* a consumer's account to be authorized in writing. A copy of the authorization must be provided to the consumer when the authorization is made.[69] When the amounts of the transfers from the consumer's account vary, the financial institution or the payee, before each transfer, must provide notice to the consumer of the amount, and must date the transfer that will be completed.[70]

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[63] 15 USC § 1693h(a)(1) (1982).

[64] Id.

[65] 15 USC § 1693h(a)(2) (1982).

[66] 15 USC § 1693h(a)(3) (1982).

[67] 15 USC § 1963h(b) (1982).

[68] 15 USC § 1693h(c) (1982).

[69] 15 USC § 1693e(a) (1982).

[70] 15 USC § 1693e(b) (1982).

The act gives a consumer the right to stop payment of any preauthorized transfer. The consumer need only notify the institution orally or in writing, at any time up to three business days before the scheduled date of the transfer.[71] The institution is entitled to require written confirmation of any oral notification within fourteen days of oral notification, if the consumer is told of this requirement at the time the consumer gives the oral notice.[72]

The act also has notice rules that apply to certain recurring preauthorized electronic fund transfers that result in a *credit* to a consumer's account.[73] These notice requirements are discussed later in this chapter.[74]

[5] Suspension of Obligations to Third Parties

Under the Electronic Fund Transfer Act, a person who has agreed to accept payment by means of an electronic fund transfer may not claim that the consumer is in default of an obligation if a malfunction in the system prevents making the transfer.[75] The consumer's obligation is "suspended" until the malfunction is corrected.[76] The person to whom payment was to be made may revive the obligation, however, by making a written demand for payment after the malfunction has occurred.[77]

[6] Disclosure and Notice Obligations

The Electronic Fund Transfer Act requires various disclosures and notices to be given to the consumer. These notices may be grouped into the following categories:

1. An initial disclosure statement at the time the consumer enters into an agreement with the institution for the electronic fund transfer service;[78]
2. Notification of changes in the terms or conditions of the consumer's account;[79]
3. Annual notice of error resolution procedures or periodic notices in lieu of the annual notice;[80]

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[71] 15 USC § 1693e(a) (1982).

[72] Id.

[73] 15 USC § 1693d(b) (1982).

[74] See infra ¶ 18.02[6][c].

[75] 15 USC § 1693j (1982).

[76] Id. See UCC § 3-802, comment 3.

[77] 15 USC § 1693j (1982).

[78] 15 USC § 1693c(a) (1982); 12 CFR § 205.7 (1988).

[79] 15 USC § 1693c(b) (1982); 12 CFR § 205.8(a) (1988).

[80] 12 CFR § 250.8(b) (1988).

4. Documentation of transfers initiated at electronic terminals;[81]
5. Periodic statement of the consumer account;[82]
6. Notices with respect to preauthorized transfers to and from a consumer account.[83]

[a] Initial Disclosure and Notice of Changes. Under the Electronic Fund Transfer Act, the financial institution providing the service must disclose to the consumer, at the time of contracting for the fund transfer service or before making the first electronic fund transfer involving the consumer's account, the following: (1) information bearing on the consumer's liability for unauthorized transfers; (2) the procedures for giving notice of unauthorized transfers; (3) the charges that will be made; (4) the consumer's right to stop payment of preauthorized transfers; (5) the consumer's right to documentation of transfers; (6) the institution's liability for failure to follow the provisions of the act; and (7) the circumstances under which the institution will disclose information, concerning the consumer's account, to third persons.[84]

When there is any change in the terms of the consumer's account that affects these matters, the consumer must be notified in writing prior to the change.[85] The act and the Board's regulations prescribe deadlines for giving this notice.

[b] Documentation of Transfers Made Through an Electronic Terminal. When an electronic fund transfer is made from an electronic terminal, the financial institution must provide the customer with written documentation of the transfer.[86] The financial institution must make available to the consumer a "written receipt," and this receipt must be available "at the time an electronic fund transfer is initiated . . . "[87] The receipt must set forth the amount and date, as well as the type of transfer, the identity of the consumer's account, the identity of any third party to whom the funds were transferred, and the identification of the terminal used.

The definition of what constitutes an electronic terminal broadly includes any "electronic device, other than a telephone operated by a consumer, through

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[81] 15 USC § 1693d(a) (1982); 12 CFR § 205.9(a), (f) (1988).

[82] 15 USC §§ 1693d(c)–1693d(e) (1982); 12 CFR §§ 205.9(b)–205.9(d), 205.9(h) (1988).

[83] 15 USC § 1693e (1982); 12 CFR § 205.10 (1988).

[84] 15 USC § 1693c(a) (1982). The contents of the disclosure are specified in 12 CFR § 205.7 (1988).

[85] 15 USC § 1693c(b) (1982).

[86] 15 USC § 1693d(a) (1982).

[87] 12 CFR § 205.9(a) (1988). The receipt must be written and cannot consist of a display on the screen of the terminal. 12 CFR pt. 205, Supp. II, § 205.9, ¶ 9-3 (1988).

which a consumer may initiate an electronic fund transfer."[88] Thus, the term includes POS terminals, ATMs, and cash-dispensing machines.[89] Transfers using such devices are subject to the documentation requirements. However, transfers accomplished by a consumer from a telephone at home do not fall within this particular documentation rule, although other disclosures with respect to the consumer's account are applicable. The Board's regulations permit a financial institution to make arrangements for third parties, such as merchants or other institutions, to make the receipt available, but the account holding financial institution remains legally responsible for seeing that the receipt is available.[90]

Home banking systems permit a consumer to use a computer terminal or television set located in the home to communicate with the financial institution for the purpose of making transfers from the consumer's accounts. Although such home banking terminals fall within the literal scope of the Board's definition of an electronic terminal, and transactions initiated through them are electronic fund transfers, the Board's staff takes the position that these home banking transactions are not subject to the documentation rules requiring the institution to make available a written receipt to the consumer at the time the consumer initiated the transfer. The staff reasons that the home banking equipment is "analogous to a telephone in function" and so should have the benefit of the exemptions for consumer use of home telephones, from the electronic terminal definition and the terminal receipt requirement.[91]

[c] **Preauthorized Transfers.** Preauthorized transfers also are subject to documentation requirements.[92] When the preauthorized transfer involves a *credit* to a consumer account by electronic funds transfer from the same payor on a recurring basis, the financial institution has an obligation to provide notice to the consumer of the credit, except where the payor provides positive notice to the consumer that the transfer has been initiated.[93] When the institution has the obligation to give notice to the consumer, there are three options: (1) transmitting by oral or written notice within two business days of the transaction that the transfer has occurred; (2) transmitting oral or written notice to the consumer within two business days after the date on which the transfer was scheduled to occur that the transfer did not occur; or (3) providing to the consumer a readily available telephone line for his or her use, to ascertain whether or not the transfer

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[88] 12 CFR § 205.2(h) (1988).

[89] Id.

[90] 12 CFR pt. 205, Supp. II, § 205.9 ¶ 9-2 (1988).

[91] 12 CFR pt. 205, Supp. II, § 205.2 ¶ 2-23 (1988).

[92] 15 USC §§ 1693d(b), 1693e (1982); 12 CFR § 205.10 (1988).

[93] 12 CFR § 205.10(a) (1988).

occurred, so long as the telephone number is disclosed to the consumer on the initial disclosures and periodic statements to the consumer.[94]

When preauthorized electronic fund transfers are made *from* a consumer's account, the consumer must first receive a copy of the authorization of the preauthorized transfers.[95] In cases where a preauthorized transfer varies in amount from the previous transfer relating to the same authorization or preauthorized amount, the institution or the payee involved must give written notice to the consumer of the amount and scheduled date of the transfer, at least ten days before the scheduled transfer date.[96] The consumer may elect to limit notice of changes to circumstances in which the amount of the transfer fails to fall within a specified range of amounts or differs from the most recent transfer by a specific agreed upon amount.[97]

[d] Periodic Statement of Account. A financial institution is under an obligation to deliver a periodic statement of account for "any account to or from which electronic fund transfers can be made . . . "[98] The statement must be delivered monthly or for a shorter cycle in which an electronic fund transfer has occurred; in the event that no transfer has occurred, a statement must be delivered at least quarterly.[99]

The statement must include information as to each electronic fund transfer occurring during the time cycle, the amount of the transfer and proper transfer charges, the date the transfer was credited or debited to the account, the type of transfer and type of accounts involved in the transfer, the place at which the consumer used an electronic terminal, information as to the location of the terminal, the name of third parties to whom or from whom funds were transferred (this does not apply to checks deposited to the consumer's account at an electronic terminal), the number of the consumer's accounts for which the statement is issued, the amount of fees or charges assessed against the account, beginning and ending balances in the account, a telephone number and address to be used by the consumer to give notice of errors, if the alternative of providing error disclosure information in the periodic statement is elected, and the telephone number to use to determine whether a preauthorized transfer has occurred, if the institution elects to use that procedure.[100]

The Board has further regulations that apply to certain passbook accounts, nonpassbook accounts that are accessed only by preauthorized transfers to the

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[94] Id.

[95] 12 CFR § 205.10(b) (1988).

[96] 12 CFR § 205.10(d) (1988).

[97] Id.

[98] 12 CFR § 205.9(b) (1988).

[99] Id.

[100] Id.

account, and certain intrainstitutional transfers between accounts of the consumer at the same financial institution.[101]

[e] Notice of Error Resolution Procedures. The initial disclosure statement must provide the consumer with information about procedures to follow in the case of errors or of questions the consumer may have about electronic transfers involving the consumer's account. Such information must include the financial institution's telephone number and address at which the consumer may contact the institution to obtain answers to the consumer's question.[102] The financial institution must make sure that the consumer receives this information periodically, by mailing to the consumer at least once every calendar year the same notice for each account from or to which an electronic transfer can be made.[103] Alternatively, the financial institution may elect to follow a different procedure. In lieu of sending the annual notice, the institution may mail or deliver a similar notice as part or with each periodic statement required by the regulations.[104]

[f] Documentation as Proof of Transfer. The documentation of an electronic fund transfer as required by the act in the periodic statement, or other documentation of transfer, is admissible as evidence in any legal proceeding that the transfer was made and, according to the act, "shall constitute prima facie proof that such transfer was made."[105]

[7] Miscellaneous Restrictions

The Electronic Fund Transfer Act forbids any person from conditioning a grant of credit to a consumer on that consumer's agreement to repay by means of a preauthorized electronic fund transfer.[106] It also prohibits anyone from requiring a consumer to establish an account for receipt of electronic fund transfers with a particular institution as a condition of employment or of receipt of a government benefit.[107]

[8] Issuing Access Cards

The Electronic Fund Transfer Act limits the circumstances under which a bank or other institution may send bank cards or other means of access to

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[101] 12 CFR § 205.9(c), 205.9(d), 205.9(h) (1988).
[102] 12 CFR § 205.7(a)(10) (1988).
[103] 12 CFR § 205.8(b) (1988).
[104] Id.
[105] 15 USC § 1693d(f) (1982).
[106] 15 USC § 1693k (1982).
[107] Id.

consumers on an unsolicited basis.[108] It is permissible to send a card or other access device to a consumer in response to a request or application of the consumer, and to renew or replace already-issued cards that the consumer has accepted.[109]

In order to send a card on an unsolicited basis to the consumer, the institution must distribute cards that are not validated. This means that the card may not be used to initiate an electronic fund transfer without some further step taken by the consumer to validate the card.[110] In addition, the institution must make disclosure to the consumer of his or her rights and liabilities, as discussed previously in this chapter. It must provide a clear explanation that the card has not been validated and of what must be done to dispose of the card if the consumer so desires. The card must be able to be validated "only in response to a request or application from the consumer, [and] upon verification of the consumer's identity."[111] Accompanying the card, there must be a "complete disclosure" of the matters covered by the initial disclosure statement, to give an explanation "of the consumer's rights and liabilities that will apply if the access device is validated."[112]

Cards sent to renew or to substitute for cards previously issued may be sent on an unsolicited basis, only when the original card was one that was "accepted" by the consumer.[113] An accepted card is one that the consumer has "requested and received or has signed or has used, or authorized another to use."[114]

As noted previously, when an unsolicited card is sent to a consumer, it cannot be a validated card. This means that it may not be a card that can be used to initiate an electronic fund transfer without further action by the consumer. The consumer must request or apply for validation of the card through a procedure that will verify the consumer's identity.[115] One method of implementing these provisions is for the issuing institution to refrain from sending the consumer a personal identification number (PIN) with the card, and to require that the consumer subsequently acquire such a number to validate the card.

The Truth-in-Lending Act also contains rules dealing with the distribution of credit cards. These rules may overlap with those in the Electronic Fund Transfer Act on the issuance of access cards, when the card combines features of both a credit card and an access card. The Electronic Fund Transfer Act does not

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[108] 15 USC § 1693i(b) (1982). See generally 12 CFR § 205.5 (1988).

[109] 15 USC § 1693i(a) (1982).

[110] 15 USC § 1693i(c) (1982).

[111] 15 USC § 1693i(b)(4) (1982).

[112] 12 CFR § 205.05(b)(2) (1988).

[113] 15 USC § 1693i(a)(2) (1982).

[114] 15 USC § 1693a(1) (1982).

[115] 15 USC § 1693i(b)(4) (1982).

contain any provision that clarifies which rules apply when these rules overlap. The Board, however, has adopted regulations on this point.[116]

An electronic fund transfer may involve an extension of credit. When this occurs, the Truth-in-Lending Act may apply. The Electronic Fund Transfer Act, however, makes clear that its provisions are to govern a consumer's liability for unauthorized electronic fund transfer and an extension of credit, pursuant to an agreement between the consumer and the financial institution that credit will be extended when the consumer's account is overdrawn.[117]

A consumer's liability for unauthorized electronic fund transfer may be limited even more than is provided by the Electronic Fund Transfer Act. The consumer and the financial institution are authorized to enter into an agreement that further limits the consumer's liability. Additionally, under the federal act, any "other applicable law," including state law, that limits the consumer's liability must be given effect.[118]

The Electronic Fund Transfer Act has been implemented by the Board of Governors of the Federal Reserve System in Regulation E. In addition, national banks may be concerned with regulations issued by the Comptroller of the Currency.[119] Federal Savings and Loan Associations will be concerned with regulations adopted by the Federal Home Loan Bank Board that deal with remote service units and transactions involving POS transfers or ATMs.[120]

[9] Relation to State Law

The Electronic Fund Transfer Act provides that state laws relating to electronic fund transfers are invalid only to the extent that they are inconsistent with the federal act.[121] It expressly provides that state law may give consumers greater protection than the federal act affords. Thus, state law may limit the liability of consumers for unauthorized electronic fund transfers beyond that granted under the federal act.

When questions arise as to whether a state law is consistent with the federal act, a procedure is provided by which the Board of Governors of the Federal Reserve System may rule on the matter. In cases where the Board determines that state law is inconsistent with the federal act, financial institutions will be

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[116] 12 CFR §§ 205.5(c), 205.6(d), 226.12(g) (1988).

[117] 15 USC § 1693g(c) (1982).

[118] 15 USC § 1693g(d) (1982).

[119] See generally 12 CFR pt. 7 (1988).

[120] Under 12 CFR § 533.1 (1988), Regulation E applies to any member of the Federal Home Loan Bank system. See also 12 CFR §§ 545.141 (FHLBB, remote service units), 545.142 (FHLBB, home banking service) (1988).

[121] 15 USC § 1693q (1982).

immune from any liability under the state law, even if it is later determined that the Board's ruling was erroneous.[122]

[10] Enforcement Powers and Private Remedies

[a] Administrative Enforcement. The Board of Governors of the Federal Reserve System has the authority to prescribe regulations to implement the purposes of the Electronic Fund Transfer Act.[123] These regulations are contained in its Regulation E.[124] The Board also has the authority to issue model clauses that financial institutions may use to comply with the disclosure requirements of the act.[125] Use of these model clauses will constitute a defense to an action brought against the institution to impose civil liability for violation of the disclosure requirements.[126]

Power to administer the Electronic Fund Transfer Act is given, in the case of national banks, to the Comptroller of the Currency and, in the case of member banks of the Federal Reserve System that are not national banks, to the Board of Governors of the Federal Reserve System. In the case of banks that are not members of the Federal Reserve System but which are insured by the Federal Deposit Insurance Corporation, power is given to the Board of Directors of the FDIC. The FHLBB and the Administrator of the National Credit Union have comparable administrative responsibilities for the institutions under their authority.[127]

The act does not exempt creditors from complying with state consumer credit laws unless the state law is inconsistent with the federal act. Effective April 1, 1982, the act provides that the Board of Governors may, upon application of a creditor, rule whether a state law is inconsistent with the federal act. When the Board determines that a state provision is inconsistent, creditors are required to follow the Board's interpretation, and will not incur liability under the state law, even though the Board's determination later may be judged to be in error.[128]

[b] Criminal Enforcement. Willful violation of the act carries criminal penalties. Violations may result in a fine of not more than $5,000 or imprisonment for not more than one year or both.[129]

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[122] Id.

[123] 15 USC § 1693b (1982).

[124] 12 CFR pt. 205 (1988).

[125] Id.

[126] 15 USC § 1693m(d) (1982).

[127] 15 USC § 1693o (1982).

[128] 15 USC § 1610(a) (1982).

[129] 15 USC § 1611 (1982).

The Credit Card Fraud Act of 1984 establishes substantial federal penalties of fines and imprisonment for engaging in intentionally fraudulent transactions with credit cards and other access devices. The act applies to persons who produce, use, or traffic in counterfeit devices, to those who use unauthorized devices, and to the knowing possession with intent to defraud of "fifteen or more devices which are counterfeit or unauthorized." The act defines "access device" broadly to include "any card, plate, code, account number, or other means of account access" that may be used by itself or with another device "to initiate a transfer of funds."[130]

Use of an unauthorized access device with intent to defraud violates the federal Credit Card Fraud Act of 1984, and may subject the user to criminal penalties of a fine of "the greater of $10,000 or twice the value obtained by the offense or imprisonment for not more than ten years, or both," and greater penalties in the event of multiple convictions.[131] Even stiffer penalties exist for certain cases in which there is intentional fraud involving one who "produces, uses, or traffics" in a counterfeit device, or with similar intent "produces, traffics in, has control or custody of, or possesses device-making equipment."[132] The penalties go up to $100,000 and/or twenty years for certain repeat offenders.[133]

[c] Liability of Institutions. Except as limited with respect to errors treated under the error resolution procedures, a financial institution will be liable to consumers for failure to comply with the Electronic Fund Transfer Act for actual damages, costs, and attorney fees and, when the action has been brought by an individual, for an amount not less than $100 nor greater than $1,000.[134] When the action is brought as a class action, the minimum recovery limits are not applicable to members of the class, and the total recovery of the class for the same failure to comply with the act may not exceed the lesser of one percent of the defendant's net worth, or $500,000.[135] The court is directed to take into account in fixing the amount of liability the frequency, persistence, nature, and willfulness of the noncompliance.[136]

Good faith is a defense to actions brought to impose liability under the

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[130] Pub. L. No. 98-473, § 1601-1603, 98th Cong., 2d Sess. (1984) (amending 18 USC § 1029).

[131] Pub. L. 98-473, § 1062(a), 98th Cong., 2d Sess. (1984) (amending 18 USC § 1029).

[132] 18 USCA § 1029(c)(2) (West Supp. 1988).

[133] 18 USCA § 1029(c)(3) (West Supp. 1988). For additional discussion of credit card fraud, see ¶ 18.03[8].

[134] 15 USC § 1693m(a)(2) (1982).

[135] Id.

[136] 15 USC § 1693m(b) (1982).

act.[137] Compliance in good faith with regulations of the Board or use of Board disclosure forms also constitutes a defense.[138] The person may avoid liability by offering to correct any failure to comply with the provisions of the act and by paying the appropriate amount of damages to the injured consumer.[139] When an action is brought under the act in bad faith or to harass, the defendant may obtain reasonable attorney fees.[140]

Additionally, the act makes invalid any writing or agreement that attempts to waive rights on any cause of action created by the act.[141] Consumer remedies exist when an institution knowingly and willfully fails to meet its responsibilities under the error resolution procedures. These are explained in the discussion of error resolution.[142]

¶ 18.03 BANK CREDIT CARDS

While the previous section of this chapter discussed the Electronic Fund Transfer Act and its application to bank card transactions involving payments and other debits and credits to and from a consumer's account that fall within the definition of an electronic fund transfer, this section considers those credit transactions that are subject to regulation by the Truth-in-Lending Act and Regulation Z. The most noteworthy of these transactions involve bank credit cards.

Generally, credit cards are big business. There are different kinds of credit cards. Many retail stores have their own credit cards, and large retailers, such as Sears Roebuck and J.C. Penney, have established extensive networks for credit card transactions with their customers. Additionally, there are credit cards that began as travel and entertainment cards, such as those issued by American Express, Diner's Club, Carte Blanche, and oil companies, but which now have expanded their scope so that they may be used in a broad range of transactions. With the entry of some large commercial firms into the financial services industry and the expansion of insurance companies, securities firms, and other financial companies into large financial services conglomerates, there are systems such as the Sears Discover card, which combine credit plans with other funds transfer features. In addition, bank cards commonly incorporate features that

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[137] 15 USC § 1693m(c) (1982). To sustain the good faith defense, the defendant must show "by a preponderance of the evidence that the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of errors reasonably adapted to avoid any such error." Id.

[138] 15 USC § 1693m(d) (1982).

[139] 15 USC § 1693m(e) (1982).

[140] 15 USC § 1693m(f) (1982).

[141] 15 USC § 1693*l* (1982).

[142] See ¶ 18.02[2].

permit direct access to the consumer's accounts for various debit and credit transactions, as well as access to credit lines in more traditional credit card transactions. The number of transactions handled through bank cards has grown rapidly, and today the bank card is a major supplement to the checking account as a method of directing payment to third parties as well as a device for extending credit.

There are two major bank "credit card systems," MasterCard (Master Charge) and Visa USA. Both systems involve four parties to the transaction. The first is a card issuing bank. On issuing the card to a customer, the bank establishes an account with the customer, the second party to the transaction, and agrees with the customer on the amount of credit to be made available, on the terms for payment, and on the rate of interest to be charged. The issuing bank may or may not be the financial institution where the customer maintains a checking or other account. Sometimes a link is created between the checking account and the credit card account to cover overdrafts in the customer's checking account.[143]

Thus the cardholder or customer of the bank is entitled to use the card as a means of payment at an establishment that has agreed to honor the card, who is the third party to the transaction. Usually the cardholder will be billed on a monthly basis for charges to his or her account, and will be provided with an option to pay the account in full, without interest charges, or to pay an agreed upon portion of the account, with finance charges being assessed. Thus, the card combines the features of both a credit arrangement and a method of payment. The major bank credit card systems provide the customer with a monthly statement describing the transactions involving the account, but do not return the credit card slips executed by the cardholder, when using the card.

Merchants and other establishments who accept the card as payment must enter into an agreement with a bank that is a member of the system (the fourth party to the transaction) that they will follow the procedures established for use of the card. The merchant may be required, for example, to obtain advance approval for transactions that exceed a certain amount. The merchant agreement with the bank also establishes the terms on which the bank will purchase the sales slips obtained by the merchant in transactions using the card, and sets the discount rate. When this relationship is established, the merchant then regularly deposits with the bank the sales slips generated through use of the card, and receives from the bank the appropriate credit at the agreed upon discounted price. The bank that purchases the sales slips from the merchant, if it is not the issuing bank that holds the account of the cardholder, thus has the responsibility of obtaining collection of the slips. Each card system has established procedures for accomplishing these clearings. They operate in a fashion similar to clearing-

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[143] See generally Penney & Baker, supra note 1, ¶ 1.01(3); Baker & Brandel, supra note 1, ¶ 1.01(3).

houses that handle check collection. In most cases, the clearing is accomplished electronically without transfer of the paper sales slips.

The precise legal characterization that should be given to these bank credit transactions is unclear. While some have viewed the credit card as an instrument similar to the letter of credit, it also has been viewed as a process by which drafts are drawn against the card-issuing bank, which are accepted in advance by the bank, through the credit card. The exact legal characterization of credit cards may not always be of great practical importance, because the rights and duties of the parties involved are controlled by contract: the cardholder enters into an agreement with the issuing bank, the merchant enters into an agreement with the bank that receives the charge slips, and the banks that are members of the system are bound by agreements and by the rules and regulations of the bank card associations.

The UCC does not govern credit card transactions. It may, however, apply to the underlying sales transaction for which the card was used. The card itself is not a negotiable instrument, and neither are the charge slips that the customer executes in using the card, as they normally are not worded to comply with the UCC's requisites for a negotiable instrument. Bank credit cards are affected by regulatory legislation. The most important such legislation at the federal level is the Truth-in-Lending Act. This act contains provisions that apply not only to the credit aspects of the bank credit card, but also to other aspects that affect bank card usage.[144]

As a result of litigation involving BankAmericard, the major bank card systems follow a practice of allowing banks to issue cards of both systems. Thus, some banks may issue both MasterCard and Visa USA. The BankAmericard litigation involved the validity of a regulation that prohibited banks from issuing cards of other systems. While the court did not view the regulation as a per se violation of the antitrust laws, it did remand it for a trial to determine whether

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[144] See generally Brandel & Leonard, "Bank Charge Cards: Need Cash or Need Credit," 69 Mich. L. Rev. 1033 (1971); Cleveland, "Bank Credit Cards: Issuer, Merchants, and Users," 90 Banking LJ 719 (1973); Clontz, "Bank Credit Cards Under the Uniform Commercial Code," 87 Banking LJ 888 (1970); Dobson, "Credit Cards," J. of Bus. L. 331 (1979); South, "Credit Cards: A Primer," 23 Bus. L. 327 (1968); Weistart, "Consumer Protection in the Credit Card Industry: Federal Legislative Controls," 70 Mich. L. Rev. 1475 (1972); Notes, "Apportionment of Credit Card Fraud Loss," 4 UC Davis L. Rev. 377 (1971); "Bank Credit Cards and the Usury Laws," 4 UC Davis L. Rev. 335 (1971); "Bank Credit Cards and Enterprise Liability," 21 UCLA L. Rev. 278 (1973); "Liability of Credit Card Issuer for Failure to Disclose Terms as Required by Truth-in-Lending Act," 26 U. Miami L. Rev. 461 (1972); "Bank Credit Cards and the Consumer: Programming Justice Into the Cashless Society," 7 Val. UL Rev. 503 (1973); "Preserving Consumer Defenses in Credit Card Transactions," 81 Yale LJ 287 (1971); Comments, "Applicability of the Law of Letters of Credit to Modern Bank Card Systems," 18 Kansas LR 871 (1970); "Credit Cards, Distributing Fraud Loss," 77 Yale LJ 1418 (1968); "Unauthorized Use of Credit Cards and Some Related Questions: What Problems Remain?" 62 Ky. LJ 881 (1973).

the prohibition would be viewed as an unreasonable restraint on completion, after all the facts were considered. The case was then settled, and following the settlement, banks were allowed to issue freely cards of both major systems.[145]

[1] Truth-in-Lending Act Provisions

The Truth-in-Lending Act contains a number of provisions that have important consequences for credit card transactions. Of course, to the extent that the credit card involves a consumer credit transaction, it may be subject to the general regulatory provisions of the act. These provisions are discussed in Chapter 26. The disclosure rules discussed in Chapter 26 are especially important for credit card issuers. In addition, there are some provisions of the federal act that apply specifically to credit card transactions. These will be discussed in the present chapter, in the sections that follow.

At the outset, it should be noted that the federal legislation exempts from its application credit transactions that are *primarily* "for business, commercial, agricultural, or organizational purposes," to "government bodies or organizations," for credit over $25,000 not secured by real property or a dwelling, for credit for public utility services whose rates are regulated, for securities or commodities accounts, as part of an installment agreement for the purchase of home fuels, and for certain federal student loan programs.[146] Even if a card has been issued for an exempt credit transaction, the card is still subject to the rules in Regulation Z on the issuance of credit cards and liability for their unauthorized use.[147] Thus, telephone calling cards and cards issued for extensions of credit in excess of $25,000 are subject to the rules on issuance and unauthorized use.[148]

The Truth-in-Lending Act defines a credit card as "any card, plate, coupon book or other credit device existing for the purpose of obtaining money, property, labor, or services on credit."[149] Regulation Z refers to "any card . . . or other single credit device that may be used from time to time to obtain credit."[150] The

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[145] Worthen Bank & Trust Co. v. National BankAmericard, Inc., 485 F2d 119 (8th Cir. 1973), cert denied, 415 US 918 (1974). See the discussion in Penney & Baker, supra note 1, ¶ 1.01, 20.02. The transaction fees Visa charges for processing paper and payments through the Visa network do not constitute an anti-competitive agreement in violation of the federal antitrust laws. National Bancard Corp. v. Visa USA, 596 F. Supp. 1231, 1256 (SD Fla. 1984), aff'd, 779 F2d 592 (11th Cir.), cert. denied, 107 S. Ct. 329 (1986).

[146] 15 USC § 1603 (1982 & Supp. IV 1986). The exemptions cover transactions that are "primarily" for these purposes or entities. The official staff interpretations offer further guidelines on how to determine if a particular transaction is primarily for an exempt purpose. 12 CFR pt. 226, Supp. I, § 226.3 ¶ 3(a) (1988).

[147] 12 CFR §§ 226.3 note 4, 226.12(a)-226.12(b) (1988).

[148] 12 CFR § 226.3 note 4 (1988).

[149] 15 USC § 1602(k) (1982).

[150] 12 CFR § 226.2(a)(15) (1988).

definition in Regulation Z does not include a check because there is no repeated use of the instrument. Nor does it cover a debit card or check guarantee card that has no credit feature.[151] The definition does include a check guarantee card that has a tie to a line of credit or to an account that is tied to a line of credit, a combination debit/credit card, and an identification card that allows deferral of payments or that indicates advance loan approval when presented to a merchant.[152]

[2] Issuing Credit Cards

The Truth-in-Lending Act prohibits issuance of credit cards unless they are issued in response to a customer's request or application for a card.[153] When the customer has previously received a credit card that he or she has accepted by signing, using, or authorizing another to use it, the issuer may send another credit card to the customer to renew or to serve as a substitute for the previously issued card, without the prior request of the customer.[154]

The rules on issuance of credit cards apply regardless of the purpose for which the card was issued.[155] Therefore, the requirements apply even to a card that may have been issued for a business or other purpose, that otherwise would be exempt from the act and the Board's regulations.[156]

[3] Preservation of Cardholder Claims and Defenses

The Truth-in-Lending Act preserves cardholder claims and defenses arising out of the commercial transaction for which the credit card was used in certain circumstances. As discussed in Chapter 16, when a purchaser uses a check for payment or signs a promissory note, the seller may transfer the instrument to a holder in due course. When the purchaser signs a contract, the seller may assign it to one who will have the rights of a holder in due course, if the contract contains an enforceable waiver of defenses clause. The holder in due course doctrine is limited in consumer transactions by the FTC rule, as discussed in Chapter 16.

What rights does a purchaser have to raise claims and defenses when that purchaser uses a credit card to pay? For example, a cardholder may use a credit card to buy an appliance from a merchant. If the appliance is defective, the cardholder has a claim against the merchant for breach of warranty. If the

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[151] 12 CFR pt. 226, Supp. I, § 226.2 ¶ 2(a)(15) (1988) (Official Staff Interpretations).
[152] Id.
[153] 15 USC § 1642 (1982).
[154] 12 CFR § 226.13(a)(2) (1988).
[155] 12 CFR §§ 226.3 note 4, 226.12(a) (1988).
[156] Id.

cardholder simply purchased from the merchant on credit, the cardholder might try to resist paying the merchant by setting off the claim against the amount owed. Having used a credit card in payment, has the cardholder lost the right to stop payment to the merchant? Further, does the bank that issued the card have a right to payment from the cardholder, free from any defenses or payments that the cardholder might have against the merchant, assuming that the bank has paid the merchant for the transaction?

The Truth-in-Lending Act provides that the claims and defenses a consumer has, arising out of transactions in which the credit card is used, will be effective against the bank or other party who issued the credit card as part of an open end consumer credit plan.[157] The card issuer's liability, however, is somewhat limited. Firstly, the cardholder must have made a good faith attempt to resolve the problem with the merchant who honored the credit card. Secondly, the cardholder may not assert claims and defenses against the issuer, in transactions that involve small amounts of money. The act gives the cardholder the right to assert such claims and defenses only when the initial transaction exceeds fifty dollars.[158] Thirdly, the underlying transaction that gave rise to the claim or defense must have occurred within the same state as that in which the cardholder maintains his or her address, or within 100 miles of the cardholder.[159] Thus the issuer's responsibility is limited to transactions occurring within an area in which it may be possible for the issuer to obtain redress against the merchant, without undue problems.

The fifty-dollar limitation and the geographic limitation do not apply when the issuer of the credit card is also the seller, or is related to the seller. Thus, the limitations do not apply to use of an oil company credit card at any of the company's franchised dealers throughout the country, nor do they apply to use of a credit card of a national retail chain. The monetary and geographic limitations also are ineffective when the cardholder has obtained the card through a mail solicitation of the card issuer.[160]

Finally, the issuer's liability under the act is limited to the amount of credit that is outstanding with respect to the underlying transaction.[161] The act provides a method by which the amount of credit outstanding may be determined, when finance charges and partial payments are involved.[162] Under regulations adopted by the Board of Governors, the cardholder is entitled to withhold payment to the card issuer up to the amount of credit that is outstanding.[163]

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[157] 15 USC § 1666i(a) (1982).

[158] Id.

[159] Id.

[160] Id.

[161] 15 USC § 1666i(b) (1982).

[162] Id.

[163] 12 CFR § 226.12(c) (1988) (Regulation Z).

The federal provision applies only to transactions in which the credit card was used as a means of payment or as an extension of credit.[164] Therefore, the cardholder's right to assert claims and defenses against the issuer does not arise in transactions involving check guarantee cards, debit cards, or overdraft plans.[165]

The relation is unclear between this provision dealing with the preservation of claims and defenses against the card issuer and those provisions of the Truth-in-Lending Act on resolution of billing errors. If a dispute arises between the bank and the cardholder, over a charge that the cardholder believes to be improper because of a claim or a defense arising out of the underlying transaction, it is possible to regard the charge as a matter subject to the billing error resolution procedures of the act.[166] It should be noted, however, that there is no time limit for asserting claims and defenses against the card issuer under the preservation of defense provisions, but that there is a deadline for asserting billing errors under the act.[167]

The act does not prevent a cardholder from raising claims or defenses arising from the underlying transaction in situations in which the geographic and other conditions of the act are not met. Further, the act does not compel the cardholder to give up any rights that the cardholder might have under the terms of the agreement with the card issuer or under general legal principles. In this aspect, the characterization of the transaction could be important. If the obligation of the cardholder is to be considered like that of a customer under a letter of credit, defects in the underlying transaction will not be a defense to the duty to reimburse the issuer. On the other hand, if the transaction is viewed as a standard checking transaction, the cardholder may be viewed as having rights against the bank, analogous to the stop payment right. Obviously, this is a matter that should be resolved in the agreement between the cardholder and the card issuer.

The Truth-in-Lending Act rules that preserve consumer claims and defenses may give a consumer a basis for avoiding payment to the card issuer for charges incurred in transactions with a credit card in which the consumer has a defense.

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[164] 15 USC § 1666i(a) (1982).

[165] See 12 CFR § 225.12(c) note 24 (1988) (Regulation Z).

[166] See 15 USC § 1666 (1982). The Board's staff takes the position that the error resolution procedures and the preservation of claims and defenses provisions are independent, and the cardholder may assert rights under either, if applicable. 12 CFR pt. 226, Supp. I § 226.12 ¶ 12(c)1 (1988). For example, payment of the disputed balance by the cardholder may prevent use of the claims and defenses procedures, but the billing error procedures might be available. Id.

[167] See Lincoln First Bank, N.A. v. Carlson, 103 Misc. 2d 467, 426 NYS2d 433 (Sup. Ct. 1980). The court also suggested that the cardholder might be able to retain defenses, even though the underlying transaction occurred more than 100 miles from his mailing address, when the card issuer failed to comply with provisions of the statute dealing with correcting billing errors.

When the card issuer complies with the consumer's right to refuse payment in such a case, a question may arise as to whether the card issuer will have recourse against the merchant that sold the goods, or against prior banks or the bank card system that participated in processing the merchant's claim for payment. If the consumer had used a check for payment, but had effectively stopped payment on it, the bank would have charge-back rights against prior parties under the UCC bank collection statutes, and holders of dishonored instruments would have recourse against prior indorsers on the contract an indorser makes to pay the instrument if it is dishonored. The Truth-in-Lending Act does not cover the relationship between the card-issuing bank and prior banks and merchants who participate in the system. The rights of the bank that holds the customer's account to recover against these prior parties will depend on the agreements entered into by the parties to the credit card system.

[4] Prohibition Against Setoff of Obligations

When the cardholder maintains deposit accounts with the issuer of the credit card, problems may arise over the right of the issuer to set off debts owed under the credit card plan against the deposits of the cardholder. The act generally prohibits such setoffs. Setoffs are allowed only when such deductions are made in connection with a written authorization by the cardholder, which allows periodic payments to be deducted automatically from the cardholder's deposit account. However, this action may not be taken with respect to any outstanding disputed amount, upon the request of the cardholder.[168] Further, this provision does not prevent the bank from utilizing any remedy that might be available to it, by state law, to attach the funds of the cardholder in the institution by following procedures available to creditors generally.[169]

[5] Wrongful Refusal to Extend Credit

There is no provision in the Truth-in-Lending Act that gives the holder of a credit card a right comparable to that of the drawer of a check against a bank that wrongfully refuses to honor checks drawn on the customer's account at the bank; similarly, although the Electronic Fund Transfer Act makes a bank liable under some circumstances for failing to carry out an electronic fund transfer,[170] the Truth-in-Lending Act does not contain comparable rules that would make a bank liable if it refused to honor a transaction that was within the credit limits of the consumer's account.

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[168] 15 USC § 1666h(a) (1982).

[169] 15 USC § 1666h(b) (1982).

[170] See supra ¶ 18.02[3] for the Electronic Fund Transfer Act rules.

Moreover, the act expressly provides that to the extent that the card issuer can show that a violation of the act, if there was such a violation, was "not intentional and resulted from a bona fide error notwithstanding maintenance of procedures reasonably adapted to avoid any such error," the card issuer would not be liable for the violation.[171] As listed in the act, "Examples of a bona fide error include, but are not limited to, clerical, calculation, computer malfunction, and programming, and printing errors, except that an error of legal judgmen with respect to a person's obligation under this title is not a bona fide error."[172] Although a cardholder has the right to invoke the billing error correction procedures of the act, when an erroneous charge is made to the cardholder's account, the creditor may reduce the credit limit granted the cardholder until the dispute is resolved.[173]

[6] Terms of Credit Card Plans Affecting Merchants and Others Who Honor the Card

The act prohibits a card issuer from requiring that a seller contract for other services from, or open other accounts with, the bank as a condition for participation in the credit card plan.[174] In credit card plans where the seller is a person other than the issuer of the credit card, the card issuer cannot prohibit a seller from offering discounts to customers who pay for goods and services by methods other than through use of the credit card.[175] When a seller offers such a discount, it will not constitute a finance charge for the purposes of usury controls under state law,[176] nor will it constitute a finance charge for the purpose of disclosure.[177] To avoid classification as a finance charge, the discount must be "offered to all buyers and its availability . . . [be] disclosed clearly and conspicuously."[178]

[7] Duty of Sellers to Notify Issuers of Returned Goods and Other Credits

The act places a duty upon sellers who have accepted a credit card as payment, to notify the card issuer promptly when the seller accepts the return of

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[171] 15 USC § 1640(b) (1982).

[172] Id.

[173] 15 USC § 1666 (1982).

[174] 15 USC § 1666g (1982).

[175] 15 USC § 1666f(a) (1982).

[176] 15 USC § 1666j(c) (1982).

[177] 15 USC § 1666f(b) (1982).

[178] 15 USC § 1666f(b) (1982). At one time the act prohibited sellers from imposing a surcharge on cardholders who use credit cards for payment, but this is no longer effective. Pub. L. No. 94-222, as amended.

the goods or gives the cardholder credit for the transaction.[179] Upon receipt of the notice, the credit card issuer must credit the account of the cardholder.[180]

[8] Credit Card Fraud

The Credit Card Fraud Act of 1984 establishes substantial federal penalties of fines and imprisonment for engaging in intentionally fraudulent transactions with credit cards and other access devices. The act applies to persons who produce, use, or traffic in counterfeit devices, and who use unauthorized devices, and to knowing possession with intent to defraud of "fifteen or more devices which are counterfeit or unauthorized." The act defines "access device" broadly, to include "any card, plate, code, account number, or other means of account access" that can be used by itself or with another device "to initiate a transfer of funds."[181]

The federal law applies both to transactions with a "counterfeit access device" and to those with an "unauthorized access device."[182] Thus, it reaches conduct in which the access device is "lost, stolen, expired, revoked, canceled or obtained with intent to defraud as well as where it is "counterfeit, fictitious, altered or forged."[183]

¶ 18.04 UNAUTHORIZED ELECTRONIC FUND TRANSFERS AND CREDIT CARD TRANSACTIONS

With the advent of new consumer payment systems, such as credit cards and automated teller machines, came the inherent risk of unauthorized use of the card or access device. Unauthorized use issues arise in various situations. Some common fact patterns include use of the card without express permission by an estranged spouse or other family member, use by a friend to whom the card was loaned for a limited purpose, use by an employee who charges personal items to a business account, and theft of credit cards or access devices. Originally, resolution of these issues would have to occur under the terms of the agreement between the bank and the consumer and under the general principles of agency and contract law. Federal legislation now regulates and limits consumer liability in cases of unauthorized use in transactions that come within the

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[179] 15 USC § 1666e (1982).

[180] Id.

[181] Pub. L. 98-473, § 1601–1603, 2d Sess., 98th Cong. (1984) (amending 18 USC § 1029). A government study of wire transfer fraud concluded that the average loss exposure, per transaction studied, exceeded $800,000. Bureau of Justice Statistics, U.S. Dep't. of Justice, Special Report: Electronic Fund Transfer Fraud (Mar. 1985).

[182] 18 USCA §§ 1029(e)(2), 1029(e)(3) (West Supp. 1988).

[183] Id. See discussion supra ¶ 18.02[10][b].

Truth-in-Lending Act, the Electronic Fund Transfer Act, and the related regulations of the Board.

Unauthorized use of credit cards is regulated by the Truth-in-Lending Act.[184] Regulation Z sets out in detail the requirements for limiting consumer liability.[185] For debit cards accessing ATMs, POS terminals, and other electronic terminals, unauthorized use is regulated by the Electronic Fund Transfer Act[186] and by Regulation E.[187] If a card serves as both a credit card and an access device, the law regulating the transaction depends on the nature of the transaction. If the unauthorized use was of the card as a credit card, Regulation Z will apply. However, if the card is used to withdraw money from a checking account at an ATM, Regulation E applies.[188] The scope of Regulation E and of Regulation Z was discussed in the earlier sections of this chapter. It is important to bear in mind that although the Truth-in-Lending Act generally does not apply to credit cards primarily issued for a business purpose, the provisions of the act on liability for unauthorized use do apply to cards issued for business purposes.

[1] Unauthorized Use of Credit Cards

[a] Statutory Rules and Regulation Z. The issuer must meet certain requirements before it can hold a consumer liable for any unauthorized use of his or her credit card:[189]

1. The credit card must be an accepted card;[190]
2. The issuer must have supplied the cardholder with adequate notice of the potential liability and a description of a means by which the cardholder may notify the issuer of loss or theft of the card;[191] and

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[184] 15 USC §§ 1601–1693r (1982 & Supp. IV 1986).

[185] 12 CFR § 226.12 (1988). Official Staff Interpretations of the statute and regulations provide additional guidance. The interpretations appear in a Supplement to the regulations.

[186] 15 USC §§ 1693–1693r (1982).

[187] 12 CFR § 205 (1988).

[188] 12 CFR § 205.6(d) (1988).

[189] 15 USC § 1643(a) (1982).

[190] Generally, an accepted credit card must be requested and received, or signed or used by the consumer. See 12 CFR § 226.12(a) note 21 (1988).

[191] Notification by the cardholder to the issuer may be oral, either in person or by telephone, or written. 12 CFR § 226.12(b)(3) (1988). Notice is deemed given when steps have been taken as may be reasonably required to provide the card issuer with the pertinent information about the loss, theft, or possible unauthorized use of the card. Id.

3. The issuer must provide a method whereby the user of the card can be identified as the person authorized to use it.[192]

If the issuer meets the requirements listed above, it may charge the consumer with liability of not more than $50, for any *unauthorized* use of the card that occurs before the issuer has been notified that an unauthorized use of the card has occurred or may occur as the result of loss, theft, or otherwise.[193]

The cardholder's liability is limited only when the use is unauthorized. The cardholder is liable without limitation for all *authorized* use. Authority is defined in the traditional way, as discussed later, to include actual, implied, and apparent authority.

The card issuer has the burden of proving that a particular use was authorized.[194] If a use was not authorized, the issuer has the burden of showing that the preconditions to liability were met.[195] Further, if state law provides more protection for the consumer, it will not be preempted by this federal regulation.[196] Similarly, the cardholder agreement between the bank and the consumer may provide more protection for the consumer, but the federal limitations are the ceiling.[197]

[b] Definition of "Unauthorized Use." The key issue in limiting consumer liability for unauthorized use of a credit card is the determination of whether the use in fact was unauthorized. Unauthorized use is defined in Section 1602(o) as the use of a credit card by a person, other than the cardholder, who does not have actual, implied, or apparent authority for such use, and from which the cardholder receives no benefit.[198] Whether such authority exists is determined by the applicable state law.[199] Generally, authority is "actual" when the cardholder

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[192] A signature, a photograph, or a fingerprint on the card, or electronic or mechanical confirmation, such as a PIN (personal identification number) all may serve this purpose. See 12 CFR pt. 226, Supp. I, § 226.12 ¶ 12(b)(2)(iii) (1988). (Official Staff Interpretations). For example, a cardholder cannot be held liable for an unauthorized use of his or her credit card number over the phone (as in mail order), because the issuer has not provided a means to identify the consumer in those circumstances. 12 CFR pt. 226, Supp. I, § 226.12 12(b)(2)(iii), 3 (1988). If, however, the issuer can prove the use was authorized, the cardholder is fully liable.

[193] 15 USC § 1643(a)(1) (1982). The $50 limit applies to a "series of unauthorized uses"; there would not be a separate $50 limit on liability for each unauthorized transaction. 12 CFR pt. 226, Supp. I, § 226.12 ¶ 12(b)(1) (1988) (Official Staff Interpretations).

[194] 15 USC § 1643(b) (1982).

[195] Id.

[196] 15 USC § 1632(c) (1982). See 12 CFR § 226.12(b)(4) (1988).

[197] 15 USC § 1632(c) (1982).

[198] 15 USC § 1602(o) (1982).

[199] 12 CFR pt. 226, Supp. I, § 226.12 ¶ 12(b)(1) (1988) (Official Staff Interpretations).

gives express permission to use the card.[200] Authority is "implied" when the surrounding circumstances indicate permission from the cardholder.[201]

The difficult cases usually involve questions of "apparent authority." Under the Restatement (Second) of Agency, apparent authority results from a manifestation by the principal to a third person that another is acting as the principal's agent.[202] It is created by conduct of the principal (the cardholder), which, reasonably interpreted, causes the third person (a merchant) to believe that the principal consents to have the act done on his or her behalf, by the person purporting to act for the principal (the allegedly unauthorized user).[203] Under the Restatement view, apparent authority exists only when the cardholder does something that the third person (the merchant) may reasonably interpret as conferring authority to conduct the transaction on the person who is making the charge to the account. Apparent authority is not created by the conduct of the wrongdoer alone, however convincing such conduct might be.

Under the Restatement, the concept of apparent authority also embraces situations that present elements of estoppel. For example, when a principal (*P*) is aware that another person (*A*) is falsely representing himself as the agent of *P*, under circumstances in which the principal has a duty to the third person (*T*) to prevent *A* from committing a fraud, *P* may be estopped from denying the authority of *A*, if *P* fails to take appropriate action and *T* changes position in reliance on the representations of *A*.[204]

Using an estoppel approach, some commentators have argued that authority can be "apparent" when the cardholder fails to take steps to dispel an impression a reasonable person would have that the credit card user has the cardholder's permission.[205] The typical situation in which this type of apparent authority argument is made is one where the cardholder loaned or gave the allegedly unauthorized user the credit card, with express authority for a specific transaction other than the one for which the card was used. As noted earlier,

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[200] See R. Brandel, J. Terraciano, B. Abbott, Truth in Lending: A Comprehensive Guide 119–120 (1986 Supp.).

[201] Id.

[202] Restatement (Second) of Agency, § 8 comment a (1958).

[203] Id. at § 27.

[204] Restatement (Second) of Agency, §§ 8, 8B (1958). "A person who is not otherwise liable as a party to a transaction purported to be done on his account, is nevertheless subject to liability to persons who have changed their positions because of their belief that the transaction was entered into by or for him, if (a) he intentionally or carelessly caused such belief, or (b) knowing of such belief and that others might change their positions because of it, he did not take reasonable steps to notify them of the facts." Id. at 8B(1)(a) & 8B(1)(b). See also comment d: "When one realizes that another is or may come under a misapprehension as to the authority of his agent . . . his duty to give information is a duty of due care . . . [T]he action required is that which would be taken by a reasonably prudent business man, with the normal regard for the interests of others and his own reputation."

[205] Id.

these cases fall into several distinct categories, which are examined separately in the text that follows.

[i] Loaning of the credit card. When a consumer lends the consumer's credit card to a friend or an acquaintance, the consumer generally will be liable for any and all charges made on the card, even if the "friend" charges more than the amount for which the cardholder expressly gave permission. Courts find that once a cardholder gives a user authority to use the card for some purpose, the user's possession of the card gives the user "apparent authority," which may make the cardholder responsible for any other use of the card until the cardholder terminates that authority by retrieving the card or by taking other action to dispel the apparent authority. Thus, the apparent authority generally lasts until the cardholder reports the card stolen, or reports that it is being used without authorization. For example, in *Martin v. American Express*,[206] the cardholder gave his credit card to his business partner with authorization to charge $500 for a business-related expense. The partner subsequently charged $5,300. The Alabama court held that where a cardholder, who is under no compulsion by fraud, duress, or otherwise, voluntarily permits the use of his credit card by another person, the cardholder has authorized the use of that card and is thereby fully responsible for any charges as a result of that use.[207] A similar situation also resulted in full liability of the consumer in *Standard Oil Co. v. Steele*.[208] Here the court quoted *Martin v. American Express* and found the cardholder liable for over $1,500 charged by a "friend" and other unknown parties after the cardholder had loaned the credit card to allow the user to get a tank of gas for a trip. The court did, however, hold that notice from the cardholder to the issuer that the card was lost, stolen, or being used without authorization would terminate the consumer's liability.[209]

A consumer credit card holder recovered damages for pain and suffering and emotional distress from a bank that billed her for charges made with her Bankamericard Visa card, after she had notified the bank of the theft of her card. The case arose under the California Credit Card Act. The consumer loaned her Visa card to a friend on May 24, 1979, to allow the friend to purchase a plane ticket to Hawaii. The friend agreed to telephone the cardholder every day and to return the credit card on his return from Hawaii. The friend disappeared, failed to telephone, and never returned the card. On May 26, two days later, the consumer notified her bank to cancel the card because it had been stolen. Although the bank recovered the card in September, by then $2,200 in charges had been incurred. The bank not only refused to remove these amounts from her account, but also informed a credit reporting service that the consumer had

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[206] 361 So2d 597, 599 (Ala. Civ. App. 1978).

[207] Id.

[208] 22 Ohio Misc. 2d 27, 29, 489 NE2d 842, 844 (1985).

[209] Id.

exceeded her credit limit and had an account that was past due. In a trial before a jury, the consumer obtained a judgment that her liability on the Visa card was limited to $50 and that she was entitled to an award of $50,000 in damages, which, under the California law, were trebled to $150,000. The court of appeal affirmed the award, holding that the credit card was a stolen card within the meaning of the statute, because the friend took the card under false pretenses without any intention of returning it. Characterizing the action brought by the consumer as in the nature of a tort, and, based on a willful violation of a statutory duty, the court held that the cardholder was entitled to compensation for all damages resulting from the breach of the duty, including those from mental and emotional distress.[210]

[ii] Estranged spouses and other family members. Estranged spouses create unauthorized use problems when the spouse is an authorized user on the credit application but is not contractually liable on the account. Under the usual terms for issuance of a credit card, the consumer who is obligated to pay the account may designate to the card issuer other persons who have authority to use the card to make charges. These persons may or may not receive a card with their name on it.[211] Often the account holding spouse designates the other spouse as an authorized user. Subsequently the spouses separate or divorce, and the cardholder who is responsible for the account no longer wants the other to be authorized to make charges on the account. The card issuers take the position that the user continues to be an authorized user until all the credit cards issued under that account are surrendered to the bank. The cardholder may then open a new account, a single card is issued, and the problem is resolved. Cardholders argue, however, that notice to the issuer informing it that a previously authorized user is no longer authorized should cut off liability of the cardholder for any subsequent purchases charged by that user.

The Federal Trade Commission apparently agrees with the cardholders.[212] Shell Oil Company required the surrender of credit cards to terminate the authority of an authorized user. The company held the cardholder liable for any balance charged until the surrender of the cards, despite notice to the company by the cardholder that the third person was no longer authorized. The FTC filed a complaint against the oil company, claiming that it was violating the terms of the Truth-in-Lending Act. Shell Oil entered into a consent order, which required them to cease charging cardholders for purchases made by third persons, subsequent to notification by the cardholder to the company that the authority of the third person had been terminated.[213]

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[210] Young v. Bank of Am. Nat'l Trust & Sav. Ass'n, 141 Cal. App. 3d 108, 111–116, 190 Cal. Rptr. 122, 125–130 (1983).

[211] 12 CFR pt. 226, Supp. I, § 226.12 ¶ 12(a)(1), (6) (1987) (Official Staff Interpretations).

[212] In re Shell Oil Co., 95 FTC 357 (1980).

[213] Id.

Courts, however, have taken the position that notification alone is not enough to terminate the authority of an authorized user. In *Oclander v. First National Bank*,[214] a woman opened a credit card account with the bank, and her husband was an authorized user. Several months later, she notified the bank that she and her husband were separated. The bank "blocked" the account from additional charges, and forwarded to her the standard divorce and separation affirmation form to be completed and returned to the bank to restore her credit. She completed and returned the forms on August 9, 1982. On the forms she indicated that she had destroyed one of the cards and retained the other. Relying on her representation, the bank "unblocked" the account, under the impression that it was for her use only. Apparently the woman had not destroyed the credit card, because various charges, totaling over $11,000, were made on the account by her husband in Spain, between October 29 and November 30. She refused to pay the charges, and the bank sued.

The appellate court affirmed the summary judgment for the bank, holding that Section 1643 did not apply to limit the wife's liability, since the husband's use was authorized. The bank had not even required her to surrender both cards, but only to account for them. Had she followed the bank's requirements, she could have protected herself.

In *Walker Bank & Trust Co. v. Jones*,[215] the court discussed the effect of notification on the issue of authority. *Walker* involved two cases consolidated on appeal, with similar facts. Two women opened credit card accounts with cards issued in their husbands' names as authorized users. Both marriages broke up, and the women notified the bank that they would no longer honor charges made by their husbands on the accounts. The bank immediately told them they had to surrender the credit cards to avoid liability for charges made by their husbands. Neither woman did so, immediately. One woman surrendered the cards three months later; the other surrendered the cards four months later, and only after a bank representative visited her place of employment to retrieve the cards from her. Purchases were made by the husbands after the date of notification by the wives, but before the cards were surrendered.

The wives argued that their liability was limited to $50 under Section 1643, because once they gave the bank notice, their husbands were no longer authorized to make charges to the account. The bank argued that while notification may cut off any further liability for unauthorized use because of the federal statutes, it does not determine whether the use was authorized or unauthorized. The court agreed with the bank that notification serves only to eliminate liability for subsequent unauthorized use.[216] Notification, if given prior to the unauthorized charges, serves to eliminate the $50 liability and not to render a use

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[214] 700 S.W.2d 804, 806 (Ky. Ct. App. 1985).

[215] 672 P2d 73 (Utah 1983), cert. denied, 466 US 937 (1984).

[216] Id. at 75.

unauthorized. Unless and until the unauthorized nature of the use has been established, the notification provisions, as well as the statute itself, are irrelevant and ineffectual.[217]

The court found that the husbands had apparent authority because they had possession of a credit card with their names imprinted on it and because their signature would naturally match the one on the card. The card was a representation to the third party (the merchant) that the agent had authority to use the credit card account. Because the husbands had apparent authority, the limitation of consumer liability did not apply, so the wives' liability was determined under their credit card agreements with the bank.[218] The agreement required return of the cards before the cardholder's liability could be terminated. Because the wives did not immediately return the credit cards, they were liable for the full balance of the account.

A strong dissent argued that notice to the bank of potential unauthorized use should revoke any apparent, implied, or actual authority of the husband.[219] The dissent found that once notice is given, the bank is in the best position to protect everyone; it can list the credit card in the warning bulletins to merchants, it can terminate the existing account, it can transfer all existing charges to a new number, and it can issue a new card to the cardholder. The dissent also claimed that the rule imposed an unreasonable burden on cardholder spouses because of the obvious difficulty in retrieving a credit card from an uncooperative estranged spouse. The rule, argued the dissent, arms the spouse with a weapon, permitting virtually unlimited spending at the expense of the other.[220]

A family relationship, by itself, generally does not establish implied or apparent authority if the family member is not a designated authorized user.[221] The bank generally has to prove facts indicating that use by the family member was authorized by the cardholder, or that the cardholder received some benefit from the charges on the account.

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[217] Id.

[218] Id. at 76.

[219] Id. at 76–77.

[220] Id. at 79. Compare Vaughn v. United States Nat'l Bank, 79 Or. App. 172, 718 P2d 769 (1986), discussed at ¶ 18.04[2][b].

[221] So far the law has not addressed what effect, if any, community property rules might have in establishing the authority of one spouse, as manager for the community, to contract debts, through use of the other spouse's credit card, that bind the marital community. It is possible, in those community property jurisdictions that regard each spouse as legally entitled to contract debts on behalf of the community, which can be satisfied out of community property, each spouse may have actual authority under the law to act. But even in cases where one spouse may incur debt that binds the community, the law may not recognize any right to collect the debt from the separate, noncommunity property of the nonconsenting spouse.

In *Fifth Third Bank/Visa v. Gilbert*,[222] the court found that a cardholder was not liable for charges made by his minor daughter on his credit card account, because the bank had not presented any evidence indicating whether she had possession of the card, whether the cardholder had accompanied her when she incurred the charges, or whether the cardholder had consented to the charges.[223] The bank could not even collect the $50 limited liability, because it had failed to make the required disclosures to the cardholder. Similarly, the Ohio Court of Appeals refused to find a cardholder liable for charges made by his wife, where no evidence was presented that the wife acted as the cardholder's agent or that the cardholder ratified her use of the credit card.[224]

[iii] Lost and stolen cards. In cases of lost or stolen credit cards, any subsequent use will be unauthorized, because the cardholder has done nothing to manifest any authorization of the actual user. The potential carelessness or negligence of a cardholder generally should not be considered, because Congress intended to eliminate negligence standards in allocating liability and to shift the risk of loss and fraud to the issuers, who could better reduce those losses and spread the risk among all cardholders.[225] Liability thus will be limited to $50, if charges are incurred before the cardholder notifies the issuer. In cases in which the credit card has been issued but not accepted by the cardholder, the act stipulates that the cardholder will have no liability.

[iv] Employer-employee. When a credit card is issued to an employer in the business entity's name, and an authorized employee uses it for personal benefit, the same rules apply as when a cardholder loans the credit card to a friend. When a cardholder voluntarily and knowingly allows another to use the card, and that person subsequently misuses it, the cardholder is still liable.[226]

Regulation Z provides that if ten or more credit cards are issued by one issuer for use by the employees of an organization, the issuer and the employer

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[222] 17 Ohio Misc. 2d 14, 16,478 NE2d 1324, 1326 (Hamilton County Mun. Ct. 1984).

[223] The court did, however, find the minor daughter personally liable for the charges she made on a theory of implied contract.

[224] Society Nat'l Bank v. Kienzle, 11 Ohio App. 3d 178, 182–183, 463 NE 2d 1261, 1265–1266 (1983).

[225] See R. Rohner, The Law of Truth in Lending, ¶ 10.03[1] (1984 & Cum. Supp. 1987); J. Weistart, "Consumer Protection in the Credit Card Industry: Federal Legislative Controls," 70 Mich. L. Rev. 1475, 1518–1519, 1525–1528 (1972).

[226] See Cities Service Co. v. Pailet, 452 So. 2d 319, 321–322 (La. Ct. App. 1984) (employer cardholder liable for balance due as of date he notified issuer that card was lost and charges were unauthorized. Employee had authorization to use the card for work-related expenses. No explanation for the charges, but employer made no allegations that it was stolen, fraudulently used, or lost). See also Mastercard v. Newport, 133 Wis. 2d 328, 396 NW2d 345 (Wis. Ct. App. 1986) (town liable for full balance of credit card account where it, as employer, authorized an employee to use the card for fuel. Employee had misused it, charging hotel and restaurant expenses and gift and clothing purchases for her personal use. Employee had apparent authority, so limitation did not apply).

may agree that the employer will be liable for unauthorized use (and thus will not be subject to the protections of Section 1643); however, the employees are still subject to the protection given to consumers.[227]

[2] Unauthorized Electronic Fund Transfers

[a] Statutory Rules and Regulation E. A consumer is subject to three different levels of liability for unauthorized electronic fund transfers, depending on the factual circumstances. Unauthorized electronic fund transfers are usually made at ATMs, generally by acquaintances who exceed their authority, through fraudulent schemes, or through mechanical mistakes made by the ATM. As with credit cards, a bank must meet three preconditions to hold a consumer at all liable for unauthorized transfers:

1. The access device must be accepted;[228]
2. The issuer has provided a means whereby the user of the access device may be identified as the person authorized to use it, such as signature, photograph, fingerprint, or electronic or mechanical confirmation;[229] and
3. The issuer has disclosed to the consumer the potential liability of the consumer for unauthorized use of the access device, and has made other required disclosures.[230]

The three tiers of liability are contingent on two factors: (1) the time at which the consumer receives notice that the access device has been lost or stolen or that an unauthorized transaction has occurred and (2) the time at which the consumer notifies the issuer of such. The rules of liability are given as follows:

1. If the consumer notifies the bank within two business days of discovering the loss of the access device, liability is limited to the lesser of $50 or the amount of unauthorized transactions that occur before notice was given to the bank.
2. If the consumer fails to notify the bank within two business days after discovering the loss, the consumer's liability increases to the lesser of:
   a. $500, or
   b. the sum of

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[227] 12 CFR § 226.12(b)(5) (1988).

[228] 15 USC § 1693g(a) (1982). "Accepted" generally means that the consumer asked for and received an access device, such as a debit card and PIN (personal identification number).

[229] 15 USC § 1693g(a) (1982).

[230] 15 USC § 1693g(b) (1982); 12 CFR § 205.6(a)(3) (1988). The required disclosures include the name and address of the office to be notified in the event of a lost or stolen access device, or an unauthorized transfer; and the financial institution's business days.

i. $50 or the amount of unauthorized electronic fund transfers that occur before the close of the two business days, whichever is less, and

ii. the amount of unauthorized electronic fund transfers that the bank proves would not have occurred but for the failure of the consumer to notify the institution within two business days after their discovery, and that occur after the close of two business days and before notice to the bank.

3. If the consumer fails to report within sixty days of transmittal of the periodic statement any unauthorized transaction that appears on the statement, the consumer's liability shall not exceed the sum of:

a. the lesser of $50 or the amount of the unauthorized transactions appearing on the statement or that occur during the sixty day period; and

b. the amount of unauthorized electronic fund transfers that occur after the close of the sixty days and before notice to the bank and that the bank establishes would not have occurred but for the failure of the consumer to notify the bank within that time.[231]

There may be situations in which both item 2 and item 3 apply. In those cases, item 2 determines the liability for any unauthorized transfers that appear on the periodic statement and that occur before the close of the sixty day period, and item 3 determines the liability for transfers that occur after the close of the sixty-day period.[232]

Examples of calculating liability appear in the Official Staff Interpretations:[233]

a. *Situation 1*: $500 Limit Applies

Date	*Event*
June 1	C's card is stolen.
June 2	$100 unauthorized transfer.
June 3	C learns of theft.
June 4	$25 unauthorized transfer.
June 5	Close of 2 business days after discovery of loss.
June 7–8	$600 in unauthorized transfers that could have been prevented had notice been given by June 5.
June 9	C notifies bank.

[231] 15 USC § 1693g(a) (1982); 12 CFR § 205.6(b) (1988).

[232] 12 CFR § 205.6(b)(3) (1988).

[233] 12 CFR pt. 205, Supp. II, § 205.6 ¶ 6-5 (1988) (Official Staff Interpretations). The examples in the text are taken from the interpretations with some modifications

Computation of Liability:

Paragraph 2 will apply to determine C's liability for any unauthorized transfers that occur before notice is given, because the consumer failed to give notice within 2 business days of discovering the loss.

- Amount of transfers before close of 2 business days = $125. The maximum liability for these 2 days = $50.
- Amount of transfers, after close of 2 business days and before notice to institution, that would not have occurred but for C's failure to notify the bank within 2 business days = $600.
- Because the sum ($650) exceeds the maximum liability under this subsection, the total liability of C = $500.

b. *Situation 2*: Both $500 and Unlimited Liability Provisions Apply

Date	*Event*
June 1	C's card is stolen.
June 3	C learns of theft.
June 5	Close of 2 business days after discovery of theft.
June 7	$200 unauthorized transfer that could have been prevented had notice been given by June 5.
June 10	Periodic statement is transmitted to C (for period from 5/10 to 6/9).
June 15	$200 unauthorized transfer that could have been prevented had notice been given by June 5.
July 10	Periodic statement of C's account is transmitted to C (for period from 6/10 to 7/9).
August 4	$300 unauthorized transfer that could have been prevented had notice been given by June 5.
August 9	Close of 60 days after transmittal of statement showing unauthorized transfer.
August 10	Periodic statement of C's account is transmitted to C (for period from 7/10 to 8/9).
August 15	$100 unauthorized transfer that could have been prevented had notice been given by August 9.
August 20	C notifies bank.

Computation of Liability:

Paragraph 2 will apply to determine C's liability for unauthorized transfers that appear on the periodic statement and unauthorized transfers that occur before the close of the 60-day period.

- Amount of unauthorized transfers before close of 2 business days = $0.
- Amount of unauthorized transfers, after close of 2 business days and before close of 60-day period, that would not have occurred but for C's failure to notify within 2 business days = $700.

- Because the $700 in unauthorized transactions exceeds the maximum, C's liability under this section is $500.

Paragraph 3 will apply to determine C's liability for unauthorized transfers occurring after the close of the 60-day period. There is no dollar ceiling on liability here.

- Amount of transfers, after close of 60 days and before notice, that would not have occurred but for C's failure to notify within 60 days = $100. C's total liability is $500 (under b) + $100 (under c) = $600.

c. *Situation 3*: $50/Unlimited Liability Provisions Apply

The facts are the same as in situation 2, except that C does not learn of the card theft, but questions the account balance and notifies the bank on August 20 of possible unauthorized transfers.

Computation of Liability:

Only paragraph 3 applies here.

- Amount of transfers appearing on the periodic statement or occurring during the 60-day period = $700. The maximum liability for this period is $50.
- Amount of transfers, after close of the 60-day period and before notice, that would not have occurred but for C's failure to notify within 60 days = $100.
- C's total liability = $150.

Notice to the bank may be oral or written. If written, notice is effective, for purposes of these regulations, upon mailing.[234] A bank also may be deemed to have notice when it becomes aware of circumstances that lead to the reasonable belief that an unauthorized electronic fund transfer involving the consumer's account has been or may be made.[235]

[b] Definition of "Unauthorized Transfer." Regulation E defines an unauthorized electronic fund transfer as

> an electronic fund transfer from a consumer's account initiated by a person other than the consumer without actual authority to initiate the transfer and from which the consumer receives no benefit. The term does not include any electronic fund transfer 1) initiated by a person who was furnished with the access device to the consumer's account by the consumer, unless the consumer has notified the financial institution involved that transfers by that person are no longer authorized, 2) initiated with fraudulent intent by

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[234] 12 CFR § 205.6(c) (1988).

[235] Id.

the consumer or any person acting in concert with the consumer, or 3) that is initiated by the financial institution or its employee.[236]

Official staff interpretations further elaborate that a consumer cannot be said to have "furnished" an access device if the consumer was robbed or induced by fraud to give it to another.[237] However, if the consumer furnishes an access device and grants actual authority to make transfers to another person who then exceeds that authority, the consumer is liable for the transfers unless the bank has been notified that transfers by that person are no longer authorized.[238]

An access device is defined as a "card, code, or other means of access to a consumer's account, or any combination thereof, that may be used by the consumer for the purpose of initiating electronic fund transfers."[239] Examples include debit cards, telephone bill payment codes, and PINS.[240]

The negligence of the consumer is not to be considered in calculating liability or in determining authorization. For example, writing a PIN on the debit card, although it may be considered negligence under the state law that applies to the unauthorized transaction, cannot be considered in determining who bears liability for an unauthorized transaction.[241]

There are few cases interpreting the definition of unauthorized electronic fund transfers. *Vaughn v. United States National Bank*[242] involved unauthorized transfers by an acquaintance-thief. On two or three occasions, Vaughn had given his ATM card and the PIN to his brother's girlfriend to make purchases for his benefit. Each time she did what was requested, and returned the card to him along with the teller receipt and the change. Shortly afterward, she moved into the house that Vaughn and his brother shared. On three occasions thereafter she stole Vaughn's ATM card from his wallet and used it to obtain money for her own use from the ATM, each time putting the card back in his wallet so that he would not suspect anything. Vaughn was unaware of this activity until the bank notified him that his account was overdrawn.

The court held that these transactions were unauthorized because the girlfriend took the card from Vaughn's wallet and used it for her own benefit. She had no more apparent authority in using the card than if a thief had stolen it; it

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[236] 15 USC § 1693a(11) (1982); 12 CFR § 205.2(1) (1988). Under 15 USC § 1693b, the Federal Reserve Board is authorized to prescribe regulations to carry out the purposes of the statute.

[237] 12 CFR pt. 205, Supp. II, § 205.2 ¶ 2-27 (1988) (Official Staff Interpretations). Similarly, if a consumer is forced by a robber to withdraw cash at an ATM, the liability limitations apply because the robber's actions are tantamount to stealing and using the access device. Id. at ¶ 2-28.

[238] 12 CFR pt. 205, Supp. II § 205.2 ¶ 2-27 (1988) (Official Staff Interpretations).

[239] 12 CFR § 205.2(a)(1) (1988).

[240] 12 CFR pt. 205, Supp. II, § 205.2 ¶ 2-1 (1988) (Official Staff Interpretations).

[241] See 12 CFR pt. 205, Supp. II, § 205.2 ¶ 6-6.5 (1988) (Official Staff Interpretations).

[242] 79 Or. App. 172, 718 P2d 769 (1986).

made no difference that she was an acquaintance, or had formerly been authorized to use the card.[243]

As with credit card unauthorized use, the bank has the burden of proving that a transfer was authorized, or if unauthorized, that the bank meets the conditions necessary to hold the consumer liable.[244] One difficult aspect of this burden is that of proving when the consumer knew, or discovered, that the access device was missing or stolen. The burden of proof may, in some situations, decide the case.[245]

¶ 18.05 FUND TRANSFERS NOT REGULATED BY THE ELECTRONIC FUND TRANSFER ACT, THE TRUTH-IN-LENDING ACT, OR THE UCC

The first part of this chapter discussed the law regulating payments that fall within the scope of the Electronic Fund Transfer Act and the Truth-in-Lending Act. These transactions, with some limited exceptions, involve consumer transactions that transfer funds or draw on credit arrangements. For the most part, fund transfer transactions initiated by customers who are not consumers will not be subject to regulation under these federal laws.[246] The transactions not covered are substantial. Among the fund transfers not covered are those which sometimes are referred to as "wholesale wire transfers," such as are made through CHIPS or FedWire.[247] Federal Reserve sources report:

> In terms of dollar volume, electronic wire transfers are by far the most important type of payments processed by the Fed. Over 142 trillion dollars were transferred over the Federal Reserve's electronic transfer system in 1987, more than 12 times the dollar volume transferred by check. Most of these transactions occurred among large corporations, depositories, and financial companies. Moreover, electronic transfers mainly involved federal funds trades and securities purchases and sales, not purchases and sales

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[243] Id. at 770.

[244] 15 USC § 1693g(b) (1982).

[245] Judd v. Citibank, 107 Misc. 2d 526, 527–528, 435 NYS2d 210, 211–212 (City Ct. 1980) presented a classic situation in which allocation of the burden of proof would decide the matter. Plaintiff claimed that she had not withdrawn funds from her account by using her Citibank access card at an automated cash machine, and the bank claimed that the computer printout from the machine demonstrated the funds could only had been withdrawn by use of the card and of the correct personal identification code. Relying upon the recommendations of the National Commission on Electronic Fund Transfers, although not deciding the case under the provisions of the Electronic Fund Transfer Act, the court held that she satisfied her burden of proof as plaintiff.

[246] The scope of the Electronic Fund Transfer Act and the Truth-in-Lending Act is discussed at ¶¶ 18.02[1], 18.03[1], 26.03[1].

[247] See supra ¶ 18.01[1].

of final goods and services. Individual electronic transfers tended to be large, averaging 2.7 million dollars each. Thus, the *number* of these small "wholesale" electronic transfers was minuscule in relation to the total check volume processed by the Federal Reserve.[248]

Additionally, transactions covered by either the Electronic Fund Transfer Act or by the Truth-in-Lending Act provisions on credits cards are regulated only in part. The federal law and the Board's regulations focus on the rights and duties of the consumer in such transactions. For the most part, the requirements placed on financial institutions under these regulations are rules that govern the institution's relationship with a consumer who engages in an electronic fund transfer or a credit card transaction. To the extent that a financial institution in processing such transactions makes fund transfers to or receives fund transfers from other institutions or parties, these aspects of the transaction are not covered by the federal regulations. The rules establishing the legal rights and obligations of the parties with respect to these unregulated aspects of the transaction will depend on general law of contracts, torts, and other common-law principles and the terms of any private agreements between the parties. There is considerable uncertainty, however, as to how general law principles might apply to such fund transfer transactions, because the case law is limited in both the number of decisions and the breadth of the issues addressed. Although the participants in such transactions seek to allocate the risks through private contracts, the nature of some of the fund transactions makes it difficult for private contracting to bind all who may be affected by a fund transfer transaction or to develop uniform rules for loss allocation that treat all participants fairly.

The present form of Articles 3 and 4 of the UCC was drafted prior to the development of payment systems through electronic fund transfers, ATMs, ACHs, and other forms of fund transfers. As a result, the provisions of Articles 3 and 4 contemplate the processing of paper instruments such as checks and other commercial paper but are ill-suited for application to the varied and different systems of fund transfer that do not utilize paper instruments.[249]

The regulatory gap is filled, in part, by regulations of the Board of Governors of the Federal Reserve System and operating circulars of the Federal Reserve banks, with respect to transactions conducted through the Federal Reserve System.[250] As a consequence of the passage in 1987 of the Expedited Funds Availability Act, which was part of the Competitive Equality Banking Act, Congress gave the Board of Governors of the Federal Reserve System broad

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[248] Federal Reserve Bank of San Francisco, Weekly Letter, p.1 (Apr. 15, 1988).

[249] See discussion supra ¶ 18.01[2].

[250] See 12 CFR pt. 210, subpt. B (1988) (Regulation J). Each Federal Reserve bank issues operating circulars covering the collection and payment of items and transfer of funds. There are circulars on check collection, automated clearinghouse items, and other transactions.

powers to change and to regulate the nation's payment systems.[251] The Board has proposed a new regulation CC on check collection, which will modify some of the rules in the UCC on collection and payment of checks. This regulation will affect electronic and other fund transfers to some extent. It is likely that the Board will play an increasingly important role in regulating the conduct of fund transfers as it exercises its powers under the Expedited Funds Availability Act.

Further, there are significant regulatory issues associated with the handling of fund transfers. A major example is the attention that regulators are giving to the risks that large dollar fund transfers create for the payment system. The Federal Reserve Board has adopted policies to identify and address some of these risks. One policy calls on banks that participate in such systems to take various actions to reduce the risks of payment failure.[252] In view of the enormous sums of moneys that are transferred by wire, any given bank at the close of business on any given day may be obligated to send funds that greatly exceed its total capital, since it anticipates receiving settlements by wire from other banks. The concern is that if one bank in the chain fails to make a settlement, there could be a chain reaction of disastrous proportions throughout the banking system.

A glimpse at the types of problems that might arise was provided by Federal Reserve Board officers, in testimony to Congress in December 1985. They described a computer failure at the Bank of New York in November 1985, a failure that prevented the bank from delivering to purchasers some $20 billion worth of government securities. Because the bank could not deliver the securities to the purchasers, the purchasers did not pay for them. As a result, at the close of business that day, the Bank of New York had an obligation to the Federal Reserve bank for $22.6 billion for the securities. To solve the difficulty, the Bank of New York obtained an overnight loan of $22.6 billion from the discount window of the Federal Reserve bank. This loan, which was the largest overnight loan ever extended by the Federal Reserve bank, amounted to almost double the asset size of the Bank of New York and exceeded the bank's capital by about twenty-three times.[253]

The remainder of this section briefly considers the hodgepodge of law and regulations that have emerged to deal with fund transfers not covered by federal

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[251] See discussion at ¶ 14.01[3][c].

[252] Board of Governors, Federal Reserve System, Interim Policy Statement (1987), reported at 3 Board of Governors, Federal Reserve System, Federal Reserve Regulatory Service ¶ 7-065 (1987). See also id. ¶¶ 7-065.1–7-065.3, 7-066. For an earlier statement of the policy see 50 Fed. Reg. 21,120 (1985); 50 Fed. Reg. 34,493 (1985). Related policies proposed by the Board include a series of proposals related to book-entry securities transfers, ACH transactions, daylight overdrafts, and other issues. See 51 Fed. Reg. 45,043, 45,046, 45,050, 45,052, 45,053, 45,054 (Dec. 15, 1986).

[253] The Bank of New York problem is described in 45 Wash. Fin. Rep. (BNA) 888 (Dec. 16, 1985).

law on credit cards or consumer electronic fund transfers. A drafting committee is working to develop a new Article 4A of the UCC, which would apply to such fund transfers. Although working drafts are in the process of review and comment, the sponsoring organizations of the UCC have not yet approved an official draft for inclusion in the UCC. The work of this group, however, should be helpful in identifying legal issues and possible solutions to them, although the work of the drafters is incomplete.

[1] Regulation of Wire Transfers by the Federal Reserve System

The Board of Governors of the Federal Reserve System has adopted regulations on the wire transfers of funds that are handled through the wire transfer facilities of the Federal Reserve banks.[254] The Board bases its authority to adopt rules regulating these wire transfers on its general authority to provide for the safekeeping of money and property deposited with Federal Reserve agents, on its authority to exercise general supervision over Federal Reserve banks, and on its authority to provide the functions of a clearing house and to regulate the access of its members to reserve accounts held by the Federal Reserve banks.[255]

[a] Basic Definitions. The Board's regulations on wire transfers cover transfers to or from a Federal Reserve Bank. The regulations contain a set of definitions. A "transferor" is a member bank, a Reserve Bank, or other institution "that maintains or uses an account at a Reserve Bank and that is authorized by that Reserve Bank to send a transfer item or request to it."[256] A "transferee" is a member bank, Reserve Bank, or other institution "that (1) maintains or, if authorized by the Reserve Bank, uses an account at a Reserve Bank and (2) is designated in a transfer item or request to receive the amount of the item or request."[257] A "transfer item" is (1) an item sent by the transferor, other than a Reserve bank, to a Reserve Bank for debit to the transferor's account at the Reserve bank and for credit to a transferee; (2) an item sent by a Reserve bank to another Reserve bank, for credit to the latter or to any other transferee; or (3) an item issued by a Reserve bank, at the request of a transferor, for credit to a transferee.[258] A transfer item is a writing that evidences a request for the pay-

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[254] 12 CFR § 210, subpt. B (1988). Amendments to other parts of Regulation J have been proposed as part of the Board's implementation of the Expedited Funds Availability Act.

[255] 12 USC §§ 248(i)-248(j), 248(o), 342, 464 (1982 and Supp. IV 1986). As discussed at ¶ 14.01[3][c], the Competitive Equality Banking Act of 1987 gave the Board additional authority over the national payments system to regulate payments transactions even when the transactions do not use Federal Reserve System facilities.

[256] 12 CFR § 210.26(g) (1988).

[257] 12 CFR § 210.26(f) (1988).

[258] 12 CFR § 210.26(d) (1988).

ment of money to be handled under these procedures, and that may be communicated not only by means of a letter, memorandum, or similar writing, but also by means of magnetic tape, a disk, "or other medium designed to contain in durable form conventional signals used for electronic communication of messages."[259] The definition of "item," for purposes of the wire transfer regulations, does not include instruments such as checks and drafts that constitute items for purposes of the Board's regulations on collection of checks and other items.[260] The regulations also cover "transfer requests," which are requests made by telephone to a Reserve Bank, requesting that the bank issue a transfer item.[261] A "beneficiary" is a person other than the transferee, who is designated in a transfer item or transfer request "to receive the amount of the item or request from the transferee."

As contemplated by the Board's regulations, Bank *A*, who is a transferor, may request that its Federal Reserve bank transfer funds from an account of Bank *A* at the Reserve bank to an account maintained by Bank *B*, who is the transferee, at the same Reserve bank. Bank *A* may be acting on behalf of a customer in sending the transfer item. The customer will be engaging in the transfer to accomplish payment to a beneficiary, who will be a person or organization who is a customer of some bank, such as Bank *B*. Because the transaction will be accomplished by the Reserve bank, making debits and credits to accounts with it, the Board refers to this type of transaction as an "intra office transaction."[262]

There also are "interoffice transactions."[263] In these transactions, two Reserve banks are involved. The following example illustrates an interoffice transfer. The transferor, Bank *A*, has an account with Reserve Bank *1*. The transferee, Bank *B*, has an account with Reserve Bank *2*. To carry out the transaction, Reserve Bank *1* is obligated to debit Bank *A*'s account and to send a "matching transfer item" to Reserve Bank *2*. A matching transfer item is a transfer item that is identical in amount, transferee, and beneficiary, to the transfer item Reserve Bank *1* received from Bank *A*. When Reserve Bank *2* receives the transfer item, it then credits Bank *B*'s account.[264]

Each of the Reserve banks, under the Board's regulations, is authorized to adopt operating circulars that govern the details of its fund transfer operations.[265] The Board's regulations and the operating circulars adopted by the Reserve banks "are binding on transferors, transferees, beneficiaries, and other

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[259] 12 CFR §§ 210.26(c), 210.28(a) (1988).

[260] 12 CFR § 210.26(c) (1988).

[261] 12 CFR § 210.26(e) (1988).

[262] 12 CFR § 210.32(a) (1988).

[263] Id., § 210.32(b).

[264] Id.

[265] 12 CFR § 210.27(a) (1988).

parties interested in an item."[266] Thus, although the regulations are drafted in terms of the rights and liabilities that exist between the Federal Reserve banks and the banks with accounts at the Federal Reserve banks, which are involved in the fund transfers, the rules established are binding on all those "interested in an item."[267]

Nevertheless, as the Board's regulations primarily concern the relationship between these banks, the relationship between the transferor bank (Bank *A* in the previous example) and its customer is largely untouched by the regulation, and thus is a matter for agreement between *A* and its customer. Similarly, the relationship between Bank *A* and the beneficiary, regarding when the beneficiary shall be deemed to have been paid, is not directly covered by the Board's regulation although the answer to that question is affected by the Board's rules on final payment to the transferee. Likewise, the relationship between the transferee institution (Bank *B* in the previous example) and the beneficiary of the transfer (who is a customer of Bank *B*) is one that falls outside the scope of the regulation.

[b] Authority of the Reserve Bank to Process Transfer. When a transferor institution sends a transfer item or makes a transfer request, the action gives authorization to the Reserve bank to charge the amount to the transferor's account and to process the transfer.[268] A transferor is required to have in its account at the Reserve bank at the end of the banking day "a balance of actually and finally collected funds sufficient to cover the amounts of transfer items debited to the account during that day."[269] The Reserve bank may refuse to act on a transfer item or transfer request or may impose conditions to its acting on such item or request, if the Reserve bank has reason to doubt the adequacy of the balance in the transferor's account. Additionally, the Reserve bank has a security interest in the assets of the transferor that are in the possession of the Reserve bank if the transferor's balance is inadequate, if the transferor suspends payments, or if the transferor is closed without having a balance to cover the amounts debited.[270]

A transferee bank, under the Board's regulations, authorizes its Reserve bank to credit the amount of transfer items to its account.[271] When a transferee bank receives a transfer item, or, when it receives advice from its Reserve bank that its account has been credited for an executed transfer of funds and the item or advice designates a beneficiary, the transferee will be held to the following

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[266] 12 CFR § 210.27(b) (1988).

[267] Id.

[268] 12 CFR § 210.29 (1988).

[269] 12 CFR § 210.31(a) (1988).

[270] 12 CFR § 210.31 (1988).

[271] 12 CFR § 210.30(a) (1988).

agreement: firstly, the bank must "credit promptly the beneficiary's account or otherwise make the amount available to the beneficiary;" or secondly, the bank must "notify promptly its Reserve bank if it is unable to do so because of circumstances beyond its control."[272]

[c] Procedures Governing Reserve Bank Transfers. The operating circulars of the Reserve bank set forth a schedule showing the hours when the Reserve bank will handle transfer items and requests.[273] The regulations establish a standard for timely action by the Reserve banks in the processing of transfer items or requests. "A Reserve Bank acts seasonably if it takes proper action on the day it receives a transfer item or request. Taking proper action within a reasonably longer time may be seasonable but the Reserve Bank has the burden of so establishing. No Reserve Bank shall represent that it will complete a transfer of funds on the day requested."[274] If a Reserve bank acts diligently, its time for acting on a transfer may be extended, when circumstances beyond the control of the bank delay the action.[275]

After a transferor sends a transfer item or request to its Reserve bank, the Reserve bank under the Board's regulations is required to send an advice of debit to the transferor.[276] The information contained in this advice will be binding upon the transferor, unless the transferor gives the Reserve bank written objection within ten calendar days of receiving the advice of debit.[277]

It is possible for a transferor to request that a Reserve bank revoke a transaction. The regulations permit a Reserve bank to cease acting on a transfer item or request, if it receives the request for revocation "in time to give the Reserve bank a reasonable opportunity to comply."[278] The regulations do not define what is "a reasonable opportunity to comply." Presumably, this would include a requirement that the Reserve bank have a reasonable time to act before final payment has occurred under the Board's regulations. Although the revocation request may come too late, the regulations authorize a Reserve bank, when the transferor so requests it, to ask for a return of the funds from the transferee.[279] Provisions also exist for situations in which an erroneous transfer occurs. In the event of an "erroneous or irregular transfer of funds," a Reserve bank on its own initiative may ask for the return of the funds from the transferee.[280]

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[272] 12 CFR § 210.30 (1988).

[273] 12 CFR § 210.33(a) (1988).

[274] 12 CFR § 210.33(b) (1988).

[275] 12 CFR § 210.37 (1988).

[276] 12 CFR § 210.34(b) (1988).

[277] Id.

[278] 12 CFR § 210.35(a) (1988).

[279] Id.

[280] 12 CFR § 210.35(b) (1988).

Fund transfers through the Federal Reserve System become final under the regulations of the Board, when the transferee's Reserve bank "sends the transfer item or sends or telephones the advice of credit for the item to the transferee, whichever occurs first."[281] Once final payment has occurred, the credit given by the Reserve bank is available for use by the transferee, subject only to the Reserve bank's right to apply the funds to an obligation owed to the Reserve bank by the transferee.[282]

Under the Federal Reserve wire transfer system, there is no separate settlement of accounts that must occur at some time subsequent to the transaction. Settlement occurs automatically, as a result of the debits and credits made to the accounts with the Reserve bank.

[d] Liability of the Reserve Bank. The Board's regulations also specify the liability of the Reserve banks that participate in wire transfer transactions. The regulations expressly provide that a Reserve bank is not responsible "to a transferee, beneficiary, or other party, except its immediate transferor."[283] Further, the liability of a Reserve bank for its transferor is limited to the requirements established by the Board's regulations, and the Reserve bank is not liable for "the insolvency, neglect, misconduct, mistake, or default of another bank or person, including a transferor, except as provided in this section."[284] The basic standard of liability that a Reserve bank undertakes is a liability for its own or for another Reserve bank's "lack of good faith or failure to exercise ordinary care."[285] The regulations set forth the liability as follows:

> (b) *Damages.* A Reserve Bank is liable to its immediate transferor for a failure to credit the amount of a transfer item or request to the transferee's account caused by a Reserve Bank's failure to exercise ordinary care or act in good faith. A Reserve Bank's liability for such a failure to credit is limited to damages that are attributable directly and immediately to the failure to credit, but does not include damages that are attributable to the consequences of the failure to credit, even if such consequences were foreseeable at the time of such failure.
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> (c) *Right to Indemnity.* The transferee's Reserve Bank shall indemnify the transferor's Reserve Bank for any loss or expense sustained (including attorney's fees and expenses of litigation) as a result of the failure of the transferee's Reserve Bank to exercise ordinary care or to act in good faith in an interoffice transaction.[286]

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[281] 12 CFR § 210.36(a) (1988).

[282] 12 CFR § 210.36(b) (1988).

[283] 12 CFR § 210.38(a) (1988).

[284] Id.

[285] Id.

[286] 12 CFR § 210.38 (1988).

There is a two-year statute of limitations for asserting claims against a Reserve bank for failure to exercise ordinary care or to act in good faith under this provision.[287]

The scheme contemplated by this liability provision is that of placing liability for a transfer not properly executed on the transferor's Reserve bank. For example, in a transaction involving an interoffice transfer, in which the transferor's Reserve bank sends a transfer item to a different Reserve bank that is the transferee's Reserve bank, but where something goes wrong in the transaction and the transfer is not properly credited to the account of the transferee, liability would be as follows: the transferor's Reserve bank would be responsible both for its own and for the transferee's Reserve bank's lack of good faith or failure to exercise ordinary care in executing the transaction;[288] the transferor's Reserve bank would be liable in damages for the failure of the transferee's Reserve bank to exercise ordinary care or to act in good faith, although this liability would be limited to damages directly attributable to the failure to make the proper credit.[289]

The liability of the transferor's Reserve bank runs only to the transferor bank.[290] The Board's regulations do not give any right of action to the customer of the transferor or to the beneficiary of the transfer. They may have rights, however, based on their own separate agreements and the terms of the agreement between the customer and the transferor bank. To the extent that the transferor Reserve bank is liable, as a result of a failure of the transferee's Reserve bank to act in good faith and with ordinary care, the transferor's Reserve bank has a claim for indemnity from the transferee Reserve bank.[291] Thus, the loss resulting from the improper handling of the transaction comes to rest ultimately on the Reserve bank that failed to exercise ordinary care or to act in good faith.

The liability of the Reserve bank is cast in terms of failure to exercise ordinary care or to act in good faith. This differs from the contract liability of a payor bank under the UCC, for wrongful dishonor or making payment of an instrument that is not properly payable. As discussed in Chapters 20 and 21, on check collection and the bank's duties to its customer, in such cases a payor bank may be liable, regardless of the payor bank's exercise of due care and good faith. There is no comparable duty for wire transfers in the Board's Regulation J. The closest requirement to such an absolute contractual liability is the regulation requirement that applies to a Reserve bank handling a transaction in which the

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[287] 12 CFR § 210.38(b)(2) (1988). This two-year statute of limitations becomes effective on January 1, 1990.

[288] 12 CFR § 210.38(a) (1988).

[289] 12 CFR § 210.38(b) (1988).

[290] Id.

[291] 12 CFR § 210.38(c) (1988).

transferee has an account at another Reserve bank. In this situation, the regulations place a duty on the transferor's Reserve bank to send "a matching transfer item" to the transferee's Reserve bank.[282] The matching transfer item must be one that matches the transfer item sent by the transferor "as to amount, transferee, and beneficiary, if any. . . ."[283] If the transferor's Reserve bank fails to send such a transfer item that is properly "matching," that failure should be the basis of liability, although the regulations speak in the language of failure to exercise ordinary care or to act in good faith.

[2] Bank Liability for Erroneous or Wrongful Fund Transfers

As noted in the discussion at the beginning of this section, a substantial body of transactions involving fund transfers is not governed by the law contained in Articles 3 and 4 of the UCC on the collection of checks and similar items, and does not fall within the scope of the Electronic Fund Transfer Act, the Truth-in-Lending Act, or the Board's regulations under these acts. To the extent that a transaction does not involve action by a Federal Reserve bank or to the extent that it raises issues not covered by the Board's regulations for such transfers handled by Reserve banks, there is no comprehensive body of law that defines the rights and duties of the parties. There are scattered cases involving situations in which wire transfers have gone awry. The courts in these instances have looked to general principles of law to define the rights of the parties. This section reviews some of these decisions.

When a bank undertakes to make a transfer of funds for its customer, it enters into a contractual obligation with the customer to carry out the customer's instructions. If the funds are being transferred through use of a negotiable instrument that the bank is acting to collect, the measure of damages that the bank is exposed to, in the event that it fails to use ordinary care in the transaction, is the amount of the item unless there is bad faith.[284] When the bank acts in bad faith, it may be liable for additional damages.[285] However, if the transfer is made electronically, it is doubtful that the UCC provision applies.[286] Also, under the UCC, a bank is liable to its customer if it charges the account of a customer for an item that is not properly payable because the amount is altered, because the signature on the time of its customer is forged or is not an authorized

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[282] 12 CFR § 210.32 (1988).

[283] Id.

[284] UCC § 4-103(5).

[285] Id.

[286] UCC § 4-103 by its terms applies only to "items." See Evra Corp. v. Swiss Bank Corp., 673 F2d 951 (7th Cir.), cert. denied, 459 US 1017 (1982). See also Delbrueck & Co. v. Manufacturers Hanover Trust Co., 609 F2d 1047 (2d Cir. 1979). As the court said in *Evra Corp.*, "Maybe the language of Article 4 could be stretched to include electronic fund transfers, see § 4-102(2), but they were not in the contemplation of the draftsmen."

signature, or because the item lacks a necessary indorsement by a party entitled to payment of the item. For the same reasons, UCC rules are not applicable to fund transfers made electronically, where there is no "item" comparable to a check that is physically transferred with "indorsements" of the parties entitled to payment.

A federal district court case, which was later appealed to the Seventh Circuit, raised the question of the standard of liability to be applied when a bank negligently fails to honor a wire funds transfer instruction. In this case, Hyman-Michaels in Chicago was engaged in chartering a ship from a foreign owner. Payment for the ship's charter was to be made to the owner's account in a Geneva, Switzerland bank. The contract was a favorable one for Hyman-Michaels. At a time when a payment was due, Hyman-Michaels instructed its Chicago bank to transfer funds to the Swiss bank. The Chicago bank telexed the transfer to the Swiss bank, but for an unknown reason the Swiss bank did not act on the message. Possibly, as the court remarked, the receiving telex machine had run out of paper on which to print the message. In any event, the owner of the ship notified Hyman-Michaels that the charter was cancelled because timely payment had not been made.

Hyman-Michaels then initiated steps to determine what went wrong with the transfer and ultimately succeeded in having the Swiss bank acknowledge transfer of the funds. However, by the time the Swiss bank recognized the funds' transfer, the payment to the ship owner was five days late, and the ship owner rejected it. A panel of arbitrators subsequently upheld the right of the shipowner to cancel the contract. Hyman-Michaels then sued the Swiss bank for failing to carry out the wire transfer instruction. A federal district court held that the Swiss bank was liable to Hyman-Michaels for the profits lost as a result of the cancellation of the favorable ship charter contract in the amount of $2.1 million.[297]

On appeal to the Seventh Circuit, the judgment for Hyman-Michaels was reversed. The court held that it would decide the case under common-law principles based on the doctrine of *Hadley v. Baxendale*.[298] In the court's view, the Swiss bank should not be held to have known the consequences of its failure to carry out the wire transfer instructions. "Electronic funds transfers are not so unusual as to automatically place a bank on notice of extraordinary consequences if such a transfer goes awry. Swiss bank did not have enough information to infer that if it lost a $27,000 payment order it would face a liability in excess of $2 million." The court recognized that, unlike *Hadley v. Baxendale*, the case in question did not involve a contract relationship between the Swiss bank and Hyman-Michaels.[299] It was argued that *Hadley v. Baxendale* should not

[297] Evra Corp. v. Swiss Bank Corp., 522 F. Supp. 820, 829 (ND Ill. 1981).

[298] 156 Eng. Rep. 145 (Ex. 1854).

[299] But compare the UCC's theory that collecting banks can be subagents. UCC § 4-201(1).

apply because the district court had found the Swiss bank liable because of its negligence in the transaction. The Court of Appeals reasoned that even though the case was tried on a negligence theory, the *Hadley v. Baxendale* principles should apply. Hyman-Michaels exhibited a lack of prudence in transferring funds at the last moment and, then, in delaying payment for five days after learning that the transfer had not been made. If Hyman-Michaels had acted promptly, the owner probably would not have been able to cancel the charter.

Applying the doctrine that a tortfeasor should not be liable for damages that the injured party could have avoided by acting in a reasonable fashion, the court concluded that the Swiss bank should not be liable for Hyman-Michaels' lost profits. Moreover, the court said, the profits lost on the ship charter contract should not be regarded as a foreseeable consequence of the Swiss bank's negligence. "In short, Swiss bank was not required in the absence of a contractual undertaking to take precautions or insure against a harm that it could not measure but that was known with precision to Hyman-Michaels, which could by the exercise of common prudence have averted it completely."

In *Center Coordinates, Inc. v. Morgan Guaranty Trust Co.*,[300] the plaintiff sued because its instructions to wire funds for the exercise of certain stock options were not timely executed. Plaintiff notified its bank, Union Chelsea, to transfer funds to Barclay's Bank for the credit of a customer of that bank in the Bahamas, who would then use the funds to make payment for the stock. Because Chelsea had no direct relationship with Barclay's, it wired the funds to the defendant bank, Morgan Guaranty, under FedWire. Morgan Guaranty had a correspondent relationship with Barclay's. The defendant received the funds and credited Barclay's account, but it failed to notify Barclay to credit the funds for the account of the specific customer. When notice finally arrived, it was too late to purchase the stock. The court held that even if electronic fund transfers were to constitute "items" within UCC § 4-103(5) on negligence, which is not necessarily the case, the plaintiff could not recover consequential damages, because Section 4-103(5) limits the bank's liability as long as it exercises ordinary care. Nor could plaintiff recover consequential damages under common-law contract, tort, or strict liability theories because of the principle of *Hadley v. Baxendale*. The court said there was no evidence that the defendant, Morgan Guaranty, knew of the purpose of the wire transfer nor of the consequences of failure to effect the transfer. The plaintiff was in the best position to avoid the risk by checking to be sure that timely delivery had occurred.

In *Bradford Trust Co. v. Texas American Bank*,[301] the court was called on to determine how to allocate the loss arising from a fraudulent scheme that induced the Boston Trust Co. to wire $800,000 of its customer's funds to a rare coin

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[300] Center Coordinates, Inc. v. Morgan Guar. Trust Co., 40 UCC Rep. Serv. (Callaghan) 1340, 1342–1343 (NY Sup. Ct. 1985).

[301] Bradford Trust Co. v. Texas Am. Bank, 790 F2d 407 (5th Cir. 1986).

dealer in Texas. Parties posing as a customer of Boston Trust sent a forged letter directing the trust company to liquidate $800,000 from a mutual fund account of another individual, and to send the funds to an account at a bank in Texas, for which the account number of the rare coin dealer was given. The trust company, using a correspondent bank, wired the funds to the account at the Texas bank, bearing the number of the coin dealer, but the transfer stated that it was for the account of the individual in whose name the funds were held by Boston Trust. Although Boston Trust had adopted internal procedures to verify such transfers (because of previous problems with a similar fraud), the trust company failed to observe its own procedures. When the trust company discovered the fraud, it reinstated its customer's account and demanded reimbursement from the bank in Texas. The trust company argued that the Texas bank should bear the entire loss, because it was negligent when it failed to deposit the funds for the account of the individual named in the transfer order. The Texas bank, on the other hand, argued that the trust company should bear the loss because it dealt with the imposter and, thus, was in the best position to prevent the loss.

Although the district court used Texas law to apply a comparative negligence approach, and so divided the damages between the trust company and the Texas bank, the court of appeals rejected this approach. In its view, commercial disputes do not present compelling reasons for a comparative negligence resolution. Texas law used comparative negligence in personal injury cases, so that a plaintiff who had suffered a serious loss might be permitted to recover, even though that individual might have been minimally negligent. The court did not believe that commercial disputes required the same consideration.

After rejecting comparative negligence, the court looked to the UCC for guidance. It drew two principles from the UCC. Firstly, it found that the UCC's imposter rules were relevant because they indicated that the person who dealt with an imposter "had the best opportunity to take precautions that would have detected the fraud." Secondly, the final payment principle in the UCC also applied, because this situation was one in which the interests of certainty in commercial transactions argued for not reopening a transaction that had been finally concluded at an earlier time. Both of these principles, the court said, required placement of the loss on the trust company.

In a Texas case, an oil company orally instructed its bank to wire $2.25 million to a trading partner but the bank transferred $2.5 million instead. Five days later, the company gave the bank written confirmation of the $2.25 million transfer order. When the company later received notice that its account had been debited $2.5 million, it advised the bank of the error by telephone. Although this was not a UCC Article 4 transaction, the bank was liable in that it had a duty to exercise ordinary care. As the court said, "A depositor may justifiably expect a bank to implement commercially reasonable internal procedures designed to process an oral transfer request in accordance with the depositor's instructions,

to verify the accuracy of, and compliance with, instructions, to detect and minimize inaccuracy and to act promptly and diligently to remedy errors."[302]

[3] Proposed Revision of UCC to Cover Modern Payment Systems

For a number of years, there have been serious efforts to develop amendments to the UCC so that it might comprehensively cover all payment systems, including transfers of funds made by electronic means and through electronic terminals. As discussed in Chapter 14,[303] a drafting group working under the auspices of the permanent editorial board of the UCC prepared a "Uniform New Payments Code," which offered a comprehensive realignment and revision of Articles 3 and 4 to apply to all payment transactions, whether made by a paper instrument, such as a check, or by means of a bank card or other electronic media. This effort proved unsuccessful, but work on the revision continued. The revisers' efforts generally fall in three categories: (1) development of a new Article 4A to the UCC that would cover large, wholesale wire transfers of the type made by corporate customers over FedWire and similar fund transfer networks; (2) revision of existing Articles 3 and 4 of the UCC to facilitate modernization of the check collection process through use of new computer and electronic technology not contemplated at the time the original articles were drafted; (3) general updating and improvement of existing Articles 3 and 4 to eliminate technical problems and to resolve questions of current concern.

Proposed Article 4A would apply to large dollar corporate wire transfers but would not attempt to cover consumer transactions within the scope of the Electronic Fund Transfer Act or most credit card or debit card transactions.[304] The proposal thus focuses on the most significant body of fund transfers that currently are not subject to comprehensive regulation. The efforts to limit the scope of a new UCC Article 4A necessarily involve the need for definitional rules to identify the transactions subject to its coverage.

The drafters of the new article address the circumstance in which a bank becomes obligated to execute a fund transfer, and deal with the question of how

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[302] Walker v. Texas Commerce Bank, N.A., 635 F. Supp. 678, 682 (SD Tex. 1986). The court relied on the decision in Securities Funds Servs., Inc. v. American Nat'l Bank & Trust Co., 542 F. Supp. 323 (ND Ill. 1982).

[303] See ¶ 14.01[2].

[304] The drafts of the proposed revisions are in a form such that they are intended for discussion only and do not represent any conclusion or official position taken by the National Conference of Commissioners on Uniform State Laws, the reporters for the project, or the advisory committee. The discussion of the project in this chapter is based upon the February 1, 1988 discussion draft. Because of the highly tentative nature of the work at this stage, this discussion does not attempt to report fully on the provisions proposed for discussion in the draft but rather intends to use this effort at developing a legislative solution to the legal problems associated with fund transfers to illustrate the types and scope of legal problems associated with these transactions.

liability should be allocated between bank and the bank's customer for losses caused as a result of unauthorized orders. As a fund transfer may involve a series of consecutive transfers between banks before the transfer reaches the bank of the intended beneficiary of the payment, the proposed article deals with the relationships between the banks who participate in the transaction. The legal issues that are presented include: (1) determining when a bank that receives a payment order becomes obligated to carry out the order and what the scope of such obligation is; (2) defining the legal recourse that a recipient of the transfer order might have against the sender in the event that the order is in error, unauthorized, or otherwise results in liability to the bank; (3) resolving the extent, if at all, to which a remote bank in this chain of transfers will have liability to the customer who originated the transaction or to the beneficiary of the payment, should the transaction fail for any reason; and (4) establishing rules as to when a transaction may be reversed and when it becomes irrevocable.

As the basic purpose of the transaction is to accomplish a payment from the customer who originated the order to some identified beneficiary, the proposed article deals with questions relevant to defining when such payment occurs, who is obligated to the beneficiary for the payment, and how the payment affects any underlying transaction between the customer and beneficiary for which the payment was made.

In response to the concern that fund transfer transactions may be affected by a bank that participated in a transfer but then suspended payment before settlement of the transaction could occur, the drafters consider rules for determining how to treat the transaction when such a bank failure occurs. Additional matters, such as the ability of the parties to contract out of the rules of the proposed Article, also are addressed.

[4] Check Truncation and Other Electronic Processing Methods of Check Collection

The search to improve the speed and efficiency of the check collection system has led to experiments with reduction of the physical transmission of paper checks in favor of systems that transmit the information on the checks by electronic media. Such approaches often are referred to as check "truncation." The checks may be retained at various stages in the process of collection. One approach is to have the depository bank retain the instrument and obtain collection by communicating with the payor bank by electronic means. Other schemes may involve retention of the instruments by the payor bank without return of the cancelled checks to the bank's customer.[305] Credit unions have widely practiced a form of truncation of the credit union share draft, and other

[305] For a description of the various types of check truncation systems, see Penney & Baker, supra note 1, ¶ 2.01; Baker & Brandel, supra note 1, ¶ 2.01.

banking institutions are initiating plans for truncation arrangements as well. The Expedited Funds Availability Act of 1987 directs the Board of Governors of the Federal Reserve System to examine the efficiency that might be gained by such an approach.[306]

The current version of UCC Articles 3 and 4 presents some legal issues with respect to truncation arrangements. Experts have questioned whether the duties imposed in UCC § 4-406 on a customer, to examine the customer's periodic statement and to report unauthorized signatures or alterations, would be effective if the bank did not return the checks to its customer or hold the checks for the customer's inspection.[307] Under UCC § 4-406, the customer's duty to report unauthorized signatures and alterations arises only when the bank (1) sends to the customer "a statement of account accompanied by items paid" in support of the entries on the statement; (2) "holds the statement and items pursuant to a request or instructions of its customer. . .; or" (3) "otherwise in a reasonable manner makes the statement and items available to the customer. . ."[308] The issue is whether the practice of having a bank other than the customer's bank hold the "items" would qualify as satisfying the bank's obligation to its customer.

Other provisions of the UCC do not fit well with a system of check truncation. The rules in Article 3 on presentment contemplate the physical delivery of the instrument to the payor. The UCC gives the party to whom presentment is made a right to examine the physical instrument and to have the instrument cancelled or a receipt for partial payment noted on the instrument.[309] Additionally, one cannot become a "holder" under the UCC, without having possession of the instrument.[310] To the extent that a bank engaged in the collection process would need to rely on having the rights of a holder or of a holder in due course, there would need to be recognition that these rights might exist without physical possession of the instrument.

A system of truncation would raise additional issues that could best be resolved by legislation. If presentment of the physical item would no longer be required such that a demand for payment made by electronic means would be sufficient, there would be a need for rules allocating loss in the event that the information electronically communicated did not accurately reflect the terms of the item for which payment was sought. The UCC scheme of warranties on transfer and presentment, which deal with title, signatures, and alterations, obviously was not drafted with electronic transfer orders in mind. Further, since the payor would not examine the physical item, the payor would not be able to

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[306] See ¶¶ 14.01[3][c], 18.01[2].

[307] Penney & Baker, supra note 1, ¶ 2.02; Baker & Brandel, supra note 1, ¶ 2.02.

[308] UCC § 4-406(1).

[309] UCC § 3-505. See also UCC § 3-504.

[310] See UCC §§ 3-202, 1-201(20), 1-201(14).

detect alterations or forgeries, regardless of how obvious such actions might be, and thus the rights of a payor to recover in such instances against the bank that examined the physical item would have to be specified. This could involve a reconsideration of the *Price v. Neal* rule. When the payor bank pays an item in which there was an obvious forgery of the drawer's signature that the truncating institution could have detected by reasonable procedures, should the *Price v. Neal* rule be preserved to deny the payor recourse against the bank that was in the best position to detect the forgery?[311]

In a truncation system, the duties of the institution that serves as the custodian of the items need to be identified. How long must the items be held and what liability might attach for inability to retrieve an item? Similarly, the rights of the customer to obtain a copy of the original item or a copy of it need to be established.

The Board of Governors of the Federal Reserve System has become involved in check truncation plans as a result of the enactment of the Expedited Funds Availability Act, as part of the Competitive Equality Banking Act of 1987.[312] This legislation requires that the Board consider adoption of regulations to improve check processing.[313] Among the improvements that Congress directed the Board to consider is action to establish check clearing through an electronic clearinghouse process.[314] In response to this direction from Congress, the Board proposes to put into effect a truncation service. The Board contemplates that, ultimately, the Federal Reserve banks will be able to offer a truncation service to permit the Federal Reserve bank of first deposit to retain the item.[315] The Board also proposes to provide a service that would permit electronic or magnetic tape transmission of data on the magnetic ink character recognition line on an item, but which would allow subsequent delivery of the paper check.[316] Under this approach, the Reserve banks could process the critical data swiftly, using electronic communications technology, and retain the benefits of having the paper instruments available to the payor, by transmitting the paper on a slower processing schedule. The Board's proposed Regulation CC would authorize banks to present checks by electronic means.[317] The authority to

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[311] For a discussion of the *Price v. Neal* rule, see ¶ 20.08.

[312] The Expedited Funds Availability Act is Title VI of Public Law 100-86, Competitive Equality Banking Act of 1987. The provisions of the Expedited Fund Availability Act are discussed in ¶ 20.11

[313] 12 USCA § 4008(b) (West Supp. 1988).

[314] Id.

[315] See Proposed Rules, "Availability of funds and collection of checks (Regulation CC) and Collection of checks and other items and transfer of funds (Regulation J)," Docket No. R-0620, 52 Fed. Reg. 47,112, 47,121 (Dec. 11, 1987).

[316] Id.

[317] Proposed Rule No. R-0620, 52 Fed. Reg. 47,112, 47,158 (Dec. 11, 1987), amending 12 CFR § 229.36(c).

make presentment in this way would depend on the presenting bank's having an agreement with the payor bank permitting the truncation.[318]

[5] Regulation of ACH Transactions

Transfers of funds through ACHs are governed by the rules adopted by the respective clearinghouse associations.[319] When a fund transfer occurs through the ACH system established by the Federal Reserve System, federal regulations apply.

Each Federal Reserve bank has adopted an operating circular to govern transactions involving the clearing and settlement of automated clearinghouse items by the Federal Reserve banks.[320] The operating circular applies to ACH "items." Such items are defined to include a writing in an approved medium evidencing a right to the payment of money that is processed by the Federal Reserve bank for clearing and settlement under the Federal Reserve bank's ACH rules. The definition excludes orders for payment that constitute "items" under Regulation J applying to the collection of checks, "items" under Subpart B of Regulation J on wire transfers of funds, U.S. government payment by ACH method, payment instructions relating to the Treasury book entry security system, and wire transfers of securities by the Federal Reserve bank.[321] The Federal Reserve bank prescribes the format for items and the media by which they may be sent.[322]

The originator of ACH items is deemed to enter an agreement with the Federal Reserve bank that includes an indemnity agreement to hold the Reserve bank harmless for any loss or expense sustained as a result of actions taken by the Reserve bank in accordance with its rules for handling ACH items.[323] The originator commits that it will have adequate funds on hand to cover the amounts to be debited to its account at the time when settlement for the ACH items is to occur.[324]

Under the operating circular, a Reserve bank may refuse to permit the use of credit given for an ACH debit item when the Reserve bank has not received finally collected funds until the Reserve bank's "opening of business on the

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[318] Id.

[319] For a general discussion of the operation of ACHs and the rules applicable to transactions involving ACHs, see Penney & Baker, supra note 1, Ch. 3; Baker & Brandel, supra note 1, Ch. 3.

[320] See e.g., Circular 4, "Automated Clearing House Items," Federal Reserve Bank of San Francisco, (Feb. 1988) (hereinafter Circular 4). This discussion is based on Circular 4.

[321] Circular 4 ¶ 3(o).

[322] Circular 4 ¶ 5-6.

[323] Circular 4 ¶ 9.

[324] Circular 4 ¶ 11.

banking day following the settlement date. . ."[325] If the bank fails to receive "actually and finally collected funds in settlement of a debit item, at or before the opening of business on the banking day following the settlement date," the bank "reverses the debit and credit previously made in settlement of the item" and gives notice of its actions.[326] When a Reserve bank gives a receiver credit for a credit item, the credit is available for use on the settlement date subject to the bank's right to apply the funds to an obligation the receiver owes to the bank.[327]

The operating circular covers both credit items and debit items. A credit item is an "item sent to a Reserve Bank by an originator for debit to the originator's account and for credit to a receiver's account."[328] A debit item is "an item sent to a Reserve Bank by an originator for credit to the originator's and for debit to a receiver's account."[329] A receiver is a "depository institution or other authorized institution. . .*that is designated in an item to receive the item from a* Reserve Bank."[330] When a receiver uses the Federal Reserve ACH service, the receiver enters into an agreement to follow the applicable ACH rules. This agreement includes an indemnification of the Reserve bank against loss resulting from its handling of transactions under the authority given to it by the receiver.[331]

The ACH rules govern when there is a right to reversal of credits and debits made, and they also establish a procedure for the handling of disputes with respect to returns.[332]

The operating circular spells out the liability of the Reserve bank. The basic rule limits liability so that the Reserve bank is responsible "only to an originator, a receiver or another Reserve Bank, and only for our own failure to exercise ordinary care or for our own or our employees' willful misconduct."[333] The circular specifies that the Reserve bank is not acting as agent or subagent of another, and is not liable for the conduct of any other bank or person and does not make any warranty with respect to items handled.[334] The measure of damages for failure to exercise ordinary care or for willful misconduct in the handling of a credit or debit item specifically excludes liability for consequential damages.[335] In certain cases, the Reserve bank under the circular has the right to

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[325] Circular 4 ¶ 23.

[326] Id.

[327] Circular 4 ¶ 24.

[328] Circular 4 ¶ 3(h).

[329] Circular 4 ¶ 3(i).

[330] Circular 4 ¶ 3(t).

[331] Circular 4 ¶ 28(d).

[332] Circular 4 ¶¶ 33–36.

[333] Circular 4 ¶ 42.

[334] Id.

[335] Circular 4 ¶ 43.

recover from other parties if it is found liable for actions taken by the Reserve bank in the handling or settling of an item.[336]

[6] Regulation of Direct Deposit Payments and Book Entry Securities Transactions

Numerous government payments are made by the ACH method through the services provided by Federal Reserve banks and other financial institutions to recipients at these institutions. The U.S. Treasury has regulations defining the obligations and responsibilities of the participants in these payment transactions. These rules cover various benefit payments including social security, civil service retirement, Veteran's Administration compensation or pension payments, and others.[337] The regulations describe how a recipient becomes entitled to receive payment through the ACH payment method. They also define the responsibility of financial institutions who enroll recipients in the ACH payment program.[338] The regulations place a duty on a financial institution that receives payment through this method to "credit the amount of the payment to the designated account of the recipient on its books, and it shall make the amount available for withdrawal or other use by the recipient not later than the opening of business on the payment date."[339]

The regulations also cover the responsibilities of the financial institution in the event of death or legal incapacity of a recipient, or death of a beneficiary.[340] Additionally, there are regulations to cover the processing of transactions involving book entry government securities under the regulations. Rules governing the registration of such securities are provided. Additionally, the regulations provide procedures through which payments may be made relating to transactions in such securities, such as interest payments, by direct deposit through ACH methods.[341]

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[336] Circular 4 ¶ 46.

[337] 31 CFR § 210.2(d) (1987).

[338] 31 CFR § 210.7(b) (1987).

[339] 31 CFR § 210.7(d) (1987).

[340] 31 CFR § 210.11 (1987).

[341] 31 CFR § 357.26 (1987). The Federal Reserve banks have adopted operating circulars that govern federal payments made by the automated clearing house method. See, e.g., Circular 11, "Federal Payments by the Automated Clearing House Method," Federal Reserve Bank of San Francisco (Feb. 1988). See also 31 CFR pts. 350, 354 (1987) (Regulations governing book entry Treasury bills, book entry securities of the student loan marketing association).

19

Bank Accounts

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¶ 19.01 BASIC UCC DEFINITIONS

Terminology in commercial banking law often is confusing because there are many sources of law that may apply to commercial banking transactions, as explained in Chapter 14. Although these sources use common terms, such as "bank," "check," "customer," and so forth, their definitions of the terms are not necessarily the same. The proper definition always depends on the specific circumstances and the specific law or regulation to be interpreted. Bearing this in mind, it is helpful to understand the UCC terminology. Because of the adoption of the UCC by all states, the UCC definitions provide a uniform terminology that is widely understood. The UCC definitions also, as a general rule, will be relevant to many of the commercial transactions discussed in Part Two.

The UCC's definition of "bank" is circular. A bank means "any person engaged in the business of banking,"[1] but the UCC provides no definition of banking.

The UCC's definition does not have to be limited to institutions chartered as banks under federal and state banking laws. Since the UCC provisions on the collection and payment of instruments are meant to provide a comprehensive statutory scheme, a sound approach would include all depository institutions engaged in the collection and payment of instruments as subject to the UCC provisions. However, there is little law on this question.[2]

Similarly, the UCC does not define branch bank, although it does provide that a branch or a separate office of a bank should be treated as a separate bank for purposes of computing the deadlines in the UCC and determining the place at which presentment, notice of protest, and similar actions must be taken.[3] Apart from this, the UCC is silent. The comments indicate that branches might be treated as separate banks for some purposes but not for others.[4] (Branch banking and its regulation are discussed in Chapter 6.)

Other important banking terms and their UCC definitions are:

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[1] UCC § 4-105(a) (1978) (subsequent citations to Uniform Commercial Code (UCC) refer to 1978 official text).

[2] UCC § 4-105(b). See generally Annot., "Construction of UCC § 4-105, Which Defines Payor Bank, Collecting Bank, and the Like," 84 ALR3d 1073 (1978).

[3] UCC § 4-105(c).

[4] UCC § 4-105(d).

1. *Depositary bank.* The first bank to which an item is transferred for collection. A depositary bank may also be a payor bank when the item deposited is payable by the bank in which it is deposited.[5]

2. *Payor bank.* The bank that pays the item involved. The payor bank of a draft or check is the drawee. Payment must be distinguished from cashing a check or purchasing it. When a negotiable instrument is paid, the liability of the drawer, indorsers, and any other party to the instrument is discharged.[6]

3. *Intermediary bank.* Any bank to which an item has been transferred for collection, not including the depository or payor bank, however.[7]

4. *Collecting bank.* Any bank, other than the payor bank, that handles the item for collection.[8] A depository bank that is not the payor bank can be a collecting bank.

5. *Presenting bank.* The bank that presents the item to the payor bank for payment. A presenting bank can be a depository bank or any collecting bank.[9]

6. *Remitting bank.* Any bank engaged in remitting the proceeds of an item to the depository bank. It includes any payor or intermediary bank engaged in the remittance process.[10]

7. *Item.* Any instrument for the payment of money but not including money, such as currency and coins, itself. An item may be either negotiable or nonnegotiable.[11] The definition of "item" has been held broad enough to include a savings account withdrawal slip.[12]

8. *Instrument.* A negotiable instrument within Article 3; may be a draft, check, note, or certificate of deposit.[13]

9. *Account.* Any account with a bank, including a checking, time, interest, or savings account.[14]

10. *Customer.* Any person "having an account with a bank or for whom a bank has agreed to collect items."[15]

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[5] UCC § 4-105(e).

[6] UCC § 4-105(f).

[7] UCC § 4-104(g).

[8] Boutros v. Riggs Nat'l Bank, 655 F2d 1257, 1260 (DC Cir. 1981); Coleman v. Brotherhood State Bank, 3 Kan. App. 2d 162, 171, 592 P2d 103, 112 (1979).

[9] UCC §§ 3-102(1)(e), 3-104(2).

[10] UCC § 4-104(1)(a).

[11] UCC § 4-104(1)(e).

[12] UCC § 4-104(1)(h).

[13] UCC § 4-104(1)(c).

[14] UCC §§ 1-201(4), 4-104(4).

[15] UCC § 4-104(1)(d).

11. *Midnight deadline.* A deadline of midnight on the banking day following the banking day when an item or notice is received or when another time for taking action begins to run.[16]

12. *Banking day.* A day on which the bank is open to the public and carries on substantially all of its banking functions.[17]

13. *Bank.* "[A]ny person engaged in the business of banking."[18]

14. *Clearinghouse.* Any association of banks or other payors that regularly clear items.[19]

15. *Settle.* To pay by cash, by clearing house settlement, by charge or credit, by remittance, or by other means as instructed. Under the UCC, settlements are either "provisional," meaning they are subject to revocation, or "final."[20]

¶ 19.02 NATURE OF BANK ACCOUNTS

[1] Legal Relationship Between Bank and Depositor

[a] Bank as Debtor to Its Depositor. When money is deposited in the normal way, the transaction amounts to an unsecured loan given by the depositor to the bank. Title to the money or securities offered for deposit passes to the bank and the depositor has, simply, the claim of an ordinary unsecured creditor against the bank, together with any rights that may develop out of the contract and the general nature of the banking business.[21]

When checks, or other instruments payable by someone other than the depositary bank, are deposited, the UCC regards the depositor as the owner of the item while it is being collected, and the UCC presumes that the bank is acting as the agent of the depositor for the purpose of collecting the instrument.[22] Likewise, the other banks who participate in the chain of collection and who are not the payor of the item are sub-agents of the depositor. This means the risks of ownership remain with the depositor. When the bank receives final payment, it

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[16] UCC § 4-104(1)(j).

[17] UCC § 1-201(4).

[18] Cf. Congress Indus., Inc. v. Federal Life Ins. Co., 114 Ariz. 361, 364, 560 P2d 1268, 1271 (Ct. App. 1977).

[19] UCC § 4-106. See Annot., "Construction of UCC § 4-106 Defining Separate or Branch Office of Bank," 5 ALR 4th 938 (1981).

[20] UCC § 4-106 & comments 1, 4, 5. See Annot., "Attachment and Garnishment of Funds in Branch Bank or Main Office of Bank Having Branches," 12 ALR3d 1088 (1967).

[21] See J.T. Morse, Jr., 1 Morse on Banks and Banking 665 (H. Voorhees ed. 6th ed. 1928) (hereinafter Morse on Banks).

[22] UCC §§ 4-104(1)(g), 4-105(d), 4-201(1). The collection process is discussed in Chapter 2.

becomes accountable to its customer for the item and a debtor-creditor relationship exists.[23] It is possible for the bank to become a purchaser of the item. In this case, the bank is not acting as an agent on behalf of the owners for the purpose of collection, because the bank becomes the owner of the item that it purchased.[24] However, the UCC provisions on collection and payment apply whether the bank is an agent or a purchaser.[25]

When a collecting bank accepts an item for deposit and gives its customer credit for the item, the UCC presumes the credit is provisional and, thus, subject to reversal if the bank cannot obtain payment from the payor bank. These UCC provisions give the bank the specific right to charge back against the customer's account any loss caused by the dishonor of the paper deposited.[26] The customer also carries all risk of losses not caused by the bank's own negligence that occur in the collection process.[27] This will be discussed in Chapters 20–21.

[b] Bank as Bailee or Trustee. Sometimes a question can arise as to whether the bank has received a deposit establishing a debtor-creditor relationship. For example, a depository institution was held not accountable for sums of cash that were entrusted to one of its officers for deposit when the money was delivered outside the bank and in a social setting.[28] Use of night depositories has raised problems and courts have regarded the bank as a bailee in this situation.[29] The provisions of the UCC forbidding disclaimers of liability for failure to exercise reasonable care apply to payment and collection only, not to bailments, but some courts nevertheless have given effect to the UCC principles.[30] Even if the

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[23] UCC § 4-213(3) & comment 9.

[24] See UCC §§ 4-201, 4-209.

[25] UCC § 4-201(1) & comment 1.

[26] UCC § 4-212.

[27] UCC § 4-201(1).

[28] Sheldon v. First Fed. Sav. & Loan, 566 F2d 805, 808 (1st Cir. 1977).

[29] See Annot., "Liability of Bank in Connection With Night Depository Service," 77 ALR3d 597 (1977).

[30] The cases are collected in H. Bailey, Brady on Bank Checks ¶ 12.1 (6th ed. 1987); Annot., "Liability of Bank in Connection with Night Depository Service," 77 ALR3d 597 (1977). See Hy-Grade Oil Co. v. New Jersey Bank, 138 NJ Super. 122, 114–115, 350 A2d 279, 281–282 (1975), cert. denied, 70 NJ 518, 361 A2d 532 (1976), which collects decisions both ways on this point—both under pre-Code law and under the UCC. The court applied Section 4-103(1) of the UCC as not permitting such a disclaimer in connection with night depository service. See also Gillen v. Maryland Nat'l Bank, 274 Md. 96, 100, 333 A2d 329, 333 (1975) (applying contract principles). But see Valley Nat'l Bank v. Tang, 18 Ariz. App. 40, 43, 499 P2d 991, 994 (1972), which might be said to hold that the operation of a night depository service by a bank is not a part of the deposit and collection process as such.

UCC does not apply, the law places a duty on bailees to exercise care in the custody of property entrusted to them.[31]

General bank deposits should be distinguished from instances in which a customer leaves securities or chattels in safekeeping. In such situations, title to the goods or chattels remains in the customer and the bank is a bailee with the duty of taking reasonable care of the securities. In case of loss or destruction that is not the bank's fault, the risk also remains with the customer.[32]

Banks also engage in trust transactions. For example, a trust is created when the trust department of a bank takes securities to hold and to manage for a customer. When a trust is established, legal title to the property passes to the bank, which becomes a trustee with a right to manage the property and deal in the securities of the customer, who remains the beneficial owner of the property. The customer in this situation is usually called a beneficiary.

Although the bank as trustee has legal title to the property or the trust estate, the trustee conducts the business for the benefit of the beneficiary and must account to the beneficiary for all profits and losses, less, of course, a reasonable fee for acting as trustee.[33] A trustee is a fiduciary and is held to a high standard of responsibility and loyalty to the beneficiary.[34]

An issue that has been litigated is the characterization of funds paid to a mortgage lending institution that the institution holds in an impound account to pay insurance costs and taxes on the mortgaged property. Arguments have been made that the institution holds such funds as a trustee for its customer. A 1983 case in federal court held that a savings and loan association did not have to pay interest on the impound funds to its customers. The customers argued that the amounts paid by them should be viewed either as a "special deposit," in which case the association's control over the funds was restricted, or as a trust, in which case the association would have to account for any benefit derived from use of its beneficiaries' funds. The court held that there was no special deposit under the terms of the mortgages:

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[31] See R. Brown, Personal Property § 11.1 (W. Rauschenbush ed. 3d ed. 1975). The standard of care varies depending on the circumstances. The bailee may have the burden of proof in explaining how the property got lost.

[32] See R. Brown, Personal Property § 11.1 (W. Rauschenbush ed. 3d ed. 1975) for a discussion of the duties of bailees. See also Annot., "Liability of Bank or Safe-Deposit Company For Its Employee's Theft or Misappropriation of Contents of Safe Deposit Box," 39 ALR4th 543 (1985). Riggs v. Bank of Camas Prairie, 34 Idaho 176, 177, 200 P.118, 119 (1921).

[33] For a brief discussion of the nature of the trustee's liabilities, see G. Bogert, Trusts §§ 1, 140–141, 144 (6th ed.; West 1987); A. Loring, A Trustee's Handbook §§ 17–18, 22, 28 (6th ed. 1962); A. Scott, 2 The Law of Trusts §§ 170.22, 172–173, 179.5 (3d ed. 1967). Some of the problems that arise when a bank deals with trustees are discussed in Chapter 15.

[34] See G. Bogert, Trusts § 93 (6th ed.; West 1987); A. Loring, A Trustee's Handbook §§ 25, 74 (6th ed. 1962); A. Scott, 2 The Law of Trusts § 174 (1967).

> Special deposits traditionally remain subject to order of the depositor. Here the monthly payments are installments on a debt. The bank is a creditor, not a depositary. Once the plaintiffs pay the defendant, they have no right to withdraw the money, demand its return, or direct its disposition by the defendant. Timely payments satisfy the plaintiffs' monthly debts created by the mortgages. In return, the defendant is bound by the mortgage contract to pay tax and insurance bills as they come due.[35]

The court also rejected the characterization of the payments as a trust. Although the mortgage agreements used the words "trust," "trustee," and "in trust," the relationship between the association and its customers was a traditional debtor-creditor relationship, not a fiduciary relationship, because the customers could not prove an express trust was intended. The court observed:

> Several factors indicate establishment of a debt rather than creation of a trust. If the monthly payments here are insufficient to cover first the sums due for taxes and insurance, and second the monthly loan debt, then the mortgagors are in default. There are no expressed restrictions on the mortgagee's use of the monthly payments until the liability arises to pay insurance and taxes. Additionally, none of the parties ever manifested an intention to create a trust other than by signing a form document.[36]

Under some circumstances banks may be held to have the duties of a fiduciary to their customer. In addition, courts have been holding that banks owe their customers an expanding duty of good faith. These developments are discussed in Chapter 24.

[c] Accounts at Branches. When a domestic bank operates a branch bank in a foreign country, customers who are depositors in the foreign bank are creditors of the bank generally. If political instability or other circumstances in the foreign country prevent the branch from paying its depositors, the bank, as a general rule, remains obligated to pay the debt owed its customers. This rule was reaffirmed in a case involving the Saigon branch of the Chase Manhattan Bank in New York City. In April 1975, Chase closed the Saigon branch to escape the communist takeover of South Vietnam. Subsequently, ten corporate plaintiffs with demand deposits at the branch and one individual plaintiff with a certificate of deposit from the branch sued Chase Manhattan Bank in New York City. The Second Circuit reversed a decision for Chase and held that Chase was obligated to pay the plaintiffs the amount owed. It stated the general rule as follows:

> A bank which accepts deposits at a foreign branch becomes a debtor, not a bailee, with respect to its depositors. In the event that unsettled local

[35] Judd v. First Fed. Sav. & Loan Ass'n, 710 F2d 1237, 1241 (7th Cir. 1983).

[36] Id. at 1241.

> conditions require it to cease operations, it should inform its depositors of the date when its branch will close and give them the opportunity to withdraw their deposits or, if conditions prevent such steps, enable them to obtain payment at an alternative location. . . . In the rare event that such measures are either impossible or only partially successful, fairness dictates that the parent bank be liable for those deposits which it was unable to return abroad. To hold otherwise would be to undermine the seriousness of its obligations to its depositors and under some circumstances (not necessarily present here) to gain a windfall.[37]

Chase argued that the corporate plaintiffs had been nationalized by the Vietnamese government and therefore could not sue on their own behalf. According to Chase, the claim that was being asserted belonged to the successor to the corporations, the Vietnamese government. The court rejected the claim that the government of Vietnam succeeded to the corporate mantle of the plaintiffs declaring, "A government which confiscates abandoned assets is no more the successor in interest to the departed corporation than a bank robber is to a bank victimized by him."[38] The Vietnamese government had not assumed the assets and liabilities of the corporate plaintiffs, nor could it be viewed as having seized the assets of the plaintiffs that the deposits in the Saigon branch represented. For one thing, the seizure by the Vietnamese government involved only the physical assets of the plaintiffs, and for another, given Chase's departure from Vietnam before the confiscation by the Vietnamese government, the debt owed by Chase to the plaintiffs was no longer located within Vietnam for that government to seize.[39] Thus, the act of state doctrine did not bar the plaintiff's recovery, because that doctrine does not require courts or the United States to give effect to foreign acts of state as to property outside the acting country's territorial jurisdiction.[40]

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[37] Vishipco Line v. Chase Manhattan Bank, 660 F2d 854, 864 (2d Cir. 1981), cert. denied, 459 US 976 (1982). The court relied upon Sokoloff v. National City Bank, 239 NY 158, 167, 145 NE 917 (1924); Heininger, "Liability of United States Banks for Deposits Placed in Their Foreign Branches," 11 L. & Pol. Int'l Bus. 903, 975 (1979). See also Sokoloff v. National City Bank, 130 Misc. 66, 224 NYS 102 (Sup. Ct. New York County, 1927), aff'd, 223 AD 754, 227 NYS 907, aff'd, 250 NY 69, 164 NE 745 (1928). One issue in the case was which law applied—the law of Vietnam or the law of the state of New York? The court did not decide. Even though this was a case in which the law of Vietnam may have governed, because the parties did not take the position during the trial that the claims of the plaintiffs had to be proven under Vietnamese law, the law of the state where the trial was held could be applied. Vishipco Line v. Chase Manhattan Bank, 660 F2d at 860.

[38] Vishipco Line v. Chase Manhattan Bank, 660 F2d at 861.

[39] Id. at 862.

[40] Id. Wells Fargo Asia Ltd. v. Citibank, 612 F. Supp. 351, 358 (SDNY 1985), raised the issue of liability of a U.S. bank for deposits in a branch located in the Philippines that could not pay deposits because of a Philippine government decree. In a later proceeding, the court held that the depositor could, under Philippine law, look to the bank's world-

Finally, Chase argued that with respect to the individual plaintiff, it was relieved of the obligation to perform because the seizure made performance impossible. While recognizing that the result might have been different if the Saigon branch had been a separate, locally incorporated subsidiary or if the deposit contract had included an explicit waiver of the depositors' right to proceed against the home office, the court held that the liability of the Saigon branch to repay the debt represented by the deposit account could be enforced against the bank generally, not just against the branch.

[d] Bank Ownership of Deposited Funds. When the bank irrevocably credits the depositor's personal account, it is free to deal with the funds deposited by the customer as it sees fit. This is because the title passes entirely to the bank in these cases and, from then on, the bank is liable to its customer for the credit given and the whole risk of business operation belongs to the bank and not to the customer. Under the UCC, the point when the bank's liability to its customers arises is the moment when the bank has made either a "final payment" or a "final settlement" for the items its customer has deposited.[41] When a bank gives its depositors provisional credit for checks or other items deposited, the bank may obtain a security interest in the items while they are in the process of collection.

[2] Kinds of Accounts

Bank accounts exist in a variety of forms. At one time, the classification was simpler than it is now. Banks could offer checking accounts that paid funds as their customers ordered by check. These accounts were "demand" deposit accounts because the checks drawn against the accounts were payable on demand.[42] Banks and other depository institutions also offered savings accounts and time deposit accounts and issued certificates of deposit. These different kinds of accounts existed in part because of laws forbidding the payment of interest on demand deposits and regulating the amount of interest that could be paid on time deposit accounts. As explained in Chapter 3, Congress has deregulated the control of interest payments on deposit accounts, although the prohibition against paying interest on demand deposits still exists,[43] has enlarged the class of depository institutions entitled to offer checking type "transaction accounts," and has authorized a variety of types of accounts from which pay-

wide assets for payment of the bank's debt incurred at the Philippine branch. Wells Fargo Asia Ltd. v. Citibank, 660 F. Supp. 946, 950 (SDNY 1987).

[41] UCC §§ 4-213(1), 4-213(2), 213(3). Finality of payment is discussed in Chapter 21.

[42] For an explanation of "payable on demand," see ¶ 14.04[2][f].

[43] 12 USC §§ 371a, 1828(g)(1) (1982 & Supp. IV 1986). The regulation of interest is discussed at ¶ 3.04[6]. For the regulations of the Federal Reserve Board on what constitutes a demand deposit subject to the prohibition against interest, see 12 CFR §§ 204.2(b)(1), 217.2(a) (1987); the similar rules of the FDIC are at 12 CFR § 329 (1987).

ments can be made to third parties on the order of the depository institution's customer.[44] These accounts from which payments may be made to third parties are deemed "transaction accounts."

Federal banking law defines a transaction account as

> a deposit or account on which the depositor or account holder is permitted to make withdrawals by negotiable or transferable instrument, payment orders of withdrawal, telephone transfers, or other similar items for the purpose of making payments or transfers to third persons or others. Such term includes demand deposits, negotiable order of withdrawal accounts, savings deposits subject to automatic transfers, and share draft accounts.[45]

The Federal Reserve Board is authorized to further define what constitutes a "transaction account" to reach accounts or deposits that are used "to provide funds directly or indirectly for the purpose of making payments or transfers to third persons or others."[46] Because the Federal Reserve Board sets different

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[44] Prior to 1980, there was a general prohibition in federal law against depository institutions' allowing customers of interest-bearing accounts to make withdrawals by negotiable instruments. There were, however, exemptions for a few states, beginning with Massachusetts and New Hampshire and, in 1976, extending to Connecticut, Rhode Island, Maine, and Vermont. In 1978, New York was added. Then, in 1980, depository institutions in all states obtained authority to offer NOW accounts with the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980. See 12 USC § 1832(a) (1982). Before the barriers to checking against interest-bearing accounts were dropped, various efforts were made to circumvent the restrictions, resulting in a series of decisions. In American Bankers Ass'n v. Connell, 686 F2d 953, 955 (DC Cir.), cert. denied, 444 US 920 (1979), the court struck down regulations that allowed automatic fund transfers from interest-bearing accounts to checking accounts. In a number of cases, the authority of thrift institutions to offer NOW accounts was litigated. For decisions upholding the efforts of thrift institutions to offer various checking arrangements, see Florida Bankers Ass'n v. Leon County Teachers Credit Union, 359 So2d 886 (Fla. Dist. Ct. App. 1978); Savings Bank of Baltimore v. Bank Comm'r, 248 Md. 461, 237 A2d 45 (1968); Consumer Sav. Bank v. Comm'r, 361 Mass. 717, 282 NE2d 416 (1972); Hudson County Nat'l Bank v. Provident Inst. for Sav. in Jersey City, 44 NJ 282, 208 A2d 409 (1965); Pennsylvania Bankers Ass'n v. Secretary of Banking, 481 Pa. 332, 392 A2d 1319 (1978); Washington Bankers Ass'n v. Washington Mut. Sav. Bank, 92 Wash. 2d 453, 598 P2d 719 (1979). But see Androscoggin County Sav. Bank v. Campbell, 282 A2d 858 (Me. 1971); New York State Bankers Ass'n v. Albright, 38 NY2d 430, 343 NE2d 735, 381 NYS2d 17 (1975); Wisconsin Bankers Ass'n v. Mutual Sav. & Loan Ass'n of Wis., 96 Wis. 2d 438, 291 NW2d 869 (1980), appeal after remand, 103 Wis. 2d 184, 307 NW2d 180 (1981) (modifying prior decree in light of the 1980 Monetary Control Act).

In Hondo Nat'l Bank v. Gill Sav. Ass'n, 696 F2d 1095, 1099–1100, 1102 (5th Cir. 1983), the court held that the federal statute forbidding checking from interest-bearing accounts did not create an implied cause of action for a commercial bank that was a competitor of the thrift institution to enforce the prohibition. The enforcement of the statute was the responsibility of the banking regulators.

[45] 12 USC § 461(b)(1)(C) (1982).

[46] 12 USC § 461(b)(1)(F) (1982).

reserve requirements for transaction accounts than for "nonpersonal time deposits," it is still necessary to distinguish between different types of accounts for these regulatory purposes. (Reserve requirements are discussed in Chapter 3.)

Some of the common types of accounts are described as follows.

[a] Checking Accounts. The checking account is simply an arrangement in which the bank borrows money from the customer and agrees to pay it upon demand. Demand is evidenced by a check, which is a negotiable instrument. Negotiable order of withdrawal (NOW) accounts, which also feature checking privileges, do not have to be demand accounts. Federally chartered savings and loan institutions are generally authorized to offer savings accounts in the form of "savings deposits, shares, or other accounts, for fixed, minimum, or indefinite periods of time. . ."[47] and may make such accounts subject to check or withdrawal on negotiable or other orders.[48] As a result of the Garn-St Germain Depository Institutions Act of 1982, such institutions may offer demand accounts to persons or organizations that have a business loan relationship with the institution. Also, such a federal thrift institution may accept a demand account from a commercial party when the account is for the sole purpose of effectuating payments to the account by a nonbusiness customer.[49]

For regulatory purposes in determining what accounts constitute deposits for which the bank must maintain reserves at the rate specified for "demand deposit," the Federal Reserve Board has a definition of "demand deposit" that includes some accounts in which the bank may require the customer to give notice of intended withdrawal for a minimum period of time.[50] When the current volume refers to instruments payable on demand or accounts that are "demand" accounts, the term "demand" is used in the sense used in the UCC, i.e., that the instrument is payable when it is presented to the proper party for payment.[51]

[b] Savings Accounts. A savings account also may be a demand account (when the institution is one not subject to the prohibition against paying interest in 12 USC § 371a), but banks may reserve the right to pay only upon notice and may require presentation of a savings account book and/or a nonnegotiable order or

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[47] 12 USC § 1464(b)(1)(A) (1982).

[48] 12 USC § 1464(b)(1)(E) (1982).

[49] 12 USC § 1464(b)(1)(B) (1982); 12 CFR § 545.12 (1987).

[50] 12 CFR § 204.2(b)(1) (1987). For the comparable rules of the Federal Deposit Insurance Corporation, see 12 CFR § 329.1(b) (1987).

[51] UCC §§ 3-102(e), 3-108. See discussion of when instruments are payable on demand in ¶ 14.04.

withdrawal slip.[52] Federal law permits banks and thrift institutions to set up savings accounts against which customers may draw checks. These are often called NOW accounts.[53]

[c] Special Deposits. Special deposits may take a number of forms. Sometimes they are a means of holding funds in litigation, trust funds, and cash securities of various types, such as deposits to show good faith in the case of contracts and the like. Attorneys maintain such accounts to hold funds of clients for whom they are fiduciaries. Special deposits are created by special contract between the bank and the depositor. In most instances of special deposits for the benefit of a third person, the bank becomes a trustee of the deposit for the benefit of the named person.[54] Special deposits are often payable upon demand, sometimes upon terms, and occasionally they bear small amounts of interest. In many instances, such accounts are evidenced by certificates of deposit.

[d] Certificates of Deposit. Certificates of deposit (CDs) are instruments issued by the bank specifying that a certain sum of money has been deposited. These certificates may be either negotiable or nonnegotiable.[55] When nonnegotiable, the bank simply contracts to return the amount to the depositor plus any contracted-for interest. If the certificate is negotiable, the bank agrees to pay the depositor or any person whom the depositor shall order, or the bearer of the certificate. When the CD is a negotiable CD, the debt of the bank is to the legal *holder* of the certificate and not to the original depositor.[56]

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[52] See Annot., "Liability of Savings Bank for Payment to Person Presenting Lost or Stolen Passbook or Savings Account Card," 68 ALR3d 1080 (1976).

[53] See ¶¶ 2.02, 3.04[6][b] for a discussion of the federal law which made these changes.

[54] See Annot., "Special Bank Deposits As Subject of Attachment or Garnishment To Satisfy Depositor's General Obligations," 8 ALR4th 998 (1981).

[55] See Chapter 14 for an explanation of the elements required for negotiability of such paper.

[56] The prohibition on the payment of interest on demand accounts in the Federal Reserve Act, 12 USC § 371 (1982), was crucial to the Federal Reserve Board's actions in limiting the participation of its member banks in establishing a secondary market for certificates of deposits or other negotiable time deposits issued by the bank. The Board concluded that a member bank could facilitate the sale of its negotiable time deposits by arranging to find a purchaser for a time deposit that a customer was trying to sell; that is, in doing this, the member bank would not be violating the principle that a penalty should be imposed for payment of a time deposit prior to maturity. However, the Board said that a member bank's purchase of a negotiable time deposit that it had issued should be viewed as an early redemption of the time deposit. Thus, here the member bank would be violating the rule that requires charging a penalty for early redemption of the time deposit. The Board indicated that a member bank could enter into an arrangement with an unaffiliated third party in which the third party agreed to purchase time deposits held by the bank's customers, but the Board believed that a reciprocal arrangement of this kind

[e] NOW Accounts. Banks, savings and loan associations, and other depository institutions are authorized to create negotiable order of withdrawal (NOW) accounts. Customers of the institutions that have established these arrangements may, thus, make withdrawals with instruments that are similar in form to checks and are payable to third parties. All depository institutions may offer NOW accounts.[57] NOW accounts can be held only by individuals, units of government, and nonprofit organizations that operate "primarily for religious, philanthropic, charitable, educational, political," or similar purposes.[58] The instruments used in NOW accounts are like checks. They fall within the UCC definition of a draft. The customer is the drawer, the savings institution is the drawee or payor. On the face of the instrument there is a blank for the name of the payee, which is inserted after the language "pay to the order of." The instrument may be "payable through" a named commercial bank, rather than through the savings institution that is the drawee.[59] There is a question as to whether a negotiable order of withdrawal is a "check" as defined in the UCC.[60] By definition, a check must be a negotiable instrument that is payable on demand and drawn on a bank. With the NOW account, although the instrument may customarily be paid on demand by the institution on which it is drawn, the drawee institution may have the right to deny payment for a period of time stipulated in the terms of the NOW account for which advance notice of withdrawal must be given. Further, a bank is defined as any person who is engaged in the business of banking. It is not clear whether a savings institution is a bank under the UCC. The better view would seem to be that the UCC should apply to negotiable orders of withdrawal since they function like checks.[61]

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between member banks violated the rule. Board of Governors of the Fed. Reserve Sys., Member Bank Participation in the Secondary Market for its Own Time Deposits, [1982–1983 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,272 (Aug. 27, 1982).

[57] 12 USC § 1832(a) (1982).

[58] The entire beneficial interest of the account must be held "by one or more individuals or by an organization which is operated primarily for religious, philanthropic, charitable, educational, political, or other similar purposes and which is not operated for profit ..." 12 USCA § 1832(a)(2) (West Supp. 4, 1987), as amended by the Competitive Equality Banking Act of 1987. NOW accounts also are available for the deposit of certain public funds. Those eligible to have NOW accounts have expanded through congressional and judicial action. See American Banker's Ass'n v. FHLBB, 668 F2d 953 (DC Cir. 1981); 12 CFR §§ 217.157, 329 (1987).

[59] This means that the bank named is not the drawee or payor of the instrument, but rather handles it only for collection. See UCC § 3-120. See H. Bailey, supra note 30, ¶ 1.22. Payable through drafts are discussed in Chapters 14 and 21 of this text.

[60] See UCC § 3-104.

[61] See H. Bailey, supra note 30, ¶ 1.22.

[f] Automatic Transfer Accounts. Automatic transfer accounts allow withdrawals to be made automatically from a savings account. The withdrawn funds are then transferred to a checking account or other demand deposit account, in accordance with an agreement made in advance between the bank and the depositor. Banks that are members of the Federal Reserve System or that are insured by the FDIC may establish such automatic transfer accounts for their savings depositors who are individuals subject to regulations established by the Board of Governors of the Federal Reserve System.[62]

Authority to establish automatic transfer accounts was litigated in *Otero Savings & Loan Association v. Federal Home Loan Bank Board.*[63] Otero had set up a program that permitted its customers to open two accounts: an interest-paying savings account and a zero balance checking account. When the customer drew a check on the checking account, the funds necessary to cover the check were automatically transferred from the savings account to the checking account. Otero established the program before the effective date of the Depository Institutions Deregulation and Monetary Control Act of 1980. Prior to this act's amendments to the federal banking laws, it was not lawful for a savings and loan institution to permit withdrawals by negotiable instrument from an account on which interest was paid. The 1980 act, however, made it permissible for all depository institutions to give their customers checking privileges from such NOW accounts.[64] Although 12 USC § 1832(a), which authorizes the establishment of NOW accounts, has applied by its express terms since 1979 to all financial institutions, 12 USC § 371a had previously provided that banks that were members of the Federal Reserve System could establish automatic transfer accounts. Otero argued that given these two sections, 12 USC § 1832(a) should be interpreted in a narrow fashion not to cover the establishment of automatic transfer accounts. The court rejected this conclusion, finding no inconsistency between the two sections. In its view, banks under 12 USC § 371a were permitted to establish automatic transfer accounts, but savings and loan associations and other financial institutions did not have this authority until the amendments of the Depository Institutions Deregulation and Monetary Control Act of 1980 became effective. The court held that there was no constitutional problem in distinguishing in this fashion between banks and other financial institutions. It stated: "Congress has undisputed authority to legislate in this area and may make reasonable distinctions between its treatment of commercial banks and savings and loans. It may also experiment by allowing particular types of accounts in one region of the country before extending the rule to others."[65]

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[62] 12 USC §§ 371a, 1828(g)(2) (1982).

[63] 665 F2d 279 (10th Cir. 1981).

[64] 12 USC § 1832(a) (1976).

[65] 665 F2d at 283.

[g] Share Draft Accounts. Share draft accounts, or share accounts, are accounts with a credit union.[66] A person who has a credit union account has an ownership interest that is represented by a share in the credit union to the extent of the account. Credit unions are also authorized to allow their members to draw from these accounts by negotiable order of withdrawal.[67]

[h] Money Market Accounts. The Garn-St Germain Depository Institutions Act of 1982 authorized offering a type of account that has no maximum interest rate and that is designed to be competitive with money market mutual funds. This account is insured by the federal deposit insuring agencies. Even though the legal controls on the payment of interest on accounts other than demand deposits have expired, the money market account has the additional advantage of not being subject to reserve requirements so long as it is not a transaction account and the number of transfers from the account by check and by preauthorized withdrawal is limited.[68]

[3] Opening an Account

Opening an account in a bank involves only a simple contract in which the depositor lends money to the bank in return for an agreement by the bank to pay back the amount either with or without interest, depending upon the nature of the contract. The exact relationship is determined by the agreement signed by the bank and the depositor, and the terms of such an agreement usually are binding upon the parties, unless they involve an unfair advantage or a violation of the banking laws. As discussed in Chapters 14 and 21, the regulations of the Federal Reserve Board and the rules in clearinghouse agreements also establish legally enforceable rights and duties between the bank and its customer.

Banks customarily place standard contracts on deposit slips and passbooks. These contracts sometimes attempt to regulate in detail the nature of the transaction and the risks involved in collecting commercial paper. These contracts are usually drawn so as to give the bank the maximum protection in the circumstances, but, if they are unduly harsh and one-sided or if they unfairly surprise the customers or attempt to disclaim responsibility for acting in good faith and with reasonable care, they may not be enforceable against the customer.[69]

Federal law requires banks to give special notice of some bank policies. For example, the Expedited Funds Availability Act requires notice on deposit slips, at ATM sites, and on signs in the bank of certain bank policies on when a

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[66] See generally 12 USC § 1752(5) (1982).

[67] 12 USC § 1785(f)(1) (1982).

[68] 21 USC § 3503(c) (1982).

[69] See UCC §§ 4-103(1), 1-203. Cf. UCC § 2-302.

depositor may use the funds deposited.[70] Other disclosures are required when the account involves a credit card account within the Truth-in-Lending Act or an access device within the Electronic Fund Transfer Act as discussed in Chapter 26.

[4] Unconscionable Agreements

Standard printed contracts, which the depositor is asked to sign and which are made out in advance by the bank's lawyers, are common not only in commercial banking but throughout the business world. A well-known rule of law incorporated in the UCC[71] is that between the parties, rules of law can be changed by agreement. Thus, courts in the past have enforced contracts signed by the parties that worked a hardship on one of the signers.[72] Taking advantage of this rule, banks and other businesses sometimes have created standard form contracts that give them great advantages and require their customers to waive legal rights. Courts will provide relief to customers from such contracts when they find them unduly oppressive or unconscionable.[73] When such contracts are not negotiated by parties with equal bargaining powers and understanding,[74] and when they work a hardship on one of the parties, they may be found to be contracts of adhesion or unconscionable contracts. Under the UCC, courts refuse to enforce these contracts against the injured party.[75]

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[70] For discussion on the Expedited Funds Availability Act, see ¶ 20.11[1][b].

[71] UCC §§ 4-103, 1-103.

[72] See Fort Knox Nat'l Bank v. Gustafson, 385 SW2d 196 (Ky. 1964).

[73] See Bolgar, "The Contract of Adhesion," 20 Am. J. Comp. L. 53, 58 (1972). See generally, "Banks Liability for Breach of Implied Contract of Good Faith and Fair Dealing," 55 ALR 1026 (1987).

[74] See Overmyer v. Frick, 405 US 174, 187 (1972), where it was held that there was equal bargaining power in negotiating a cognovit provision.

[75] UCC § 2-302. See Fuentes v. Shevin, 407 US 67 (1972); Williams v. Walker Thomas Furniture Co., 350 F2d 445 (DC Cir. 1965). See also Dostert, "Appellate Restatement of Unconscionability: Civil Legal Aid at Work," 54 ABAJ 1183 (1968). Section 2-302 of the UCC, on unconscionable contracts, does not expressly apply to agreements between banks and their customers. Although it is contained in the UCC article on the sale of goods, it probably applies by analogy. See UCC §§ 1-103, 1-203. See Comment, "Unconscionability: Uniform Commercial Code Section 2-302," 36 Alb. L. Rev. 114 (1971–1972); Navin, "Waiver of Defense Clauses in Consumer Contracts," 48 NCL Rev. 505, 531 (1969–1970); Hilman, "Debunking Some Myths About Unconscionability: A New Framework for UCC § 2-302," 67 Cornell L. Rev. 1 (1981–1982).

The California Supreme Court held that a cause of action for unconscionable conduct was established by allegations that a California bank's customers were charged $6.00 for each check drawn on insufficient funds, although the cost to the bank of processing such checks was only $.30. Perdue v. Crocker Nat'l Bank, 702 P2d 503, 513, 216 Cal. Rptr. 345 (1985).

Sometimes banks form contracts providing that the customer shall not hold the bank liable for losses caused by negligence or wrongdoing on the part of the bank or its employees. Agreements of this sort are made illegal and void by the express provisions of the UCC and are, therefore, unenforceable.[76] Such stipulations do little more than create ill will on the part of the customer and invite charges that the bank has acted in bad faith. Further, a bank's contract with its customer will be interpreted in light of the course of dealings between the bank and the customer.[77] As a result, action by a bank that is inconsistent with an established manner of dealing between the bank and its customer may not be proper even though the written contract is ambiguous or lacks a specific clause on the matter.

The UCC also specifically provides that the contracts between the bank and its depositors shall be performed in good faith.[78] The bank's duty of good faith to its customer is discussed in Chapter 24.

[5] Termination of Relationship

The relationship of banker and depositor, being created by contract, can be terminated in the same manner at the will of either the bank or the depositor. The bank may terminate the relationship by notification and by payment of the balance owed to the depositor, and the depositor may do so by notification and by checking out the balance of the account. In the absence of notification, the depositor's account being overdrawn does not terminate the relationship. In such a situation, the overdraft represents a loan by the bank to the depositor.[79]

In the case of the customer's death or incompetence, the UCC allows the bank to continue to pay until it has received notice of the death or incompetence.

See Gianni Sport, Ltd. v. Gantos, Inc., 151 Mich. App. 598, 599–600, 391 NW2d 760, 761–762 (1986). A clause in a contract for the purchase of clothes to sell for the Christmas holidays allowed the buyer to cancel without notice at any time before delivery. The court upheld a jury finding of unconscionability when the buyer canceled just before the October delivery date and took the goods only when the seller agreed to a 50 percent price reduction. Although both parties were experienced merchants and the cancellation clause was standard in the industry, the last-minute cancellation was unconscionable because it put the seller in the position of having to absorb the loss or agree to a price reduction. The order represented 20 percent of the seller's annual business. Thus, the court agreed the clause was unreasonable and was the product of unequal bargaining power.

[76] UCC § 4-103(1). See UCC § 1-103.

[77] UCC §§ 1-103, 1-205(3)–(4), 4-103(1). See UCC §§ 2-208–2-209. A course of performance may be relevant in establishing a waiver or modification of a contract term. UCC § 2-208(3).

[78] UCC § 1-201(19), 1-203, 1-208. Cf. Fort Knox Nat'l Bank v. Gustafson, 385 SW2d 196 (Ky. 1964).

[79] See UCC § 4-401(1).

Even in cases in which the bank knows of the death, it may pay or certify checks drawn before death for ten days after that death unless it is ordered to stop by a person claiming an interest in the account.[80] This person may be a creditor or a relative, the bank has no responsibility to determine the validity of the claim.[81] When the relationship is terminated by death, the bank can settle upon order of the probate court.

In the case of multiple party accounts, the rights of the survivors in the account when one of the parties dies depend upon the general property and probate law of the jurisdiction. The Uniform Probate Code, for example, presumes that the account goes to the survivors.[82] If the bank pays innocently, not knowing of the death, it is protected by the UCC provision just mentioned.

Whereas UCC Section 4-405 has the effect of authorizing payment from an account under some circumstances, notwithstanding death or incompetence, the provision apparently does not require a bank to honor a check drawn by a representative of an incompetent person when there has been no judicial appointment or qualification of the representative.[83]

When a debtor delivered to his bank five checks on his account to pay certain unsecured and unmatured notes, it was held that the bank might properly apply the checks to pay the notes after the debtor's sudden death, even when the bank was aware of the debtor's death.[84] In addition to being notified of the fact of death, the bank must be ordered to stop payment by a person claiming an interest in the account.[85]

As indicated, payment of a check by a bank after the death of the drawer may or may not be proper. Similarly, the person receiving the payment may or may not have the right to keep it. In one case, a check was drawn by a wife on a joint account kept with her husband and paid by the bank after the wife's death. Local law and the facts of the particular case indicated that the surviving joint

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[80] UCC § 4-405. See Sumitomo Shoji N.Y., Inc. v. Chemical Bank N.Y. Trust Co., 47 Misc. 2d 741, 746, 263 NYS2d 354 (NY Sup. Ct. 1965), aff'd, 25 AD2d 499, 267 NYS2d 477 (1966). Prior to the UCC, it was usually held that if a bank pays in good faith, without knowledge of the death, such a payment is valid. Glennan v. Rochester Trust Co., 209 NY 12, 14, 102 NE 537, 539 (1913). Balkam, "Payment of Bill of Exchange or Check by the Drawee After the Drawer's Death," 14 Harv. L. Rev. 588 (1901); Zane, "Death of the Drawer of a Check," 17 Harv. L. Rev. 104, 117–118 (1903).

[81] UCC § 4–405, comment 4.

[82] Uniform Probate Code § 6-104.

[83] Cf. Beaucar v. Bristol Fed. Sav. & Loan Ass'n, 6 Conn. Cir. 148, 154–156, 268 A2d 679, 685–687 (1969).

[84] In re Estate of Schenck, 63 Misc. 2d 721, 723–724, 313 NYS2d 277, 279–280 (1970). The decision indicated that final payment took place upon delivery of the checks to the payor bank. The debtor was killed in an accident the day after delivering the checks and another creditor of the debtor objected to the application of the checks to pay the bank debt, without success.

[85] Cirar v. Bank of Hartshorne, 567 P2d 96, 98 (Okla. 1977).

depositor (the husband) could recover the payment from the person who received it.[86]

In another case, it was pointed out that the UCC provision dealing with payment following the death of a customer merely protects the bank making payment but does not prevent an executor or administrator of the deceased depositor's estate from recovering from the person obtaining payment of a decedent's check when such recovery is authorized under a probate statute.[87]

When an agent or other person signing a representative account dies, the bank's authority to honor checks is terminated in the same manner as in individual accounts, and no checks may be drawn against the account until a new representative is appointed by one who has authority to open the account.

When a federal check or payment is involved, the UCC rules do not apply because the rights and duties of the parties are determined by federal law. Federal rules cover direct deposit payments made by the U.S. Treasury and the payment of U.S. Treasury checks, such as those for social security benefits. The rules determine the liability of banks for failing to return funds when the death of the payee revokes the right to receive payment, as in the case where death of the payee terminates the right to social security benefits.[88] The regulations do not give the bank a right to recover such benefit payments that its customer may have withdrawn from the account. Although the bank may be liable for the return of money to the U.S. Treasury, the bank's right to recover from its customer or to charge its customer's account depends upon the applicable state law and the contract between the bank and its customer.[89]

The death of a depositor can cause problems for a bank when there is an arrangement with other parties, such as insurance companies or pension companies, to have proceeds paid directly into the customer's account at the bank. The agreements in such direct deposit arrangements usually provide that the bank will reimburse the persons making the deposits if funds are paid out after the customer dies. Counsel for the Comptroller of the Currency has advised that

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[86] Blair v. Davis, 281 So2d 247, 248 (Fla. Dist. Ct. App. 1973), which actually involved a question of the proper venue of the legal action by the survivor to recover the amount of the check from the payee.

[87] Black v. Hart, 301 So2d 787, 789 (Fla. Dist. Ct. App. 1974).

[88] 31 CFR §§ 210.11, 240.11, 240.12 (1987). See Comptroller of the Currency, Banking Circular No. 224, "Federal Recurring Payments Through Financial Institutions By Means Other Than By Check" (Nov. 18, 1987). The Social Security Act establishes procedures to protect recipients in the case of overpayments, but the cases have generally treated payments after death as "erroneous" payments that are not within the protections of the statute. Thomas V. Bowen, 791 F2d 730, 733 (9th Cir. 1986); Breault v. Heckler, 763 F2d 62, 63 (2d Cir. 1985); Dockstader v. Miller, 719 F2d 327, 329–331 (10th Cir. 1983), cert. denied, 467 US 1256 (1984); Powderly v. Schweiker, 704 F2d 1092, 1096–1097 (9th Cir. 1983). See also First Interstate Bank v. Haynes, 73 Or. App. 714, 718, 699 P2d 1168, 1172 (1985).

[89] 31 CFR § 210.11(c) (1987).

banks may enter into such arrangements to reimburse without violating the prohibition in the National Bank Act against guaranteeing debts of third parties.[90]

The right of the bank to pay from any account may be suspended by court action. This may take the form of an attachment of an individual account by a creditor of the depositor. In this case, the bank may not honor any checks after attachment occurs and the bank has a reasonable time to act on it.[91] Bankruptcy or receivership of the depositor also automatically suspends the right of the bank to pay at the depositor's order. Accounts so suspended can be reopened only by order of the court or properly constituted officers.

¶ 19.03 FORMS OF ACCOUNTS

Accounts may be opened in a number of forms. The owner may be an individual or multiple parties may have an ownership interest. When there are multiple parties, the rights of each party in the account will depend on the legal form of the account selected. The person or persons who have an interest may be an individual or another legal entity such as a partnership or corporation.

[1] Individual Accounts

The individual account, which is the simplest form, is merely an arrangement in which an individual has the right to deposit and withdraw money. No special formality is necessary for opening such an account unless the individual is a minor, is under interdiction, or is under legal guardianship. In any of these cases the bank should receive authorization of the parent or legal guardian before opening such an account. If the bank fails to take this precaution, the applicable state law may make the bank liable for conversion of the funds even though it has paid them on the order of the incompetent individual. At one time, married women had to receive permission from their husbands before opening bank accounts. Of course, this is no longer true. Married women are now fully able to enter into contracts on their own. Requiring the consent of the spouse would, in fact, violate federal law prohibiting credit discrimination.[92]

[2] Joint or Multiple Party Accounts

The Probate Code defines a joint account as "an account payable on request to one or more of two or more parties whether or not mention is made of any

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[90] Office of the Comptroller of the Currency. Letter No. 177 [1981–1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,258 (Jan. 14, 1981).

[91] UCC § 4-303.

[92] 15 USC § 1691(a)(1) (1982); 12 CFR § 202.7(a) (1987). See infra ¶ 26.06.

right of survivorship."[93] As this definition indicates, there is more than one type of joint account. In some arrangements, when one of the joint parties dies, the interest of the deceased party passes to the surviving parties. Other arrangements have no survivorship feature and the interest in the account passes to the estate of the deceased party. Also, during the lifetime of the parties to the joint account, questions may arise as to the respective interest of each of the parties in the account. In some arrangements, all parties must sign in order to make withdrawals. In others, each party has a right to draw separately against the account. The extent of the interest of each of the parties in the account, the power of creditors of any one of the parties to levy on funds in the account, and the right of one party (when the account permits checking) to stop the payment of checks drawn by another are also troublesome issues. The resolution of these issues will vary, depending on the particular circumstances and the contract entered into by the bank and the parties to the account. Whatever the arrangement, the bank needs clear rules to guide it in making payments so that it can avoid liability for improper payment of funds in the account.

Clearly, the relationship between the parties to a joint account is not a simple one. Although the parties usually can accomplish their desired objectives by clearly defining their respective rights in the deposit agreement, this clarity of intent is often missing. In these cases, problems arise. Was a survivorship feature intended? Were all parties to have a right of separate withdrawal? What interest does each party have in the account?

[a] Common-Law Rules. The common law evolved rules of property to describe the relationships between parties who held joint interests in property. One form of joint ownership was known as *tenancy in common*. Under this arrangement, each joint tenant had a specific, although undivided, interest in the corpus of the property (the interest could be 30 percent, 50 percent, 75 percent, and so forth). All tenants had an equal right to the property and there was no survivorship feature. The common law also recognized a form of joint ownership known as *joint tenancy*. In this form, all the joint tenants had an equal interest in the property and the interest of any one joint tenant passed to the survivors upon the joint tenant's death. The common law presumed the creation of a joint tenancy when the intent of the parties was unclear, but this presumption has been reversed by statute in many states, thus creating a presumption in favor of tenancy in common. Unfortunately, these common-law rules do not apply well to bank accounts.[94] Joint bank accounts usually do not meet the

[93] Uniform Probate Code § 6-101(4).

[94] See Note, "Joint Savings Accounts: Rights of Nondepositors While Original Joint Tenants Still Alive (First National Bank v. Munns, 602 SW2d 910, Mo. App., ED 1980)," 46 Mo. L. Rev. 666 (1981); Comment, "The Joint and Survivorship Bank Account," 1957 U. Ill. LF 655 (1957); Note, "Joint Bank Deposits," 15 Cornell LQ 96 (1929–1930); Note, "Bank Accounts: Transfer of Property at Death," 23 U. Chi. L. Rev. 289 (1955–1956);

technical requirements needed by common law for creation of joint tenancies, and tenancy in common often does not serve the interests of the parties because it lacks the survivorship feature.

Although the common-law rules on joint property interests do not, as a general rule, fit the joint-account situation well, the courts have permitted parties to establish the arrangements they desire by contract. Fortunately, in most states, the rights of parties to joint accounts are controlled by statutes that clarify some of these ambiguities.

[b] Uniform Probate Code. The Uniform Probate Code contains a comprehensive treatment of multiple party accounts.[95] These provisions create a series of presumptions that apply to joint accounts unless the parties give "clear and convincing evidence" of a different intention. One presumption is that any sums remaining on deposit at the death of one party to a joint account belong to the surviving party or parties.[96] Another presumption is that during the lifetime of all the parties, the joint account belongs to the parties "in proportion to the net contributions by each to the sums on deposit."[97] Whatever the legal relationships between the parties to the joint account, the bank will be protected if it follows its deposit contract provisions.[98] The bank is not required to inquire as to the source of the funds in the joint account or the purposes for which any sum withdrawn is to be used.[99]

One problem with joint accounts concerns the rights of survivors when one of the joint owners dies. When an elderly or ill person opens the account and makes all deposits to the account, but the name of another is included on the account, does the party opening the account intend to make a gift of any of the

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Kepner, "The Joint and Survivorship Bank Account—A Concept Without a Name," 41 Cal. L. Rev. 596 (1956); See generally Farnum, "Joint Tenancy and Joint Bank Accounts—Danger, Handle With Care," 17 Idaho L. Rev. 101 (1980–1981); Note, "Banking Law—Overdrafts—Liability for Overdrafts of a Joint Bank Account Under the UCC—Cambridge Trust Co. v. Carney, 333 A2d 442 (NY 1975)," 1976 BYU L. Rev. 499 (1976); Note, "Cambridge Trust v. Carney: Overdraft Liability on Account Co-Signatories," 28 Me. L. Rev. 254 (1976); R. Brown *Personal Property* § 8.8 (W. Rauschenbush ed. 3d ed. 1975). See generally Annot., "Creation of Joint Savings Account or Savings Certificate as Gift to Survivor," 43 ALR3d 971 (1972).

[95] Probate Code §§ 6-101 through 6-113.

[96] Probate Code § 6-104(a). Although the Probate Code recognizes the survivorship feature of joint accounts, there are rights, which may be asserted by the deceased party's estate against survivors, for the payment of taxes, debts, and administrative expenses, when the other assets of the estate are insufficient. However, the bank can pay the survivor before any legal claim to the account has been asserted by the representative of the estate without fear of liability.

[97] Probate Code § 6-103(a).

[98] Probate Code §§ 6-102, 6-108.

[99] Probate Code § 6-108.

account to the other person named? The second name may have been added simply as a convenience in making deposits and withdrawals with no gift intended.[100] Moreover, even when a gift was clearly intended, the person who opened the account and deposited the funds may have intended the interest to pass only upon his or her death. The latter kinds of arrangements have been attacked as not satisfying the legal formalities for transferring interests at death.

The Uniform Probate Code assists in the resolution of these problems. It creates a presumption that persons who use joint accounts intend the proceeds of the account to go to the survivors.[101] It makes clear that transfers pursuant to joint account arrangement do not have to be measured by the requirements the law establishes for wills.[102] The Uniform Probate Code also recognizes a "payable on death" account (POD), which is payable to only one person during that person's lifetime but which becomes payable, upon his or her death, to one or more other POD payees.[103]

[c] Creditors' Rights Against Joint Account. The creditors of one party to the joint account have rights to levy against the account, and these rights have also been a source of problems. (Banks face similar questions in exercising setoff rights against a joint account when only one of the parties is indebted to the bank.) Just because an account is held jointly does not mean that creditors can treat all of the funds in the account as the exclusive property of any one of the depositors, for purposes of satisfying that depositor's debts.[104]

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[100] See In re Estate of Michaels, 26 Wis. 2d 382, 386, 132 NW2d 557, 561 (1965). A similar problem can exist with trust accounts. See In re Totten, 179 NY 112, 115-116, 71 NE 748 (1904). See generally Annot., "Liability of Bank to Joint Depositor for Removal of Name From Account at Request of Other Joint Depositor," 39 ALR4th 1112 (1985).

[101] Probate Code § 6-104.

[102] Id.

[103] Probate Code §§ 6-101(10), 6-104(b). See generally Annot., "Payable-on-Death Savings Account or Certificate of Deposit as Will," 50 ALR4th 272 (1986).

[104] Hayden v. Gardner, 238 Ark. 351, 352–353, 381 SW2d 752, 753–754 (1964). See generally Annot., "Bank's Right to Setoff, Based on Debt of One Depositor, Against Funds in Account Standing in Name of Debtor and Another," 68 ALR3d 192 (1976); Annot., "Joint Bank Account as Subject to Attachment, Garnishment, or Execution by Creditor of One of the Joint Depositors," 11 ALR3d 1465 (1967). In Uttecht v. Norwest Bank of Norfolk, N.A., 221 Neb. 222, 224–225, 376 NW2d 11, 13–14 (1985), noted Collins, "Bank's Right to Vary Setoff Statute by Means of Contract," 103 Banking LJ 380 (1986), the Nebraska Supreme Court upheld the bank's setoff of a debt of one party to a joint account against CDs as to which only one of the other joint owners was the beneficial owner. This result was contrary to Section 6-113 of the Uniform Probate Code, because the bank's debtor did not have a "present right of withdrawal" in the account and had not contributed to the account. However, the court held that a contract between the bank and the parties to the account was controlling. The contract provisions were obtained in a bank pamphlet referenced on the face of the CDs. See also Annot., "Joint Bank Account as

A creditor of one party to a joint bank account must exercise caution when taking action against a joint account to obtain satisfaction of the debt. The creditor has no interest in the portion of the joint account owned by the parties who are not indebted to the creditor. In *Atkinson v. Federal Deposit Insurance Corp.*,[105] the court limited the ability of a bank to set off a husband's debt to the bank against a joint account at the bank held by the husband and his wife.[106] In *Yakima Adjustment Service Inc. v. Durand*,[107] the court held that a joint bank account established by a mother and her son was owned entirely by the son, so that a creditor of the mother was unable to garnish funds in the account. Although Washington has a statute creating a presumption of equal ownership in a joint account, the court held that the statutory presumption was for the benefit of the bank and did not apply in a case in which the bank was merely a stakeholder and the creditor was claiming an interest in the account. The court applied the general rule that a creditor could attach only whatever interest the debtor had in the account.

In *Smith v. Idaho State University Federal Credit Union*,[108] the court indicated that a state statute designed to protect banks when funds are paid out of multiple-party accounts would extend to the situation in which one party to a joint account pledged the deposits in that account as security for a loan made by the bank to him. The court indicated that the pledge of the account by one of the parties should be treated, for purposes of the statute, as payment of the account to satisfy the loan.

In *Estate of Oney v. Getty*,[109] there was a situation similar to one involving the claim of a creditor to a joint account, but in this case the claimants were persons who claimed an interest in accounts under a will of the decedent who had opened the joint accounts. The claimants challenged the validity of the joint tenancy bank accounts that the decedent had opened with a relative. Two statutes were involved in the case. One statute made the establishment of a joint tenancy account, in the absence of fraud or undue influence, conclusive evidence of intent to vest title in the survivor to the account in any action in which the bank or the surviving depositor was a party. The court held that since the lawsuit brought by the claimants under the will was a probate proceeding against the executor of the estate, it was against neither the bank nor the surviving

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Subject to Attachment, Garnishment, or Execution by Creditor of One of the Joint Depositors," 11 ALR3d 1465 (1967).

[105] 635 F2d 508, 511–512 (5th Cir. 1981). If the United States proceeds against a joint account to enforce the tax obligations of one of the parties to the joint account, the state law rules governing debt collection procedures may not apply. See United States v. National Bank of Commerce, 472 US 713 (1985) discussed infra ¶ 19.03[2][g].

[106] See also Haynes v. Bank of Wedowee, 634 F2d 266, 271 (5th Cir. 1981).

[107] 28 Wash. App. 180, 184–186, 622 P2d 408, 410–411 (1981).

[108] 103 Idaho 245, 247–248, 646 P2d 1016, 1018–1019 (Idaho Ct. App. 1982).

[109] 31 Wash. App. 325, 327–328, 641 P2d 725, 727–728 (1982).

depositor, so the presumption did not apply. The other statute created a rebuttable presumption of intent to create a survivorship tenancy when a joint account was created by a savings and loan association. The court held that the trial court should conduct a hearing to determine whether the decedent intended to create a right of survivorship or make a gift of an interest in the account or simply added the other name to the account as a convenience with no intention of relinquishing ownership of the funds.

[d] Ownership Interests. When one party to a joint account deposits substantially all the funds in the account, serious questions may arise as to the ownership interests of the joint tenants in the account during the lifetime of the parties. In some situations, it may be possible to regard the party who deposits the funds as intending to make a gift to the other parties to the account. In other situations, it may be clear that no such intent was present. These problems were raised in *Anderson v. Baker.*[110] Sanders opened several accounts in her name and that of her son Baker. The signature cards provided that the parties to the account agreed that any funds placed in the account shall be "conclusively intended to be a gift" at the time of deposit of the funds to the extent of the account holders' pro rata interest in the account. It was clear, however, that Sanders' purpose in creating the account was for convenience, with no intention to make a gift to her son. Shortly before Sanders died, she started an action against her son to compel the return of control of the account and the funds in it. Montana law made the entering of an agreement between co-depositors conclusive in establishing the intent of one joint depositor to make a gift of an interest in a joint account to the other depositors, but the court did not follow this rule in *Anderson v. Baker.* Sanders asserted her sole rights to the account during her lifetime. The court reasoned that the agreement on the signature card may not have accurately expressed Sanders' intentions with respect to the joint account. In its view, signature cards were similar to contracts of adhesion in that the joint depositors had no control over the terms of the card. Accordingly, the court held that when "a depositor during his or her lifetime raises the issue of ownership of funds in a joint tenancy account, the statements on the signature card are not conclusive and additional evidence may be examined to ascertain the true intent of the parties."[111] The court upheld the use of parol evidence to ascertain the intent of the parties.

Sly v. Barnett[112] also involved the ownership rights of two parties to a joint

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[110] 196 Mont. 494, 641 P2d 1035 (1982). See generally Annot., "Nondrawing Cosigner's Liability for Joint Checking Account Overdraft," 48 ALR4th 1136 (1986).

[111] 641 P2d at 1038. See Annot., "Parol Evidence Rule as Applied to Deposit of Funds in Name of Depositor and Another," 33 ALR2d 569 (1954); Annot., "Creation of Joint Savings Account or Savings Certificate as Gift to Survivor," 43 ALR3d 971 (1972).

[112] 97 Nev. 587, 588–589, 637 P2d 527, 528–529 (1982).

tenancy account during the lifetime of the parties. The terms of the signature card provided that the parties to the account were "joint depositors" who owned the money "jointly with the right of survivorship." Nevertheless, the funds in the account were contributed by only one of the parties, who maintained control over the account passbook, checks, withdrawal slips, and deposit book. When that party withdrew all the funds in the account and closed it without the consent of the other party, the court held that there was sufficient evidence to rebut the presumption of an intent to establish a joint tenancy account and that the other party to the joint account had no present or survivorship interest in the account.

[e] Bank Payment of Joint Account Funds. The scope of statutes designed to protect banks who pay out proceeds of a joint account to one of the joint tenants was limited in a decision by the New York Court of Appeals. The court held that the statute did not apply to protect the bank when the bank permitted one of the joint tenants to substitute a new name for the name of the other joint tenant on the account and then allowed the person whose name was added to withdraw the funds. The bank argued that the change in name was the equivalent of a withdrawal of funds from the account and the establishment of a new account. The court held that the statute protecting the bank when withdrawals were made by a joint tenant did not apply to name changes.[113]

The UCC permits a depositary bank to supply any indorsement of its customer that is missing when the indorsement is needed in order to collect the check for the customer.[114] In addition, deposit agreements between banks and their customers sometimes provide that the bank may credit instruments payable to the customer to the customer's account at the bank when they are sent to the bank for deposit. When a joint account is concerned, these provisions may produce problems for one of the joint parties to the account. *Susen v. Citizen's Bank & Trust Co.*[115] is an example of one of these problems. Susen had a joint checking account with her daughter. A $5,000 check payable to Susen and bearing an indorsement purporting to be Susen's was deposited into the account. Before Susen received notice of the deposit, the bank paid out two large checks from the account. These checks had been signed by the daughter, but were otherwise not filled in. The checks were stolen from the daughter, filled in, and cashed at another institution before presentation to Susen's bank. The bank defended its actions in paying the checks on the ground that the daughter's signing blank instruments constituted negligence that estopped the bank's customer from recovering against the bank under UCC § 3-406. Susen argued in response that the bank should not have deposited the $5,000 check without her

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[113] Brown v. Bowery Sav. Bank, 51 NY2d 441, 443–444, 415 NE2d 906, 908–909, 434 NYS2d 916, 917–918 (1980).

[114] UCC § 4-205(1).

[115] 111 Ill. App. 3d 909, 911-912, 444 NE2d 701, 703-704 (1982).

indorsement. Without this deposit, the account would have lacked sufficient funds to pay the two other checks. Relying upon the account agreement card between the bank and Susen, the court held the bank was entitled to credit the funds from the $5,000 check into the joint account and acted according to reasonable commercial standards notwithstanding Susen's claim that her indorsement on the check had been forged. The agreement with the bank, the court concluded, permitted the deposit of Susen's funds into the account without her knowledge and without her indorsement.

[f] Liability for Overdrafts. Liability for overdrafts on a joint account is a troublesome issue. A new twist on this problem occurred in *United States Trust Co. of New York v. McSweeney*.[116] Edward and Christine, husband and wife, had a joint checking account. The bank honored a number of overdrafts, some of which were written by Christine and others by Edward. The bank sued Christine for payment of the overdrafts, and Christine offered three defenses: (1) that her husband controlled the account and she simply followed his directions and received no benefits from the overdrafts; (2) that deposits made to the account should be allocated in a pro rata manner to the overdrafts written by her; and (3) that she should not be held liable for overdrafts of her husband. The court ruled against Christine on the first two contentions. Firstly, as the drawer of checks that constituted overdrafts, she was liable for payment. Although she might have a claim for reimbursement against Edward, as between Christine and the bank

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[116] 91 AD2d 7, 8–9, 457 NYS2d 276, 277–278 (NY App. Div. 1982).

The Texas Supreme Court held that a co-signor on a joint checking account should not be charged for overdrafts created by the other party to the account without some showing that the co-signor had either "participated in the transaction which created the overdraft; was enriched by the overdraft; or in some manner ratified the transaction creating the overdraft. . . ." The court held that a party to the account should not be viewed as a "customer" of the bank under UCC § 4-401(a) on the mere signing of the bank's signature card. Although the trial court had determined that such a person could be treated as the bank's "customer" and, therefore, could be charged for any items properly payable from the account, the court reversed this decision. In reaching this result, the court noted that the party the bank was seeking to charge had never signed a check on the account or made a withdrawal from the account. The court did not consider whether the outcome would have been changed had the parties entered into a written indemnity agreement as part of their deposit contract with the bank. The court did not consider whether state community property rules might establish liability because there was no showing that such property rules applied to this account. Williams v. Cullen Center Bank & Trust, 685 SW2d 311, 314–315 (Tex. 1985). This decision was critically reviewed in "Overdraft Liability on Joint Checking Accounts," 102 Banking LJ 491 (1985). In Yoder v. Cromwell State Bank, 478 NE2d 131, 135–136 (Ind. Ct. App. 1985), one party to a joint checking account deposited checks that were subsequently dishonored and charged back to the account. The court held that the bank could charge back and recover the amount owed from all parties to the account because all were "customers" of the bank under UCC § 4-212(1), which gives a bank the right to charge back against its customers.

the control over the account by her husband, even if true, did not exculpate her from liability on her checks. Secondly, the court held that the bank could allocate deposits made to the account as it saw fit to the debts of either Edward or Christine and, therefore, could allocate the deposits entirely to Edward's overdrafts and sue Christine for the full amount of her overdrafts. Thirdly, the court recognized that the liability of one joint tenant to a checking account for the overdrafts of another joint tenant was not a settled matter and held that, in the absence of any specific term in the account agreement on the matter,

> the liability of one co-signatory for the overdrafts of the other depends... upon the resolution of such issues as the knowledge of the co-signatory of the overdrafts, the degree of participation of the co-signor in the day to day operations of the account, and the benefits allegedly derived by the co-signatory from the overdrafts.[117]

The court adopted this approach because joint tenants ordinarily are not agents for each other and become such only upon ratification or acquiescence by the other tenant.

[g] Conflicting Claims. In *Fortune v. City Nat'l Bank & Trust Co.*,[118] the court discussed the dilemma a bank faces when presented with a demand by one joint tenant for funds in the account and a claim by another that the funds belong to someone else. The other claimant argued that because of a statute on adverse claimants to bank deposits, the bank could not pay the funds in the account to the joint tenant until a court order had been obtained. The court held that this statute was not meant to apply to parties who were cotenants on an account, because it would mean the bank would have to either sue or be sued every time a private dispute existed between the cotenants. The court held that the bank had an absolute duty to honor the demand of any one of the tenants to the funds. In honoring the demand of the joint tenant for the funds, the bank "simply acted in conformity with the contractual obligation the cotenants themselves had agreed to, and such an act cannot form the basis for a cause of action against Bank."[119]

When the United States levies against a joint bank account in order to collect a tax obligation of one of the parties to the joint account, the result may be different than if it were a private party making the levy under state debt-collection procedures. In *United States v. National Bank of Commerce*,[120] three individuals were parties to a joint checking and a joint savings account. Under the terms of the accounts, each individual had the right to make a complete

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[117] 457 NYS2d at 279.

[118] Fortune v. City Nat'l Bank & Trust Co., 671 P2d 69 (Okla. Ct. App. 1983).

[119] Id. at 72.

[120] United States v. National Bank of Commerce, 472 US 713, 724–726 (1985) (five-to-four decision).

withdrawal of all of the funds in the accounts. One of the parties owed delinquent taxes. Acting on the powers granted by 26 USC § 6331(a), the Internal Revenue Service levied on both the checking account and the savings account. The bank argued that state law determined the rights of the delinquent taxpayer in the two accounts and that the Service could levy on the accounts only to the extent that state law gave the delinquent taxpayer a property interest in the accounts. The Supreme Court agreed that state law determined the property rights of the parties. However, it stated further that state law did not control the remedies that were available to the United States as a creditor where it was reaching the taxpayer's property to satisfy the tax obligation. Because state law gave the taxpayer an unlimited right of withdrawal in the accounts, the court concluded that the taxpayer had a "property right" that entitled the Internal Revenue Service to levy upon the entire amounts in both accounts. The state law limitations on levies by state creditors did not bind the federal government. The court concluded that the Service's levy on the full amounts in both accounts would not divest the other owners of their property interests in the accounts. The procedure used by the service was "provisional" and expressly provided a method for these other parties to assert their ownership claims after the levy was made. Thus, the ownership questions were deferred and the levy on the accounts could go forward without a prior adjudication of the rights of all of the parties to the joint accounts.

Another problem arises when one joint depositor tries to stop payment on a check drawn by another joint depositor. In this situation, the bank is caught in a crossfire. If it pays the check, it may be subject to claims, by the joint depositor who attempted to stop payment, against improper payment and even against wrongful dishonor if subsequent checks are not paid as a result of the improper payment. If the bank follows the stop payment instruction, it may be liable for wrongful dishonor to the joint depositor who drew the check. Obviously, the deposit agreement should resolve this problem. Absent agreement, unfortunately, the law is not clear.[121]

[3] Partnership Accounts

Partnership accounts usually are opened to handle the funds of a partnership. Any general partner may act as agent for the partnership and, therefore, can open an account for such a firm. However, in the case of an unlimited partner-

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[121] Cf. Valley Bank & Trust Co. v. Weyerman Feathers, 30 Utah 2d 161–163, 514 P2d 1282–1284 (1973) (bank liable for wrongful payment for not following stop payment order issued by wife on check drawn by husband) with Brown v. Eastman Nat'l Bank, 291 P2d 828 (Okla. 1955) (bank not liable for payment of check drawn by husband over a stop payment order issued by wife). See generally Annot., "Bank's Liability for Its Payment of Checks Drawn By One Depositor After Stop Payment Order By a Joint Depositor," 55 ALR2d 975 (1957). Stop payments are discussed at ¶ 20.05.

ship, it is safer if authorization for opening such an account is given by all the members of the partnership, and, in the case of the limited partnership, it is safer if authorization is given by the general partners.

[4] Corporate Accounts

Corporate accounts can be opened in the name of the corporation only by properly constituted officers of the corporation. Although a corporation may be estopped from denying the authority of an agent it has allowed to carry on a continuous course of dealing, the bank should require a resolution of the board of directors or a written authorization by a responsible officer under such a resolution for the opening of the account.

When an employee or other purported agent forges resolutions of corporate authority, the resolutions are not effective to give the employee power to act, by signing checks, on behalf of the corporation.[122] Unless the corporation ratifies the employee's conduct, or is estopped because of its own carelessness to challenge the actions taken, the signature cannot bind the corporation and will not constitute its signature.[123] Problems arising from the payment of checks with unauthorized signatures are discussed in Chapter 20.

¶ 19.04 SIGNATURES

In the case of the ordinary checking or commercial account, the bank is authorized to pay upon the order of the person whose signature is recorded on the signature cards kept for that purpose. The signature card constitutes the bank's contract with its depositor and contains the terms that give the persons named on the card authority to act on behalf of the depositor in making deposits and withdrawals and signing instruments. It has been held that a bank may properly refuse to pay a check when the account to be charged is not accurately described and when the name of the signer is in a form different from that on the bank's records of those authorized to sign.[124]

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[122] UCC § 3-404(1).

[123] UCC §§ 3-404–3-406. See Nationwide Homes v. First Citizens Bank & Trust Co., 262 NC 79, 81, 136 SE2d 202, 204 (1964). See also H. Bailey, supra note 30, § 3.6 (6th ed. 1987). Contra Flo-Control, Inc. v. Northeast Bank, 150 Ga. App. 880, 258 SE2d 695 (1979), which reached a contrary result because of a special statute exculpating the bank.

[124] Commonwealth Nat'l Bank v. Kennedy Co., 20 Utah 2d 83, 86, 505 P2d 298, 301 (1973); see UCC § 3-203. Cf. Roland v. Republic Nat'l Bank, 463 SW2d 747, 750 (Tex. Civ. App. 1971).

[1] What Constitutes a Signature

Under the UCC, no person can become liable on a check or other negotiable instrument without signing it.[125] Very few formalities are necessary for a signature to be effective. A signature can be made by using a "trade or assumed name" or by "any word or mark used in lieu of a written signature."[126] The following official comment reveals the flexibility recognized by the UCC:

> A signature may be handwritten, typed, printed or made in any other manner. It need not be subscribed, and may appear in the body of the instrument, as in the case of "I, John Doe, promise to pay—" without any other signature. It may be made by mark, or even by thumbprint. It may be made in any name, including any trade name or assumed name, however false and fictitious, which is adopted for the purpose. Parol evidence is admissible to identify the signer, and when he is identified the signature is effective.[127]

For a signature to be effective, it must either be authorized or ratified by the person who is bound or be made under circumstances justifying an estoppel or preclusion against denying its validity.[128] An authorized signature is one made with "actual, implied or apparent authority," as those concepts are understood in the law of agency generally.[129] Grounds for preclusion may include negligence as well as circumstances in which there are express or tacit representations as to the genuineness of the signature.[130] Also, special rules govern the allocation of responsibility for signatures made by agents and employees in certain circumstances, impostors, and others.[131] (These rules are discussed in Chapter 20 in the sections on forged and altered checks.)

The UCC negligence rule applies when the negligence of a person "substantially contributes . . . to the making of an unauthorized signature. . . ."[132] Not all negligence will meet the test of "substantially contributing" to the forgery.

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[125] UCC § 3-401(1). Although there is no liability on the instrument without a signature, liability may arise as a result of other duties based on the law of contract, tort, fraud, and so forth. UCC § 3-401; comment 1.

[126] UCC § 3-401(2).

[127] UCC § 3-401; comment 2. See also the definition of "signed," which encompasses "any symbol executed or adopted by a party with present intention to authenticate a writing." UCC § 1-201(39).

[128] UCC § 3-404.

[129] See UCC §§ 1-201(43), 3-403, 3-404. An "unauthorized signature" includes a forged signature as well as a signature otherwise lacking authorization.

[130] UCC § 3-404, comment 4; see UCC § 3-406.

[131] UCC § 3-405(1).

[132] UCC § 3-406.

In *Springhill Bank & Trust Co. v. Gish*,[133] a depositary bank sued Gish to recover payment on checks that had been stamped "for deposit only, Gish General Store." The bank had given credit for the checks but was unable to obtain payment from the drawee bank because the drawer of the checks had stopped payment. Gish, however, had not received the credit for the checks because the account was opened and the checks were indorsed and deposited not by Gish but by prospective purchasers of Gish's business. Gish had given the purchasers access to his cash register to familiarize themselves with the business, but they used this opportunity to unlawfully remove checks received by the business, indorse them, and deposit them in the account with the bank. Gish had never authorized these transactions. Accordingly, the court held that the signatures on the checks were not effective as his signature.[134] Moreover, permitting the purchasers to have access to the cash register was not action that "substantially contributed" to the unauthorized indorsements.[135]

A signature may be made by an agent.[136] No special formalities are necessary for one to become an agent. Questions sometimes arise as to whether a signature on an instrument has been made in a representative or agency capacity or it has been made to bind the signer personally.[137] These matters are discussed in Chapter 15.

Deceptive practices may make a signature ineffective. A lender obtained the signatures of its borrower's wife and his mother on a contract guaranteeing the loan by having a trusted employee of the borrower deliver the documents to the wife and the mother. The wife and the mother signed the papers, wrongly believing that the husband had previously reviewed and approved the loan. (They customarily signed other papers this employee had brought to them.) The lender misled the women by conduct the court regarded as overreaching; therefore, enforcement of the contract was deemed unconscionable.[138] If the deception is serious enough to prevent the signer from having a reasonable opportunity to know what is being signed, the fraud in obtaining the signature may be a defense even against a holder in due course.[139]

[2] Single, Multiple, and Facsimile Signatures

Accounts may be drawn upon by use of single, multiple, or facsimile signatures. In the case of the single signature, the bank is simply required to pay upon

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[133] 403 So2d 819 (La. Ct. App. 1981).

[134] 403 So2d at 820. See UCC § 3-404(1).

[135] 403 So2d at 821. See UCC § 3-404(1).

[136] UCC § 3-403(1).

[137] See UCC § 3-403. These matters are discussed in ¶ 15.04.

[138] ITT Indus. Credit Co. v. Alex Cooley's Ballroom, Inc., 726 F2d 1559, 1561 (11th Cir. 1984).

[139] UCC § 3-305(2)(c). See ¶ 16.02[2].

the order of the indicated signature. Multiple signatures may be handled in two ways. The bank may be authorized to pay either on any one signature or only when all signatures appear on the check. The signature card and the official corporate or other authorization should identify which signatures are necessary. In the absence of specification in the bank's contract with its customer, there may be uncertainty in accounts held by multiple parties as to who owns the account and is entitled to withdraw funds. These rights may be determined by local statutes, such as the Probate Code, on ownership rights in multiple party accounts.

The facsimile signature is a mechanical device used by some large businesses for signing checks. It may be a rubber stamp or a printed signature; both methods of signing are entirely valid.[140]

Before the UCC, the law provided, in absence of agreement to the contrary, that the bank was required to pay only when the signature was placed upon the check by a properly constituted officer.[141] In case such a stamp got into the hands of a wrongdoer, or if the printed signatures were stolen, the loss would fall on the bank and not on the depositor.[142] This rule of law has been changed by the UCC, which provides that the customer is liable if the misuse of the signature has been caused by his own negligence or if he has contributed substantially to the situation upon which the bank relied.[143] There still remain cases in which the unauthorized signature was created in circumstances beyond the control of the depositor. Unless the bank protects itself by special agreement with its customer, the bank may be liable for paying checks over facsimile signatures in these circumstances because the customer cannot be shown to be negligent. The bank should protect itself either by insurance or by a contract under which the depositor assumes the risk of loss in cases in which it is impossible for the bank tellers to distinguish the proper from the improper use of the facsimile signature. Such contracts have been upheld.[144]

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[140] UCC §§ 1-201(39), 3-401. See Toon v. Wapinitia Irrigation Co., 117 Or. 374, 243 P554 (1926); Carroll v. Mitchell-Parks Mfg. Co., 60 Tex. Civ. App. 263, 128 SW 446 (1910); Lexington v. Union Nat'l Bank, 75 Miss. 1, 22 So. 291 (1897).

[141] F. Beutel, Beutel's Brannon Negotiable Instruments Law § 23 (7th ed. 1948).

[142] Id. at Section 15; Paul Goodall Real Estate & Ins. Co. v. North Birmingham Am. Bank, 225 Ala. 507, 508, 144 So. 7, 8 (1932).

[143] UCC § 3-406. Comment 7, Section 3-406, describes as the "most obvious case" of negligence that would preclude a person from challenging the validity of a signature negligence in the safekeeping of a signature machine or stamp.

[144] Perini Corp. v. First Nat'l Bank, 553 F2d 398, 403 (5th Cir. 1977). Wilmington Trust Co. v. Phoenix Steel Corp., 273 A2d 266, 268 (Del. 1971), where the court held that the depositor was precluded from asserting forgery under Section 3-404 of the UCC. Wall v. Hamilton County Bank, 276 So2d 182, 183–184 (Fla. Dist. Ct. App. 1973). See Phoenix Die Casting Co. v. Manufacturers & Traders Trust Co., 29 AD2d 467, 469, 289 NYS2d 254, 256 (1968) (decided under pre-UCC law). In Fred Meyer, Inc. v. Temco Metal Prods. Co., 267 Or. 230, 232–233, 516 P2d 80, 82–83 (1973), the drawer used a protectograph

Even when the bank and its customer have entered into an agreement to protect the bank's paying checks with facsimile signatures, courts have interpreted the agreements narrowly and imposed liability on the bank in some situations. In *Cumis Insurance Society Inc. v. Girard Bank*,[145] the bank paid a series of checks that bore a forged facsimile signature of its customer, the drawer of the checks. The bank claimed that a resolution on file with the bank, signed by the customer, relieved the bank from liability for making payment against the facsimile signature of its customer even when the signature was unauthorized and forged. The language of the resolution stated that the bank would pay checks "bearing or purporting to bear the facsimile signature or any signature or signatures resembling the facsimile specimens . . . with the same effect as if the signatures were manual signatures." The court held that the bank was liable for paying the checks. Because the signatures were not authorized by its customer, the checks were not properly payable. Although the resolution arguably altered the relationship between the bank and the customer with respect to the bank's duty to pay, the court construed the resolution narrowly, reading it to mean that facsimile signatures were to be treated the same as manual signatures. Thus, unless its customer was negligent, the bank was liable for paying over an unauthorized nonauthentic signature. In interpreting the resolution in this fashion, the court expressed grave doubts as to the validity of any agreement that tried to change the rules relating to forged signatures to eliminate the bank's liability.

In *Mercantile Stores Co. v. Idaho First Nat'l Bank*,[146] an employee of the drawer, Mercantile Stores, stole bank checks from Mercantile and traced the facsimile signature of Mercantile on the stolen checks, using carbon paper and a previous dividend check issued by Mercantile as a model. The drawee bank, Idaho First National, ultimately paid the checks. The court held that Mercantile was not negligent under UCC § 3-406 or UCC § 4-406, so that the bank was liable for paying the checks over an unauthorized signature. The bank attempted to rely upon a resolution Mercantile had signed that gave the bank the right to pay checks bearing Mercantile's facsimile signature "regardless of by whom or by what manner the facsimile signature thereon may have been affixed thereto if such facsimile signature resembles the facsimile specimen impressed on this

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machine to write the amounts of the checks but a manual signature was needed. The drawer's carelessness in looking after the machine and blank check forms was not enough to make the drawer liable when the machine was stolen and checks forged. The court held UCC § 3-406 did not apply under the circumstances. It might be said that the checks resembled paychecks and thus had an "extra" appearance of authenticity, but they were not *signed* by the purported drawer, and the drawer's negligence did not contribute to the forgery. In First Nat'l Bank & Trust Co. v. Cartright, 189 Neb. 805, 808, 205 NW2d 542, 545 (1973), the bank was liable for paying on a rubber stamp signature without having the authorization of its customer. See West Penn Administration, Inc. v. Union Nat'l Bank of Pittsburgh, 15 UCC Rep. 428 (Pa. CP 1973); H. Bailey, supra note 30, § 22-8.

[145] 522 F. Supp. 414, 420–423 (ED Pa. 1981).

[146] 102 Idaho 820, 822–823, 641 P2d 1007, 1009-1010 (Idaho 1982).

resolution." The court held that the act of manually tracing the signature on the forged checks did not constitute a "facsimile signature" within the meaning of the resolution given the bank.

In *Corsica Livestock Sales, Inc. v. Sumitomo Bank*,[147] the court held the bank was bound by its signature card with its customers to pay checks only when the checks drawn against the account were signed by persons whose signatures were on file with the bank. The bank could not defend having paid the check on the ground that its customers had otherwise authorized a person whose signature was not on record with the bank to sign checks against the account. The court rejected the bank's argument, which was based upon UCC § 1-201(43)'s defining "unauthorized signature" as one made "without actual, implied or apparent authority," because, it reasoned, the bank's duty should be defined on a "contract basis" rather than on an "agency basis."

¶ 19.05 NONDEPOSIT LIABILITIES

In recent years, banks have increasingly used short-term transactions to obtain working funds that historically have been provided by deposits. These include so-called federal funds and repurchase agreements. The latter, "repo," agreements are short-term transactions in which a bank receives funds against a "sale" of securities that do not leave its possession because it has agreed concurrently to buy them back a day or so later at the "selling price" plus the going market rate of interest on transactions of this type. Thus, although cast in the form of a purchase and sale, the "repo" agreement functions like a loan and a repayment of funds. The purchase of federal funds is also a short-term transaction that, strictly speaking, involves only the transfer of a balance from one member bank to another on the books of the Federal Reserve. The term, however, sometimes has been used in a wider sense to apply to any short-term (one-day) interbank transfer of funds and even to a bank's nondeposit liability to a nonbank customer.

Sometimes the distinction between the foregoing transactions and deposits is difficult to establish by an objective index. Nonetheless, the distinction is crucial. If the obligations are not deposits, they are not subject to reserve requirements or to Federal Deposit Insurance assessments, since they are uninsured. The bank regulatory agencies have warned that caution must be used in entering into repurchase arrangements, as there use can raise substantial legal issues, including questions arising under the securities laws.[148]

A bank may be on either side of these transactions, that is, the seller (depositor) of federal funds or the buyer (depository) of them. To the same

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[147] 726 F2d 374, 378–379 (8th Cir. 1983).

[148] See generally Hexter, "That Which We Call a Deposit. . .," 26 Bus. Law. 1, 69 (1970-1971).

functional effect, in a repurchase agreement, the bank can be the seller-depository or the buyer-depositor. A resale agreement would be the same arrangement, with the participants reversed.

Another distinction between deposit and nondeposit sources of working funds lies in the formalities of the structural and operating arrangements. In contrast to the provisions for signature cards, deposit agreements, passbooks, and checks of the deposit arrangement, the nondeposit arrangements usually are characterized by informality and flexibility. They may involve little or no documentation and are consummated largely by telephone. Remarkably enough, and despite their frequency and magnitude, nondeposit agreements have produced little litigation and the amount of applicable law, whether statutory, decisional, or regulatory, is quite sparse.

The use of repurchase agreements by banks came prominently to the public's attention when a major dealer in government securities defaulted upon the payment of an estimated $207 million in overdue interest on government securities that were the subjects of repurchase agreements.[149] The Federal Home Loan Bank Board has issued a series of memoranda and regulations that establish guidelines for the use of repurchase agreements involving government securities by federally insured savings and loan associations.[150] The Federal Reserve Board has also issued guidelines for member banks and has cautioned member banks about participating in repurchase agreements. It advised that retail repurchase agreements should state conspicuously that "the obligation is not a deposit and is not insured by the Federal Deposit Insurance Corporation."[151] It further advised banks to make it clear in their advertising and marketing of repurchase arrangements that these arrangements are not deposits and are not insured by the FDIC. The guidelines also contained a caution about wholesale repurchase agreements. The Board pointed to the risks that the bank might bear if the securities that are the subject of the repurchase agreement could not be returned to the bank.[152] The staff of the Securities and Exchange Commission has issued a release on the issuance of repurchase agreements by banks and savings and loan

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[149] N.Y. Times, May 20, 1982, at D-1.

[150] FHLBB, "Proposed Rule on Transfer and Repurchase of Government Securities," 47 Fed. Reg. 8204 (FHLBB Feb. 25, 1982); FHLBB, Memorandum No. R-51a, 2 FHLBB Annot. Manual of Statutes and Regulations (5th ed. Sept. 8, 1981); FHLBB, Memorandum No. R-51 2 FHLBB Annot. Manual of Statutes and Regulations (5th ed. May 8, 1981). The FHLBB has adopted regulations concerning retail repurchase agreements to expand the consumer protection features of the existing regulations. FHLBB, Resolution No. 82-367 (May 20, 1982) cited in FHLBB, Memorandum No. R-51b, 2 FHLBB Annot. Manual of Statutes and Regulations (5th ed. Feb. 28, 1983). Memorandum No. R-51b, which replaces Memorandums R-51 and R-51a, is codified at 12 CFR § 563.8.

[151] Board of Governors of the Federal Reserve System, Letter to Presidents of all Federal Reserve Banks (Apr. 13, 1982), reprinted in Fed. Banking L. Rep. (CCH) ¶ 37,022 (Apr. 30, 1982).

[152] Id.

associations that states that the antifraud provisions of the federal securities laws apply to transactions involving repurchase agreements.[153] The Federal Financial Institution Examination Counsel drafted a policy to govern financial institutions dealing in repurchase agreements. The Board adopted these guidelines on October 30, 1985.[154] The Comptroller of the Currency, the FDIC, the National Credit Union Administration, and the FHLBB have also adopted the guidelines.[155]

A risk to bank customers who invested in repurchase agreements became a reality when the Mount Pleasant Bank and Trust Company of Mount Pleasant, Iowa, failed. The FDIC, as receiver for the failed bank, determined that customers with claims against the bank as a result of repurchase agreements did not have priority over the claims of depositors or other general creditors of the bank. The steps necessary to perfect a security interest in the underlying federal securities to protect the purchasers had not been taken in setting up the repurchase transaction. Accordingly, when bankruptcy occurred, the purchasers could not depend upon the underlying federal securities for payment and were, instead, in the position of general unsecured creditors of the bank. In making this determination, the FDIC stated that its conclusion was based upon the particular repurchase arrangements used by the Mount Pleasant bank and that it was not intended to be of general applicability to all repurchase arrangements.[156]

It is strongly recommended that counsel be consulted on setting up any repurchase arrangements and that when such transactions are undertaken, appropriate documentation be made.

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[153] See SEC Release No. 33-6351, dated Sept. 25, 1981, "Retail Repurchase Agreements by Banks and Savings and Loan Associations; Interpretations," 46 Fed. Reg. § 48,637 (SEC Oct. 2, 1981).

[154] "Supervisory Policy Statement on Repurchase Agreement Transactions," 50 Fed. Reg. 47,451 (Bd. of Governors of the Fed. Reserve Sys. Nov. 18, 1985).

[155] "Federal Savings and Loan Insurance Corporation; Repurchase Agreements and Reverse-Repurchase Agreements," 50 Fed. Reg. 48,372, 49,940 (FHLBB, Dec. 6, 1985); 1 Fed. Banking L. Rep. (CCH) ¶¶ 2014–2016 (Apr. 18, Oct. 22, Oct. 31, 1985); Fed. Deposit Ins. Corp., BL-43-85 [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 86,467 (Nov. 18, 1985).

[156] See 39 Wash. Fin. Rep. (BNA) No. 13, at 595 (Oct. 4, 1982); Fed. Deposit Ins. Corp., Press Release 77-82 [1982-1983 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,308 (Sept. 29, 1982).

20

Mutual Duties of the Bank and the Depositor

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¶ 20.01 BANK'S RIGHT TO CHARGE CUSTOMER'S ACCOUNT

Under the Uniform Commercial Code, a bank may charge its customer's account for "any item which is otherwise properly payable from that account even though the charge creates an overdraft."[1] This rule expressly permits the bank to pay checks drawn by its customer even though the customer's account does not contain sufficient funds and the payment creates a deficit in the account. The UCC's reasoning is that "the draft itself authorizes the payment for the drawer's account and carries an implied promise to reimburse the drawee" bank.[2] A bank is not required to pay a check that would create an overdraft, however, because such a check is not "properly payable."[3]

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[1] UCC § 4-401(1) (1978) (subsequent citations to the Uniform Commercial Code refer to the 1978 official text). On the relationship between the bank and the customer, see generally Alces, "Toward a Jurisprudence of Bank-Customer Relations," 32 Wayne L. Rev. 1279 (1986); Fox, "Banker-Customer Relationship: Maintaining the Legal Status Quo," 130 Solic. J. 638 (1986).

[2] UCC § 4-401, comment 1. A bank's payment of a check was held proper under UCC § 4-401, even though the account did not have sufficient funds to cover the check and the check had been dishonored previously. Lincoln Nat'l Bank & Trust Co. v. Peoples Trust Bank, 177 Ind. App. 312, 379 NE2d 527 (1978).

[3] UCC § 4-401(1).

Apart from the overdraft problem, there is little in the UCC to explain when an item is "properly payable." The most common problems involve checks subject to stop payment orders, altered checks,[4] checks with forged necessary indorsements,[5] and checks on which the drawer's signature has been forged.[6] All of these checks are not properly payable. The bank's customer has grounds for objections if the drawee bank pays such checks, and the drawee bank may refuse to honor them without liability to its customer (the drawer) for failing to pay. Although the bank may properly refuse payment, this does not necessarily mean the bank will suffer loss if it pays these types of checks. This depends on the particular circumstances. For example, negligence by the drawer may permit the bank to charge the full amount of an altered check to the drawer. These problems are discussed in subsequent sections. The drawee bank also may be justified in refusing to pay, without liability to its customer, certain other types of checks although payment by the bank under proper circumstances would allow the bank to charge the payment to its customer. Such items include checks presented after the death of the drawer,[7] postdated checks,[8] and stale checks.[9]

A bank's liability for paying a check over a forged signature of its customer is a primary obligation owing to the customer, not the secondary liability of a surety. Therefore, the bank cannot defend an action brought by the customer on the ground that its recourse against a forger was impaired by a settlement agreement the customer entered into with the forger.[10]

A customer's right to force the bank with whom it has an account to recredit that account for improper payments must be carefully distinguished from a situation where a customer seeks recovery from other parties in the collection chain, such as prior collecting banks and transferees of the check, based on theories of conversion, negligence, and so forth. There may be circumstances where the customer has a right to require the drawee bank to recredit its account because the item was not properly payable, but the customer has no cause of action against other parties who have handled the instrument.[11]

Banks frequently charge customers fees for providing various services in connection with the customer's accounts. Of course, the bank's contract with its customer or other agreement with the customer when the services are provided

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[4] See infra ¶ 20.09.

[5] See infra ¶ 20.08.

[6] Id. See UCC § 3-510, comment 2.

[7] See ¶ 19.02[5].

[8] See infra ¶ 20.04.

[9] Id.

[10] SCCI, Inc. v. United States Nat'l Bank, 78 Or. App. 176, 714 P2d 1113 (1986).

[11] See Kings Premium Serv. Corp. v. Manufacturers Hanover Trust Co., 115 AD2d 707, 496 NYS2d 524 (1985), where the court held the drawer of a check that had been completed without authorization could not recover against the depository bank but would have an action against the drawee bank to recredit the account.

should authorize the charges. Customers have challenged some of these charges as unconscionable. One area of litigation had been the fees banks have charged for processing insufficient funds checks. In a California case, the Supreme Court of California ruled a bank could be held liable for charging its customers excessive fees for handling such checks.[12] Fees charged by banks also may be regulated by special federal rules when the transaction involves consumer credit or other matters subject to special disclosure and notification requirements. Some of these requirements are discussed in Chapter 26.

¶ 20.02 IMPROPER PAYMENT AND BANK'S RIGHTS OF SUBROGATION

When a bank mistakenly pays a check that is not properly payable, it must recredit the account of the customer for any charge made against the account on the item involved.[13] The bank does have rights of subrogation when it makes a payment that is otherwise improper.[14] Under the UCC, it is subrogated to rights that any holder in due course, or any other payee or holder, might have against the drawer or maker of the instrument.[15] It also is subrogated to any rights of the drawer, or maker against other parties to the check, that might arise out of the transaction for which the check was given.[16] Under these principles, when a bank pays an item improperly, but the payment is made to a holder in due course, the bank has no liability to its customer for wrongful payment. Because the customer would be obligated to the holder in due course in any event (unless the customer has a special defense that would be good even against a holder in due course), the customer cannot complain of the fact of payment by the bank.

One consequence of a bank's improper payment of an item may be that when a subsequent item on the same account is presented for payment, the bank will dishonor it because the bank erroneously believes the customer's account lacks the funds to cover the item. This may make the bank liable for wrongful dishonor because the check would have been paid if the bank had not made a mistake in charging the customer's account for the first check (which was not

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[12] Perdue v. Crocker Nat'l Bank, 38 Cal. 3d 913, 702 P2d 503, 216 Cal. Rptr. 345 (1985), appeal dismissed, 475 US 1001 (1986). See also Best v. United States Nat'l Bank, 78 Or. App. 1, 714 P2d 1049, aff'd, 303 Or. 557, 739 P2d 554 (1987).

[13] UCC § 4-401.

[14] UCC § 4-407.

[15] Id. Although the bank wrongfully paid a check without the correct number of signatures, the bank was subrogated to the rights of the payee who supplied advertising services to the customer. American Communications Telecommunications, Inc. v. Commerce N. Bank, 691 SW2d 44 (Tex. Ct. App. 1985).

[16] UCC § 4-407(c).

properly payable).[17] In these cases, the bank may have rights based on subrogation against its customer, the drawer, for the item the bank improperly paid, but it is not clear legally that such subrogation rights are enough to justify the bank's charging the customer's account for the improperly paid check and thereby excusing the resulting dishonor for insufficient funds of subsequent checks.

The subrogation rights of a payor bank that pays a check in violation of its customer's stop payment order are discussed later in this chapter, in the section on stopping payment.

¶ 20.03 LIABILITY OF BANK FOR REFUSAL TO PAY

The checking account normally involves a relationship between at least three parties: the banker, the depositor, and the person to whom the depositor, by its check, orders payment.

The bank is indebted to the depositor but has no obligation to the payee or other holder until the bank "certifies" or "accepts" the instrument. The bank is the drawee and has not signed the check. Until the bank does sign the instrument,[18] either by accepting it or by certifying it, the bank has no liability as a party to the check to the holder.[19] The bank's contract is with its depositor to pay items that are "properly payable"[20] and, upon breach of this obligation, its liability runs to its customer.[21]

Absent special circumstances, a check is not an assignment to the payee of the debt owed by the bank;[22] therefore, the bank is under no obligation to the holder of the check as a result of the drawer's action in transferring the instrument to the holder. The drawee is not liable unless it accepts or certifies the check.[23] Even if the depositor and the payee of the check arrange by a separate contract to have the check operate as an assignment, the bank owes no duty to the holder unless it has been notified of the provisions of this contract. Even then, as the bank's duties to the third party are derived only from its duties to the depositor, any claim a third party may have against the bank is subject to the

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[17] UCC § 4-402. See infra ¶ 20.03.

[18] See UCC §§ 3-409–3-410.

[19] "No person is liable on an instrument unless his signature appears thereon." UCC § 3-401(1).

[20] UCC § 4-401. See ¶ 20.01.

[21] UCC § 4-402. See generally Dow, "Damages and Proof in Cases of Wrongful Dishonor: The Unsettled Issues Under UCC Section 4-402," 63 Wash. ULQ 237 (1985); Sabbath, "Drawee Bank's Liability for Wrongful Dishonor: A Proposed Checkholder Cause of Action," 58 St. John's L. Rev. 318 (1984).

[22] UCC § 3-409.

[23] Id. Certification of a check is acceptance. UCC § 3-411(1). See the discussion of acceptance at ¶ 15.02[3].

bank's claim against the depositor.[24] Thus, except in special circumstances, the bank is not liable to the check's holder for refusing to honor a check.[25]

The bank, however, is under absolute liability to its depositor to pay at the depositor's order when the signature on the order corresponds with the signature on file at the bank, when the amount to be paid is within the amount of money on deposit in the checking account, and when the order is otherwise properly payable.[26] A bank that fails to honor a check properly drawn upon available funds is liable not only for breach of contract with its depositor but also for any resulting damages. Thus, even in the case of a mistaken refusal to honor a check drawn against sufficient funds, the bank may be liable. Such cases may involve damages far beyond the amount of the check, or even the total amount in the account, if the depositor can show actual damage to his or her business and credit caused by the bank's refusal to pay.[27]

There are many situations in which liability for wrongful dishonor may arise as a result of a mistake. For example, if the bank mistakenly sets off a debt owed to the bank against the account or in good faith pays a check that is not properly payable, the bank's action will reduce the funds in the account to pay subsequent checks. If the bank subsequently dishonors a check that would have been paid but for the erroneous charge to the account, the dishonor is wrongful, and the bank is liable for damages to its customer, regardless of its good faith in charging the account.[28]

Under the UCC,[29] the bank is liable for any damages proximately caused by

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[24] See UCC § 9-318(1) for an illustration of the types of defenses and claims an obligor might assert against an assignee.

[25] The court in Atlantic Cement Co. v. South Shore Bank, 730 F2d 831 (1st Cir. 1984), enforced the rule of UCC § 3-409(1) that a check is not an assignment and held that the payee of a check dishonored by the drawee bank had no cause of action against the bank, whether or not the dishonor was wrongful as against the drawer or there had been a prior history of payment of checks of the drawer.

Because a check is not an assignment of funds, the holders of checks did not have standing to contest the forfeiture of the account for violation of federal narcotics laws. United States v. Four Million, Two Hundred Fifty-Five Thousand, 762 F2d 895 (11th Cir. 1985), cert. denied, 474 US 1056 (1986).

[26] UCC § 4-401(1). A court has applied the UCC principles of wrongful dishonor to the issuer of a money order who mistakenly refused to pay the money order when it was presented by the payee. The purchaser of the money order was permitted to sue the issuer for wrongful dishonor. Lovejoy v. Weese, 689 SW2d 387 (Mo. Ct. App. 1985).

[27] UCC § 4-402.

[28] See Loucks v. Albuquerque Nat'l Bank, 76 NM 735, 418 P2d 191 (1966), Coles Country Nat'l Bank v. First Nat'l Bank & Trust Co., 20 Ill. App. 3d 23, 312 NE2d 643 (1974) (abstract only).

[29] UCC § 4-402 contains the following provision:

> A payor bank is liable to its customer for damages proximately caused by the wrongful dishonor of an item. When the dishonor occurs through mistake, liability is

the dishonor, even for damages due to arrest or prosecution of the customer. When the dishonor is due to an honest mistake on the part of the bank, the liability is limited to the actual damages proved.[30] The comments by the drafters of the UCC say that this provision rejects the pre-UCC law of some states, which lets business persons recover substantial damages without proof of actual injury (on the theory that dishonor of the checks is a "per se" defamation of the person's credit reputation).[31] By negative implication, however, when the dishonor is intentional, the UCC does not restrict liability to "actual damages proved."[32]

The UCC has been applied to deny damages for mental anguish or emotional disturbance sustained by a customer after wrongful dishonor. However, in one case, in which wrongful dishonor was found to have occurred under aggravated circumstances, the court permitted recovery of punitive damages as well as damages for injury to the depositor's credit and damages for mental anguish. In this instance, a check on the account of a third person payable to the depositor was cashed at the bank on a forgery of the depositor's indorsement. The drawee bank returned the check as improperly signed and the check was charged against the depositor's account. In the meantime, the depositor had written checks on his account. He notified an officer of his bank of the forgery of his indorsement, but the bank refused to take any action, and, the court said "the officer called

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limited to actual damages proved. If so proximately caused and proved damages may include damages for an arrest or prosecution of the customer or other consequential damages. Whether any consequential damages are proximately caused by the wrongful dishonor is a question of fact to be determined in each case.

[30] Id.

[31] UCC § 4-402, comment 3. See generally Davenport, "Wrongful Dishonor: UCC § 4-402 and the Trader Rule," 56 NYU L. Rev. 1117–1147 (1981).

[32] See J. White & R. Summers, Uniform Commercial Code § 17-4 (2d ed. 1980) (hereinafter White & Summers). The bank's customer sued the bank for wrongful dishonor when the bank improperly set off debts against special accounts the customer had with the bank and checks were subsequently dishonored. The accounts were special accounts where the bank was a trustee and where the bank's relationship with its depositor was not the normal debtor/creditor relationship. "When money is deposited in a bank for a specific purpose, it is a special deposit to the extent that title to the money does not pass to the bank but remains in the depositor." Larstone Corrugated Carton Co. v. First Seneca Bank & Trust Co., 39 UCC Rep. Serv. (Callaghan) 1397, 1405 (Pa. Ct. CP 1984). In this case, the special accounts were required under the customer's financing contracts with the Small Business Administration, and the bank had participated in setting up the contracts. When the bank applied an overdraft on the customer's general account against funds in the special accounts, the court held that the customer was entitled to recover damages for wrongful dishonor. These damages included loss of credit and damage to business standing under UCC § 4-402. The court further held that if the dishonor was done intentionally and not "by mistake," the customer might be entitled to recover substantial damages for injury to his credit and business standing without proving actual damages. Id. at 1404.

over a uniformed guard." The bank then dishonored the checks on the account, marking them "paid in error" and "account closed." The court held that the conduct of the bank was deliberate and in disregard of the depositor's claim of right, thus justifying the damage award.[33]

In another case, the court found a bank to have wrongfully dishonored certain corporate checks after it reneged on its promise to make a loan to the corporation. The bank was held liable for compensatory damages to the two individuals who owned and operated the corporation; these compensatory damages included damages for emotional distress caused by certain "criminal and administrative investigations and charges as well as various acts of harassment and vandalism" that followed the dishonor.[34] The court said that the owners "did not merely allege a subjective state of discomfort at having their checks dishonored; rather they gave proof of objectively verifiable events which followed the dishonoring of their checks and which would have induced mental suffering in any reasonable person."[35] However, the court declined to award punitive damages, since it found no malice on the part of the bank personnel, only a "bona fide disagreement" as to how far the bank was required to go in helping the owners with their financial problems.[36]

The Arkansas Supreme Court upheld a verdict of $18,500 for mental anguish and loss of credit and a $45,000 award of punitive damages when a bank wrongfully froze its customer's account for four years. The bank froze the account when the customer notified the bank that its checkbook had been lost. The bank had honored two forged checks on the account a few days before the notice of the lost checkbook was given. Subsequently, the police arrested the forger and notified the bank that the customer had no connection with the forgeries. Nevertheless, the bank continued to freeze the account for four years. The customers lost their credit standing; a check written for a down payment on a house was dishonored and they were unable to conclude the purchase; and marital difficulties appeared to result from the financial strain and the repossession of two vehicles. The court held that UCC § 4-402 "impliedly recognizes

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[33] Northshore Bank v. Palmer, 525 SW2d 718 (Tex. Civ. App. 1975). The court stated that the statutory liability of a bank for wrongful dishonor is "more in the nature of tort than contract" and justified the award on the ground that the dishonor was deliberate and did not occur through mistake.

[34] Kendall Yacht Corp. v. United Cal. Bank, 50 Cal. App. 3d 949, 958, 123 Cal. Rptr. 848, 854 (1975). The court also held that the owners, as the only active principals of the corporation, might sue for wrongful dishonor under the UCC.

[35] Id.

[36] Id. at 958–959, 123 Cal. Rptr. at 854–855. In a wrongful dishonor suit resulting from miscrediting of a deposit to a savings rather than a checking account, it was noted that neither the UCC nor pre-UCC Michigan law foreclosed damages for mental anguish. Harvey v. Michigan Nat'l Bank, 19 UCC Rep. Serv. (Callaghan) 906, 912 (Mich. Ct. CP 1974).

mental suffering and other intangible injuries" and further stated that "exactness in proof" of damages is not required.[37]

Another issue in interpreting the scope of the UCC provision on wrongful dishonor is determining who is entitled to recover when wrongful dishonor occurs. Under UCC § 4-402, the bank's liability for wrongful dishonor runs only to its "customer," the person or entity that has the account with the bank.[38] Because of this definition of the term "customer," courts have held that individuals who were partners or officers could not recover for injuries to themselves for dishonor of checks drawn on the partnership or corporate accounts.[39]

In *Shaw v. Union Bank & Trust Co.*,[40] the court held that because a savings withdrawal slip constitutes an "item" under the UCC, a depositor in a savings account could sue for wrongful dishonor when the bank refused to honor the withdrawal slip. The court went on to hold that in a proper case the depositor could recover not only consequential damages for the wrongful dishonor but also punitive damages.[41]

In *Farmers & Merchants State Bank v. Ferguson*,[42] the bank froze its customer's account without notice and then dishonored checks drawn against the account even though the account had sufficient funds to pay them. The bank's conduct was found to constitute such gross indifference to the customer's rights as to constitute actual malice entitling recovery of damages for mental anguish, loss of credit, loss of time, loss of money, and loss of the use of the funds in the account.

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[37] Twin City Bank v. Isaacs, 283 Ark. 127, 672 SW2d 651 (1984).

[38] UCC § 4-104(1)(e).

[39] Farmer's Bank v. Sinwellan Corp., 367 A2d 180 (Del. 1976); Loucks v. Albuquerque Nat'l Bank, supra note 28. P2d 191 (1966). But see First Nat'l Bank v. Hobbs, 248 Ark. 76, 450 SW2d 298 (1970); Kendall Yacht Corp. v. United Cal. Bank, 50 Cal. App. 3d 949, 123 Cal. Rptr. 848 (1975). See also Murdaugh Volkswagen, Inc. v. First Nat'l Bank, 801 F2d 719 (4th Cir. 1986). The president and sole stockholder of a corporation that had a corporate checking account with the bank could be a customer of the bank for purposes of UCC § 4-402 when the bank's dealings with the corporation treated the individual as responsible for the corporate obligations. In addition, the jury could find wrongful dishonor, even though the customer had drawn the dishonored checks against previously deposited checks that had not cleared, because the bank failed to notify its customer of its termination of an agreement to give immediate credit. The customer was entitled to rely, under the circumstances, on the balances shown on the bank statement. The court upheld an award of $268,000 in damages because the jury could find that the bank's dishonor of the checks ruined the business of the customer (an automobile dealership) and entitled the customer to a recovery based on the value of assets lost in bankruptcy. The dishonor led suppliers to deal COD and the manufacturer to terminate the franchise. An award of $175,000 was allowed for defamation of the officer of the company for injury to business reputation and for emotional harm where the bank's dishonor was not in good faith.

[40] 640 P2d 953 (Okla. 1981).

[41] Id. at 956–957.

[42] 617 SW2d 918 (Tex. 1981).

¶ 20.04 POSTDATED CHECKS AND STALE CHECKS

Postdated checks are not properly payable before their date.[43] In many cases, however, there will be no practical liability to the bank if a postdated check is mistakenly paid, because the bank will be subrogated to the rights of any holder of the check against the drawer.[44] If, as is often the case, the holder is a holder in due course, the drawer will have an obligation to pay that cannot be avoided by most defenses.[45]

A postdated check is an enforceable obligation and is a negotiable instrument if it otherwise satisfies the requirements for negotiability. Postdating the instrument does not make the obligation conditional and does not destroy negotiability.[46] Because a postdated check is an enforceable obligation, it is consideration for a sale if the seller accepts the check.[47]

A check that is more than six months old is considered a stale check. A bank may refuse to pay such a check.[48] If a bank acts in good faith, it may pay checks presented more than six months after their stated date.[49] There is considerable uncertainty as to what constitutes "good faith" when the bank knows the check is stale, particularly if customary banking practice is to refuse payment. Some take the view that as a general rule, a bank should be liable to its customer for knowingly paying a stale check.[50]

The drafters of the UCC take the view that a bank should not be held liable to its customer for paying a check against which there is an expired stop payment order after the check has become stale.[51]

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[43] UCC § 3-114(2). See generally Annot., "Extent of Bank's Liability for Paying Postdated Check," 31 ALR4th 329 (1984).

[44] UCC § 4-407. There may be problems if premature payment of the postdated check leads to dishonor for insufficient funds of subsequent checks.

[45] See generally Chapter 15; see also White & Summers, supra note 32, § 17-3. See generally Annot., "Application of 'Bad Check' Statute With Respect to Postdated Checks," 52 ALR3d 464 (1973).

[46] UCC § 3-114(1). Esecson v. Bushnell, 663 P2d 258 (Colo. Ct. App. 1983).

[47] *Esecson*, at 260. Acceptance of a postdated check as payment suspends the underlying obligation for which the check was taken until the check has been dishonored. The rule is the same as that for checks taken in payment that are not postdated. Grumet v. Bristol, 125 NH 537, 484 A2d 1099 (1984). See generally ¶ 21.03[4].

[48] UCC § 4-404.

[49] Id.

[50] See White & Summers, supra note 32, § 17-3.

[51] See UCC § 4-403, comment 7, which suggests that the last sentence of Section 4-403(2), together with the second clause in Section 4-404, rejects the reasoning of pre-Code cases, which held a bank liable for paying a stale check against which there had been an expired stop payment order.

¶ 20.05 STOPPING PAYMENT

Because the relationship of bank and depositor creates an implied agreement on the part of the bank to pay only on the order of the depositor, the depositor may revoke this authority at any time before payment. A bank that pays after receipt of a stop payment notice, either on an individual check or on an entire account, is liable to the drawer for so doing because the check is not "properly payable."[52]

[1] Basic Rules on Stopping Payment

To be effective, a stop payment order must be received by the bank "at such time and in such manner as to afford the bank a reasonable opportunity to act . . . "[53] This doubtless means the customer must reasonably describe the check. What is "reasonable" may not be so clear. Some inaccuracy in the description has been tolerated.[54] For example, when a customer correctly named the payee and provided the date and number of the check, but supplied the wrong amount, the court held identification was sufficient to stop payment.[55] With the use of magnetic ink character recognition, and computer processing, what amounts to a reasonable identification may depend upon the check-searching system used by the bank.[56] In any event, it is appropriate for the bank and the

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[52] UCC § 4-403, comment 8. A bank's failure to give proper notice of dishonor made the bank liable for payment of a check drawn on insufficient funds. However, the bank was entitled to charge its customer's account for the overdraft caused by the check even though the bank had advised its customer the check had been dishonored and returned NSF when the customer gave the bank a stop payment order. Brown v. Lee County Bank, 501 So. 2d 702 (Fla. Dist. Ct. App. 1987).

[53] UCC § 4-403(1).

[54] See H. Bailey, Brady On Bank Checks § 23.7 (6th ed. 1987) (hereinafter Brady on Bank Checks). It has been said that an oral stop payment order must describe the check with particularity. Sherrill v. Frank Morris Pontiac-Buick-GMC, 366 So. 2d 251 (Ala. 1978). See generally Annot., "Sufficiency of Description of Check in Stop Payment Order Under UCC § 4-403," 35 ALR4th 985 (1985); Annot., "Construction and Effect of UCC § 4-403(2) Regulating Oral or Written Nature of Stop Payment Order," 29 ALR4th 228 (1984).

[55] Elsie Rodriguez Fashions, Inc. v. Chase Manhattan Bank, 23 UCC Rep. Serv. (Callaghan) 133 (NY Sup. 1978).

[56] The check identification method used by the payor bank's computer system was the critical factor in Capital Bank v. Schuler, 421 So. 2d 633 (Fla. Dist. Ct. App. 1982). Although the customer gave her bank the correct check and account numbers for the check she instructed the bank to stop, her error in describing the amount as $750 rather than $700 was determinative. Under the magnetic ink encoding system used by the bank for computer processing, the amount of the check is encoded by the first bank to handle it, and this becomes the key method of identifying the instrument as it is processed for payment. Because the check could not be identified in this system without the amount, the court held the failure to describe the amount accurately deprived the bank of a reasonable

customer to enter into an agreement as to the information necessary to identify checks that should be stopped.

[a] When Is a Stop Payment Order Timely? A stop payment order will not be effective unless it is received by the bank before the check has been paid. In addition, the UCC states that the stop payment order must be received not only prior to final payment or certification, or prior to some act indicative of a decision by the bank to pay the item, but also in time to enable the bank to act on the item prior to performance of one of the actions previously specified.[57]

This principle was applied in a case in which the drawer of a check appeared at the bank at its opening time on Monday morning to stop payment on a check dated some six days earlier. The bank employee who received the stop payment order checked the records to see whether the check had cleared before he gave the drawer a printed notice confirming his request to stop payment. However, the check had been cashed on the preceding Saturday morning, when the bank had been open for certain transactions; but such Saturday transactions had not

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opportunity to act on the customer's order. The case arose under the Florida variation of UCC § 4-403 which requires a stop payment order to describe the check "with certainty." The court held that this standard was meant to require a more precise description than what would qualify under the UCC uniform provision. A bank's computer system also failed to catch a check in Staff Serv. Assocs., Inc. v. Midlantic Nat'l Bank, 207 NJ Super. 317, 504 A2d 148 (1985), because the customer incorrectly described the number of cents in the check he directed the bank to stop. The correct amount of the check was $4,117.12 but the amount described in the stop payment order was $4,117.72. The customer correctly described the date, check number, account number, and payee's name. Although the bank's stop payment order form advised the customer that information on it must be correct "including the exact amount of the check to the penny, or the bank will not be able to stop payment," the court held that the bank could not avoid liability for paying the check over the stop payment, because the check was reasonably described. By electing to use a computer system that was dependent on the amount of the check, the bank assumed the risk of being unable to stop a check a customer had reasonably described. The court concluded that the bank "should not be permitted to relieve itself of this risk unless it calls attention to its computerized system and the necessity for the exact check amount to meet computer requirements." The statement on the stop payment order form was ineffective because it erroneously informed the customer that all the information requested on the order form needed to be correct when in fact only the amount of the check had to be accurate. See generally Graziano, "Computerized Stop Payment Orders Under the UCC: Reasonable Care or Customer Beware?" 90 Com. LJ 550 (1985).

In Marine Midland Bank, N.A. v. Berry, 123 AD2d 254, 506 NYS2d 60 (1986), the customer did not give his bank a reasonable opportunity to act on his stop payment order when he made three errors in identifying the check: he gave the check number as 245 rather than 244, the amount as $6,511.31 rather than $6,518.31, and the payee as "First National Bank of Middlebury, Vermont, R. Hamilton," rather than "R. Hamilton and the National Bank of Middlebury, Vermont." There was no discussion of how these errors may have caused the bank to fail to identify the check.

See generally White & Summers, supra note 32, § 17-5.

[57] UCC §§ 4-303(1), 4-403(1).

yet been recorded or processed through the bookkeeping system of the bank at the time on Monday morning when the bank employee receiving the stop payment order had checked the records. The court held that the bank did not have a reasonable amount of time to act on the stop payment order and that, in any event, the order had come too late when the bank had paid the item in cash.[58]

When a check given as earnest money in a real estate transaction was taken by the payee to the bank on which it was drawn and there exchanged for a cashier's check payable to the same payee in an identical amount, the court found that the original check was finally paid at the time the cashier's check was issued. The court said that the bank was not required to honor a stop payment order that was received the following day and that came too late, from its own customer (the drawer of the original earnest-money check). Accordingly, the bank was not entitled to recover the amount of the cashier's check from the payee.[59]

In another case, the drawer of a check went to the bank and ordered that payment be stopped, taking this action at 9 a.m. The bank certified the check at 10:40 a.m. the same morning, at the request of the payee. The court held that the bank had sufficient time to act on the stop order and that the certification was improper; also, the drawer did not have the burden of proving any negligence on the part of the bank.[60] A bank that received a stop payment order from a depositor and then paid the check two days later, by issuing two treasurer's checks for the same amount, was not allowed to charge the payee's account and was held responsible for the loss.[61]

Before the UCC was enacted, a single stop payment notice was sufficient and did not need to be renewed. Under the UCC, stop payment orders have a limited duration—oral notices are effective for only fourteen days; written notices are good for only six months.[62]

[b] Subrogation Rights and Proof of Loss. Under pre-Code law, a bank was not entitled to charge the account of its customer for a check paid over a stop payment order, even though payment was made to a holder in due course who had a good claim against the customer; nor could the bank recover the amount

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[58] Siniscalchi v. Valley Bank, 79 Misc. 2d 64, 359 NYS2d 173 (NY Dist. Ct. 1974), where the court cited Section 4-403 in support of its ruling.

[59] Citizens & S. Nat'l Bank v. Youngblood, 135 Ga. App. 638, 219 SE2d 172 (1975).

[60] Tusso v. Security Nat'l Bank, 76 Misc. 2d 12, 349 NYS2d 914 (NY Dist. Ct. 1973). The court also held that the bank could recover the amount of the check from the payee in a third-party action.

[61] Anthony Roberts Properties, Inc. v. Industrial Valley Bank & Trust Co., 16 UCC Rep. Serv. (Callaghan) 1088 (1973), aff'd mem. 228 Pa. Super. 854, 322 A2d 661 (1974). The court indicated, however, that the bank might be subrogated to the drawer's rights, if any, against the payee under Section 4-407 of the UCC, but did not rule on this point.

[62] UCC § 4-403(2).

paid from a bona fide holder.[63] Under the UCC, the bank has rights of subrogation against both its customer and third party payees and holders. These rights may insulate the bank from liability in many cases in which payment is made to a holder in due course, even though the bank has wrongfully failed to honor a stop payment order.[64]

This subrogation provision was given effect in a case in which a bank paid a corporate check, signed by a dying president to his wife, over a stop payment order given by the successor president of the corporation. In this instance, the bank was deemed to have paid the check because of failure to return it within the prescribed time limits or to give timely notice of dishonor. The court indicated right of subrogation was possible even though the bank had not charged the account of the corporate drawer and, by not appealing an order of the trial court denying its right to charge the account, had lost the right to charge its drawer's account.[65]

When a bank pays a check over a stop payment order and the drawer demands that his or her account be reimbursed for the payment, the bank has, under this provision of the UCC, a right of subrogation against the payee for the loss suffered. When the bank pays over a stop order and the drawer does not demand reimbursement for the payment, according to one court, the bank has no subrogation right since it has not suffered any loss.[66] When a wife placed a stop payment order on a check drawn by her husband on their joint account and the bank paid the check over the stop order because of a failure in the bank's computer system, the bank was held to have no right of recovery from the husband.[67]

In *Lynnwood Sand & Gravel Inc. v. Bank of Everett*,[68] the court held that a payor bank acquired the rights of a holder in due course because it was subrogated to the rights of a depository bank. The depository bank was a holder in due course because it had applied a provisional credit for a check against an existing overdraft in the depositor's account. Because of the payor bank's subrogation rights, the bank was entitled to summary judgment in a suit brought against the

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[63] Johnson v. First State Bank, 144 Minn. 363, 175 NW 612 (1920); National Bank of N.J. v. Berrall, 70 NJL 757, 58 A 189 (1904). Contra National Loan & Exch. Bank v. Lachovitz, 131 SC 432, 128 SE 10 (1925). See Annot., "Bank's Right to Recover Back Money Paid on Stopped Check," 39 ALR 1239 (1925). Cf. Note, "Bank May Recover Money Paid on Stopped Check," 81 Banking LJ 624–628 (1964) & 80 Banking LJ 1075 (1963); UCC § 3-418.

[64] UCC § 4-407. See supra ¶ 20.02.

[65] Sunshine v. Bankers Trust Co., 34 NY2d 404, 314 NE2d 860, 358 NYS2d 113 (1974).

[66] Aljax Corp. v. Connecticut Mut. Life Ins. Co., 458 Pa. 57, 333 A2d 469 (1974).

[67] Valley Bank & Trust Co. v. Weyerman Feathers, 30 Utah 2d 161, 514 P2d 1282 (1973). The bank had sought recovery from the payee of the check, as well as from the husband. See also Johnson v. Eudora Bank, 257 Ark. 518, 517 SW2d 957 (1975).

[68] 29 Wash. App. 686, 630 P2d 489 (1981).

bank by the customer who had issued a stop payment order on the check.

The UCC provides that the burden of establishing the fact and the amount of loss resulting from the payment of an item contrary to a binding stop payment order is on the customer.

There is some doubt under the UCC on how the stop payment and subrogation provisions interact and relate to the bank's liability for wrongful dishonor for nonpayment of subsequent items. Consider the following hypothetical case, which illustrates these issues. Suppose a customer draws Check 1 for $5,000 but gives the drawee bank a timely stop payment order. Because of a clerical error, the bank pays Check 1 and deducts $5,000 from the customer's checking account. As a consequence, when the customer's Check 2 for $3,000 is presented, the customer's account does not have sufficient funds to pay it, so the bank dishonors the check. On a lawsuit by the customer against the bank for the wrongful dishonor, the bank may make two arguments: First, until the customer shows there was "loss" as a result of the payment of Check 1, as required under UCC § 4-403(3), the charge by the bank to the customer's account for Check 1 is proper and, thus, the dishonor of Check 2 for insufficient funds is not wrongful. Second, the bank has subrogation rights under UCC § 4-407 against its customer (assuming there is a holder in due course or payee to whom the drawer would be obligated for nonpayment of the check), and these rights justify the bank's charge to its customer's account for Check 1, so that the subsequent dishonor of Check 2 was proper.

The answers to the bank's arguments are not clear. In an earlier version of the UCC, an official comment explained the customer's duty to prove loss as follows: "When a bank pays an item over a stop payment order, such payment automatically involves a charge to the customer's account. Subsection (3) imposes upon the customer the burden of establishing the fact and amount of loss resulting from the payment. Consequently until such burden is maintained either in a court action or to the satisfaction of the bank, the bank is not obligated to recredit the amount of the item to the customer's account and, therefore, is not liable for the dishonor of other items due to insufficient funds caused by the payment contrary to the stop payment order."[69] When a revised edition of the UCC was published, although the text of the main section remained the same, the comment just quoted was eliminated without any explanation.

The customer's burden under UCC § 4-403(3) to establish the "fact and amount of loss" should be construed in light of the UCC's provisions giving the bank rights to subrogation in Section 4-407. A comment to Section 4-407 states:

> If a bank pays an item over such a stop order it is prima facia liable, but under Subsection (3) of 4-403 the burden of establishing the fact and

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[69] UCC § 4-403, comment 9 (1952 edition). For an excellent discussion of this issue, see E. Allan Farnsworth and J. Honnold, Cases and Materials on Commercial Law 242–243 (4th ed. 1985).

> amount of loss from such payment is on the customer. A defense frequently interposed by a bank in an action against it for wrongful payment over a stop order is that the drawer or maker suffered no loss because he would have been liable to a holder in due course in any event. On this argument some cases have held that payment cannot be stopped against a holder in due course. Payment can be stopped, but if it is, the drawer or maker is liable and the sound rule is that the bank is subrogated to the rights of the holder in due course.[70]

This comment suggests that a customer makes a prima facia case against the bank by showing payment occurred over a timely stop order. The burden of establishing the fact and amount of loss is on the customer. It is unclear whether this means the customer must always present additional proof.[71] If the bank chooses not to present any evidence, the comment can be read as support for holding the bank liable for wrongful payment because the customer has shown the bank is "prima facia liable" once the customer has shown the bank paid over a binding stop payment order. The second part of the comment suggests that the bank's right to subrogation is a matter of defense on which the bank would have the burden of establishing that subrogation rights exist against the customer. On this view, it would be inappropriate to construe the customer's burden under Section 4-403(3) as having to negate the possibility that the bank is subrogated to the rights of a holder in due course or other party against the customer under Section 4-407.

The bank's second argument, that its rights to subrogation give it a right to maintain the charge to the customer's account for paying the check over the stop payment order, also is a matter of uncertainty. In a New York case, a bank gave a customer credit for a check the customer deposited that was drawn on another customer of the bank. The bank subsequently deducted the credit from the customer's account because the drawer of the check stopped payment, but the bank's action was too late and the debit occurred after the bank had made final payment. The bank claimed to have subrogation rights against the customer whose account it had debited. The court said, "When the bank is suing as subrogee, it may not at the same time make a preliminary determination of the merits of the case by charging back on the depositor's account . . . so that in this case the Bank has no more or less right to take away or freeze Elizabeth's [the customer's] account than would the Bank's subrogor. . . . When the bank is acting as subrogee, it has the burden of going forward."[72] The New York case is not like the problem posed above where the bank is using subrogation to justify charging

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[70] UCC § 4-407, comment 1.

[71] The UCC defines "burden of establishing" a fact as meaning the person with such a burden has "the burden of persuading the triers of fact that the existence of the fact is more probable than its nonexistence." UCC § 1-201(8).

[72] Sunshine v. Bankers Trust Co., 34 NY2d 404, 314 NE2d 860, 864, 358 NYS2d 113, 117 (1974). For a good analysis of this case, see E. Farnsworth and J. Honnold, Cases and

its customer's account. In the New York decision, the bank tried to use the subrogation doctrine to justify reversing a final payment. In the problem above, the final payment rule is not in issue.

Overdrafts are authorized by the UCC. As a result, where a depositor reduces the balance in his account in lieu of stopping payment, a bank inadvertently paying a check is entitled to collect that amount from the defaulter.[73] In many instances, banks have attempted to relieve themselves of the risk of paying stopped checks by special agreement with the depositor. Although some provisions of the UCC may be varied by agreement and there is some leeway to define by agreement the identification needed by the bank to stop payment and to regulate similar details, the UCC takes the position that agreements exculpating banks from liability for not following stop payment orders are invalid.[74]

[2] Claims of Third Parties to Checks

Since the payment of checks depends upon a contract between the depositor and the bank, third parties normally are not allowed to stop payment on checks. However, in a number of instances, the holder of a check may lose the check, be defrauded, have it stolen from him, or have other claims to the proceeds. In such a case the right to payment may belong to the injured holder and not to the person who has possession of the instrument. Under the former Uniform Negotiable Instruments Law, the bank could not safely make payment if the injured holder gave notice in time.[75] To protect itself, the bank would have to pay the money into court and interplead the parties.

Under the UCC, the bank may, even if notified, still make payment to the person presenting the check as long as the bank makes sure the person is a "holder" of the check, subject to two exceptions discussed later.[76] The bank may elect not to pay the check in deference to the wishes of the injured holder, as the UCC allows the bank to insist upon "indemnity deemed adequate" to itself as a condition to refusing payment.[77] If the bank is not willing to voluntarily refuse

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Materials on Commercial Law 252-253 (4th ed. 1985), referring to Thomas v. Marine Midland Tinkers Nat'l Bank, 86 Misc. 2d 284, 381 NYS2d 797 (Civ. Ct. 1976), Saratoga Polo Ass'n v. Adirondack Trust Co., 118 Misc. 2d 247, 460 NYS2d 712 (Sup. Ct. 1983); and Siegel v. New England Merchants Nat'l Bank, 386 Mass. 672, 437 NE2d 218 (1982).

[73] Continental Bank v. Fitting, 114 Ariz. 98, 559 P2d 218 (Ct. App. 1977).

[74] A number of states have varied the UCC provision on stop payment orders. UCC § 4-403, comment 8. See Brady on Bank Checks, supra note 54, § 23.20; White & Summers, supra note 32, § 17-2.

[75] F. Beutel, Beutel's Brannon Negotiable Instruments Law, § 88 (7th ed. 1948).

[76] UCC § 3-603. See generally Sumitomo Shoji N.Y., Inc. v. Chemical Bank N.Y. Trust Co., 47 Misc. 2d 741, 263 NYS2d 354 (1965); aff'd mem. 25 App. Div. 2d 499, 267 NYS2d 477 (1966); Spinazzola v. Manufacturers Nat'l Bank, 28 Mich. App. 207, 184 NW2d 265 (1970).

[77] Comment 3 to UCC § 3-603 makes clear that the bank is free to choose not to pay the instrument, even when the instrument is not indemnified or enjoined. If the bank has liability on the instrument, the holder may sue to compel payment and the bank will be

payment, the injured holder has the burden of taking action to prevent payment. The injured holder has two alternatives—to indemnify the bank[78] or to bring suit to enjoin payment in an action in which all three parties (bank, injured holder, and the adverse claimant who possesses the check) are subject to the jurisdiction of the court.[79]

There are two exceptions to the bank's freedom to pay the holder who presents the check without liability to other claimants: (1) The bank is liable for not observing the rules in the UCC on restrictive indorsement[80] and (2) the bank is liable if, in bad faith, it makes payment to a thief or to someone who has obtained the instrument through a thief, unless the person seeking payment qualifies as a holder in due course.[81]

[3] Stopping Payment on Cashier's Checks, Bank Drafts, and Certified Checks

Problems that involve attempts by third parties to stop payment of checks often arise in connection with cashier's checks, bank drafts, and certified checks. For example, a buyer may obtain a cashier's check from a bank, made payable to

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limited in its ability to assert the rights of the injured holder of the instrument as a defense. UCC § 3-306(d).

[78] The indemnity must be "deemed adequate" by the bank, under Section 3-603(1) of the UCC, which seems to establish a subjective test, but the bank is under a general obligation to act in good faith under Section 1-103 of the UCC, and should be wary of taking action that could be regarded as an unreasonable rejection of indemnity.

A court took a different approach in a case where a stock brokerage firm issued checks of its own for a customer, and the customer subsequently asked the brokerage firm to stop payment on the instruments. The customer asked the brokerage firm to issue checks to pay $85,000 to the seller of a horse. When the customer desired to cancel the purchase of the horse, he notified the brokerage firm to stop payment on the checks at a time when the firm could have stopped payment if it had taken timely action to notify the banks on which the checks were drawn. Instead, the brokerage firm told its customer that it was too late to stop payment. The court held that the firm owed a duty to its customer to communicate the stop payment request. "Although the issuance of third party checks for its customers may or may not be part of a defendant's daily routine, once it undertook the responsibility, it had a duty to use due care in carrying out the transaction, including effectively communicating any stop payment requests." Weiss v. Advest, Inc., 780 F2d 1014 (3d Cir. 1985) (unpublished opinion) (opinion reported at 46 Wash. Fin. Rep. (BNA) 27 (Nov. 29, 1985)). The opinion did not discuss the application of UCC § 3-603.

[79] When the check has been stolen, the party in possession will be unknown in most cases. This creates an obvious problem in satisfying the UCC provision requiring jurisdiction over the adverse claimant. The purpose of this section is to protect the bank against conflicting claims, and it appears possible for a court to satisfy this objective through indemnity conditions even though it is not in a position to conclusively adjudicate the rights of the absent claimant.

[80] UCC § 3-603(1)(b).

[81] UCC § 3-603(1)(a).

a seller, to use in purchasing goods. After the check is given to the seller, the goods are not delivered or some other defense arises as a result of the sale transaction. Can the buyer direct the bank to stop payment on the cashier's check? The cases that have been decided in this area are confusing. Some of the decisions may be criticized for not following the UCC.

It is clear under the UCC and the case law that the injured claimant (the buyer in the preceding example) cannot compel the bank to stop payment of the cashier's check by merely giving notice to the bank. Cashier's checks, bank drafts, and certified checks are not like ordinary checks because, with these instruments, the bank is liable as the drawer or the acceptor of the instrument. The bank's signature appears on the check, and the bank is contractually bound under the UCC to pay the holder of the check. Because the bank has a legal obligation to pay, the UCC provisions giving customers the right to stop payment do not apply.[82]

Although the injured claimant (buyer) cannot make the bank stop payment by giving notice, the claimant may be able to use the provisions in the UCC for supplying indemnity or enjoining payment.[83] These provisions contemplate the circumstance, given in the example, that by following the procedures in those provisions, *the claimant (buyer) could force the bank to refuse to pay the holder* even though the bank as a party to the instrument, absent a good defense, would be liable to the holder, as would be the case with a cashier's check, bank draft, or certified check.[84]

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[82] Section 4-402 of the UCC expresses the policy that the stop payment order is too late if the bank has taken any action with respect to the check that would make it liable for payment under UCC § 4-303. Thus, a customer cannot stop payment on a certified check. See comment 5. The same principle should apply when a cashier's check or bank draft is used, but the literal language of UCC § 4-403(1) does not fit. (The bank has not taken any action under UCC § 4-303 with respect to these instruments.) Perhaps the reason the language of § 4-403(1) appears inapt is that the provisions of § 4-403 are not meant to apply to cashier's checks or bank drafts. Cashier's checks and bank drafts are not items payable for the account of the customer as required in Section 4-403(1).

[83] UCC § 3-603. In Ward v. First Interstate Bank of Riverton, 718 P2d 886 (Wyo. 1986), the plaintiff sued to enjoin the issuing bank from paying a cashier's check that he had purchased. The check, which was for almost $30,000, was delivered to the payee but never presented for payment. The plaintiff sued to stop payment, claiming that a reasonable time for presentment had passed and also that the bank was being unjustly enriched by the use of the money during the time the check was outstanding. The court affirmed a summary judgment for the bank, finding that the effect of delay in presenting the check was a matter between the payee and the bank, which would be relevant, if relevant at all, when the check was presented for payment. The court also rejected the claim of unjust enrichment on the part of the bank because the plaintiff had not shown any right to the funds. The court did not discuss UCC § 3-603, although that section would appear to provide a basis for denying an injunction against the issuing bank when the party seeking the injunction had not obtained jurisdiction over the payee of the instrument.

[84] See UCC § 3-603, comment 3. A court has held that it is improper to enjoin a bank from paying the proceeds of its cashier's check because the cashier's check constitutes the

Can the bank elect to refuse to pay the holder on the request of the injured claimant and raise, as a defense in any subsequent action brought by the person in possession of the instrument, that the rights of the injured claimant are superior? Unfortunately, the answer given by the cases is not clear. Numerous statements suggest that the bank may not stop payment,[85] but the UCC seems to contemplate that the bank may choose to refuse to pay if it is willing to assume the risk of subsequent litigation.[86]

If the person in possession of the instrument sues the bank on the bank's liability as drawer or acceptor, the UCC limits the right of the bank to raise the rights of the injured claimant as defenses to payment. With the exception of the defenses that (1) the person seeking payment acquired the instrument through a thief or (2) that payment would violate a restrictive indorsement, the injured claimant who is asserting rights superior to the party presenting the check for payment must intervene in the litigation and personally assert the claims to the check.[87] Of course a person presenting the check for payment who has the rights of a holder in due course has a right to payment of the instrument that is superior to any claim to the instrument that may be asserted by adverse parties.[88] Although the UCC thus seems to permit the bank to elect to refuse payment, so as to allow the competing claimants to litigate their rights to the instrument in a suit brought against the bank for payment, the cases in this area are not clear and advice of counsel should be sought.[89]

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primary obligation of the bank. Key Int'l Mfg., Inc. v. Stillman, 103 AD2d 475, 480 NYS2d 528 (1984), aff'd as modified 66 NY2d 924, 489 NE2d 764, 498 NYS2d 795 (1985).

[85] See generally Brady on Bank Checks, supra note 54, § 23.11.

[86] See UCC §§ 3-306, comment 5, 3-603, comment 3. See generally Note, "Uniform Commercial Code: A Bank's Right to Dishonor a Cashier's Check," 38 Okla. L. Rev. 359 (1985); Annot., "Bank's Right to Stop Payment on Its Own Uncertified Check or Money Order," 97 ALR3d 714 (1980).

[87] UCC § 3-306(d).

[88] UCC § 3-305(1).

[89] See generally Annot., "Uniform Commercial Code: Bank's Right to Stop Payment on Its Own Uncertified Check or Money Order," 97 ALR3d 714 (1980); Brady on Bank Checks, supra note 54, § 23.11; White & Summers, supra note 32, § 17-5.

In a 1984 case, a bank issued its cashier's check after receiving a personal check from a third party. The personal check was dishonored. The bank refused to pay its cashier's check when it was subsequently presented. The court held that the bank could not refuse to pay the cashier's check because the bank's knowledge of the lack of payment of the personal check came too late to terminate the bank's duty under UCC § 4-303. The court was persuaded, as a matter of policy, that a cashier's check ought to be treated as the equivalent of cash. In dicta, the court suggested a different result would have been obtained had the cashier's check been issued to the person who had defrauded the bank by giving it a forged or stolen personal check. In this situation, the court said the bank could use a defense of fraud or lack of consideration. Da Silva v. Sanders, 600 F. Supp. 1008 (DDC 1984).

¶ 20.06 BANK'S DUTY TO PAY THE HOLDER

The drawee or other payor of an instrument has the obligation to pay the *holder*[90] of the negotiable instrument when the instrument is due and when any steps required for proper presentment are met.[91] As long as payment is made to the holder, the payor may disregard claims to the instrument or its proceeds asserted by other persons unless adequate indemnity is supplied or payment is properly enjoined.[92] This rule does not protect a payor who acts in bad faith to pay a holder who received title to the instrument through a thief, unless the

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A federal court reached a result similar to that in the *Sanders* case. A bank issued a cashier's check to the payee, who paid for the cashier's check with two other checks on which the payee had forged the indorsements. The payee subsequently gave the cashier's check to the Hotel Riviera in payment of a gambling debt. When the cashier's check was presented for payment, the bank dishonored the check because it had not been able to obtain payment on the two other checks with the forged indorsements. The hotel sued the bank for payment of the cashier's check. Even though the hotel conceded it was not a holder in due course, the court held that the bank could not assert the defense of failure of consideration. The court came to this conclusion because it believed that a cashier's check should be a reliable form of payment. Moreover, the hotel had not participated in the fraud that led to the issuance of the cashier's check. The cause of the loss was the bank's own actions in dealing with a customer who had committed fraud. Hotel Riviera, Inc. v. First Nat'l Bank & Trust Co., 768 F2d 1201 (10th Cir. 1985).

The purchaser of a cashier's check has ownership rights in the check and is entitled under UCC § 3-419 to bring suit for conversion against someone who misappropriates his property. Lawrence v. Central Plaza Bank & Trust Co., 469 So. 2d 201 (Fla. Dist. Ct. App. 1985).

Relying on general equitable principles, a Wisconsin court permitted a bank to stop payment on its cashier's check and assert a defense of failure of consideration against the customer-payee to whom it issued the check. The check had been issued in exchange for the customer's personal check, but the customer stopped payment on the personal check. Pulaski Chase Co-op v. Kellogg-Citizens Nat'l Bank, 130 Wis. 2d 200, 386 NW2d 510 (Ct. App. 1986). In Fur Funtastic, Ltd. v. Kearns, 120 Misc. 2d 794, 467 NYS2d 499 (Sup. Ct. 1983), the court said a bank may stop payment on its own check as an accommodation to its customer, but the bank is liable on the instrument. Because the customer who uses the bank instrument for payment will be discharged from liability on the underlying contract, the court concluded the bank ought not to be allowed to raise contract defenses of the customer if the holder sued the bank. "This approach preserves the function of bank checks as cash equivalent items, inasmuch as banks will presumably be disinclined to stop payment if they are precluded from raising their customers' defenses or warranty claims in subsequent litigation with the holder."

In University State Bank v. Allied Conroe Bank, 712 SW2d 193 (Tex. Ct. App. 1986), the court ruled that a bank cannot stop payment on its own cashier's check, even when the check issued was part of a check-kiting scam. The bank's claim that it was raising a defense for non-payment allowed by UCC §§ 3-306 and 3-408 rather than stopping payment was rejected as a distinction without a difference.

[90] UCC § 3-603(1). See UCC § 3-504(1) (presentment is made "by or on behalf of the holder").

[91] The presentment requirements are explained in Chapter 21.

[92] UCC § 3-603(1). Third party claims are discussed at ¶ 20.05[2].

holder is a holder in due course,[93] nor does it protect a payor who violates the UCC provisions on restrictive indorsements.[94]

When a drawee bank pays a check to a person who is not the holder, the bank may have to pay twice. The true owner of the check may have an action for conversion against the drawee[95] or an action based on the UCC provision on lost or stolen instruments.[96] Because the instrument is not properly payable, the bank's customer may be able to require the bank to remove the charge to the customer's account until payment is made to the proper person.[97]

How may a bank or other payor determine who is entitled to payment? The following subsections explain what rules apply.

[1] Order Paper and Identification of Payees and Indorsers

Since the agreement between the bank and the depositor is that the bank must pay at the order of the depositor, the bank is required to identify the payee or holder of the check.[98] Payment to the wrong person is at the risk of the bank.

In cases where a check payable to the order of a named payee carries a number of indorsements, each one in the chain of title must be genuine and properly authorized. If not, the bank cannot charge the check against the drawer's account.[99] When there is an irregularity in any one of the indorsements, the bank may have recourse, based on breach of warranty of title or of right to payment, against the person who indorsed it to the bank or who received payment.[100] In many instances, banks gurantee among themselves all prior indorsements.[101] The UCC imposes the same responsibilities automatically as a matter of law on transfers by collecting banks without need for the words "prior indorsements guaranteed."[102] This gives the bank recourse against prior collecting banks for breach of warranty, but, absent grounds for estopping the drawer from challenging the signature,[103] the drawee-bank cannot charge the drawer's

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[93] UCC § 3-603(1). See supra ¶ 20.05[2].

[94] UCC § 3-603(1). Restrictive indorsements are discussed at ¶ 15.01[3][a].

[95] UCC § 3-419(1). See discussion of conversion infra ¶ 20.08[2].

[96] UCC § 3-804. See discussion at ¶¶ 20.08, 21.08.

[97] UCC § 4-401. See discussion supra ¶¶ 20.01, 20.06[1].

[98] The bank may pay only items that are "properly payable" from its customer's account. UCC § 4-401. Only items that are properly presented are entitled to payment, see UCC §§ 3-505, 3-507, and only a person who qualifies as a holder can make a proper presentment. UCC § 3-504. Payment must be made to the holder in order to discharge liability on the instrument. UCC § 3-603.

[99] See ¶ 15.01 on indorsement, transfer, and negotiation.

[100] UCC § 4-207. See also UCC § 3-417. The warranties are discussed in ¶ 15.03.

[101] These warranties arise automatically under UCC § 4-207.

[102] UCC § 4-207, comment 2.

[103] See UCC §§ 3-405–3-406.

account if one of the necessary indorsements is, in fact, a forgery or otherwise unauthorized.[104]

A bank may require the person seeking payment to supply identification and to give evidence of authority to obtain payment when the person presenting the item seeks payment on behalf of someone else.[105]

When the bank pays a person who is not entitled to payment, the rightful owner of the instrument has an action against the payor bank for conversion.[106] The payor bank may be able to recoup its loss by seeking recovery from the presenting bank, prior collecting banks, or other indorsers. Each of these parties warrants to the payor that it has a good title to the check.[107] In this fashion, the loss ultimately should come to rest on the party who dealt with the forger. That party then bears the risk and expense of collecting from the forger.[108]

[2] Bearer Paper

When the drawer has ordered the bank to pay to "bearer" or to "a named payee or bearer," the bank is justified in charging the drawer's account when it has actually paid out the money to any holder in good faith.[109] Checks made payable to "cash," "current funds," "payroll," or similar names that do not purport to be any persons are also payable to bearer until the check is specially indorsed.[110]

When a check originally payable to bearer is indorsed to a special person, the bank must pay to this person or to his order and the check is no longer payable to bearer.[111] The manner in which other indorsements can change the duties of the bank to the customer are discussed in Chapter 15.

[3] Fictitious or Nonexisting Payees

The provisions in the UCC that deal with fictitious or nonexisting payees[112] evolved from prior law and can best be understood in light of the decisions

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[104] UCC § 3-404.

[105] UCC § 3-505(1)(b).

[106] UCC § 3-419.

[107] UCC §§ 3-417(1), 4-207.

[108] The forger is liable on the check by signing it. UCC §§ 3-401, 3-404(1).

[109] UCC § 3-603.

[110] UCC §§ 3-111(c), 3-204(1).

[111] UCC § 3-204.

[112] UCC § 3-405. See generally Annot., "Bills and Notes: Nominal Payee Rule of UCC § 3-405(1)(b)," 92 ALR3d 268 (1979); Annot., "Construction and Application of UCC § 3-405(1)(a) Involving Issuance of Negotiable Instrument Induced by Imposter," 92 ALR3d 608 (1979); Note, "The Role of Negligence in § 3-405 of the Uniform Commercial Code," 69 Ky. LJ 143 (1980).

reached in cases decided pre-UCC. Under the Uniform Negotiable Instruments Law, checks drawn to fictitious or nonexisting payees known as such by the person drawing the check were treated as bearer paper and charged to the account of the drawer, no matter to whom payment was made in good faith,[113] and no matter what the chain of title was as shown by the indorsement.

Cases of this kind fell into a number of classes and were the source of much difficulty and litigation. They usually arose from two causes: either the drawer, for some business reason, desired to keep the real payee of his check secret, or some type of fraud or embezzlement was involved.

Another difficult situation involving use of a fictitious name is the one in which a person receiving payment by check impersonates another for the purpose of receiving money due to the other. Under pre-UCC law, if the drawer of the check and the impersonator were face to face when the check was delivered, the courts usually held that the drawer meant to pay the person in front of him and that the bank was justified in paying to the impersonator or to his order. But if the transaction between drawer and payee was not face to face, the courts usually held that the payee was not fictitious and that the bank was justified in paying only to the person intended by the drawer.[114] In cases of this sort, the bank's best protection was to insist upon careful identification of persons to whom checks are paid, as it was impossible for the bank to know the depositor's or his agent's intention when either of them drew the check.

The UCC operates on an entirely different theory. It provides that in cases in which the payee's name is fictitious or the drawer of the check or the employer is defrauded by imposters, or by employees using fictitious names for paper not payable to bearer on its face, any person may indorse in the name of the fictitious or defrauding payee and such indorsement passes title or authorizes the bank to make payment according to the face of the instrument.[115] The difference between the two rules seems to be that under pre-UCC law, when the payee's name was intended to be fictitious, the bank could pay without any indorsement, but under the UCC an indorsement in the name of the fictitious or defrauding payee is necessary and anyone can so indorse. When it pays with due care, the bank is protected according to the chain of title appearing on the indorsements and the loss falls on the depositor.

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[113] F. Beutel, supra note 75, §§ 9(3), 88.

[114] Mercantile Nat'l Bank v. Silverman, 148 App. Div. 1, 132 NYS 1017 (1911), aff'd, 210 NY 567, 104 NE 1134 (1914); Cohen v. Lincoln Sav. Bank, 275 NY 399, 10 NE2d 457 (1937); City of New York v. Bronx County Trust Co., 261 NY 64, 184 NE 495 (1933); McHenry v. Old Citizens National bank, 85 Ohio St. 203, 97 NE 395 (1911). First Nat'l Bank v. American Exch. Nat'l Bank, 170 NY 88, 62 NE 1089 (1902).

[115] UCC § 3-405 & comments. See Brady on Bank Checks, supra note 52, at ¶ 28.2. Philadelphia Title Ins. Co. v. Fidelity-Philadelphia Trust Co., 419 Pa. 78, 212 A2d 222 (1965).

The UCC rule that deals with imposters and unfaithful employees does not apply to all forgeries, but only to those within the terms of the provision. It states:

> (1) An indorsement by any person in the name of a named payee is effective if
>
> (a) an imposter by use of the mails or otherwise has induced the maker or drawer to issue the instrument to him or his confederate in the name of the payee; or
>
> (b) a person signing as or on behalf of a maker or drawer intends the payee to have no interest in the instrument; or
>
> (c) an agent or employee of the maker or drawer has supplied him with the name of the payee intending the latter to have no such interest.
>
> (2) Nothing in this section shall affect the criminal or civil liability of the person so indorsing.[116]

When a credit union issued its loan check to the order of two payees (a borrower who represented that the loan was to buy a car and the car dealer) and when the borrower collected the check on a forgery of the car dealer's indorsement, the court held that the "impostor" rule of the UCC did not apply, since the borrower had impersonated no one. Instead, the borrower had presented a forged purchase order to the credit union as the means of obtaining the loan. The result was that the car dealer's indorsement was forged and the bank that took the check with the forged indorsement on deposit was held liable to the drawee or payor bank that paid and then made good to its depositor (the credit union) the check in question.[117]

It has been held that the "fictitious payee" rule of the UCC applied to a check with a forgery of both a drawer's signature and an indorsement; the court took the position that the forger intended the named payee to have no interest in the check and indorsement in the payee's name was considered legally valid and not forged.[118]

The "fictitious payee" rule of the UCC was also applied in a case in which so-called bill of sale drafts (considered by the court as ordinary checks), drawn by a cattle dealer ostensibly for the purchase of cattle and naming a purported cattle seller as payee, were, on the drawer-dealer's forgery of indorsements of the payee, paid by the bank on which they were drawn. The drafts were drawn to deceive the bank and to obtain funds from an account and a line of credit,

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[116] UCC § 3-405.

[117] East Gadsden Bank v. First City Nat'l Bank, 50 Ala. App. 476, 281 So. 2d 431 (1973). But see Perini Corp. v. First Nat'l Bank, 553 F2d 398 (5th Cir. 1977).

[118] *Aetna Life & Cas. Co. v. Hampton State Bank*, 497 SW2d 80 (Tex. Civ. App. 1973). The court took the position that the forger might be considered a person signing "as or on behalf of a ... drawer" within the "fictitious payee" rule of Section 3-405(1)(b) of the Uniform Commercial Code.

extended by the bank to enable the dealer to purchase cattle. The court held that the particular drafts were not intended to be payable to the named payee and that the indorsements were effective.[119]

The fictitious payee rule was not applied in the case of a firm president's son, who obtained checks payable to the firm and, misrepresenting his identity but correctly stating his relationship, indorsed the checks in the firm's name with the suggestion that such indorsement might be valid by reason of actual or apparent authority.[120]

In another case, it was held that the "fictitious payee" rule, though applicable, did not absolve a bank from liability when the president of a company drew company checks to the order of a creditor of the company but then deposited the checks in his personal account at the bank, with indorsements of the creditor's name made without the creditor's authority. The court held that although the president had drawn the checks to the order of the creditor but intended the creditor to have no interest in them, the transactions by which the president deposited the checks payable to a third person in his own account were so irregular as to call into question their validity and thus give the bank notice of irregularity, depriving it of holder-in-due-course status.[121]

The UCC extends the fictitious payee rules to situations in which the name of the payee is supplied to the drawer of the check by an agent or employee who intended that the payee have no interest in the check.[122] These are the so-called padded payroll cases. The UCC adopts a policy that makes the drawer of the check, as part of his risks of doing business, responsible for supervising his agents and employees.

A New York case considered under which circumstances an employee should be deemed to have "supplied" the payee's name to the employer, intending the payee to have no interest in the check.[123] In this case a bookkeeper received invoices for payment from a legitimate firm with which his employer did business. The employee then diverted the checks, forged the payee's signature, and obtained the proceeds of the checks. When the employer sued the payor

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[119] Kansas Bankers Sur. Co. v. Bank of Odessa, 386 F. Supp. 555 (WD Mo. 1974). The action was by the surety of the bank on which the drafts were drawn, against the bank taking the drafts on forged payee indorsements. Because of the rule of Section 3-405(1)(b) of the UCC, the indorsements were held effective; thus they denied recovery by the drawee's bank's surety on either a breach of warranty theory or a conversion theory.

[120] W.R Grimshaw Co. v. First Nat'l Bank & Trust Co., 563 P2d 117 (Okla. 1977).

[121] McConnico v. Third Nat'l Bank, 499 SW2d 874 (Tenn. 1973).

[122] UCC § 3-405(1)(c). A Texas appeals court applied this rule to hold indorsements effective in a case where a company's bookkeeper forged the indorsements of payees on checks drawn by the company that employed her in order to divert the checks to her personal account. Clinton Weilbacher Builder, Inc. v. Kirby State Bank, 643 SW2d 473 (Tex. Ct. App. 1982).

[123] Danje Fabrics Div. v. Morgan Guaranty Trust Co., 96 Misc. 2d 746, 409 NYS2d 565 (Sup. Ct. 1978).

bank, Morgan Guaranty Trust, the bank contended that because of the impostor rule, the forged indorsement on the check was effective and so payment by Morgan was proper. The employer took the position that since the checks were prepared as part of "bona fide business transactions" between the named payee and the employer, the clerk who prepared the checks for signature did not "supply" the checks to the employer within the meaning of the imposter rule but simply was guilty of conversion. The court agreed with the employer's argument, saying: "the checks involved were based upon bona fide transactions and obligations of the plaintiff which arose out of the normal business relationship with the payee named on said checks. In such instance, it cannot be claimed that the employee . . . supplied his employer . . . with the name of the payee, . . . as said checks were legitimately based upon open invoices due and owing to the payee . . . ."[124]

The UCC impostor rule was applied in a case in which James F. Beaird, Jr., contacted a prospective investor in an oil lease and represented himself to be an employee of a certain company that sold oil leases. The investor telephoned the company and was informed that it had an employee named James Baird. The investor then obtained a cashier's check from a bank payable to James Baird and delivered it to Beaird. Beaird then cashed the check at another bank where he was known, indorsing it twice, in the names of James Baird and James F. Beaird, Jr. The court held that the indorsement of Beaird was effective and that there was no forgery.[125]

In another case, a bank, in making a cashier's check payable to a purported seller of a motor vehicle, was not guilty of negligence contributing to forgery or alteration of the instrument, nor did the matter come within the so-called impostor rule.[126]

In *Valley Bank & Trust Co. v. Zions First Nat'l Bank*,[127] a bank issued a cashier's check made payable to two named joint payees. One of the payees was an individual and the other was a company selling an automobile for which the check was to be used as payment. The bank issued the check on the basis of phony documents presented by the individual named as payee. The court held this was not a situation within the UCC imposter rule, under which an indorsement in the name shown on the instrument would be effective.[128] Rather, the court held that the case should be treated as within the UCC comment that the

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[124] Id. at 569.

[125] Covington v. Penn Square Nat'l Bank, 545 P2d 824 (Okla. Ct. App. 1975). See Note, "UCC Section 3-405: Of Imposters, Fictitious Payees, and Padded Payrolls," 47 Fordham L. Rev. 1083 (1979); "The Effect of Bank Misconduct on the Operation of the Padded Payroll Preclusion of UCC § 3-405," 27 UCLA L. Rev. 147 (1979).

[126] Guaranty Trust Co. v. Federal Reserve Bank of Kansas City, 454 F. Supp. 488 (WD Okla. 1977).

[127] 656 P2d 425 (Utah 1982).

[128] See UCC § 3-405.

imposter rule does not apply to a false representation that the party is the authorized agent of the payee.[129] The court reasoned that the principle underlying this comment should apply to protect a party who makes a check payable to the seller of goods.

In still another case, *Dykstra v. National Bank of South Dakota*,[130] a bank officer's payment of a check made payable jointly to two parties after observing one of the joint parties forge the signature of the other joint party was held not commercially reasonable. The court said the bank could not argue that the impostor rule of UCC § 3-405 applied, because that section did not absolve the bank from conducting its business in a proper manner. It is important to note, however, that unlike other loss allocation provisions of the UCC,[131] the impostor provisions do not expressly require the bank to observe reasonable commercial standards in paying the check.[132]

The fictitious name situation should be distinguished from the situation in which the drawer has simply misspelled or misdesignated the payee. In either of these cases, the bank is justified in paying the person intended, and may charge the drawer's account, even though the indorsement may vary slightly from the name of the payee.[133] For example, a check drawn payable to West Wisconsin Limestone Company may be properly paid under the indorsement Wisconsin Limestone Company when the latter is the person who is entitled to payment. However, a bank or transferee of paper payable to a misspelled name may, if it gives value for the paper, require the indorsement in both the misspelled and the proper name of the holder.[134]

¶ 20.07 MISCREDITED PROCEEDS AND RESTRICTIVE INDORSEMENTS

It follows from the principle that the bank must pay the person properly entitled to payment under the terms of the check that the bank must properly credit the proceeds of the check when it is given to the bank for deposit. When the check is made payable to the bank itself, the bank must act carefully. It has been held that when a bank takes a check from an employee of the depositor that is previously signed by the depositor and that is made payable to the bank, the

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[129] Id. comment 2.

[130] 328 NW2d 862 (SD 1983).

[131] See UCC §§ 3-406, 4-406.

[132] UCC § 3-405. See City of Phoenix v. Great Western Bank & Trust Co., 148 Ariz. 53, 712 P2d 966 (Ct. App. 1985), which explores this issue and indicates the bank's negligence does not preclude application of the rule.

[133] UCC § 3-203.

[134] Id.

bank must apply the check to the credit of the depositor; the bank is liable to its depositor if it cashes the check or credits it to the employee's account.[135]

When a check is restrictively indorsed, the transferees of the instrument may have special obligations with respect to payment of the proceeds of the instrument. When the transferee is not a bank, the transferee of an instrument containing an indorsement that states "for collection," "for deposit," or similar terms must act consistently with the terms of the indorsement.[136] If the transferee is a bank, only the first bank after the check has been restrictively indorsed is placed on notice by the indorsement.[137] Transferees that take an instrument with notice that it has been restrictively indorsed in this manner, but that do not credit or disburse the proceeds of the instrument in accordance with the instructions of the indorsement, are not regarded as holders for value.[138] Therefore, they cannot qualify as holders in due course, and their interest in the instrument is subject to the lawful claims of other parties.[139]

In *Rutherford v. Darwin*,[140] the court considered the liability of a bank that credited proceeds of a restrictively indorsed check to the wrong account. The court upheld summary judgment against the bank in favor of the person who owned the account that should have been credited. The case raised an additional question as the bank's defenses in such an action. Darwin deposited the check. He was the general partner of Rancho Village, the firm that owned the check, and had full authority to manage the funds of this firm. Darwin restrictively indorsed the check to be paid to Rancho Village, but he instructed the bank to deposit the

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[135] Sun 'N Sand, Inc. v. United Cal. Bank, 21 Cal. 3d 671, 148 Cal. Rptr. 329, 582 P2d 920 (1978); Pacific Indem. v. Security First Nat'l Bank, 248 Cal. App. 2d 75, 56 Cal. Rptr. 142 (1967); Bank of S. Md. v. Robertson's Crab House, Inc. 39 Md. App. 707, 389 A2d 388 (1978). 9 CJS Banks and Banking § 340 (1938). The topic of miscredited proceeds is considered in Note, "A Co-Payee Has a Cause of Action in Conversion Against Both the Collecting and Payor Banks for Payment of a Check Over His Missing Endorsement, Despite the Payee's Lack of a Proprietory Interest in the Proceeds,—Trust Co. v. Refrigeration Supplies, Inc., 241 Ga. 406, 246 S.E.2d 282 (1978)." 13 Ga. L. Rev. 677 (1979). See also the discussion of fiduciaries transferring instruments at ¶ 15.08.

[136] UCC § 3-206(3).

[137] UCC §§ 3-206(2)–3-206(3).

[138] UCC § 3-206(3).

[139] UCC § 3-306(a). Restrictive indorsements are discussed generally at ¶¶ 15.01[3], 20.07. See Citibanc of Alabama/Fultondale v. Tricor Energies, Inc., 493 So. 2d 1344 (Ala. 1986). One of Tricor's officers deposited a $75,000 check payable to Tricor into his personal account. Tricor then sued the depositary bank, claiming conversion and payment contrary to a "for deposit" indorsement. The court held that Tricor had ratified the bank's action, and that Tricor had acted as though the officer's use of the check were a personal loan, which he partially repaid. Another count, alleging failure to dishonor a check within the bank's midnight deadline, was barred by the statute of limitations. In this instance, the court applied the limitation period for statutory penalties; not the longer period for conversion actions.

[140] 95 NM 340, 622 P2d 245 (Ct. App. 1980).

proceeds to the account of a different firm. The court held that Rancho Village was entitled to recover from the bank because the bank failed to follow the terms of the restrictive indorsement. The bank argued that Rancho Village had waived the indorsement because its general partner, who had authority to act in the matter, directed that payment be made to a different account. The court rejected the argument, reasoning that the utility of restrictive indorsements would be impaired by such a defense because the presence of a restrictive indorsement on a negotiable instrument "creates the legitimate expectation that it was negotiated in accordance with the restrictions."[141] The restrictive indorsement should have been canceled for the bank to properly pay the proceeds of the check in a way inconsistent with the indorsement. The court further held that Rancho Village was not estopped from recovering because of lack of care in structuring its affairs so that Darwin's embezzlement was not discovered earlier. The court refused to accept the bank's contention that UCC § 4-406, which requires a bank customer to examine his bank statement, expressed a policy of customer responsibility for managing a bank account that should be extended by analogy to release the bank from liability.

A bank also was held liable under the principles discussed in this section for crediting the proceeds of drafts drawn payable to the bank to the personal account of the individual who deposited the drafts rather than to the account of the drawer.[142] The bank argued it could properly make payment to the person depositing the check because it could give funds to a fiduciary for deposit in the fiduciary's own account as long as the bank did not have notice of any breach of the fiduciary duty. The court held this principle did not apply as the depositor did not hold the funds as a fiduciary and had no authority to indorse the checks.[143]

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[141] Id. at 249.

[142] Arvada Hardwood Floor Co. v. James, 638 P2d 828 (Colo. Ct. App. 1981).

[143] Id. at 830.

In Bullitt County Bank v. Publishers Printing, 684 SW2d 289 (Ky. Ct. App. 1984), the drawer's office manager (Young) took company checks to the bank that were made payable to the bank and exchanged the checks for cashier's checks that were made payable to Citizens Fidelity Bank in another city where Young maintained a private account. Young did not have authority to cash, write, or indorse checks. The employer maintained accounts at the depository bank. The depository bank routinely permitted Young to exchange the checks for cashier's checks without questioning Young about his authority to do so. The court quoted from *Corpus Juris* to find that the depository bank had a duty to the drawer of the check. It quoted the following statement:

> Where a check is drawn to the order of a bank to which the drawer is not indebted, the bank is authorized to pay the proceeds only to persons specified by the drawer; it takes the risk in treating such a check as payable to bearer and is placed on inquiry as to the authority of the drawer's agent to receive payment.

684 SW2d 289, 292, (quoting from 9 CJS *Banks and Banking* § 340 (1938)). The court then concluded that the failure of the bank to notify its depositor regarding the checks was

Although a depository bank may supply the indorsement of its customer when it is missing under UCC § 4-104(e), the bank will be liable if it fails to pay the proceeds of the check consistently with the indorsement. In a case decided by the New York Court of Appeals, the defendant law firm issued a check naming a construction company as the payee. An employee of the construction company took the checks to the Marine Midland Bank and asked the bank to wire the funds to an account of the construction company at an Oklahoma bank. The construction company had not indorsed the checks. Although the construction

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a violation of its duty of care. The bank would have had a defense if the employer had cloaked the agent with apparent authority to receive the proceeds of the checks, but the record contained no evidence that the agent had such apparent authority. Id. at 292–293.

In Federal Ins. Co. v. Banco Popular, 750 F2d 1095 (1st Cir. 1983), the court applied the law of Puerto Rico and apportioned liability on a comparative negligence basis between a negligent bank, which had miscredited the proceeds of a check, and the owner of the check, which had been negligent in its office procedures. The suite was brought by the insurers of International Charter Mortgage Corporation (ICMC) to recover from two Puerto Rican banks for losses suffered as a result of the fraud of Pagan. Over a ten-year period, Pagan, who was an ICMC financial officer with authority to sign checks on corporate accounts, embezzled approximately $400,000. The amount in question in this suit, slightly more than $100,000, was obtained by drawing company checks made payable to the order of the two Puerto Rican banks. Although ICMC required a second signature on the checks, Pagan obtained this through misrepresenting the purpose of the checks. The checks then were sent to the banks with Pagan's personal credit card bills and the credit card numbers written on the backs of the checks. The banks credited Pagan's accounts without any inquiry about his authority to use corporate funds for personal debts. The plaintiff insurers charged the banks with negligence. The trial court found the banks to be negligent in paying the checks to Pagan's personal accounts without inquiry as to his authority, but also found that ICMC maintained a grossly negligent system of internal control. Because of ICMC's own negligence, the court reduced the recovery by 75 percent. On appeal, the court upheld the determination that the banks were liable for paying the proceeds to satisfy Pagan's personal obligations, saying that in many jurisdictions "the banks would have been negligent as a matter of law merely by crediting a check made payable to their own order to the debt of a third party without inquiring of the drawer." 750 F2d at 1099. The court did not feel it necessary to decide whether this principle would apply in Puerto Rico, a jurisdiction that does not have the UCC, because suspicious circumstances existed that should have alerted the bank to the improper diversion of funds, including the facts that the checks were drawn on trust accounts, the debts on the credit cards were substantial amounts from hotels with gambling casinos, the banks knew Pagan earned less than $20,000 per year, and two of the checks used were visibly altered. The court further upheld the determination of negligence on the part of ICMC for not having adequate internal controls. A major fault was leaving Pagan unsupervised so that he could both execute checks and reconcile the corporation's bank statements. Furthermore, the second signature procedure was inadequate, since no invoice or signed authorization was required. The plaintiffs argued that the negligence of the employer, ICMC, should not be a basis for apportioning loss because the wrong committed by the bank constituted conversion, and comparative negligence is not a defense in an action for conversion. The court held that the law of Puerto Rico controlled this issue and the statute in question treated conversion as merely one form of fault that is properly subject to the principle of apportionment.

company had never maintained an account at the Marine Midland Bank, a bank employee stamped the checks "credit to the account of the payee herein named, Marine Midland Bank" and then transferred the funds to the Oklahoma bank as requested. Subsequently, the defendant stopped payment on the checks, and they were returned to Marine Midland Bank, who could not recover from the construction company because the company had become bankrupt. Marine Midland Bank sought to collect from the defendant law firm that had issued the check. Marine Midland claimed it was entitled to recover as a holder in due course because its supplying of the construction company's indorsement was effective as an indorsement under UCC § 4-104(e). The court agreed the bank was entitled to supply this indorsement, because it was acting as an agent for collection on behalf of the construction company. Although the defendant argued that the bank had purchased the check for its own account and that it was not handling the check for collection on behalf of the construction company, the court rejected the defendant's interpretation on the grounds that UCC § 4-201 intended the bank's liability for handling checks to be decided without regard to the bank's status as agent or owner. In any event, the court did not have to decide this question because Marine Midland Bank was not a holder in due course. The court said that the indorsement supplied by Marine Midland Bank was a restrictive indorsement that required the bank to deposit the proceeds to the construction company's account. Payment of the funds in a way inconsistent with this indorsement, such as transferring the funds to the Oklahoma bank, did not constitute the payment of value for the instrument under UCC § 3-206(3) on restrictive indorsements. Without having given value, Marine Midland Bank could not be a holder in due course.[144]

In *Spielman v. Manufacturers Hanover Trust Co.*,[145] a check was given to a law firm (Pitney, Hardin & Kipp), which was the named payee, to be used as payment in settling a dispute. The check was indorsed:

Pay to Special Account
012-043478
/s/ Pitney, Hardin & Kipp
For Deposit Only
Special Account 012-043478

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[144] Marine Midland Bank, N.A. v. Price, Miller, Evans & Flowers, 57 NY2d 220, 441 NE2d 1083, 455 NYS2d 565 (1982).

[145] 6 NY2d 221, 456 NE2d 1192, 469 NYS2d 69 (1983). The appellate court decision is reported at 90 AD2d 499, 454 NYS2d 743 (1982). The court distinguished the decision in Underpinning & Found. Constructors v. Chase Manhattan Bank, 46 NY2d 459, 386 NE2d 1319, 414 NYS2d 298 (1979), where the court had held that although a forged indorsement may be effective so that no action would lie against the drawee bank for improper payment, there may be circumstances in some "comparatively rare instances" where the conduct by the depository bank would be wrongful and entitle the drawer to recover from the depository bank even though recovery could not be had from the drawee bank. Failure to follow a restrictive indorsement could be such a case.

An attorney with the firm forged the indorsement of the payee's name, deposited the check in his personal account at the Chemical Bank branch that had the account number 012-043478, withdrew the funds and absconded. He was subsequently found dead from a bullet wound in the head. The law firm (the payee) did not have an account at Chemical Bank. The check was paid by the drawee bank. The drawer then sued both the drawee bank (Manufacturers Hanover Trust) and the depository bank (Chemical Bank). Since the forgery of the payee's agent was effective as the indorsement of the payee under UCC § 3-405, the drawer could not recover against the drawee, because the check had been effectively negotiated and properly paid. The drawer succeeded in recovering against the depository bank in the appellate court on the grounds that the check had been restrictively indorsed by the payee and the bank was obligated to pay the instrument in accordance with the restrictive indorsement. The deposit to the attorney's personal account, even though it had the same number, was not consistent with the restrictive indorsement because "deposit only" meant the proceeds had to be credited to an account of the payee. The New York Court of Appeals reversed, stating that if the name of the attorney had been used in the indorsement, rather than the account number, the actions of the depositary bank clearly would have been correct. The payee would have indorsed the check to the attorney, and the attorney would have restrictively indorsed the check for deposit to his numbered account. Thus, "[i]f the account number was sufficient to identify the transferee and as a signature, the depositary honored the directions given it and it is not liable to plaintiffs."[146] The court decided the depository had followed the instructions in the indorsement. The bank could have viewed the check as containing two indorsements with the number identifying the attorney as the indorsee from the payee firm:

> If it is contended that the writing must be considered as two indorsements and that the special indorsement was not proper because the statute requires transfer to a "person," as indeed it does, then the answer is that there is no requirement that the person be identified by name nor any prohibition against identification by bank account number, title or similar means. That the account number was used rather than the name of the owner of the account does not alter the designation when the account is in existence and identifiable as belonging to a specific person. Furthermore, there is no specific requirement of the form of the signature necessary for a valid indorsement. Once the indorsee was identified by number, the indorsement could be executed consistent with it.[147]

Or, if the indorsement were viewed as a single indorsement, "both special and restrictive," to deposit the proceeds to the account indicated, the depository

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[146] Spielman v. Manufacturers Hanover Trust Co., 6 NYS 221, 223, 456 NE2d 1192, 1194, 469 NYS2d 69, 71 (1983).

[147] *Spielman*, 6 NY2d at 221, 456 NE2d at 1195, 469 NYS2d at 72.

bank's actions still were reasonable. "[T]here are many instances in which a family member or a business may indorse for deposit funds to the credit of another and a depositary is not on notice of chicanery because of it nor is it liable if it faithfully follows such a direction."[148] In short, when the depository bank took the check, "its examination of the check disclosed either a negotiation of the check to its customer by special indorsement and then a direction to deposit the proceeds to his account or a single indorsement, both special and restrictive to similarly deposit the proceeds."[149] If the latter was the case, the bank was not on notice as to any improper conduct by the direction to deposit the funds to the account of one other than the named payee.

In *Brite Lite Lamps Corp. v. Manufacturers Hanover Trust Co.*,[150] the defendant bank allowed an employee of the plaintiff to deposit to the employee's personal account at the bank checks made payable to the plaintiff as payee and indorsed "pay to the order of Manufacturers Hanover Trust Company or pay to the order of any bank, banker or trust company." The court held that by paying the proceeds of the check into the employee's personal account, the bank obviously violated the indorsement on the check.

In *Menthor, S.A. v. Swiss Bank Corp.*,[151] the court considered who was entitled to bring a conversion action under UCC § 3-419. The plaintiff, Menthor, was the transferee of various checks drawn against the Manufacturers Hanover Trust Bank (MHT) that had been indorsed in blank by various payees to Menthor. Menthor, in turn, indorsed the checks "for deposit only" and forwarded them to be deposited in Menthor's account at Swiss Bank. The checks never were deposited as Menthor intended and instead wound up being presented on MHT by Banco di Napoli. When the checks arrived at MHT, the indorsement "for deposit only" was blacked out, leaving only the signature of Menthor's agent and, below that signature, the signature of a party named Esteban. Menthor sued MHT for conversion for paying the checks. MHT contended that Menthor was not entitled to recovery in conversion because Menthor no longer was the holder of the checks, having transferred them to Swiss Bank for collection. The court rejected this argument, saying that Swiss Bank was merely Menthor's agent. Menthor remained the beneficial owner of the instruments and could sue in conversion for violation of its ownership rights.

In the same case, MHT sued the presenting bank, Banco di Napoli, for breach of warranty of presentment under UCC § 4-207 for breach of the warranties of good title and no material alteration. The court held MHT was entitled to recover. Blacking out the restrictive indorsement amounted to an alteration.

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[148] Id.

[149] Id.

[150] 34 UCC Rep. Serv. (Callaghan) 1221 (NY Sup. Ct. 1982) (the indorsements are restrictive because they are in the form "pay any bank." UCC § 3-205(c)).

[151] 549 F. Supp. 1125 (SDNY 1982).

Because the warranty was absolute, without regard for whether Banco di Napoli acted reasonably, MHT was entitled to recover. The court also rejected the argument that Banco di Napoli should be relieved from liability for breach of these warranties because it no longer possessed any proceeds of the checks. Although this principle limits the liability of representatives (but not payors) in UCC § 3-419(3) on conversion, it does not apply to actions for breach of warranty under UCC § 4-207, such as this action between MHT and Banco di Napoli.

A bank that treated the imprint from a rubber address stamp that simply contained the name and address of the payee as an effective indorsement was held liable to the payee in *Pargas, Inc. v. Estate of Taylor.*[152] The district manager of the payee diverted checks to his personal account at the bank by indorsing checks payable to the payee with a rubber address stamp containing the name and address of the payee. The bank did not have a corporate resolution authorizing the employee to indorse checks on behalf of the payee. In a suit by the payee's insurer against the bank, the court held that it would take notice of the fact that checks payable to a corporation are not normally indorsed in blank by use of a return address stamp and delivered to third parties. By allowing such procedures, the bank failed to act in a commercially reasonable way and also violated its internal procedures. Although UCC § 3-304(4)(e) provides that notice to the bank that a person negotiating the instrument is a fiduciary does not give the bank notice of a claim against the check, the court held that the bank's failure to act in a commercially reasonable manner prevented use of Section 3-304(4)(e) as a defense.[153] The court also took the position that the payee had not ratified its employee's actions because the payee had no knowledge of the employee's embezzlement and could not readily discover it in light of the employee's control of the books.

In a North Carolina case, the court held that a company that was the payee of checks that had been wrongfully diverted by the company's employee to a separate personal account could not recover from the depository bank that paid the checks over the restrictive indorsement of the company if the company could be viewed as having ratified the actions of its employee. The depository bank was entitled to raise the company's ratification as a defense to the suit without having to establish that the bank acted in a commercially reasonable fashion. In the court's view, UCC § 3-404 on ratification does not require the bank to show it acted with commercial reasonableness.[154]

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[152] 416 So. 2d 1358 (La. Ct. App. 1982).

[153] Pargas, Inc. v. Estate of Taylor, 416 So. 2d 1358 (La. Ct. App. 1982) (note that UCC § 3-304(4)(e) does not impose any standard of commercially reasonable action on a person dealing with the fiduciary).

[154] American Travel Corp. v. Central Carolina Bank & Trust Co., 57 NC App. 437, 291 SE2d 892, petition denied, 306 NC 555, 294 SE2d 369 (1982).

In a Georgia case, the court allowed the drawer of checks to recover from the depository bank that had deposited the checks to the benefit of the wrong person, without requiring proper indorsements of the checks. Although the court based its result on a breach of warranty under UCC § 4-207 by the depository bank, it did not discuss how the drawer of the checks could take advantage of the warranties. In placing liability on the depository bank, the court refused to offset from the damage award an amount that subsequently came to benefit the drawer, because the benefit was "completely fortuitous" so far as the depository bank was concerned. Finally, the court indicated that the depository bank had made a deliberate business decision not to examine incoming checks and should consequently bear the risk of the loss it incurred as a result of following this policy.[155]

In *PWA Farms, Inc. v. North Platte State Bank*,[156] the purchaser of a farm, DRW, drew a check payable to North Platte State Bank, and sent it to the bank intending it to be used to pay off a mortgage on the farm as part of the purchase. DRW did not give the bank instructions on how to apply the check, although it had enclosed a copy of the mortgage statement showing the amount due, and the check had a notation "interest re. PWA Farms." One of the sellers, Williams, who also had a personal obligation owing to the bank, advised the bank that a check would be coming to be applied to his note. On receipt of the DRW check, the bank contacted Williams who instructed the bank to apply it to his personal note. PWA Farms, the seller, sued the bank for misappropriation and conversion. The court ruled for PWA Farms. "By using a bank's name as the payee of the check, a drawer is intending to place the proceeds in the bank's custody and under its control, and nothing may be inferred from the language of the check."[157] The bank was not free to use the proceeds as it saw fit. The court noted:

> It is a well established rule that when a check is drawn to the order of a bank to which the drawer is not indebted, the bank is authorized to pay the proceeds only to persons specified by the drawer; it takes the risk in treating such check as payable to bearer and is placed on inquiry as to the authority of the drawer's agent to receive payment.[158]

Thus, the bank took the risk of the consequences of its action by paying Williams. The court further held that PWA Farms was entitled to recover as the assignee of the cause of action that DRW had for conversion. The court said:

> [T]he bank was clearly exercising a wrongful act of dominion over the proceeds of DRW's check. It is elementary that when a check is drawn to the

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[155] C. & S. Bank v. Pilco Plantation, Inc., 173 Ga. App. 37, 325 SE2d 426 (1984).

[156] PWA Farms, Inc. v. North Platte State Bank, 220 Neb. 516, 371 NW2d 102 (1985).

[157] Id. at 519, 371 NW2d at 105.

[158] Id. at 519, 371 NW2d at 105.

order of a bank and the drawer gives no specific instructions as to the disposition of the funds, the bank has no right to pay the proceeds of the check to a stranger to the transaction.[159]

¶ 20.08 CHECKS WITH FORGED OR UNAUTHORIZED SIGNATURES

Since the bank can pay out of its customer's account only on the order of the person whose name appears on the signature card, it follows that the bank cannot charge the drawer's account when the drawer's signature has been forged or used without his or her authority.[160] The bank, at its own peril, must know and recognize its depositor's signature.[161] When the bank pays an innocent holder for value of a check upon which the drawer's signature has been forged, it cannot recover the amount, even from the holder to whom it paid.[162] The UCC makes payment final when it is made to a holder in due course or other person who has changed position in reliance on the payments.[163]

The UCC follows the rule of *Price v. Neal*, which puts the loss on the bank when it pays a draft with a forged drawer's signature.[164] Showing how this is so requires some analysis, however. The UCC sections on warranties made on presentment and transfer, Sections 3-417 and 4-207, distinguish between warranties made to a person who pays an instrument and warranties made on the

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[159] Id.

[160] The check is not "properly payable." UCC §§ 3-404, 4-401. The person who signs the instrument will be liable as a drawer, indorser, or other party according to the capacity in which he or she signed. UCC § 3-404(1). See generally Lechner, Jr., "The Drawer's Negligence: A Powerful But Underutilized Defense in Forged Check Cases," 15 UCCLJ 291 (1983); McDonnell, "Bank Liability for Fraudulent Checks: The Clash of the Utilitarian and Paternalistic Creeds Under the Uniform Commercial Code," 73 Geo. LJ 1399 (1985); Triantis, "Allocation of Losses From Forged Indorsements on Checks and the Application of § 3-405 of the Uniform Commercial Code," 39 Okla. L. Rev. 669 (1986); Note, "Section 3-405 of the Uniform Commercial Code: Time for a Negligence Standard?" 37 Ala. L. Rev. 199 (1985).

[161] An unauthorized signature is "wholly inoperative," absent ratification or estoppel. UCC § 3-404(1).

[162] UCC §§ 3-417 & comment 4, 3-418, 4-207. See Price v. Neal, 3 Burr. 1354, 97 Eng. Rep. 871 (KB 1762). See generally, Brady on Bank Checks supra note 54, at § 25.12; White & Summers, supra note 32, § 16-2.

[163] UCC § 3-418. This changes the pre-UCC rule, which had allowed the bank to recover for mere negligence on the part of the holder. UCC § 3-418, comment 4; see Brady on Bank Checks, supra note 54, at § 25.12. There is further argument that the bank cannot recover, even when the person receiving payment is not a holder in due course or has not acted in reliance. Apart from the requirements of § 3-418, UCC § 4-301 may make payment final. See White & Summers, supra note 32, § 16-4.

[164] 3 Burr. 1354, 97 Eng. Rep. 871 (KB 1762). UCC §§ 3-417 and comments, 3-418 comment 2, 4-207 and comments.

transfer of an instrument to a transferee or subsequent holder. The presentment warranties are contained in Sections 3-417(1) and 4-207(1). The transfer warranties are contained in Sections 3-417(2) and 4-207(2). These sections are mutually exclusive.

When a check is transferred, the transferor warrants to the transferee and to subsequent collecting banks that on the item "all signatures are genuine or authorized."[165] Therefore, if the check contains a forged drawer's signature or a forged indorsement, there is a breach of warranty, and the transferee or subsequent collecting bank will have recourse for breach of warranty against the transferor.

The warranties made to a payor such as a drawee of a draft or a payor bank on a check are different from the transfer warranties. There is a warranty that the person presenting the instrument "has no knowledge that the signature of the maker or drawer is unauthorized" subject to certain exceptions.[166] This warranty would not be broken if the person presenting the check for payment did not know of the forgery. The person presenting the instrument also makes a warranty of "good title to the item" or authority to obtain payment on behalf of one who has a good title.[167] This warranty is broken when there is a forged indorsement that is necessary in order to transfer title to the instrument to the transferee. In such a case, the true owner of the instrument will not lose any ownership rights as a result of the transfer because the forged indorsement is ineffective and so there cannot be a holder in due course on the instrument. When the person in possession of such an instrument presents it for payment or acceptance, the warranty of good title is breached because the true owner prior to the forged indorsement has title to the instrument, not the presenter. When the check contains only a forged drawer's signature, however, there is no breach of the warranty of good title. The check is not "owned" by the person whose signature was forged. Rather, it is an instrument of the forger.[168] It can be transferred to subsequent holders who will obtain rights against the forger on the instrument. There is no breach of the warranty of good title even though the signature of the person purporting to be the drawer is not genuine. Thus, when there is a forged drawer's signature, there will be a breach of the warranty made on *transfer* of an instrument to a collecting bank,[169] because of the warranty that signatures are genuine, but there is no breach of the warranties made on *presentment* to a payor bank,[170] because the warranty that signatures are genuine is not made to a payor bank.[171]

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[165] UCC §§ 3-417(2)(b), 4-207(2)(b).
[166] UCC §§ 3-417(1)(b), 4-207(1)(b).
[167] UCC §§ 3-417(1)(a), 4-207(1)(a).
[168] UCC § 3-404(1).
[169] UCC § 4-207(2)(b); see also § 3-417(2)(b).
[170] UCC § 4-207(1); see also § 3-417(1).
[171] See UCC §§ 3-417 & comment 4, 4-207 & comment 4.

When the forged signature is an indorsement (and not the drawer's signature) that is a "necessary" indorsement because it is a link in the chain of title,[172] the bank cannot charge the drawer's account.[173] But, in contrast to the forged drawer's signature, because of the operation of the transfer warranties, the bank can recover from the person it paid.[174] Payment over a forged indorsement also constitutes conversion and the payor bank will be liable to the rightful owner of the check for its amount.[175]

The UCC provision on conversion, UCC § 3-419, distinguishes between conversion by a drawee or person who is to pay the instrument and conversion by a representative such as a depository or collecting bank. The relevant paragraph states:

> Subject to the provisions of this Act concerning restrictive indorsements a representative, including a depositary or collecting bank, who has in good

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[172] See ¶ 15.01 on indorsements and negotiation.

[173] The item is not "properly payable." UCC § 4-401. See Taylor v. Equitable Trust Co., 269 MD 149, 304 A2d 838 (1973); Sumiton Bank v. Funding Sys. Leasing Corp., 512 F2d 774 (5th Cir. 1975).

[174] There is a warranty made by the person obtaining payment that he has "good title." UCC §§ 3-417(1)(a), 3-418, 4-207(1)(a). Prior indorsers also make this warranty.

[175] UCC § 3-419(1)(c). See generally Annot., "Bank's 'Reasonable Commercial Standards' Defense Under UCC § 3-419(3)," 49 ALR4th 888 (1986); Annot., "Payee's Right of Recovery, in Conversion Under UCC § 3-419(1)(c), for Money Paid on Unauthorized Indorsement," 23 ALR4th 855 (1983).

An action by the payee of a check against a bank for failing to deposit the check to his account because a former bank officer forged the indorsement and diverted the checks to his own account was governed by the state's six year statute of limitations, which applied to conversion actions, rather than the two year statute of limitations, which applied to tort actions generally. Vest v. First Nat'l Bank, 659 P2d 1233 (Alaska 1983). In Daube v. Bruno, 493 So. 2d 606 (La. 1986), in an action for conversion based on UCC § 3-419, the court applied the one-year limitations period for tort actions, not the period applicable to suits to recover on negotiable instruments.

A depository bank was liable in conversion for allowing one of several joint payees on a draft to obtain credit for the draft without the indorsement of the other joint payees. The court reached the result under the general common law of conversion because UCC § 3-419(1) refers only to a forged indorsement and not a missing indorsement. Failure to act in a commercially reasonable manner deprived the bank of the UCC § 3-419(3) defense. Great Am. Ins. Cos. v. American State Bank, 385 NW2d 460 (ND 1986). A similar result was reached when one of four joint payees on a check forged the indorsements of the other payees and obtained the proceeds. In this case, the unauthorized indorsements were made in the presence of the bank employee, who testified that he took the indorser's word as to his authority to sign for the other payees. Clark v. Griffin, 481 NE2d 170 (Ind. Ct. App. 1985).

In Crockford v. Merchants Nat'l Bank, 132 Misc. 2d 959, 505 NYS2d 525 (Sup. Ct. 1986), a thief stole a government check before the payee received it. The payee obtained a replacement check from the government and then sued to recover interest from the depository bank that took the stolen check over a forged indorsement. The court held that the plaintiff had a cause of action based on conversion.

> faith and in accordance with the reasonable commercial standards applicable to the business of such representative dealt with an instrument or its proceeds on behalf of one who was not the true owner is not liable in conversion or otherwise to the true owner beyond the amount of any proceeds remaining in his hands.[176]

Under this provision, then, a bank other than the payor bank may have a defense to an action for conversion for paying a check over a forged indorsement. This defense, under the literal terms of the UCC provision, will exist when the collecting bank can show the following. Firstly, the bank must have acted "in good faith and in accordance with the reasonable commercial standards" applicable to the bank's handling of the item. Secondly, the defense is available only to the extent that the conversion claim is for an amount "beyond the amount of any proceeds remaining in his [the bank's] hands." Because the section is expressly subject to the provisions on restrictive indorsements, the defense will not be available to a depository bank that pays a check in a manner contrary to the terms of a restrictive indorsement. The effect of the section, if implemented fully, would be to preserve a cause of action in conversion against the payor of the instrument, but to provide a defense to collecting banks, including depository banks, who in good faith pay out the proceeds of an instrument under circumstances where a conversion claim might exist.

UCC § 3-419 does not expressly state that a cause of action in conversion exists against one other than a payor or drawee. But the presence of the defense in UCC § 3-419(3) strongly implies that the UCC acknowledges the existence of such a cause of action either by implication from UCC § 3-419 or as a matter of general common law rules that have not been disturbed by the UCC.[177] The UCC's Section 3-419(3) defense has encountered resistance in the courts. Often, the depository bank may be the most convenient target for a conversion action involving checks with forged indorsements because the payor banks may be located in distant cities and there may be multiple payor banks involved in a given forgery case, although the bulk of the forged instruments may be deposited or collected through one or a few depository banks. As a result, some decisions have strained the express language of the provision to find that there were funds remaining in the hands of the depository bank.[178]

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[176] UCC § 3-419(3).

[177] See UCC § 1-103.

[178] See Cooper v. Union Bank, 9 Cal. 3d 371, 507 P2d 609, 107 Cal. Rptr. 1 (1973); Ervin v. Dauphin Deposit Trust Co., 3 UCC Rep. Serv. (Callaghan) 311 (Pa. Ct. CP 1965). Contra, Knesz v. Central Jersey Bank & Trust Co., 97 NJ 1, 477 A2d 806 (1984). See also Hydraflo Corp. v. First Nat'l Bank, 217 Neb. 20, 349 NW2d 615 (1984), where the court held that the good faith and reasonableness of the action of the depository bank were for the jury to decide when the bank accepted a check payable to a corporation for deposit to an individual account.

The UCC provision makes any "unauthorized" signature, not just forgeries, invalid.[179] The person whose name is signed can ratify the signature or be estopped from denying it.[180] Furthermore, the authority to sign may be implied or apparent.[181] Where, after a dissolution of a law partnership by the withdrawal of one partner the old account was kept open by the continuing partners, and a check drawn in favor of the withdrawn partner and a continuing partner was indorsed with a rubber stamp, in accordance with the old practice, for deposit in the old account, the court held that the bank had acted properly in accepting the deposit and later permitting its withdrawal by the continuing partners, since the indorsement could be made by an agent having actual, implied, or apparent authority and since the withdrawing partner had not put the bank on notice of any change in the practice.[182] Ratification will make the signature effective, but a joint payee, whose indorsement is forged by the copayee, could not be held to have ratified the indorsements where it was found he had not been aware of the forgeries.[183] The affirmance required to create a ratification of an unauthorized signature may arise from conduct that can be rationally explained only if there were an election to treat a supposedly unauthorized act as, in fact, authorized.[184]

The forgery need not be on the instrument itself. When a savings bank grants withdrawal payments to a person who does not represent himself as the

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[179] UCC § 3-404(1). A signature by an agent that is in excess of his authority has been held to be an unauthorized signature. Pine Bluff Nat'l Bank v. Kesterson, 257 Ark. 813, 520 SW2d 253 (1975). See Krieg, "The Missing Signature as an Unauthorized Signature of the Customer: The Debate Continues," 103 Banking LJ 542 (1986). Annot., "Bank's Liability for Payment or Withdrawal on Less Than Required Number of Signatures," 7 ALR4th 655 (1981).

[180] UCC § 3-404(1). See generally Annot., "What Constitutes Ratification of Unauthorized Signature Under U.C.C. § 3-404," 93 ALR3d 967 (1979). Although ratification may occur as a result of conduct that can be explained only as an election to treat the signature as authorized, "ratification requires intent to ratify plus full knowledge of the material facts." Bank of Hoven v. Rausch, 382 NW2d 39, 41 (SD 1986). There may be cases where a party has not ratified a signature, but the party is precluded from claiming the signature was not authorized because failing to give effect to this signature would be inequitable or unconscionable. No ratification was found where the defendant had signed an original promissory note but that note was cancelled and the defendant's son signed the defendant's name to a subsequent note at a higher interest rate. The court found that the second note was not a renewal note and that the defendant did nothing to affirm any prior act that, absent ratification, would not otherwise have been binding upon him. Id. at 42–43.

[181] See UCC §§ 1-201(43), 3-404, comment 1; Equipment Distrib. Inc. v. Charter Oak Bank & Trust Co., 34 Conn. Supp. 606, 379 A2d 682 (1977).

[182] Keane v. Pan Am. Bank, 309 So. 2d 579 (Fla. App. 1975). The court cited Section 3-419(3) of the Uniform Commercial Code, holding that the bank had acted with commercial reasonableness in making the check payable to two firm members on the indorsement of the dissolved firm.

[183] United Bank v. Mesa N.O. Nelson Co., 121 Ariz. 438, 590 P2d 1384 (1979).

[184] Fulka v. Florida Comm'l Banks, Inc., 371 So. 2d 521 (Fla. Dist. Ct. App. 1979).

depositor and who obtains payment upon the strength of an order purported to be signed by the depositor, the bank may not charge the amount of the check against the account of the person whose name is forged.[185]

When a bank pays a check where *both* the drawer's signature and the payee's signature are forged, the UCC loss allocation rules are inconsistent. The forged indorsement creates a breach of the presentment warranty of good title, which allows the bank to recover from the presenter; the forged drawer's signature creates no breach of any presentment warranty, thus requiring the bank to absorb the loss. The UCC fails to say which rule should apply. Some cases regard the forgery of the drawer's signature as the critical factor in allocating loss, and place the loss on the payor bank on the grounds that the finality policy of Section 3-418 of the UCC should apply.[186]

What constitutes a forgery is important for the purposes of bond coverage. A "counterfeit" check has been held equivalent to a "forged" check, within the meaning of the coverage term of a "discovery blanket bond" that referred to "forgery or alteration of any instrument." In this instance, the insured, a credit union, had arranged with its bank to pay checks impressed with facsimile signatures made by a check-writing machine in the credit union's possession. The bank paid a number of checks printed on paper different from that of the checks of the credit union and imprinted with a check-writing machine that impressed a facsimile signature "nearly identical" to that used on the credit union's own checks. The credit union was held as entitled to recover from the insurance company under the blanket bond.[187]

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[185] Maddox v. First Westroads Bank, 199 Neb. 81, 256 NW2d 647 (1977).

[186] Perini Corp. v. First Nat'l Bank, 553 F2d 398 (5th Cir. 1977). See also Baker, "The Perini Case: Double Forgery Revisited (Part I)," 10 UCCLJ 309 (1978). The *Perini* case was followed in Cumis Ins. Soc'y v. Girard Bank, 522 F. Supp. 414 (ED Pa. 1981). In a double forgery case, the drawee bank is viewed as having spent its own money when it honors a check with a forged drawer's signature. Consequently, the drawee bank cannot be held liable in conversion for paying on a forged indorsement. Another court followed the same liability rule, placing the loss on the payor bank in a case in which the instrument contained both a forged drawer's signature and a missing indorsement of the named payee. National Credit Union Admin. v. Michigan Nat'l Bank, 771 F2d 154 (6th Cir. 1985). Ed Stinn Chevrolet, Inc. v. National City Bank, 28 Ohio St. 3d 221, 503 NE2d 524 (1986) reh'g en banc on other grounds 31 Ohio St. 3d 150, 509 NE2d 945 (1987), followed the *Perini* case in holding that a double-forgery case should be treated as a forged drawer's signature situation. In this case, the endorsements were effective, since they were made by an employee who procured checks intending the payees to have no interest.

[187] MBTA Employees Credit Union v. Employers Mut. Liability Ins. Co., 374 F. Supp. 1299 (D. Mass. 1974). As to kinds of losses which are covered by a banker's blanket bond, see Annot., "What Are 'Securities, Documents or Other Written Instruments' Within Terms of Bankers' Blanket Bond Insuring Losses From Counterfeiting or Forgery," 38 ALR3d 1437 (1971).

[1] Breach of Warranty by Customer Obtaining Payment of Check With Forged Indorsement

A bank that pays a check containing a forged indorsement is entitled to recover the amount it has paid from the prior collecting banks or customer who obtained payment of the check. The basis for the payor bank's recovery is breach of warranty. Every customer or collecting bank who obtains payment of a check makes a warranty to the payor bank of having a good title to the check or of being authorized to obtain payment on behalf of someone who has good title to the check. When the collecting bank obtains payment of a check that has a forged necessary indorsement, the bank cannot claim to have good title. The rightful owner of the check whose indorsement has been forged has title.[188] Similar warranties are made by those who are not banks but who obtain payment of a negotiable instrument.[189] (See also the discussion earlier in this section explaining the difference between the *presentment* warranties and the *transfer* warranties.)

A bank sued for breach of warranty by the payor bank can raise as a defense that the payor bank unreasonably delayed giving notice of its claim. If the bank can demonstrate that it suffered loss as a result of the payor bank's delay in giving notice of the forgery, it will be relieved from liability to the extent of the loss caused by the delay.[190] In *Home Indemnity Co. v. First National Bank*,[191] the court held that a payor bank on an insurance draft unreasonably delayed giving notice to the depository bank that accepted the check with the forged indorsement. Because of the payor bank's delay in giving notice, the depository bank allowed the forger to withdraw the proceeds of the check and disappear.

[2] Conversion of Check When Bank Pays Over a Forged Indorsement

When a bank pays a check over a forged indorsement, the bank will be liable in conversion to the rightful owner of the check.[192] This liability for conversion is

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[188] UCC § 4-207(1)(a).

[189] UCC § 4-207(1)(a) provides that any person who obtains payment (and any prior transferor of the instrument) makes a warranty to the payor of the instrument that he has a good title or is authorized to obtain payment on behalf of someone who has a good title to the instrument. See also UCC § 3-404(1).

[190] UCC § 4-207(4). The South Carolina Court of Appeals recognized an equitable defense to the payor bank's action for breach of warranty against a collecting bank that had obtained payment of a check with a forged indorsement. In this case, the proceeds of the check reached the intended payee. The court held that the payor bank could not recover for breach of warranty because it could not show that it had suffered damage as a result of the forgery. Bankers Trust v. South Carolina Nat'l Bank, 284 SC 238, 325 SE2d 81 (Ct. App. 1985).

[191] 659 F2d 796 (7th Cir. 1981).

[192] UCC § 3-419(1)(c). Section 3-419(1)(c) gives a cause of action in conversion to the "true owner" of the check. One court held that a payee who had never received physical

not limited to forgeries, but also includes unauthorized indorsements.[193] These principles were reaffirmed in *Aetna Casualty & Sur. Co. v. Hepler State Bank.*[194] The payee company relied upon an employee to collect checks owed to the firm. The employee, without authority, used a signature stamp of the firm to indorse the checks and obtain payment. The court held that the bank at which the employee deposited the checks was liable in conversion to the payee company.[195]

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possession of the check and who could not be regarded as having had constructive delivery of the instrument was not the "true owner" of the check for purposes of suit under Section 3-419. The payee would not be without a remedy, however. The payee could still enforce the underlying obligation for which the checks originally were issued. Lincoln Nat'l Bank & Trust Co. v. Bank of Commerce, 764 F2d 392 (5th Cir. 1985).

[193] See Aetna Casualty & Sur. Co. v. Hepler State Bank, 6 Kan. App. 2d 543, 630 P2d 721 (1981). Accord D&G Equip. Co. v. First Nat'l Bank, 764 F2d 950 (3d Cir. 1985).

[194] 6 Kan. App. 2d 543, 630 P2d 721 (1981).

[195] Although the court relied on UCC § 3-419(1)(c), this section establishes conversion liability for payors. It is not clear from the facts that the defendant bank was the payor bank as well as the depository bank. If it was not the payor bank, then it would not be liable for conversion under Section 3-419(1)(c), but a similar conversion liability could be implied under Section 3-419(3). Section 3-419(3) offers the non-payor bank defenses which are not available to payor banks under Section 3-419(1), however. See also Top Crop Seed & Supply Co. v. Bank of Southwest La., 457 So. 2d 273 (La. Ct. App. 1984). The court held that UCC § 3-419 changed prior law and permitted a payee to bring a direct cause of action for conversion against a depository bank. The court also noted that Section 3-419(3) contained a defense for certain representatives who no longer retained funds attributable to the converted instrument. However, the court declined to rule on the extent to which such a defense might be available and noted that the defense had been restricted in other jurisdictions. There is an extensive and growing case law on the circumstances under which the depository bank and collecting banks are entitled to take advantage of the UCC § 3-419(3) defense to an action for conversion. A depository bank had a defense to conversion under UCC § 3-419(3), where the forger withdrew the funds and the bank had no knowledge that the signature of the payee was a forgery. The court extensively canvassed the case law on the liability of depository banks for conversion and concluded the drafters intended to create a defense although the depository bank might ultimately bear the loss because of the warranties it made to the payor bank. Moore v. Richmond Hill Sav. Bank, 117 AD2d 27, 502 NYS2d 202 (1986).

The UCC scheme for allocating risk through the transfer and presentment warranties was circumvented in Great Am. Ins. Cos. v. American State Bank, 385 NW2d 460 (ND 1986), which involved an insurance draft where Great American was both the drawer and the drawee. Great American paid the draft over a missing indorsement of one of two joint payees. If Great American had sued for breach of warranty, the defendant depositary bank would have a defense based upon delay in notifying the defendant bank of its claim. Instead of pursuing a breach of warranty theory, Great American took an assignment from the payee of its rights to the draft and sued in conversion. The court permitted Great American to maintain the conversion action but allowed the defendant to assert the defense of unreasonable delay in notification of the breach of warranty under UCC § 4-207(4). Because the drawer and the drawee were the same company, the court further ruled that the drawee had an obligation to notice that there was a missing indorsement of a joint payee; the time when Great American learned of the missing indorsement for the

The bank defended the conversion suit on the grounds that the payee firm should be precluded from asserting the indorsement was not authorized because it was negligent in entrusting its checks to the employee. The court held that there need be no inquiry into the negligence of the payee because the bank could not raise this defense if it failed to act in good faith and in accordance with reasonable commercial standards. In the court's view, permitting an individual to cash a check made payable to a corporate payee "is an unreasonable commercial banking practice as a matter of a law."[196]

[3] Customer Negligence as Defense to Bank's Payment of Check With Unauthorized Signature or Alteration

A bank may be able to escape liability for paying a check over a forged or unauthorized signature if it can establish negligence or other breach of duty to the bank by the person who claims injury as a result of the bank's action. The

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purpose of determining the availability of the defense of delay should run from the time it approved payment of the draft.

[196] 630 P2d at 728. Under UCC § 3-419(3), a collecting bank's liability for conversion when it pays over a forged indorsement is limited to the proceeds it has on hand as long as the bank acts in accordance with reasonable commercial standards. In Coulter Elecs., Inc. v. Commercial Bank, 727 F2d 1078 (11th Cir. 1984), an employee of Coulter Electronics, Inc. opened an account with the bank in the name of "Coulter Electronics" and deposited company checks to the account. The company claimed the bank could not raise Section 3-419(3) as a defense because it was commercially unreasonable as a matter of law for the bank to deposit checks payable to "Coulter Electronics, Inc." to a sole proprietor account in the name of "Coulter Electronics." Finding that the variance between the name of the payee and the indorsement was so small that it did not impose an obligation as a matter of law on the bank to make further inquiry, the court held the bank's action was not commercially unreasonable.

A bank was liable for conversion when it permitted a former corporate officer to deposit checks payable to the corporation into the officer's personal account at the bank. The bank had notice that the officer lacked authority to sign checks for the corporation, since the corporation had given the bank a new signature card and corporate resolution that did not authorize the former officer to act on behalf of the corporation. The court held further that the bank could not raise the defense of acting in a commercially reasonable manner under Section 3-419(1)(c) because "the failure of a bank to inquire when an individual presents a check made payable to a corporate payee for deposit to his personal account is deemed an unreasonable commercial banking practice as a matter of law." D&G Equip. Co., Inc. v. First Nat'l Bank, 764 F2d 950 (3d Cir. 1985). In Lincoln Nat'l Bank & Trust Co. v. Bank of Commerce, 764 F2d 392 (5th Cir. 1985), the court also found that a bank acted unreasonably in permitting a check that had been made payable to a corporation to be deposited into a personal account.

A bank did not follow reasonable commercial standards when it failed to require proper identification on opening of a new checking account and, further, allowed the signature card for the account to be taken from the bank for signature by other parties. River Parish Servs., Inc. v. Goodhope Refineries, 457 So. 2d 1290 (La. Ct. App. 1984), cert. denied, 462 So. 2d 650 (La. 1985).

UCC gives the bank two possible defenses. The first arises when the customer of the bank breaches his duty to examine his monthly statement and report forgeries and alterations to the bank. (This defense is discussed later in this chapter.) The second defense is based upon the negligence of the claimant. Under UCC § 3-406, when the claimant's own negligence "substantially contributes" to the making of the alteration or unauthorized signature, the claimant is estopped from asserting a claim based upon the alteration or unauthorized signature against the bank. This defense is available only to a holder in due course or a person who has paid the instrument "in good faith and in accordance with the reasonable commercial standards" of the payor's business.[197]

The UCC does not define what negligence will be regarded as substantially contributing to an alteration or an unauthorized signature. That determination

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[197] UCC § 3-406. In Confederated Welding & Safety Supply, Inc. v. Bank of the Mid-South, 458 So. 2d 1370 (La. Ct. App. 1984), cert. denied, 462 So. 2d 1264 (La. 1985), the court held that a bank had acted unreasonably by not asking to see a corporate resolution identifying those authorized to indorse checks when the president of the corporation deposited corporate checks to his personal account. In this case, the corporation did not maintain an account with the bank. In another case, the court held that although the corporate resolution authorized the president of the company to indorse checks for deposit to corporate accounts, the president had no authority to deposit checks to his personal account. There could be no implied authority or appearance of authority, because any appearance of authority the president had to conduct the business as he saw fit was based solely upon appearances created by the president himself. The court said further, "[I]t is well established that the mere fact that an employee has managerial status and is in charge of the company's office does not entitle third persons to assume that he had the authority to execute or indorse negotiable paper belonging to his employer." 458 So. 2d at 1375.

The Michigan Supreme Court has held that Section 9 of the Uniform Partnership Act confers the powers on one partner to indorse checks of the partnership that are payable to other partners. Grosberg v. Michigan Nat'l Bank, 420 Mich. 707, 362 NW2d 715 (1984).

Because the UCC has carefully balanced the interests of the parties and allocates loss depending upon the applicability of the various sections that deal with customer negligence and bank commercial reasonableness, it is not appropriate to apply general principles of comparative fault to determine the rights and responsibilities of the parties. Five Towns College v. Citibank, 108 AD2d 420, 489 NYS2d 338 (1985).

In Fidelity Bank v. United Nat'l Bank, 630 F. Supp. 16 (DDC 1985), Fidelity drew a check on itself that was taken by United with a forged payee's indorsement and then paid by Fidelity. The court ruled that Fidelity's negligence in handling the transaction barred it under UCC § 3-406 from asserting against United that the check had been paid over a forged indorsement. The court assumed Section 3-406 was applicable without discussing whether United was a "payor" covered by Section 3-406. Ed Stinn Chevrolet, Inc. v. National City Bank, 28 Ohio St. 3d 221, 503 NE2d 524, reh'g en banc on other grounds, 31 Ohio St. 3d 150, 590 NE2d 945 (1987), rejected a trial court's use of comparative negligence to allocate liability in a forged check case.

See ¶ 16.01[3] for a discussion of good faith. A related defense, discussed at ¶ 20.06[3], is that based upon the UCC impostor rule in UCC § 3-405.

is left for the court or jury.[198] Examples are given in the comments to the UCC, however. They include leaving blank spaces in the instrument so that words or figures may easily be inserted, lack of care in safeguarding signature stamps or automatic signing devices, negligently mailing a check to the wrong person having the same name as the payee, and failing to take steps to prevent additional forgeries by the same person after having received notice of a prior forgery.[199]

A repeatedly litigated issue is the extent of an employer's responsibility for supervising an employee who forges the signature of the employer. In *Commercial Credit Equipment Corp. v. First Alabama Bank,*[200] the court held that a corporation could not recover from a bank that paid checks forged by an employee when the corporation had failed to make a proper background check, which would have revealed prior fraudulent acts by the person before the person was hired, and also had failed to safeguard the corporation's blank checks and check embossing equipment. An employer also may be found negligent for failing to establish business procedures to oversee the activities of its employees or by failing to follow its own procedures for controlling the actions of its employees.[201]

When an employee pads the employer's payroll by arranging for the employer's checks to be issued to payees named by the employee and the employee intends to divert payment for his own purposes, the UCC prevents the employer from claiming that the employee's indorsement of the checks was unauthorized.[202] The UCC's theory is that this loss should fall upon the employer as a risk of his business rather than upon the subsequent party who has taken or paid the instrument. This result is reached under UCC § 3-405, the so-called impostor rule, and does not require proof of negligence as such. The drafters of the UCC regarded the employer as in a better position to prevent the forgeries by exercising "reasonable care in the selection or supervision of his employees" or

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[198] See UCC § 3-406, comment 3. Five Towns College v. Citibank, 108 AD2d 420, 489 NYS2d 338 (1985) (issues of fact for the jury to decide were whether a customer's delay in notifying the bank of forged signatures constituted negligence, whether the bank failed to exercise reasonable care when it did not attempt to verify signatures on checks, and whether bank policy regarding signature verification was commercially reasonable).

[199] UCC § 3-405, comments 3, 7.

[200] 636 F2d 1051 (5th Cir. 1981).

[201] See Commercial Credit Equip. Corp. v. First Ala. Bank, 636 F2d 1051 (5th Cir. 1981); Ashley-Hall Interiors, Ltd. v. Bank of New Orleans, 389 So. 2d 850 (La. Ct. App. 1980); Thompson Maple Prods., Inc. v. Citizens Nat'l Bank, 211 Pa. Super. 42, 234 A2d 32 (1967). A court found that giving the same person responsibility for both possessing the checkbook and reconciling bank statements, while failing to supervise the employee and controlling a signature stamp, was negligence as a matter of law. Read v. South Carolina Nat'l Bank, 286 SC 534, 335 SE2d 359 (SC 1985).

[202] UCC § 3-405(1)(c).

at least "in a better position to cover the loss by fidelity insurance."[203] This provision applies only when an employee supplies the employer with the name of the payee with the intention that the payee will not have any interest in the check.[204] The philosophy of enterprise responsibility that this provision reflects,

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[203] UCC § 3-405, comment 4.

[204] UCC § 3-405(1)(c). Ordinarily a forged indorsement is not effective as an indorsement and payment by the payor bank over such a forgery is improper. The drawer of the check is entitled to recover against the bank. However, when an employee engages in fraudulent conduct by submitting names of payees to his employer, intending that the payees would not receive any interest from the checks, the UCC holds the employer responsible for the conduct of its employee and regards the indorsement, although a forgery, effective for purposes of allocating liability. It makes no difference under this rule, UCC § 3-405(a)(3), that the payees were actual customers. In this case, the suit was brought by the drawee bank, who was also the payor bank on a cashier's check that had been intercepted by the drawee bank's employee and deposited with a collecting bank, First City Bank. The court held that there was no cause of action against First City Bank for breach of warranty in presenting the check for payment because the effect of the faithless employee provisions in UCC § 3-405 meant that the warranty of title was not violated. Moreover, the drawee had no action under common law theories of negligence or conversion, because the payment made on the check to First City Bank was final. UCC § 3-418. Although First City Bank indorsed the check in a manner that stated that the prior indorsements were guaranteed, the court held that this indorsement did not enlarge upon the principles in the UCC regarding warranties made between banks. Fidelity & Casualty Co. v. First City Bank, 675 SW2d 316 (Tex. Ct. App. 1984).

One court held that when a bank advances the fictitious payee defense under UCC § 3-405, the indorsements on the checks must be "exactly the same as the named payees." Thus, the court refused to recognize the defense where the indorsement varied from the name on the check, although the variations were minor in nature. Consolidation Pub. Water Supply Dist. No. C-1 v. Farmer's Bank, 686 SW2d 844 (Mo. App. 1985). A bank must act in good faith in order to obtain the advantage of the fictitious payee defense. The standard for the bank's good faith, however, is that of honesty in fact, as provided in UCC § 1-201(19). This is a subjective standard. Therefore, unlike UCC § 3-406, which requires the bank to observe reasonable commercial standards, the fictitious payee defense of UCC § 3-405 does not require the bank to observe objective reasonable commercial standards. Consolidated Pub. Water Supply Dist. No. C-1 v. Farmer's Bank, 686 SW2d 844 (Mo. App. 1985). But see E.F. Hutton & Co. v. City Nat'l Bank, 149 Cal. App. 3d 60, 65, 196 Cal. Rptr. 614, 619 (1983).

When the fictitious payee rule applies, the indorsement of the unfaithful employee in the name of the employer is effective as the employer's indorsement. The drawer of the check cannot claim that there was no proper negotiation, and the drawer does not have a cause of action against the collecting bank for negotiating the check. Furthermore, when the collecting bank sends the check on for payment, there is no breach of the warranty of genuineness of the indorsements on the part of the collecting bank because the indorsement is good. In a case in which the collecting bank acted negligently in allowing the employee to obtain the proceeds of the check, the court held that the collecting bank could assert the fictitious payee defense of UCC § 3-405 and would not be liable for negligence. Although the bank has an obligation to act in good faith under UCC § 1-203, the court concluded this was a standard of "honesty in fact" and not of commercial reasonableness. The court declined to superimpose a negligence standard on the good faith requirement in

however, could be relevant in other situations in which the reasonableness of the employer's conduct under UCC § 3-406 is in question.

A signature by one who has authority to act as an agent for the person whose name is signed does not constitute a forged or unauthorized signature. Accordingly, a depository bank could not sue its customer for breach of the warranty of title when the customer obtained payment of a check that was payable to a third party who had authorized her to obtain payment.[205] Proof of authority to obtain payment can be made in accordance with the general laws of agency and requires no special showing.[206]

[4] Bank's Improper Payment of Check as Cause of Customer Loss

A bank will have a defense to paying a check over a forged indorsement if it can show the proceeds were applied to the intended obligation of the check. One court has ruled, however, that this defense will not be available where the proceeds of the check were not applied to the obligation for which the check was issued even though the proceeds may have been received by the payee for payment on a different account.[207]

When a check is paid over a forged indorsement, the proceeds may be recovered even when they come into the hands of one other than the forger. Although the person receiving the funds may neither have breached any war-

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UCC §§ 1-201(19) and 1-203 for the purposes of interpreting the availability of the fictitious payee defense in UCC § 3-405. City of Phoenix v. Great W. Bank & Trust, 148 Ariz. 53, 712 P2d 966 (Ct. App. 1985).

For further discussion of UCC § 3-405, see ¶ 20.06[3].

[205] First Nat'l Bank v. Nunn, 628 P2d 1110 (Mont. 1981).

[206] Id.

[207] Sherrill White Constr., Inc. v. South Carolina Nat'l Bank, 713 F2d 1047 (4th Cir. 1983). In D&G Equip. Co. v. First Nat'l Bank, 764 F2d 950 (3d Cir. 1985), the court rejected the bank's defense of mitigation of damages based on an argument that the corporation, whose indorsement was unauthorized, had obtained the benefit of the funds. In the court's view, the mitigation defense required the bank to show that payment was made to the parties that the corporation would have specifically designated. A customer had no damages for improper payment of checks when proceeds of forged checks were deposited back to the customer's bank account. Ed Stinn Chevrolet, Inc. v. National City Bank, 28 Ohio St. 3d 221, 503 NE2d 524 (1986). But as the forged checks were a device used by an employee of the customer's to cover thefts of cash from the customer, these losses might be recoverable damages. The court remanded the case to determine whether they could be classed as consequential damages and, if so, the customer could recover them because of the bank's bad faith as provided in UCC § 4-103(5) or because the damages were within the contemplation of the parties under *Hadley v. Baxendale*. On rehearing, however, the Ohio Supreme Court held that appellees may not recover consequential damages, concluding that as a matter of law there was insufficient showing of bad faith. Ed Stinn Chevrolet, Inc. v. National City Bank, 31 Ohio St. 3d 150, 509 NE2d 945 (1987).

ranty with respect to the check, nor have perpetrated a fraud on the owner of the check, the rightful owner may be able to recover the proceeds that have been converted. In *Angelos v. First Interstate Bank*,[208] the court described the rule of liability as follows:

> It needs no citation of authority to support the proposition that when a person has stolen, embezzled or misappropriated another's property, the injured party should be restored to the possession of his property or its equivalent so long as it has not passed into the hands of a bona fide purchaser without notice.[209]

In a suit for conversion against a depository or collecting bank under UCC § 3-419(c), the banks have a defense if they acted in good faith and in accordance with reasonable commercial standards and no longer have any proceeds remaining in their hands. In a Texas case, a bookkeeper diverted checks that came to her employer by indorsing the company's name and depositing them to her personal account. The company sued her bank (the depository bank) for conversion. Because the bookkeeper had withdrawn the funds from her account, the bank had a defense if it could establish its good faith. The company claimed the bank lacked good faith because it had failed to verify the indorsement of the firm, which was the payee on the checks, when it accepted the checks for deposit to its customer's personal account. The court found sufficient evidence of the bank's good faith and nothing irregular about the checks to require the bank to depart from its normal practice of not verifying indorsements of payees of checks submitted for deposit.[210]

¶ 20.09 ALTERATION

When the drawer's signature is genuine but other parts of the check have been altered, either by filling in blanks or changing material provisions of an already completed check (such as the amount or, in the case of notes, the rate of interest) the situation is treated, under the UCC, as an alteration.[211]

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[208] Angelos v. First Interstate Bank, 671 P2d 772 (Utah 1983).

[209] *Angelos*, 671 P2d at 778. The court also held that the doctrine of "avoidable consequences" or mitigation of damages did not operate to prevent the owner of the instrument from claiming damages as a result of the forgery when the embezzlement consisted of a series of wrongful acts rather than one continuous act, because the doctrine did not require one to take steps in advance to avoid the consequence of a future threatened wrong. Also, the doctrine would not apply where the bank was in as good as if not better position to avoid the damages than the owner of the instrument.

[210] Steven-Daniels Corp. v. Commercial Nat'l Bank, 673 SW2d 651 (Tex. Ct. App. 1984).

[211] UCC § 3-407. See generally Annot., "What Constitutes 'Fraudulent and Material' Alteration of Negotiable Instrument Under UCC § 3-407(2)(a)," 88 ALR3d 905 (1978).

Alterations can be authorized by the drawer or maker of the paper or they can be made without consent. When the drawer authorizes a holder to fill in blanks or change some term in the paper, there is no problem. The holder may enforce the instrument according to the authority given to him.[212] The bank on which such a check is drawn may pay it and may charge the account of the drawer.[213] (The rules for unauthorized alterations are discussed in the next two subsections.) A drawer or maker of an instrument may be precluded from challenging an alteration that is due to negligence on his part, or where there is subsequent ratification, or where there is any other ground for estoppel.[214]

An instrument that is incomplete or bears visible signs of alteration so as to "call into question its validity, terms or ownership" gives notice to anyone who takes the instrument that there is a defense or claim to it.[215] This prevents the person who takes it from qualifying as a holder in due course.

The UCC rules have been used to help define the crime of forgery. See State v. Rovin, 21 Ariz. App. 260, 518 P2d 579 (1974).

[212] UCC § 3-407(3). Under UCC § 3-407, an alteration would be neither material nor fraudulent if done with the consent of the parties concerned. See American Bank & Trust Co. v. Straughan, 248 So. 2d 73 (La. Ct. App. 1971); See Brady on Bank Checks, supra note 54, at § 24.3. In In re Estate of Norris, 532 P2d 981 (Colo. App. 1974), a man who was in a hospital and terminally ill signed a check in blank and did not otherwise fill it in except to insert the figures "3,300" after the word "for" in the lower left-hand corner. He gave the check to a friend who was visiting him and asked the friend to give it to his (the signer's) sister. The check was filled in for $3,300. The sister then deposited the check, but it was not paid because the signer had died in the meantime. In a claim by the sister against the signer's estate, the court held that the presumption that the check had been properly completed had not been overcome, as there was no evidence regarding the amount to be filled in except the cryptic "3,300" in the lower left-hand corner of the instrument. The court cited Section 3-115 of the UCC as supporting its holding. The court also observed that the payor bank was not liable to the payee where the drawer was deceased and, furthermore, stated that the drawer's estate had not met the burden of showing lack of consideration for the check.

When a bank believed that it had authority to change the interest rate on a promissory note by increasing it, the alteration was not fraudulent and the maker of the note was not discharged from liability on it. Because the maker of the note consented to the alteration, the bank could enforce the note for the altered amount. The change made in the note was final, and the bank could not elect to enforce the original agreement, rather than the note as changed. As a result, the maker had a defense to payment of the note because the altered note violated state usury laws. Citizen's Nat'l Bank v. Taylor, 368 NW2d 913 (Minn. 1985).

[213] UCC § 4-401.

[214] See UCC §§ 3-406, 4-406. See generally Annot., "Commercial Paper: What Amounts to 'Negligence Contributing to Alteration or Unauthorized Signature' Under UCC § 3-406," 67 ALR3d 144 (1975).

[215] UCC § 3-304(1)(a).

[1] Altered Checks That Were Complete When Signed

Where a check is complete when signed but is subsequently altered, such alteration by the holder discharges any party whose contract is thereby changed, unless that party assents or is precluded from asserting the defense.[216] However, the bank paying such an instrument in good faith may recover from the drawer the amount originally specified on the check. For example, if a check originally calling for $100 has been raised to $1,000 and been paid in good faith, the bank may charge the drawer's account only $100.[217] In cases in which a bank pays an altered check, the bank may have recourse upon the persons to whom it paid for the amount of the loss under the UCC warranty sections.[218] Both presenters and transferors warrant that the item has not been materially altered.

An alteration is a material alteration under the UCC when it changes the contract of a party to the instrument.[219] Material alterations include a change in the number of the parties to the instrument, additions or deletions to the instrument, and unauthorized completion of blank instruments. In *St. Paul Fire & Marine Insurance Co. v. State Bank*,[220] the court held that an alteration to the amount of the check was not material because the words of the check describing the amount controlled the figures placed on the check,[221] and only the figures were altered.

Alteration of a check in any material respect by a holder voids the check so far as the drawer is concerned, and it releases the drawer from the obligation to pay unless the item comes into the hands of a holder in due course. A holder in due course can enforce the check according to its original terms.[222] Under the UCC, the alteration must be fraudulent and material in order for the drawer and any other party to the check whose contract is changed to be discharged from liability; otherwise, the bank can enforce the check according to its original provisions.[223]

Notations in the margins of checks, indicating the amount when the handwriting is doubtful or noting part payments, are not material alterations within this rule because they do not change the contract of the parties who have signed the check and would not be fraudulent changes. They have no effect whatever upon the instrument.[224]

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[216] UCC § 3-407(2).

[217] UCC § 4-401(2)(a).

[218] UCC §§ 4-207, 3-417.

[219] UCC § 3-407(1).

[220] 412 NE2d 103 (Ind. Ct. App. 1980).

[221] UCC § 3-118.

[222] UCC § 3-407(3). Visible alterations may prevent the holder from qualifying as a holder in due course. UCC § 3-304(1)(a).

[223] UCC § 3-407 & comment.

[224] UCC § 3-407(2)(b).

Negligence in completing a check that makes it easy to alter precludes the drawer from challenging the alteration. But the bank that pays such a check must act in "good faith and in accordance with the reasonable commercial standards" of the payor's business.[225] The UCC provides in § 3-406 that:

> Any person who by his negligence substantially contributes to a material alteration of the instrument or to the making of an unauthorized signature is precluded from asserting the alteration or lack of authority against a holder in due course or against a drawee or other payor who pays the instrument in good faith and in accordance with the reasonable commercial standards of the drawee's or payor's business.

The UCC does not define what will constitute negligence. The comment to the section states that this question is "left to the court or the jury upon the circumstances of the particular cases."[226] The comment further states that circumstances in which negligence has usually been found include those in which "spaces are left in the body of the instrument in which words or figures may be inserted."[227] The comment then says, "No unusual precautions are required, and the section is not intended to change decisions holding that the drawer of a bill is under no duty to use sensitized paper, indelible ink or a protectograph; or that it is not negligence to leave spaces between the lines or at the end of the instrument in which a provision for interest or the like can be written."[228] A connection must exist between the negligence and the alteration. As the drafters of the UCC put it, "It must afford an opportunity of which advantage is in fact taken."[229]

The negligence creates an estoppel against the negligent party against subsequent holders in due course or persons who pay the instrument in good faith and who act in a commercially reasonable manner.[230]

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[225] UCC § 3-406. An alleged salesman induced his victim to allow him to fill in a check from the victim's checkbook, for $1.26 to pay for a small purchase. He filled in the amount both in figures and in long hand but left space to the left of the entries so that the check could be easily raised. The check was then raised to $6,841.26. The check was later cashed at the bank on which it was drawn. In an action to recover the difference between the original and the raised amount of the check, a trial court judgment permitting recovery against the bank was reversed on the ground of "failure of the court to instruct the jury on the provisions of the Uniform Commercial Code." In particular, the court referred to failure to have the jury instructed "as to what reasonable commercial standards are." Williams v. Montana Nat'l Bank, 167 Mont. 24, 534 P2d 1247 (1975).

[226] UCC § 3-406, comment 3.

[227] Id.

[228] UCC § 3-406, comment 3.

[229] UCC § 3-406, comment 4.

[230] UCC § 3-406 & comment 5. The requirement that the party who will have the benefit of the preclusion be a holder in due course creates a technical problem when the negligence has made possible a forged indorsement through which the claimant bases rights to the instrument. Although the policy of the preclusion rule applies, the claimant is not a holder and so cannot be a holder in due course unless one accepts the circular logic

[2] Instruments Issued With Blanks

Instruments issued with blanks are subject to slightly different rules although the UCC also classifies such instruments as "altered" when they are completed without authority. Where a depositor draws a check and puts it into circulation with any material part blank, a bank paying in good faith may charge the depositor's account for the manner in which the check is actually filled in, whether it has been completed in accordance with the customer's instructions or not. For example, if a depositor signs a check and leaves the amount blank, intending to make it for $10, and it is wrongfully filled in for $100 and paid by the bank in good faith, the bank may charge the account for $100.[231] The bank may pay the check, even when it knows the check was filled in by someone other than the drawer, as long as the bank acts in good faith and does not have notice that the completion is improper.[232]

The case of instruments issued with blanks should not be confused with the situation in which the depositor has filled in the blanks but left them in such a condition that they may be easily altered. In this situation, if the instrument is subsequently altered, the trier of fact could view the loss under the UCC as attributable to the negligence of the drawer in writing the check and so would fall on the depositor if the check comes into the hands of a holder in due course or is paid in good faith.[233]

Where a depositor signs an incomplete check that is subsequently stolen and filled in for an amount, the loss falls on the depositor who signed the check. It makes no difference whether the depositor lost the check as a result of carelessness in handling it or the check was stolen from the depositor without any fault on his or her part. In either case, a holder in due course can enforce the check for

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that the preclusion rule has made the claimant a holder in due course. This reasoning is not logically satisfying, but it appears to be what the drafters intended, as shown by the examples in the comments. UCC § 3-406 comment 7 gives as an example mailing a check negligently "to the wrong person having the same name as the payee." For this example to fit the section, the transferee after the forged payee indorsement has to be treated as a holder.

[231] UCC § 4-401(2)(b). See §§ 3-115, 3-407.

[232] UCC § 4-401(2)(b). This establishes a less restrictive test for payor banks than for persons claiming as holders in due course. See UCC § 3-304(1). A drawer insurance company signed a check but left it blank; it was later completed without authority. The check contained a printed legend stating, "This check only payable to automobile insurance plan or an insurance company." As completed, the check was payable to an individual. The insurance company drawer brought suit against the depository bank. The court held that there was no cause of action against the depository bank. The drawer's claim was against the drawee bank to force it to properly recredit the drawer's account for the improper charge. In the court's view, the legend on the check was notice that it had been completed in an unauthorized manner, since the individual was not an automobile insurance plan or an insurance company. *Kings Premium Serv. Corp. v. Manufacturers Hanover Trust Co.*, 115 AD2d 707, 496 NYS2d 524 (1985).

[233] UCC § 3-406, comment 3.

the completed amount against the depositor/drawer and the bank can charge the depositor's account if it pays in good faith.[234]

A holder in due course always can enforce a completed instrument according to its terms as completed.[235] Thus, even if the bank on which the check is drawn refuses to pay it (perhaps because of a stop payment order), a holder in due course can require the drawer to pay the amount of the check as completed. In the case of a fully completed check that has been altered, a holder in due course may enforce it for its original amount.

¶ 20.10 DEPOSITORY BANK'S OBLIGATION OF GOOD FAITH

In addition to the previously mentioned obligations to its depositors, a bank is required to exercise due care and good faith in all dealings with its customers. Thus, it must use due care in notifying a depositor of overdrafts on collecting paper, of chargebacks on collecting paper, and of receipt of the depositor's goods and funds that may come into its hands. In the absence of such reasonable notification, the bank may be liable for resulting injuries.[236] A bank is also required to use due care in dealing with valuables left in safe keeping, collateral securities, and other properties of the customer that come into its possession.[237] These liabilities are attached by law, and courts would usually give no effect to contracts by which banks attempt to relieve themselves of liability for the negligence of their employees.[238]

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[234] UCC § 4-401(2)(b). See UCC §§ 3-115, 3-407, 3-603(2), and comments therein.

[235] UCC § 3-407(3). See Saka v. Sahara-Nev. Corp., 92 Nev. 703, 558 P2d 535 (1976). A holder was held to have had notice of the fraudulent completion of a check when the holder, who was facing a $400,000 loss if it did not obtain payment from the party who delivered the fraudulent check, took it under circumstances that the court believed required further inquiry. Because the holder took the check not in the regular course of business and under circumstances where the holder "either knew of the circumstances, or closed its eyes and in bad faith simply did not seek the truth in order to get its money," the holder was not a holder in due course, and the drawer of the check had a defense based on the check's fraudulent completion. E. Bierhaus & Sons, Inc. v. Bowling, 486 NE2d 598 (Ind. Ct. App. 1985).

See Virginia Capital Bank v. Aetna Casualty & Sur. Co., 231 Va. 283, 343 SE2d 81 (1986). A bank that held an altered note had not suffered a loss within its blanket bond because it could enforce the note in its altered amount as a holder in due course, even though the maker's and the indorser's insolvency made the note uncollectible. The note had been executed in blank and an amount greater than that authorized by the indorser was filled in later.

[236] UCC §§ 1-103,1-203. For an able discussion of this liability under pre-Code law, see 1 Morse on Banks and Banking § 252 (Voorhees ed., 6th ed.; 1928) (hereinafter Morse on Banks).

[237] See Morse on Banks, supra note 236, Ch. 14.

[238] UCC § 4-103.

If the depositor's own negligence contributes to the loss, the UCC rules for allocating the loss are more complex; specific sections must be consulted. In some situations the bank will be obligated to follow reasonable commercial standards notwithstanding its customer's negligence.[239] In the absence of negligence, the bank and its customer, under the provision of the UCC, may make contracts changing these rules; but neither party can contract away its exercise of due care and good faith.[240]

There has been a dramatic expansion in bank liability in a series of cases, most involving situations in which the bank acted as a lender or made a commitment to extend credit, because the bank breached a duty to act in good faith toward its customer.[241] The implications of the bank's liability for breach of its duty of good faith raised by these cases radiate beyond the specific fact patterns involved and signal the need for a bank to act with care and in good faith with respect to all of its actions toward its customers.

¶ 20.11 BANK'S RIGHT TO REVOKE CREDITS TO CUSTOMER'S ACCOUNT AND TO CHARGE CUSTOMER FOR ITEMS NOT PAID

When a customer deposits a check and that check is not paid, the bank has the right to charge back any credit given to the customer, as long as the bank acts properly in handling the check. When the check deposited is drawn upon a bank other than the depository bank, there is a presumption under the UCC that any credit given to the customer for the check by the depository bank is provisional.[242] This presumption applies even though the credit given by the bank is subject to "immediate withdrawal as of right or is in fact withdrawn."[243] If, subsequently, the check is not paid, the depository bank may revoke the credit it gave and charge back the amount to its customer's account.[244] In order to take advantage of this right to charge back, the depository bank must act promptly in notifying its customer or in returning the dishonored check. The bank must return the check or send notice to its customer before midnight of the banking day after which it learns that the check was not paid.[245] The bank need only

[239] See, e.g., UCC §§ 3-406, 4-407; but see UCC § 3-405.

[240] UCC § 4-103.

[241] These cases are discussed at ¶ 24.02[2].

[242] UCC § 4-201(1).

[243] Id. Of course, the parties can expressly agree to treat the settlement as "provisional" or "final." Id.

[244] UCC § 4-212(1).

[245] Id. Oral notice by telephone from a bank clearing house to the depository bank that it is returning an item is effective to give notice to the depository collecting bank. Upon receipt of the notice, the depository bank must then give notice prior to its midnight

"send" notice within the deadline; actual receipt of notice by the customer is not required.[246]

The bank loses its right to charge back when it gives a *final* settlement to its customer or when it receives a *final* settlement for the check.[247] Of course, the bank has a duty of due care in handling the check for collection.[248]

When a payor bank pays an item in cash over the counter, the UCC views this as a final payment.[249] Disputes may arise as to whether a check presented to a payor bank has been paid in cash or whether the bank has accepted it for deposit, given a provisional credit, and made a general withdrawal of cash from the customer's account. Characterization of the bank's action may depend upon the form of the bank's deposit slip and how the slip is filled out.[250] The comments to the UCC provision on final payment say that the UCC permits a bank to make clear that credit given to its customer in settlement for an item is "provisional" and subject to the bank's right to revoke if the bank acts in a timely manner

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deadline to the indorsers of the check if it is to hold the indorsers liable on the instrument. In this case, the bank waited until it received written notice of dishonor and then promptly notified the indorsers. The dispute involved a check for $490,000. The court rejected the argument that UCC § 4-202(a) requires written notice of dishonor. Moreover, there was an agreement between the clearinghouse bank and the depository bank that oral notice could be given. Although the depository bank could not recover against the indorser for liability on the check because of its failure to give timely notice and the depository bank also lost its right to charge back the amount of the dishonored check to its customer's account under UCC § 4-212, the court held the chargeback remedy was not exclusive. Because the indorser was also the customer of the bank, the bank was entitled to recover on equitable principles of unjust enrichment. Greer v. White Oak State Bank, 673 SW2d 326 (Tex. Ct. App. 1984).

[246] UCC §§ 1-201(26), 1-201(38), 4-212(1). Section 4-212(1) says "send," but oral notice may be effecitve. Brady on Bank Checks, supra note 54, at ¶ 21.8.

[247] UCC § 4-212(1). In Yoder v. Cromwell State Bank, 478 NE2d 131 (Ind. Ct. App. 1985), the court held that a depository bank could charge back a dishonored check to its customer's account under Section 4-212(1), even though the payor bank had become accountable for the check. The payor bank became liable for payment of the instrument because its deadline for dishonoring the check had been missed and final payment had occurred. The court reasoned that: "Given the volume and speed of check processing, it would be unrealistic to require the collecting bank to inquire and ascertain the grounds for, and propriety of, every item which is dishonored. The bank's duty of ordinary care extends to presenting or sending an item for collection and seasonably notifying the customer of any dishonor." The depository bank must be able to rely upon the notice of dishonor it receives so that it may act promptly with respect to its own customer. The court also held that once the depository bank has given proper notice of dishonor and chargeback to its own customer, the bank may wait a longer period of time before actually exercising its chargeback right.

[248] UCC § 4-202. See Chapter 21.

[249] UCC § 4-213(1)(a). See UCC § 4-213, comment 3, "traditionally and under various decisions payment in cash of an item by a payor bank has been considered final payment."

[250] See Kirby v. First & Merchants Nat'l Bank, 210 Va. 88, 168 SE2d 273 (1969).

under the UCC, an applicable clearinghouse agreement, or other special agreement.[251]

UCC § 4-212, unlike other sections of the UCC, does not state that the collecting bank becomes accountable for the amount of the item if it fails to follow the procedures there prescribed for giving notice of dishonor.[252] One court interprets this omission as meaning the customer must establish damages. Under UCC § 4-103, the customer is entitled to recover only the amount of damages the customer suffered from the bank's lack of care reduced by any amount that could not have been realized had the bank used ordinary care. Thus, instead of strict liability for the face amount of the item, the bank is liable only to the extent that its actions caused injury.[253]

The ability of a depository bank to charge back an uncollected check to its customer's account was disputed in one case because the bank erroneously advised the customer on the time it would take for the check to be returned if it was not paid. The customer deposited a check drawn upon a bank in the Cayman Islands. The customer claimed a bank employee said the normal time for return of bad checks was about ten days, although the time involved for the return of a check drawn upon a Cayman Islands bank was actually longer. Claiming reliance on the employee statement, the customer drew against the credit the check represented. The court held the bank did not have a duty to inform the customer of the delay involved in collecting Cayman Islands checks, but even if the customer had been misled by the employee statements, the bank would be liable under UCC § 4-212(4) for negligence in collection only when the negligence of the bank was the cause of the dishonor.[254]

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[251] UCC § 4-213, comment 4. The comment states that a payor bank may keep settlements provisional "by general or special agreement with the presenting party or bank; by simple reservation at the time the settlement is made; or otherwise. Thus a payor bank (except in the case of statutory provisions) has control whether a settlement made by it is provisional or final, by participating in general agreements or Clearing House rules or by special agreement or reservation."

[252] See UCC §§ 4-213 and 4-302.

[253] Appliance Buyers Credit Corp. v. Prospect Nat'l Bank, 708 F2d 290 (7th Cir. 1983).

[254] Chase v. Morgan Guarantee Trust Co., 590 F. Supp. 1137 (SDNY 1984). The same principles were applied in a New York case. When a person deposits a check to her account, credit given for the check is provisional until the check is finally paid. Although a bank teller told the depositor that the check had "cleared" and the depositor then withdrew money from the account, drawing on the credit, the bank did not lose its right to charge back to the account for the amount of the check when it was returned to the bank unpaid. Even if the bank teller acted negligently in giving the erroneous statement to the depositor, the negligence was not the cause for the nonpayment of the check. Under UCC § 4-103(5), the measure of damages for failure to exercise ordinary care in handling a check is the amount of the check reduced by the amount that could not have been realized by the use of ordinary care. Allen v. Carver Fed. Sav. & Loan Ass'n, 123 Misc. 2d 704, 477 NYS2d 537 (NY Sup. Ct. 1984).

When the check deposited with a bank is drawn upon that bank, so that the bank is both the depository and the payor bank, the bank must act promptly in deciding whether the check should be paid. The bank is required to give at least a provisional settlement for the item before "midnight of the banking day of receipt" and must decide before midnight of the banking day following the day of receipt whether it will choose to refuse to pay the item, in which case it must return the check or send written notice of its action.[255] If the payor bank holds the item without observing these deadlines, the bank will be accountable for the amount of the item.[256] After the bank becomes accountable for the item, any subsequent risk of not being able to collect it is upon the bank, not the customer.

The payor bank's right to charge back its customer's account also terminates when the bank makes final payment of the item.[257] Under the UCC, final payment occurs when the bank

1. Pays the item in cash;
2. Settles for the item without reserving a right to revoke or having a right under statute or agreement to revoke; or
3. Completes the process of posting the item to the account of the person to be charged for it; or
4. Makes a provisional settlement for the item and fails to revoke it in a timely fashion as permitted by statute or agreement.

When final payment occurs, the payor bank becomes accountable for the amount of the item.[258]

The provisions of the UCC on the collection of checks are affected by the Expedited Funds Availability Act of 1987 (EFAA), which requires banks to conform to federal standards in making funds available to their customers that the customers have deposited. This act does not change the concept of when payment of an instrument is "final"; it does impose obligations that may require a bank to make funds available before a check is finally paid or before the bank has the opportunity to learn whether the check has been finally paid. These matters are discussed in the next subsection.

Regulations of the Federal Reserve Board also affect the time within which a payor bank must give notice to prior banks of the dishonor of a check. Failure

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[255] UCC § 4-301(1).

[256] UCC § 4-302.

[257] UCC § 4-301(1). The jury must determine when a bank has completed the process of posting checks to establish that final payment has occurred. Consolidated Cigar Co. v. Texas Commerce Bank, 749 F2d 1169 (5th Cir. 1985).

[258] UCC § 4-213(1). See ¶ 21.03 on final payment and payor bank's right to cancel payment.

to give timely notice under the federal guidelines may make the payor bank liable for loss caused by its failure to exercise the proper degree of care.[259]

Given the Federal Reserve Board's general authority to adopt measures to speed up the collection of checks, it is reasonable to expect there will be greater regulation by the Board of the check collection process that may modify the provisions in the UCC. The Board's authority in this regard is discussed in Chapter 14. One area of recent experimentation involves modification of deadlines to permit representment of checks for small dollar amounts because the experience in processing such checks indicates that a high proportion of them are paid on such a representment.[260] The Board also has adopted a new Regulation CC, which became effective on September 1, 1988. This resolution makes substantial changes in the traditional rules on check collection, and should be consulted in determining the rights and duties of the parties involved in the check collection process. Chapter 21 discusses the aspects of the regulation that deal with check collecting generally. This chapter discusses EFAA and the parts of Regulation CC that deal with funds availability and disclosure rules.

[1] Customer's Right to Withdraw Against Items Deposited

A customer's right to withdraw funds or to have checks paid against funds that have been deposited is an issue that has stirred some controversy. A general provision in the UCC, § 4-213(4), gives the customer certain rights of withdrawal. As discussed later, in cases in which the customer has deposited a check in the customer's account that is payable on another bank, the customer does not have a right to withdraw funds represented by that deposit until the depository bank has received a settlement for that check that has become final "and the bank has had a reasonable time to learn that the settlement is final."[261] Because of the way the bank collection process works, where the bank treats deposited checks as cash items that will be paid and receives notification from a payor bank only when the payor is dishonoring the item or refusing to make payment for some reason, there is no particular time when the bank learns that a given check has been paid.[262] Some depository institutions have adopted policies of

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[259] 12 CFR § 210.12 (1987) (Regulation J). (See further discussion of Federal Reserve Board requirements at ¶ 21.11[2][d].)

[260] See 52 Fed. Reg. 10,812 (1987). See discussion of Board's proposal at [Current Developments] Fed. Banking L. Rep. (CCH) 86,915 (Mar. 30, 1987). For a general discussion of the Board's authority in this regard, see ¶ 21.06.

[261] UCC § 4-213(4)(a).

[262] There are a number of excellent law review articles on the subject of funds availability. These include excellent descriptions of the bank collection process. See generally Baxter & Patrikis, "The Check-Hold Revolution," 18 UCCLJ 99 (1985); Jordan, "Ending the Floating Check Game: The Policy Arguments for Delayed Availability Reform," 36 Hastings LJ 515 (1985); Note, "Bank Check-Hold Policies: A Proposal to

varying flexibility under which they would impose "holds" on deposited checks drawn against other institutions. These hold policies sparked complaints from consumer interests and resulted in litigation and state legislation giving customers a right to withdraw deposited funds according to specified schedules of availability. At the same time, Congress had been considering adopting national legislation on this subject for several years. This consideration finally resulted in a congressional decision to greatly enlarge the involvement of the federal government in the payments system, with the Board of Governors of the Federal Reserve System as the primary federal regulator. This decision is reflected in Title VI of the Competitive Equality Banking Act of 1987. Title VI is known as the Expedited Funds Availability Act of 1987.[263] The Board has adopted extensive regulations in a new Regulation CC to implement the act. These regulations become effective September 1, 1988. The next two subsections discuss first the provisions of the UCC and state law and then the impact of the Expedited Funds Availability Act of 1987.

[a] Customer's Right to Withdraw Against Deposited Items Under the UCC. A customer depositing a check or other instrument with a bank does not have an immediate right to withdraw the funds represented by the deposit. The bank does not have to permit the customer to withdraw against the deposit until the bank determines that the item will be paid.[264] When a customer deposits a check, in his or her own bank account, that is drawn upon a different bank, the depository bank ordinarily gives the customer provisional credit, or what the UCC calls a provisional settlement for the amount deposited. Under the UCC, when a collecting bank gives a credit to its customer, there is a presumption that it is provisional.[265] The bank may revoke any provisional settlement it has given and may charge back the amount to the account of its customer.[266] The customer does not have a right to draw against the provisional credit until it becomes final and until the bank has had a reasonable time to learn of its finality.[267] The settlement becomes final when the check is paid by the payor bank and the proceeds have been remitted to the depository bank.[268]

Under the customary procedures for collecting payment of checks, checks are treated as "cash" items, and a depository bank will ordinarily not receive

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Protect Consumers," 14 J. Legis. 53 (1987); Note, "Delayed Funds Availability: A Bank Customer's Right to Deposited Check Funds," S. Ill. ULJ 121 (1986).

[263] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, tit. VI, 101 Stat. 552 (1987).

[264] UCC § 4-213(4).

[265] UCC § 4-201(1).

[266] UCC § 4-212. See ¶ 21.03[4].

[267] UCC § 4-213(4).

[268] UCC §§ 4-211, 4-213.

notice that a particular check it has forwarded for payment to a payor bank has in fact been paid. The depository bank receives a settlement for the check when it is received for collection under the applicable clearinghouse rules, special agreement with the correspondent banks, or Federal Reserve operating rules and regulations. If the check or other item is subsequently dishonored by the payor bank, notice of dishonor is given and the settlement provisionally given to the depository bank is reversed. When the payor bank honors the check or other item by paying it, no notice is given. The provisional settlement previously given to the depository bank simply becomes a final settlement automatically through the passage of time.[269] As a result, the depository bank usually receives no notice when a check is paid but receives notice only when a check is dishonored. Because the system for returning dishonored checks and giving notice of dishonor to the depository bank, in sharp contrast to the system for obtaining payment of checks, has worked in a notoriously slow manner, a considerable period of time may elapse before the depository bank learns that a particular check is not paid. Fraud involving tampering with routing instructions on the check can extend the delay.

To protect themselves against the possibility that a deposited check might not be paid, some institutions adopted policies of placing "holds" for varying lengths of time on deposited items before the institutions would permit their customers to make withdrawals or to draw checks against those items. These policies were administered with varying degrees of flexibility, according to the commentators who have studied the subject, but in some cases the holds imposed significant delays on a customer's access to funds. Such hold policies often reached quite broadly, as the banks generally applied them to broad categories of checks, with the result that a customer was prevented from using funds deposited from checks that in fact were paid and were probably paid relatively quickly after deposit. In a New York case, a customer challenged the hold policies adopted by a bank, but the court ruled that the UCC permitted a bank to enter into agreements with its customers on check hold periods.[270]

When the customer deposits a check, in his or her own account, that is drawn upon the bank where the check is deposited (so that the depository bank is also the payor bank), the bank must decide before its midnight deadline whether or not to pay the check.[271] If the bank decides to pay the item, the credit given becomes available to the customer for withdrawal "at the opening of the bank's second banking day following receipt of the item."[272] The right of the customer

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[269] See the description of the bank collection process contained in *Brady on Bank Checks*, supra note 52, at Ch. 11. See generally the discussion of the bank collection process contained in the comments to UCC §§ 4-201, 4-211, 4-213, 4-301.

[270] Rapp v. Dime Savings Bank, 48 NY2d 658, 396 NE2d 740, 421 NYS2d 347 (1979), aff'g 64 AD2d 964, 408 NYS2d 540 (1978).

[271] UCC § 4-302.

[272] UCC § 4-213(4)(b).

to make withdrawals against credits the bank gives for deposit to the account is subject to any rights the bank might have to set off the credit against some other obligation the customer owes the bank.[273]

Consumer interest groups are paying increased attention to bank policies on how long depository banks hold consumer checks while in the process of clearing. Some states have adopted legislation aimed at curtailing banks' use of lengthy waiting periods before allowing customers to withdraw against the items deposited. New York adopted a measure giving the State Banking Regulator authority to prescribe "a reasonable period of time" for checks to clear. California also has modified UCC § 4-213(4) to permit state banking regulatory agencies to establish reasonable periods for check clearance.[274]

As discussed next, the EFAA makes the Federal Reserve Board the regulator of the rules on availability of funds, and customer-bank rights and duties in this regard now are controlled by federal law.

[b] The Expedited Funds Availability Act of 1987 [EFAA]. For several years Congress has considered legislation that would impose a duty on a depository institution to make funds deposited by its customer available for withdrawal by the customer based on a schedule of availability established by law. With the passage of the Competitive Equality Banking Act of 1987, Congress adopted the legislation in Title VI of the Act.[275] This legislation—known as the EFAA—requires depository institutions to make funds available for withdrawal in accordance with a statutorily prescribed schedule of availability.

When the Federal Reserve Board acts under the authority granted by the act, the Board's regulations will preempt state law, including the provisions of

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[273] UCC § 4-213(4).

[274] For a description of the New York statute, see 41 Wash. Fin. Rep. (BNA) No. 8, at 271 (Aug. 22, 1983). See also Cal. UCC §§ 4-212–4-213, and Article 1.8, Cal. Fin. Code, Ch. 7, Div. 1 (1983). The California legislation followed a lawsuit against Crocker National Bank, which was settled when the bank agreed to adopt a publicly disclosed policy regarding "holds" on the payment of checks and agreed to stipulations regarding the periods it would hold payment of checks of $1,000 or less pending collection. See 41 Wash. Fin. Rep. (BNA) 811 (Nov. 28, 1983). At the federal level, a Joint House Subcommittee of the House Banking Committee held hearings on the pricing of check clearing and related problems, such as check "float." 40 Wash. Fin. Rep. (BNA) 1304 (June 20, 1983) (hearings held June 15-16, 1983). For an informative article that analyzes the time needed for check collection and the risk of nonpayment, see Cooper, "Checks Held Hostage—The Funds Availability Controversy," 102 Banking LJ 532 (1985).

[275] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, tit. VI, 101 Stat. 552 (1987) (hereinafter CEBA). The Board has adopted rules in a new Regulation CC to implement the act. Regulation CC (1988) (to be codified at 12 CFR pt. 229). The proposed rules were published at 52 Fed. Reg. 47, 112–147, 179 (Dec. 11, 1987), amending 12 CFR parts 210, 229.

the UCC that may be in effect in any state.[276] The only exception to this preemption of state law occurs when a state law or regulation that has been in effect on September 1, 1988 provides a shorter period of time for a depository institution to make deposited funds available for withdrawal by its customers than is provided by the federal schedules of availability. When there is such a state law or regulation providing for a shorter availability period, it will supersede the provisions of EFAA and will also, as a result of specific language in the EFAA, be binding on all federally insured depository institutions in such state.[277]

[i] Definitions and scope of EFAA. EFAA contains general definitions that affect the scope of the new legislation. Many of these definitions deal with terminology commonly used in describing check collection and payment. Some of the terms are used in the UCC, but the definitions in EFAA are not necessarily the same as those in the UCC. Thus, great care must be used in reviewing EFAA to apply the appropriate definitions. The following terms are among those specifically defined in EFAA: account, business day, cash, cashier's check, certified check, check, check clearing house association, check processing region, consumer account, depository check, depository institution, local originating depository institution, noncash item, nonlocal originating depository institution, proprietary ATM, nonproprietary ATM, originating depository institution, participant, receiving depository institution, teller's check, wire transfer.[278] The regulations that implement EFAA have their own terminology and definitions, some of which are different than those used in EFAA.[279]

[ii] Funds availability requirements. The funds availability provisions of EFAA generally require a depository institution to make available to its customer funds that the customer has deposited with the institution according to a schedule that varies with the type of instrument deposited. In some situations EFAA distinguishes between availability of funds for withdrawal in cash and availability of funds for withdrawal in other ways, such as by a check drawn on the account by the customer. As discussed later, specific rules determine when the customer must be permitted to make withdrawals in cash and when funds "shall be available for withdrawal" generally. The discussion that follows describes the provisions in EFAA. The Board has established in its Regulation CC, effective September 1, 1988, the specific requirements that depository institutions must meet. The regulations contain many important details and clarifications of how EFAA applies.

"Available for withdrawal" is defined in the Board's regulations to mean that the funds deposited are "available for all uses generally permitted to the

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[276] CEBA § 608(b) (to be codified at 12 USC § 4007(b)).

[277] CEBA § 608(a) (to be codified at 12 USC § 4007(a)). The preemption provisions are complex. See Regulation CC § 229.20 (1988) (to be codified at 12 CFR § 229.20).

[278] Regulation CC § 229.2 (1988) (to be codified at 12 CFR § 229.2).

[279] CEBA § 602 (to be codified at 12 USC § 4001).

customer for actually and finally collected funds under the bank's account agreement or policies, such as for payment of checks drawn on the account, certification of checks drawn on the account, electronic payments, withdrawals by cash, and transfers between accounts."[280] Thus, the rules on funds availability affect whether a bank may properly dishonor a check drawn on the account for insufficient funds. There is civil liability under the act and regulations for failure to comply with the availability rules, as discussed in the following paragraphs, but the federal liability rules do not apply when the claim is for wrongful dishonor.[281]

Although EFAA requires banks to make funds available for withdrawal, the bank retains the rights the bank otherwise has under the UCC or other law to revoke a settlement given to its customer or to charge back the customer's account for checks deposited by the customer that have not been paid.[282]

1. *Availability Schedules.* There are four categories of deposits treated in EFAA. The availability schedules vary depending upon the category. Subject to the exceptions discussed later, the general availability schedules for these categories are as follows:

a. Cash deposits and wire transfers. When a deposit is made in cash or when a depository institution receives funds by a wire transfer for deposit to an account at the institution, EFAA establishes the general rule that the funds "shall be available for withdrawal" no later than on the business day after the business day on which the deposit was made. This means that if the customer deposited cash on Monday or the institution received a wire transfer on Monday, the institution would have to make the funds available for withdrawal on Tuesday.[283] EFAA leaves the definition of the term "wire transfer" to regulations of the Federal Reserve Board.[284]

b. Government checks, cashier's checks, and low risk instruments. When the customer deposits funds in the form of government checks, cashier's checks, or similar instruments, the institution must make the funds available for withdrawal no later than the business day after the business day on which the funds are deposited.[285] Thus, when the customer deposits funds on Monday, if the deposit consists of govern-

[280] Regulation CC § 229.2(d) (1988) (to be codified at 12 CFR § 229.2(d)).

[281] Id. § 229.21(f).

[282] Id. § 229.19(c)(2)(ii).

[283] CEBA § 603(a)(1) (to be codified at 12 USC § 4002(a)(1)).

[284] CEBA § 602(25) (to be codified at 12 USC § 4001(25)). See Regulation CC § 229.2(*ll*) (1988) (to be codified at 12 CFR § 229.2(*ll*)). The definition excludes electronic fund transfers under the Electronic Fund Transfer Act. Id. An "electronic payment" is a wire transfer or an ACH credit transfer. Id. § 229.2(p).

[285] CEBA § 603(a)(2) (to be codified at 12 USC § 4002(a)(2)).

ment checks meeting the requirements of EFAA, the institution must make the funds available for withdrawal on the next business day, which would be Tuesday when the institution opens for business. The checks that qualify for this next day availability are those that Congress thought would have a low risk of nonpayment. There are several subcategories of these checks. There is generally next day availability for checks that are obligations of a government entity, either the United States, a state government, or a local government, when the bank's customer is the person to whom the check was issued and is the only indorser. EFAA is specific that these must be checks that are drawn on the U.S. Treasury, drawn by a state, or drawn by a unit of general local government. State and local government checks must be deposited in a receiving depository institution located in the same state as the state in which the government unit is located, and the check must be accompanied by a special deposit slip identifying the check as one drawn by the state or the local government.[286]

The next business day availability rule applies to three other subcategories of deposited funds as well. There is next day availability for up to the first $100 each bank customer deposits by check on any given business day.[287] There is next day availability for a check deposited in a branch of the same depository institution on which the check was drawn if both the depository branch and the branch on which the check was drawn are located in the same state or in the same check processing region. And there is next day availability for the deposit of a cashier's check, certified check, teller's check, or depository check.[288] As with state and local government checks, the bank's customer must be the person to whom the check was issued and the only indorser, and the check must be accompanied by a special deposit slip when the instrument is deposited.[289]

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[286] CEBA § 603(a)(2)(B), (C) (to be codified at 12 USC § 4002(a)(2)(B), (C)). The Board's regulations require the check to be deposited to an account of the payee. Regulation CC § 229.10(c) (1988) (to be codified at 12 CFR § 229.10(c)).

[287] The $100 applies to that part of the checks deposited that are not otherwise subject to next day availability, and the $100 is for the customer's aggregate deposits to all accounts. The amount is reduced if the amount of the deposits entitled to this next day availability is less than $100. Regulation CC § 229.10(c)(1) (to be codified at 12 CFR § 229.10(c)).

[288] A depository check includes a cashier's check, certified check, teller's check, and "any other functionally equivalent instrument as determined by the Board." CEBA, § 602(11) (to be codified at 12 USC § 4001(11)). The check must be deposited to an account of the payee. Regulation CC § 229.10(c) (1988) (to be codified at 12 CFR § 229.10(c)).

[289] CEBA § 603(a(2))(F) (to be codified at 12 USC § 4002(a)(2)(F)).

In the case of certain checks that otherwise would qualify for next day availability but that are not deposited in person to an employee of the depository bank, the Board's regulation provides that the funds shall be available on the *second* business day after the banking day on which the funds are deposited.[290]

c. Local and nonlocal checks. Local checks are checks a customer deposits at a depository institution that are drawn on a local originating depository institution.[291] Given the definition of local originating depository institution as the branch that is the drawee on the check and that is located in the same check processing region, a local check is one that is both drawn on a branch of a depository institution and deposited in a branch of a depository institution located within the same check processing region. The term "check processing region" refers to the geographical areas served by a Federal Reserve Bank Check Processing Center.[292] Nonlocal checks are checks drawn on a branch of a depository institution that is located outside of the check processing region where the check is deposited. Subject to exceptions discussed later, when a customer deposits local checks, the institution must make the funds available for withdrawal according to first a temporary availability schedule and eventually a permanent schedule. The permanent schedule goes into effect on September 1, 1990 or such earlier date as the Board may require.

Under the *permanent* schedule, with respect to local checks, not more than one business day can intervene between the business day of deposit and the day on which the funds are available for withdrawal.[293] Under the permanent schedule, if the check deposited is a nonlocal check, not more than four business days may intervene between the business day of deposit and the day on which the institution makes the funds available for withdrawal.[294]

Before the permanent schedule goes into effect, there is a temporary schedule of availability. The temporary schedule becomes effective after August 31, 1988.[295] Under the temporary schedule for local checks, no more than two business days may intervene between the business day of deposit and the day the institution makes the funds

[290] Regulation CC § 229.10(c)(2) (1988) (to be codified at 12 CFR § 229.10(c)).

[291] CEBA § 603(b)(1) (to be codified at 12 USC § 4002(b)(1)).

[292] CEBA § 602(9) (to be codified at 12 USC § 4001(9)). The Federal Reserve Board by regulation may define a larger area as a check processing region. Id.

[293] CEBA § 603(b)(1) (to be codified at 12 USC § 4002(b)(1)).

[294] CEBA § 603(b)(2) (to be codified at 12 USC § 4002(b)(2)).

[295] CEBA § 603(c)(3) (to be codified at 12 USC § 4002(c)(3)).

available for withdrawal.[296] Under the temporary schedule for nonlocal checks, up to six business days may intervene between the day of deposit and the day on which the institution makes the funds available.[297] To illustrate the operation of these rules, if a customer deposits a nonlocal check on Friday, the depository institution must make the first $100 of the deposit available on a next-business-day basis, but as to the remainder of the deposit, the bank may then wait until six business days have elapsed (Monday, Tuesday, Wednesday, Thursday, Friday, and Monday) before permitting the customer to withdraw the funds—on the second Tuesday after the day of deposit.

The rules on when funds are "available for withdrawal" are modified when withdrawal is in cash. When the deposit consists of local checks or nonlocal checks, the general rule is that funds shall be available for "cash withdrawal" no later than on the business day after the funds become available for withdrawal under the *permanent* schedule of availability for such local checks and nonlocal checks.[298] However, a portion of the funds must be available for withdrawal in cash by 5 P.M. of the business day on which the funds are generally available under the permanent schedule for local checks and nonlocal checks. The institution must permit the customer to withdraw in cash at least $400 of funds deposited by this 5 P.M. deadline.[299] The $400 cash withdrawal amount is in addition to the $100 that is to be available on the next business day after the business day of deposit under the rules relating to government checks and other items for which next-day availability should be provided, but the $400 is the total amount the institution needs to make available for all of the local and nonlocal checks deposited on the same business day.

Under the *temporary* schedule, there are also provisions dealing with cash withdrawal. As in the case of the permanent schedule, the general rule is that the institution must make the funds available for cash withdrawal not later than the business day after the business day when the funds would otherwise be generally available under the rules on local checks.[300] There also is a $400 cash withdrawal allowance that the institution must make available to the customer by 5 P.M. on the business day after the funds become available for local checks under

[296] CEBA § 603(c)(1)(A) (to be codified at 12 USC § 4002(c)(1)(A)).
[297] CEBA § 603(c)(2) (to be codified at 12 USC § 4002(c)(2)).
[298] CEBA § 603(b)(3)(A) (to be codified at 12 USC § 4002(b)(3)(A)).
[299] CEBA § 603(b)(3)(B) (to be codified at 12 USC § 4002(b)(3)(B)).
[300] CEBA § 603(c)(1)(B) (to be codified at 12 USC § 4002(c)(1)(B)).

the temporary schedule.[301] However, under the temporary rules, the ability of a customer to make cash withdrawals against nonlocal checks is different. When a customer deposits nonlocal checks, there is no provision in the act mandating when the institution must make the funds available for cash withdrawal. The only applicable provision speaks of availability for withdrawal generally,[302] and this is the rule that allows six intervening business days.

There are no special rules that adjust the time when funds must be available for cash withdrawal in the case of deposits that qualify as deposits of government checks, cashier's checks, or similar next-day availability items. In these cases, the customer is entitled to withdraw funds by any means, cash or other payment instrument, because EFAA specifies the institution must make funds "available for withdrawal," without further qualification. This reading of the statute is consistent with the reading of those special sections on cash withdrawals that speak of "time period adjustments" on the categories of checks to which those provisions apply.[303]

The cash withdrawal rules for nonlocal checks, discussed in this section, apply to certain actions by the bank that are not cash withdrawals but that involve a similar bank commitment to pay. According to the Board's commentary, "the cash withdrawal rule also includes withdrawals by electronic payment, issuance of a cashier's or teller's check, certification of a check, or other irrevocable commitment to pay, such as authorization of an on-line point of sale debit. The rule would also apply to checks presented over-the-counter for payment on the day of presentment by the depositor or other person."[304]

d. ATM deposits. The legislation distinguishes between a proprietary ATM and a nonproprietary ATM. A proprietary ATM is a machine that is located at or adjacent to a branch of the receiving depository institution, is located in close proximity to the branch of the receiving

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[301] CEBA § 603(c)(1)(B)(ii) (to be codified at 12 USC § 4002(c)(1)(B)(ii)). When the local check is drawn on a bank that participates in the same clearinghouse as the depository bank, and in certain other similar cases, under the temporary schedule, the funds must be available for cash withdrawal on the day when the funds must be available under the general rule, without the one day extension. Regulation CC § 229.11(b)(2) (1988) (to be codified at 12 CFR § 229.11(b)(2)). In the case of withdrawals by automated teller machine, the institution does not have to permit withdrawals that exceed the maximum amount otherwise allowable for withdrawal from an ATM. CEBA § 603(c)(1)(B)(ii).

[302] CEBA § 603(c)(2) (to be codified at 12 USC ¶ 4002(c)(2)).

[303] CEBA §§ 603(b)(3), 603(c)(1)(B) (to be codified at 12 USC §§ 4002(b)(3), 4002(c)(1)(B)).

[304] Regulation CC § 229.11(b) commentary (1988) (to be codified at 12 CFR § 229.11(b) appendix).

depository institution, or is owned by the receiving depository institution and operated by or exclusively for it.[305] A nonproprietary ATM is simply an automated teller machine other than a proprietary ATM.[306] As with checks, there is both a temporary schedule and a permanent schedule for which the depository institution must make funds available for withdrawal.[307] Under the temporary schedule, all categories of deposits are treated similarly in the case of nonproprietary ATMs. This schedule provides that not more than six business days shall intervene between the business day of deposit and the day when the depository institution must make the funds available for withdrawal.[308] The temporary schedule goes into effect after August 31, 1988, and it expires before the permanent schedule goes into effect on September 1, 1990 or such earlier date as the Board directs.

Under the permanent schedule, the funds availability schedule for deposits at nonproprietary ATMs depends upon the category of deposit. When nonlocal checks are deposited, not more than four business days may intervene between the day of deposit and the day the institution makes the funds available for withdrawal.[309] When the deposit is in cash, government checks or related instruments, or local checks, the general rule for nonproprietary ATMs is that no more than one business day may intervene between the business day of deposit and the business day on which funds are available for withdrawal.[310] In order for the check to be classed as a "local" check, the local originating depository institution on which the check is drawn must be located in the same check processing region as the ATM where the customer makes the deposit.[311] The rules on the availability of funds deposited at *proprietary* ATMs generally are the same as those in the temporary and permanent schedules for other deposits.[312]

The Federal Reserve Board has general authority to reduce the time period as provided in the permanent and temporary schedules for funds availability to as short a time as possible based upon "the period of time achievable under the improved check clearing system for a receiving depository institution to reasonably expect to learn of

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[305] CEBA § 601(16) (to be codified at 12 USC § 4001(16)).

[306] CEBA § 601(18) (to be codified at 12 USC ¶ 4001(18)). An on-premises ATM does not have to be owned or operated by the bank under this definition. Id.

[307] CEBA § 603(e) (to be codified at 12 USC 4002(e)).

[308] CEBA § 603(e)(1) (to be codified at 12 USC § 4002(e)(1)).

[309] CEBA § 603(e)(2)(B) (to be codified at 12 USC § 4002(e)(2)(B)).

[310] CEBA § 603(e)(2)(A) (to be codified at 12 USC § 4002(e)(2)(A)).

[311] CEBA § 603(e)(2)(C) (to be codified at 12 USC § 4002(e)(2)(C)).

[312] CEBA § 603(e)(3) (to be codified at 12 USC § 4002(e)(3)).

the nonpayment of most items for each category of checks."[313] Under this authority, the Board can shorten the time period in either the temporary or the permanent schedule if the adoption of improvements, such as electronic clearing of payments, gives depository institutions faster notice when checks are being returned for nonpayment.

EFAA allows one additional business day for deposits in depository institutions located in Alaska, Hawaii, Puerto Rico and the Virgin Islands, where the check is drawn on a depository institution not located in the same state, commonwealth, or territory.[314]

For clarification, EFAA expressly states that it is not to be construed as requiring the physical return of checks to a depository institution or that notice of nonpayment be given within the times set forth for the funds availability.[315]

2. *The Safeguard Exceptions to the Availability Schedules.* The rules on funds availability are subject to five categories of "safeguard exceptions."[316] The first category deals with new accounts. During the first thirty days of the opening of a new account, special rules apply. There is a requirement of next-business-day availability for cash deposits, wire transfers received, cashier's and similar checks, and government checks.[317] There are no availability schedules that apply to other types of deposit items. The permanent and temporary schedules for local and nonlocal checks and ATMs specifically do not apply.[318] Even in the case of cashier's checks and government checks, the rules on next-business-day availability apply only with respect to the first $5,000 of the aggregate amount deposited.[319] As to the excess over $5,000, EFAA allows not more than eight business days to intervene between the business day of deposit and the business day on which the funds are available.

The second category of exceptions deals with large deposits in one day, redeposited checks that previously had been returned unpaid, and accounts that have had repeated overdrafts. In these cases, the Federal Reserve Board may adopt regulations to provide for exceptions to the normal schedules of availability.[320] A large deposit is one that is more than $5,000 in any one day.

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[313] CEBA § 603(d)(1) (to be codified at 12 USC § 4002(d)(1)).

[314] CEBA § 603(d)(2) (to be codified at 12 USC § 4002(d)(2)).

[315] CEBA § 603(f) (to be codified at 12 USC § 4002(f)).

[316] CEBA § 604 (to be codified at 12 USC § 4003).

[317] CEBA § 604(a)(1) (to be codified at 12 USC § 4003(a)(1)). Regulation CC § 229.13(a) (1988) defines a new account.

[318] CEBA § 604(a)(2) (to be codified at 12 USC § 4003(a)(2)).

[319] CEBA § 604(a)(3) (to be codified at 12 USC § 4003(a)(3)).

[320] CEBA § 604(b) (to be codified at 12 USC § 4003(b)). The Board has done this. See Regulation CC § 229.13 (1988) (to be codified at 12 CFR § 229.13).

The third category is a "reasonable cause exception."[321] The availability rules do not apply when the receiving depository institution has "reasonable cause to believe that the check is uncollectible from the originating depository institution."[322] Reasonable cause "requires the existence of facts which would cause a well grounded belief in the mind of a reasonable person."[323] When a depository institution invokes the reasonable cause exception, it must give notice of the reasons it believes such cause exists. The institution's determination that reasonable cause exists must be on an individual basis because it cannot be based on "any class of checks or persons."[324] The depository institution may not collect fees for the customer's overdraft on the account with respect to such deposits unless the institution conforms with the written notice requirement in EFAA.

The fourth category of exceptions deals with emergency conditions. The availability rules in the permanent and temporary schedules and those pertaining to ATMs do not apply when there is an interruption of communication facilities, suspension of payments by another depository institution, war, or "any emergency condition beyond the control of the receiving depository institution," but the receiving depository institution in all cases must exercise diligence under the circumstances in responding to the emergency.[325]

The fifth category of exceptions are exceptions that the Federal Reserve Board may adopt if it determines that institutions are experiencing "an unacceptable level of losses due to check related fraud."[326] On making such a finding, the Board has authority to suspend the provisions of EFAA with respect to the class of checks concerned. If the Board exercises such authority, it must report to Congress in detail and the effective period of its order is limited.[327]

3. *Notice and Disclosure Rules.* When a depository institution uses an exception other than the new account exception, it must give notice of the day the funds will be available for withdrawal.[328] The notice also must state the

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[321] CEBA § 604(c) (to be codified at 12 USC § 4003(c)).

[322] CEBA § 604(c)(1) (to be codified at 12 USC § 4003(c)(1)).

[323] Id.

[324] CEBA § 604(c)(2) (to be codified at 12 USC § 4003(c)(2)). The reasonable cause exception provoked expressions of concern from bankers about potential liability in stating reasons for concern why a check might not be paid. The Board commentary states the Bank may say it is applying the exception based on "confidential information" in an appropriate case. Regulation CC § 229.13(e) commentary (1988) (to be codified at 12 CFR § 229.13(e) appendix).

[325] CEBA § 604(d) (to be codified at 12 USC § 4003(d)).

[326] CEBA § 604(e)(1) (to be codified at 12 USC § 4003(e)(1)).

[327] CEBA §§ 604(e)(2)-604(e)(3) (to be codified at 12 USC §§ 4003(e)(2)-4003(e)(3)).

[328] CEBA § 604(f)(1) (to be codified at 12 USC § 4003(f)(1)).

reason the exception was invoked.[329] Moreover, the federal law specifies a time when the notice must be given.[330] In the case of deposits made in person, the institution must "immediately" provide notice in writing; in the case of other deposits, the institution must mail the notice not later than the close of the next business day. Federal Reserve Board regulations govern the time for notice when the emergency conditions exception or the prevention of fraud exception applies. When an institution learns of facts that justify the use of an exception, although the knowledge is gained after the deposit has been made, the institution may give notice as soon as practicable as long as it is not later than the first business day following the day the facts became known.[331] In addition, EFAA requires institutions to give advance written notice when a customer opens a new account.[332] The institution's preprinted deposit slips must contain a summary notice that deposited items may not be available for immediate withdrawal.[333]

EFAA requires a mailing to customers about the institution's funds availability policy in the first regular mailing to customers after the effective date of the act.[334] When the policy changes, subsequent written notice must be sent. The institution also must post notices at manned teller stations where deposits are accepted and must post a general notice at ATM locations.[335] In certain cases where the institution defers accrual of interest on funds deposited, the institution must include notice of its policy on accruing interest in the disclosures.[336] The Board has published model disclosure forms and clauses that depository institutions may adopt.[337]

[iii] Accrual of interest on deposits. The law requires depository institutions to begin accruing interest on funds deposited in an interest bearing account at the institution no later than the business day on which the institution receives provisional credit for the funds.[338] The Board's regulations specify how banks should comply with this accrual rule. They also clarify that the interest accrued rule applies only to an "account" that is covered by Regulation CC. This has the

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[329] CEBA § 604(f)(1)(A)(ii) (to be codified at 12 USC § 4003(f)(1)(A)(ii)).

[330] CEBA § 604(f)(2) (to be codified at 12 USC § 4003(f)(2)).

[331] CEBA § 604(f)(3) (to be codified at 12 USC § 4003(f)(3)).

[332] CEBA § 605(a) (to be codified at 12 USC § 4004(a)).

[333] CEBA § 605(b) (to be codified at 12 USC § 4004(b)].

[334] CEBA § 605(c)(1) (to be codified at 12 USC § 4004(c)(1)).

[335] CEBA § 605(d) (to be codified at 12 USC § 4004(d)). A notice posted at the manned teller stations must be specific in describing the time periods applicable to the availability of funds deposited. The notice posted at ATM locations may be general in nature. Id.

[336] CEBA § 605(e) (to be codified at 12 USC § 4004(e)).

[337] CEBA § 605(f) (to be codified at 12 USC § 4004(f)). Regulation CC Appendix C (1988) (to be codified at 12 CFR part 229).

[338] CEBA § 606(a) (to be codified at 12 USC § 4005(a)).

result of excluding interest bearing accounts that are not transaction accounts.[339] There are two exceptions to the general interest accrual rule. The first exception is for credit unions that follow a general policy on accrual of interest or dividends with respect to all funds that are deposited into accounts at such institutions.[340] The second exception is for checks that are returned to the depository institution unpaid.[341]

[iv] Calculation of business days. The computation of business days is important in determining the application of the funds availability schedules. A business day is "any day other than a Saturday, Sunday, or legal holiday."[342] When a deposit is made on a nonbusiness day or after the close of business on a business day, it is treated as a deposit being made on the next business day.[343] Unless EFAA provides otherwise, when a requirement provides that funds be available for withdrawal on a business day, the funds must be available for withdrawal at the start of the day.[344] The Board's Regulation CC defines when a day starts for these purposes. It also contains rules to determine when a deposit is received.[345] The regulation distinguishes a "business day," which is defined to be "a calendar day other than a Saturday or a Sunday . . . " or certain specified holidays, from a "banking day," which is a business day when "an office of the bank is open to the public for carrying on substantially all of its banking functions."[346]

[v] Administrative enforcement and private remedies. EFAA provides for enforcement under the general administrative enforcement authority of the appropriate federal banking agency.[347] In addition to the general authority given to the Federal Reserve Board, EFAA authorizes the Board to order depository institutions to stop dealing with other depository institutions or persons who fail to comply with EFAA or the Board's regulations.[348] This gives the Board authority to deny access to the payment and collection system to institutions who fail to comply.

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[339] Regulation CC § 229.14 commentary (1988) (to be codified at 12 CFR § 229.14 appendix).

[340] CEBA § 606(b) (to be codified at 12 USC § 4005(b)). This exception was adopted because credit unions have followed the practice of allowing only partial dividends on funds not on deposit for an entire dividend period. H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess. 182, reprinted in 1987 US Code Cong. & Admin. News 489, 651.

[341] CEBA § 606(c) (to be codified at 12 USC § 4005(c)).

[342] CEBA § 602(3) (to be codified at 12 USC § 4001(3)).

[343] CEBA § 607(a) (to be codified at 12 USC § 4006(a)).

[344] CEBA § 607(b) (to be codified at 12 USC § 4006(b)).

[345] Regulation CC § 229.19 (1988) (to be codified at 12 CFR § 229.19).

[346] Regulation CC §§ 229.2(b), 229.2(g) (1988) (to be codified at 12 CFR §§ 229.2(b), 229.2(g)).

[347] CEBA § 610(a) (to be codified at 12 USC § 4009(a)).

[348] CEBA § 610(c) (to be codified at 12 USC § 4009(c)).

EFAA also creates a civil remedy for persons who are injured by the failure of depository institutions to comply with the requirements of EFAA or the Board's regulations under EFAA.[349] The depository institution is liable to persons who are injured by the institution's noncompliance to the extent of any actual damage sustained and, in a nonclass action, an additional amount over actual damages of not less than $100 nor more than $1,000 as the court may allow.[350] When an aggrieved party is successful in enforcing liability, the party may recover costs of entertaining the action including reasonable attorney's fees.[351] An institution has a defense when it makes an innocent mistake. It may not be held liable when it demonstrates the violation was not intentional and resulted from a bona fide error and it had maintained procedures reasonably adapted to avoid making such errors.[352]

[vi] Federal Reserve Board Regulation CC. The Federal Reserve Board has implemented EFAA by promulgating Regulation CC, which became effective September 1, 1988.[353] Subpart B of this regulation, which is discussed in this chapter, details what banks must do to meet the funds availability and disclosure duties imposed by EFAA. Subpart C of the regulation contains rules on the collection and return of checks, which are discussed in Chapter 21. Bankers must carefully review the requirements of Regulation CC because it will be the *controlling source of law on many aspects of a bank's collection, payment, and* return of checks. Because the relationship of the Board's regulation to the UCC produces an intricate web of federal and state law which is not yet fully developed, this is an area in which bankers should consult with legal counsel to review bank practices and procedures.

Future supplements to this book will discuss Regulation CC in greater detail. This section can only alert the banker to some of the significant features of the regulation.

Regulation CC preempts state law, including the UCC, but there are differences in the scope of the preemption between Subpart B of the regulation dealing with funds availability and disclosure and Subpart C of the regulation dealing with check collection and return.[354] The funds availability regulations preserve state rules in effect on or before September 1, 1989, that require funds to be

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[349] CEBA § 611(a) (to be codified at 12 USC § 4010(a)).

[350] CEBA § 611(a)(2)(A) (to be codified at 12 USC § 4010(a)(2)(A)). There is a maximum amount which may be recovered in the case of a class action. It can be no more than the lesser of $500,000 or one percent of the net worth of the depository institution. Id. at § 611(a)(2)(B).

[351] CEBA § 611(a)(3) (to be codified at 12 USC § 4010(a)(3)).

[352] CEBA § 611(c) (to be codified at 12 USC § 4010(c)). See liability rules at Regulation CC § 229.21 (1988) (to be codified at 12 CFR § 229.21).

[353] Regulation CC (1988) (to be codified at 12 CFR part 229).

[354] Regulation CC §§ 229.20, 229.41 (1988) (to be codified at 12 CFR §§ 229.20, 229.41).

available for withdrawal in a shorter time at state chartered banks and extend the scope of any such state rule so that it also applies to all federally insured banks in the state.[355] But when there is an inconsistency with state law, either because of longer state funds availability periods or because of the existence of state disclosure or notice duties, Regulation CC preempts the state law.[356] The Board commentary indicates that when a conflict in availability schedules exists, the state schedules may be preempted in their entirety, not just to the extent of the inconsistency.[357] When state law requires disclosure of funds availability policies, the Board indicates that a general policy of preemption will apply unless state law applies to deposits, such as certain savings and time deposits, that are not "accounts" covered by the regulation.[358] In contrast, the preemption provisions with respect to the check collection and return rules of Subpart C of the regulation are drawn more narrowly. In this instance, the regulation preempts only "to the extent of the inconsistency," thus preserving to whatever extent there is no inconsistency the applicability of the UCC and the other state laws to the collection and return process.[359]

Regulation CC contains model forms, clauses, and notices that may be used to meet the disclosure obligations of EFAA.[360] Since a bank is protected from civil liability when it engages in an act in good faith in conformity with a "rule, regulation, or interpretation" of the Board, the availability of the model clauses offers a means for minimizing potential problems.[361]

The terminology of Regulation CC is important because it defines the scope of the regulation. The terminology, which is similar to that used in the UCC and, in some instances, the terms used in EFAA itself, differs in several important respects. A "check" is defined more comprehensively than under the UCC.[362] It includes a traveler's check drawn on or payable through or at a bank, for example.[363] This makes the funds availability rules apply to such instruments. The definition of "account" generally limits the scope of the regulation to banks with transaction accounts.[364] Although the regulation uses the term "bank," this term includes depository institutions generally, and the definition is broader for

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[355] Id. § 229.20(a).

[356] Id. §§ 229.20(b), 229.20(c), & commentary.

[357] Id. § 229.20(c) commentary. The Board takes the view that superceding state law in its entirety "avoids the necessity of forming very complex hybrids of state and federal law that could not have been contemplated by the state or federal legislatures." Id.

[358] Id.

[359] Id. § 229.41 & commentary. The Subpart C preemption rules are discussed in Chapter 21.

[360] Id. Appendix C.

[361] Id. § 229.21(e).

[362] Regulation CC § 229.2(k) (1988) (to be codified at 12 CFR § 229.2(k)).

[363] Id.

[364] Id. § 229.2(a).

the purposes of Subpart C than for the funds availability and disclosure rules of Subpart B.[365] There also are specific exclusions from the various parts of the regulation.

Regulation CC elaborates in much greater detail than EFAA does the specific availability schedules that banks must meet and draws some important distinctions that are not present in EFAA. For example, on the schedule applicable to checks when next day funds availability must be afforded, the regulation extends the availability date by an additional business day in some situations when the deposit is not made to a deposit facility of the depository bank manned by an employee of the bank.[366] In these situations, the funds must be made available on the second business day after the banking day when the customer deposited the checks.[367] Further, some key definitions do not appear in EFAA. The regulation defines "wire transfer" and "electronic payment" and clarifies that a bank does not receive an electronic payment until the bank has received both "payment in actually and finally collected funds . . . and . . . [i]nformation on the account and amount to be credited."[368]

The regulation computes the funds availability schedules in a manner different from EFAA. Although EFAA describes the time limits in terms of the number of business days that must intervene between the day when the deposit is received and the time when the funds must be made available, Regulation CC calculates the time when the funds must be available in terms of a specified number of business days after the banking day of deposit. Thus, the regulation uses both the term "business day" and "banking day" to compute time periods within which banks must take action.[369]

The Federal Reserve Board has summarized the availability rules under Regulation CC in a useful manner in the following tables. They are set forth below to illustrate the operation of the various time periods discussed in the early sections of this chapter on EFAA.

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[365] Id. § 229.2(e).

[366] Id. § 229.10(c)(2).

[367] Id.

[368] Id. § 229.10(b)(2).

[369] Id. §§ 229.2(f), 229.2(g).

Temporary Funds Availability Schedules

Figure 1

Illustrates availability of different types of checks under the temporary schedules

1. The first $100 of a day's deposit must be made available for either cash withdrawal or check writing purposes at the start of the next business day § 229.10(c)(1)(vii).

2. For local checks *cleared through a local clearinghouse*, the remainder of the deposit must be made available for either cash withdrawal or check writing purposes by the third business day following the day of deposit § 229.11(b)(1).

3. For local checks *cleared outside a local clearinghouse*, the remainder of the deposit must be made available for check writing purposes by the third business day following the day of deposit § 229.11(b)(2).

4. For local checks *cleared outside a local clearinghouse*, $400 of the deposit must be made available for cash withdrawal no later than 5:00 p.m. on the day specified in the schedule. This amount is in addition to the $100 that must be made available on the business day following the day of deposit § 229.11(b)(2).

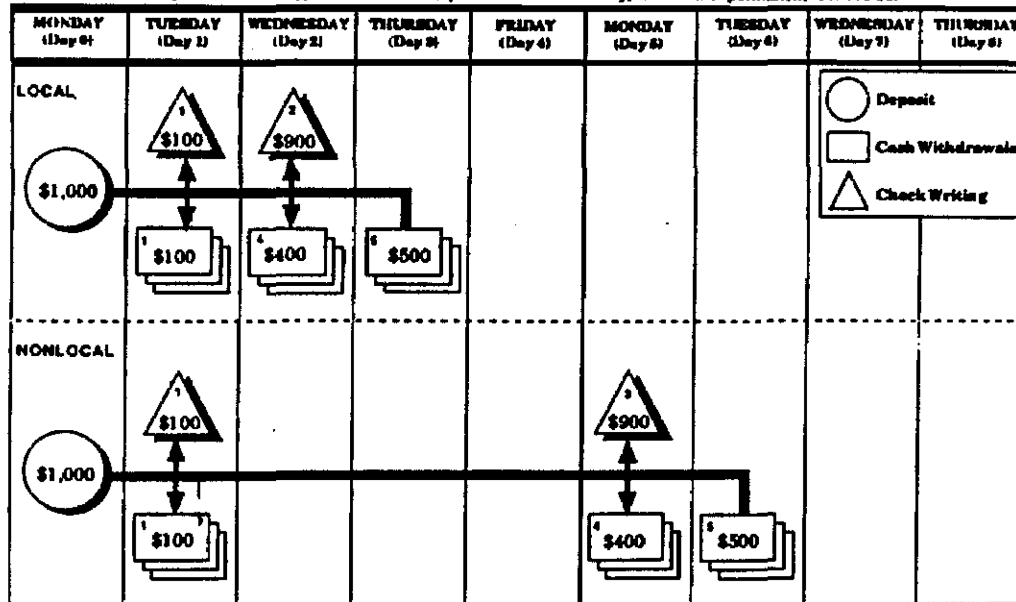
5. The remainder of the deposit must be available for cash withdrawal at the start of business on the following day § 229.11(b)(2).

6. For nonlocal checks, the remainder of the deposit must be made available for either cash withdrawal or check writing purposes by the seventh business day following the day of deposit § 229.11(c).

Source: Board of Governors of the Federal Reserve System, Supplementary Information Relating to Regulation CC, 53 Fed. Reg. 19,374–19,376 (1988).

Permanent Funds Availability Schedules — Figure 2

Illustrates availability of different types of checks deposited the same day, under the permanent schedules.



1. The first $100 of a day's deposit must be made available for either cash withdrawal or check writing purposes at the start of the next business day § 229.10(c)(1)(vii).

2. Local checks must be made available for check writing purposes by the second business day following deposit § 229.12(b).

3. Nonlocal checks must be made available for check writing purposes by the fifth business day following deposit § 229.12(c).

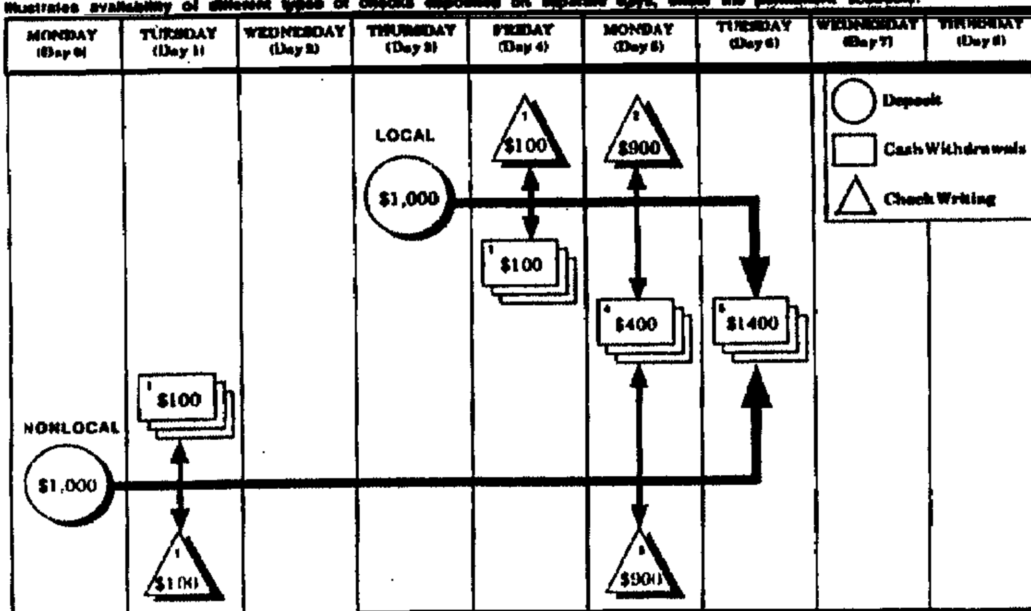
4. $400 of the deposit must be made available for cash withdrawal no later than 5:00 p.m. on the day specified in the schedule. This is in addition to the $100 that must be made available on the business day following deposit § 229.12(d).

5. The remainder of the deposit must be made available for cash withdrawal at the start of business the following day § 229.12(d).

Source: Board of Governors of the Federal Reserve System, Supplementary Information Relating to Regulation CC, 53 Fed. Reg. 19,374–19,376 (1988).

Permanent Funds Availability Schedules

Figure 3



1. The first $100 of a day's deposit must be made available for either cash withdrawal or check writing purposes at the start of the next business day § 229.10(c)(1)(vii).

2. Local checks must be made available for check writing purposes by the second business day following deposit § 229.12(b).

3. Nonlocal checks must be made available for check writing purposes by the fifth business day following deposit § 229.12(c).

4. $400 of the deposit must be made available for cash withdrawal no later than 5:00 p.m. on the day specified in the schedule. This applies to the aggregate amount of deposits that must be made available on a specified day, and is in addition to the $100 that must be made available on the business day following deposit § 229.12(d).

5. The remainder of the deposit must be made available for cash withdrawal at the start of business the following day § 229.12(d).

Source: Board of Governors of the Federal Reserve System, Supplementary Information Relating to Regulation CC, 53 Fed. Reg. 19,374–19,376 (1988).

There are separate provisions creating civil liability for failure to comply with the Regulation in Subparts B and C.[370] Under Subpart B of the regulation a bank is liable to any person its failure has harmed, for damages in an amount

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[370] Id. §§ 229.21, 229.38. Liability under Subpart C, id. § 229.38, is discussed in Chapter 21.

equal to the "actual damage sustained by that person as a result of the failure . . . " plus "such additional amount as the court may allow. . . . "[371] As to the "additional amount," there is both a minimum recovery specified and a limitation on the maximum amount that may be recovered in an action brought by an individual, and there are constraints on class action awards.[372] When there is a successful action enforcing liability for failure to comply with the regulation, the party may recover costs and a "reasonable attorney's fee . . . "[373] The liability provisions of Subpart B of the regulation do not apply to matters involving compliance with Subpart C, which has its own liability rules, and do not apply to cases involving wrongful dishonor.[374] Because of this exclusion, wrongful dishonor claims presumably still will be governed by the UCC rules. The Subpart B liability rules give a bank a defense in the case of unintentional violations that represent errors made in good faith.[375] They also impose a duty of record retention on a bank to retain evidence of compliance with the funds availability and disclosure requirements for two years.[376]

¶ 20.12 CUSTOMER'S DUTY TO EXAMINE STATEMENTS OF ACCOUNT

[1] Duty to Examine Statements and to Report Improper Payments

It is customary for banks to issue statements of account to its customers at monthly intervals or at such times as they are requested. Like any other statement of account, this statement is not binding upon the customer or upon the bank. Normally a bank can rectify mistakes and show the true state of account, but it is possible for the statement to become a representation that binds the bank or the depositor if either party, by failing to act upon the statement, causes loss to the other. Although no specific UCC provision produces this result, the UCC allows general principles of equity and estoppel to apply.[377]

Since the bank may suffer loss as the result of paying forged and raised checks, the customer owes the bank a reasonable duty to investigate statements and to notify it in case such improperly paid checks are contained in the statement. At common law, it was necessary for the bank to show loss resulting from absence of notification before it could hold the customer to the statement

[371] Id. § 229.21(a).

[372] Id. § 229.21(a). For an individual action, this liability is "not less than $100 nor greater than $1,000." Id.

[373] Id. § 229.21(a)(3).

[374] Id. § 229.21(f).

[375] Id. § 229.21(c).

[376] Id. § 229.21(g).

[377] UCC § 1-103.

as issued. In attempting to relieve themselves of this liability, banks often put notices on the monthly statements that they had to be checked or returned in ten days or they would be regarded as correct. Or, in some instances, they required the depositor to sign an agreement, upon receipt of the statement, providing that in the absence of notification by the depositor, the statement would be regarded by the bank as correct. The courts generally held that neither the notice nor the agreement was binding on the customer under such circumstances, unless the bank showed direct resulting loss.[378] Under the UCC, good faith contracts of this nature that do not try to exculpate the bank from its duty of reasonable care and that are willingly made by the customer are probably enforceable.[379]

The UCC provides that when a bank sends a statement, the customer must use reasonable care and promptness to discover and notify the bank of any alterations or forgeries of the customer's signature. If the customer fails to do this, the bank is relieved from liability as to the items the customer failed to report if the bank can show that the failure to report by the customer caused the bank loss. Further, if the forgeries or alterations continue to occur after the time when the customer should have given notice, the bank will not be liable for its good faith payment of forged or altered items by the same wrongdoer as long as the bank observes reasonable commercial standards in paying the items.

The theory underlying the UCC is that if the customer had given the bank timely notice, it would have been alerted and could have prevented paying the subsequent checks passed by the person who altered or forged the first check.[380] The duty of the customer to report forgeries is different when a forged indorsement is involved. Although the customer should know his or her own signature and be able to detect any forgery, this is not necessarily true with respect to

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[378] See Union Tool Co. v. Farmers & Merchants Nat'l Bank, 192 Cal. 40, 218 P 424 (1923); Denbigh v. First Nat'l Bank, 102 Wash. 546, 174 P 475 (1918); and see Annotation, "Examination of Accounts, Pass Books, or Canceled Checks by Bank Depositors," 103 ALR 1147 (1936), 67 ALR 1121 (1930); 28 ALR 1435 (1924), 15 ALR 159 (1921).

[379] UCC §§ 1-102(3), 1-205, 4-103. In New York Credit Men's Adjustment Bureau, Inc. v. Manufacturer's Hanover Trust Co., 41 AD2d 912, 343 NYS2d 538 (1973), the court gave effect to an agreement requiring the depositor to give written notice within thirty days of the mailing or delivery of any statement or account that the signature upon any returned item was forged. The court held the agreement did not absolve the bank for negligence, lack of good faith, or ordinary care, but instead provided a condition precedent to liability in the form of an abbreviated period of limitations.

[380] UCC § 4-407. See Federal Ins. Co. v. Groveland State Bank, 37 NY2d 252, 333 NE2d 334, 372 NYS2d 18 (1975), where the court applied the duty to examine bank statements to a bank that was the issuer of checks. A customer's report of forgery to a bank need not take a special form. See American Home Assurance Co. v. Scarsdale Nat'l Bank & Trust Co., 96 Misc. 2d 715, 409 NYS2d 608 (1978).

In Consolidated Pub. Water Supply Dist. No. C-1 v. Farmer's Bank, 686 SW2d 844 (Mo. Ct. App. 1985), the court held as a matter of law that notification to the bank by a party other than the bank's customer satisfied the requirement for notice to the bank of forgeries in UCC § 4-406.

forgeries of indorsements. The customer's failure to detect a forged indorsement will not preclude the customer from challenging the bank's payment of the item, as long as he or she acts reasonably in examining the statement and as long as there was not a prior forgery of the customer's signature by the same forger on any other check.[381] In any event, if the customer can establish that the bank has exercised a lack of ordinary care in paying the items that were forged or altered, the loss will remain on the bank.[382]

The UCC further establishes an absolute statute of limitations for reporting forgeries and altered items. Regardless of due care on the customer's or the bank's part, the loss will fall on the depositor if he does not report his unauthorized signature or any alteration on the face or back of the item within one year or if he fails to report unauthorized indorsements within three years.[383]

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[381] UCC § 4-407(1). UCC § 4-406, which imposes certain duties upon a customer to review his bank statement and notify the bank of "his unauthorized signature or any alteration on an item," does not impose any responsibilities on the customer to notify the bank that an indorsement of a joint payee is missing. A court held that UCC § 4-406 "imposes no responsibilities on the customer with regard to indorsements of any kind, except that it fixes a three-year statute of limitations on the customer's right to sue for an *unauthorized* endorsement." Travelers Ins. Co. v. Connecticut Bank & Trust Co., 40 Conn. Supp. 70, 72, 481 A2d 111, 113 (1984). (It should be noted that UCC § 4-406(2)(b) extends the customer's liability to any subsequent "unauthorized signature" by the "same wrongdoer" after the customer failed in his duty to report "his unauthorized signature" on an item.)

[382] UCC § 4-407(3). In Nu-Way Serv. Inc. v. Mercantile Trust Co. Nat'l Ass'n, 530 SW2d 743, 746–748 (Mo. App. 1975), the court found that the company had not exercised reasonable care in examining its bank statement and canceled checks for *forgeries*, where the bookkeeper merely reconciled the amounts of the canceled checks mathematically but never examined the checks for forgeries or alterations and did not compare the checks with the company checkbook. The court held that the bank had exercised reasonable care in paying the item since the forgeries were well done. In the same case, the bank was liable for paying *altered* checks, notwithstanding the customer's failure to exercise reasonable care in reporting the alterations, because "the alterations were maladroitly performed and the changes so egregious as to call for the reproval of the bank clerk" who handled the payment of the checks. Id at 748. See also G. & R. Corp. v. American Sec. & Trust Co., 523 F2d 1164 (DC Cir. 1975); Parsons Travel Inc. v. Hoag, 18 Wash. App. 588, 570 P2d 445 (1977).

[383] UCC § 4-406(4). See generally Annot., "Construction and Application of UCC § 4-406, Requiring Customer to Discover and Report Unauthorized Signature, in Cases Involving Bank's Payment of Check or Withdrawal on Less Than Required Number of Signatures," 7 ALR4th 1111 (1981).

In McMickle v. Girard Bank, 356 Pa. Super. 521, 515 A2d 16 (1986), the court held that a bank had made its statement available to its customer under UCC § 4-406(1) when it sent the statements and canceled checks to the person its customer had designated. Thus, the customer was bound by the one-year preclusion when she failed to report to the bank forgeries by the person who received the statements.

It has been held that this statutory deadline cannot be avoided by suing on common-law negligence, conversion, or other theories. Brighton, Inc. v. Colonial First Nat'l Bank, 176 NJ Super. 101, 422 A2d 433 (1980), aff'd, 86 NJ 259, 430 A2d 902 (1981).

Section 4-406(4) of the UCC, which provides one year for the customer to give notice to the bank, is not a statute of limitations that begins to run when the customer "knew or should have known" of the forgery. It is a statutory prerequisite of notice and establishes a deadline for giving notice to the bank.[384]

In *American Heritage Bank & Trust Co. v. Isaac*,[385] the court held that it was not proper for a bank to pay a draft drawn on the firm name of "Cash Cattle Company, Inc." when the account with the bank was in the name of "Cash Cattle Company" even though the individual signing the draft was a partner with authority to draw drafts against "Cash Cattle Company." The court viewed the bank's action in paying such drafts to be negligence that prevented the bank from asserting that its customer breached the duty to examine and report unauthorized signatures under UCC § 4-406. However, because the partnership did not prove that the partner had diverted these funds for personal use, the court held that there was no showing of any loss as the proximate result of the bank's negligence.

It has been held that the payment of a check by a bank on less than all of the required signatures for the account constitutes a payment on an "unauthorized signature." Although the bank may well lack ordinary care in paying such an instrument, if the customer waits more than a year to report to the bank that payment was made without all of the necessary signatures, the one-year limitation period for reporting unauthorized signatures will apply, and the bank's lack of care will not be relevant. The customer will be absolutely barred from claiming payment was improper.[386]

The duty of a customer to examine his or her bank account and report forgeries and unauthorized signatures to the bank extends not only to checks paid from the account but to other withdrawals as well, according to one authority. *In Boutros v. Riggs National Bank*,[387] the court held that the UCC imposed upon a person who maintained a savings account a duty of examination to detect unauthorized withdrawals. The court reasoned that the withdrawal slip constituted an "item" under the UCC.[388]

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[384] Jensen v. Essexbank, 396 Mass. 65, 483 NE2d 821 (1985).

[385] 636 P2d 1926 (Colo. App. 1981), aff'd, 675 P2d 742 (Colo. 1984).

[386] See Annot., "Construction and Application of UCC § 4-406, Requiring Customer to Discover and Report Unauthorized Signatures, in Cases Involving Bank's Payment of Check or Withdrawal on Less Than Required Number of Signatures," 7 ALR4th 1111 (1981); Annot., "Bank's Liability for Payment or Withdrawal on Less Than Required Number of Signatures," 7 ALR4th 655 (1981). See also cases cited note 396 infra.

[387] 655 F2d 1257 (DC Cir. 1981).

[388] Id. at 1260. See Coleman v. Brotherhood State Bank, 3 Kan. App. 2d 162, 592 P2d 103 (1979). The duties imposed upon a customer to examine his bank statement and report unauthorized signatures by UCC § 4-406 were applied to withdrawals from a savings account in Tally v. American Sec. Bank, 35 UCC Rep. Serv. (Callaghan) 215 (DDC 1982). The court treated the withdrawal slips as "items" under UCC § 4-406. Although the bank retained the withdrawal slips, they were available to the customer for

In *K&K Manufacturing, Inc. v. Union Bank*,[389] the court held that "[m]isplaced confidence in an employee will not excuse a depositor from the duty of notifying the bank of alterations on items paid from the depositor's account."[390] The depositor argued that it had exercised reasonable care and promptness in examining its monthly statements because the forged checks paid by the bank were forged by a trusted employee.[391] The court held that the employer's duty to examine its statement should be measured against a standard that charged the depositor "with the knowledge of all facts a reasonable and prudent examination of his bank statement would have disclosed if made by an honest employee."[392]

A bank cannot take advantage of the defense that its customer failed to use reasonable care and promptness in examining and reporting unauthorized signatures and authorizations if the bank itself has not acted in good faith and in accordance with reasonable commercial standards in paying the check.[393] In *K&K Manufacturing, Inc. v. Union Bank*,[394] the court held that a bank's procedure of manually checking signatures on checks with the depositor's signatures on file at the bank was reasonable in view of the fact that most large banks have completely abandoned making physical comparisons of the signatures. In *Thoreson v. Citizens State Bank*,[395] the court held that a bank's acceptance of checks that had neither the indorsements of the payees nor a stamp guaranteeing the

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inspection as Section 4-406 requires. The court did not have to decide whether the one-year statute of limitations should run from the time the customer received the statement of account from the bank or from the time the withdrawal slips would have been made available for inspection, pursuant to a reasonably prompt demand for inspection after the customer received the statement, because the court concluded under either alternative the time for reporting the unauthorized signatures to the bank had clearly elapsed. Id. at 220-221. In Shaw v. Union Bank & Trust Co., 640 P2d 953 (Okla. 1981), the court held a savings account withdrawal slip was an "item" under the UCC. Accordingly, the depositor could sue for wrongful dishonor of the withdrawal slip.

[389] 129 Ariz. 7, 628 P2d 44 (Ct. App. 1981).

[390] Id. at 48.

[391] Id. See Jackson v. First Nat'l Bank, 55 Tenn. App. 545, 403 SW2d 109 (1966), which excused a church from negligence in a case where checks were forged by a long-time faithful and trusted employee.

[392] *K&K*, 129 Ariz. at 11, 628 P2d at 48. See generally Pine Bluff Nat'l Bank v. Kesterson, 257 Ark. 813, 520 SW2d 253 (1975); Exchange Bank & Trust Co. v. Kidwell Constr. Co., 463 SW2d 465 (Tex. Civ. App. 1971), writ denied, 472 SW2d 117 (1971); Faber v. Edgewater Nat'l Bank, 101 NJ Super. 354, 244 A2d 339 (1968).

[393] UCC § 4-406(3).

[394] 129 Ariz. 7, 628 P2d 44 (Ct. App. 1981).

[395] 294 NW2d 397 (ND 1980).

absent indorsements could amount to failure to exercise ordinary care by the bank.

When a bank pays a check with only one signature that is drawn against a corporate account for which the bank has a corporate resolution on file requiring at least two signatures before payment, the bank should be regarded as having paid the check over an unauthorized signature according to the Texas state courts. Because payment of the check involved an unauthorized signature, the corporate customer has a duty under UCC § 4-406(d) to examine its bank statement to see if the proper signatures are present and report any unauthorized payment to the bank.[396]

The one-year preclusion in UCC § 4-406(4) applies only to forgeries or alterations on checks drawn on the customer's account, not to items deposited by the customer drawn on other accounts. Thus, it does not apply to the alteration of a restrictive indorsement on checks the customer deposited.[397]

[2] Duty to Report Forgeries and Alterations When Bank Retains Checks

As banks shift to electronic means of transferring funds and making payments, new systems for permitting the collection of checks without physically transferring the checks have emerged.[398] These check truncation systems provide for the retention of the checks at various points in the banking system. Under one approach, the checks are held by the payor bank. Under another, the bank of deposit retains the check. Although the customer receives a statement with information about his account and about the transactions involving it, the checks he has drawn are not returned to the customer with the statement.

Under the UCC, the customer's duty to discover and report unauthorized signatures or alterations normally arises because the bank sends the customer a "statement of account accompanied by items paid."[399] Under this provision, sending only a statement is not enough to trigger the customer's duty to report.

The UCC also provides that the customer has a duty to report unauthorized signatures or alterations when the bank either "holds the statement and items

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[396] First Nat'l Bank v. La Sara Grain Co., 646 SW2d 246 (Tex. Ct. App. 1982). On appeal, the bank was ultimately held liable because the evidence supported the trial court's finding that the bank had actual knowledge that two signatures were required and thus did not meet the good faith requirement in UCC § 4-406(d). 673 SW2d 558 (Tex. 1984). See also Provident Sav. Bank v. United Jersey Bank, 207 NJ Super. 303, 504 A2d 135 (1985) (reviewing the existing case law). But a contrary decision was reached in In re Florida Airlines, Inc., 57 Bankr. 113 (Bankr. MD Fla. 1986), without giving reasons for it.

[397] Patterson Produce Co. v. First Nat'l Bank, 475 So. 2d 1368 (Fla. Dist. Ct. App. 1985).

[398] These systems are described in N. Penney & D. Baker, The Law of Electronic Fund Transfer Systems ¶ 2.01 (1980 & Supp. 1987).

[399] UCC § 4-406(1) (emphasis added).

pursuant to the request or instruction of its customer" or reasonably "makes the statement and items available" to the customer.[400] These alternatives also are difficult to implement in a check-truncation system. A major problem exists when the checks are not to be held by the customer's bank but are retained elsewhere in the system by the depository banks. Since the customer's bank is not "holding" the items for the customer, it is questionable whether the items are reasonably "available." Probably the only solution is for the bank and the customer to enter into an agreement in which the customer accepts a duty to report forgeries and alterations, although the cancelled checks will not be returned with the statement.[401]

[3] Negligence and the Duty of Due Care Under the UCC

The UCC contains an elaborate system for allocating the risk of loss when a check contains forged signatures or has been altered. This system begins with the warranty provisions that permit banks or other parties that have taken an item as a transferee or that have paid an item to charge back their loss to a prior party when a breach of warranty can be shown. These basic allocation rules are modified (1) by certain special provisions that apply when a party's negligence contributes to an unauthorized signature or alteration[402] or a customer fails to comply with the customer's duty to examine bank statements of the customer's account[403] and (2) by rules imposing more general supervisory responsibility upon enterprises to supervise the activities of their employees who may be involved in check handling functions.[404] Following the UCC's scheme for allocation of liability may appear inconvenient at times because it seems to involve a circuity of action where a customer must first object to the customer's bank that it improperly paid an item and this bank, the payor bank, must in turn seek recovery for breach of warranty over against prior banks, and so forth.[405] In various situations, persons have attempted to short circuit the UCC allocation scheme by finding liability based upon rules not expressly set forth in the UCC.[406] One of the more celebrated cases in which these efforts were successful is *Sun 'N Sand, Inc. v. United California Bank.*[407] Here, the court found that the presentment warranties made by a collecting bank to a payor bank should also be

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[400] UCC § 4-406(1).

[401] For an excellent discussion of these problems, see N. Penny & D. Baker, supra note 398.

[402] UCC § 3-406.

[403] UCC § 4-407.

[404] UCC § 3-405.

[405] See Stone & Webster Engineering Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 184 NE2d 358 (1962).

[406] Id.

[407] 21 Cal. 3d 671, 582 P2d 920, 148 Cal. Rptr. 329, (1978).

treated as for the benefit of the drawer. The court also found a negligence liability of a collecting bank to the drawer of an item that the collecting bank had handled for collection. The extent to which it might be appropriate under the UCC to resort to common law principles establishing liability, such as negligence, is not clearly specified by the UCC. As previously noted, UCC § 1-103 permits resorts to general principles of law but it is not appropriate to rely upon such general principles when they are "displaced by the particular provisions" of the UCC.[408] Given the particularity and specificity of the UCC provisions on loss allocation among parties involved in handling a check for collection and payment, including treatment of the consequences when a customer is negligent and when a bank fails to observe reasonable commercial standards, there is a powerful argument that the UCC provisions should not be avoided by resort to negligence rules that are outside the UCC.

Although general common law principals ought not be used to circumvent the UCC's complex calculus for allocating loss, there are specific provisions in the UCC that impose liability upon a depositor for failing to exercise due care. These situations include the failure to exercise care with respect to signatures and alterations.[409] They also include circumstances in which the customer will be held responsible for having issued checks to persons who were not intended to have an interest in the instruments under the "fictitious payee provisions."[410]

¶ 20.13 LIABILITY OF BANK ON PROMISES AND REPRESENTATIONS WITH RESPECT TO ITS CUSTOMER'S ACCOUNT

A bank may become liable to those it deals with for representations it makes about the status of accounts held by its customers at the bank or for undertakings with respect to those accounts.[411] In *Harwood & Associates, Inc. v. Texas Bank & Trust*,[412] a bank was held liable for failing to carry out a promise to transfer funds from one of its customer's accounts to the plaintiff. In this case, the funds transferred were to pay for a computer ordered by the bank's customer and sold

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[408] UCC § 1-103.

[409] UCC § 3-406.

[410] UCC § 3-405. See generally Park State Bank v. Arena Auto Auction, Inc., 59 Ill. App. 2d 235, 207 NE2d 158 (1965). For other examples of situations where the carelessness of the depositor resulted in the loss falling upon him, see George Whalley Co. v. National City Bank, 55 Ohio App. 2d 205, 380 NE2d 742 (1977) (failure to supervise bookkeeping); Dominion Const., Inc. v. First Nat'l Bank, 271 Md. 154, 315 A2d 69 (1974) (carelessness in naming joint payees).

[411] See Herbert, "Truth or Consequences? A Bank's Liability for Erroneous Assurances Concerning a Customer's Account," 6 Ann. Rev. Banking L. 95 (1987).

[412] 654 F2d 1073 (5th Cir. 1981).

to a third party. The bank agreed to transfer the funds from its customer's account to the plaintiff in exchange for the plaintiff's taking action to obtain the release of a stop payment order on a check given by the third party purchaser to the bank's customer and deposited by the customer at the bank. The court held that the bank's undertaking was a valid oral contract that did not constitute a guarantee contract, which must be in writing to satisfy the statute of frauds. The court further held that the benefit for the bank from the plaintiff's arranging for the lifting of the stop payment order and the detriment to the plaintiff from his giving up the protection that the withholding of payment to the bank's customer would have represented constituted sufficient consideration to make the bank's promise to transfer the funds an enforceable contract.

It is also necessary for bank officers to be careful in making representations to their customers as to the extent to which deposits with the bank will be regarded as security for debts to the bank. In *Zimeri v. Citizens & Southern International Bank*,[413] the debtors claimed that the bank promised that their certificates of deposit would not be used as collateral for a particular loan, although they had signed an agreement that said that the certificates of deposit were security for that loan. The court held that the bank was not estopped from setting off the loan amount against the certificates of deposit because the debtors had not established all the elements of estoppel. In this case, although arguably there had been a representation by the bank and a justifiable reliance by the debtors on that representation, the debtors had not established that, as a result of that reliance on the bank's representation, they had changed their position to their detriment. The court came to this conclusion because the debtors had an independent motivation for keeping the certificates of deposit at the bank. In other circumstances, it may be difficult for a bank to show such an independent reason.

In *LeBovici v. Jamaica Savings Bank*,[414] a bank officer's statement to a customer that the customer could, by paying an interest penalty, make a with-

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[413] 664 F2d 952 (5th Cir. 1981).

[414] 81 AD2d 150, 439 NYS2d 688 (1981), aff'd, 56 NY2d 522, 434 NE2d 1332, 449 NYS2d 954 (1982).

The Second Circuit dismissed an action to recover from a bank for a negligent misrepresentation that the bank would make a loan. The court held that New York law required proof of a special relationship between the bank and the person to whom the statement was made that would create a "duty" to avoid negligent misrepresentations. Quoting from another New York case, the court said, "The imposition of a duty to speak carefully when the damages are limited to economic loss, requires proof of a special relationship between the parties sufficient to justify actionable reliance." Durante Bros. & Sons, Inc. v. Flushing Nat'l Bank, 755 F2d 239, 252 (2d Cir.), cert. denied, 473 US 906 (1985). In the court's view, "An ordinary creditor-debtor relationship between bank and customer does not create such a duty of care." Id. Moreover, when the misrepresentation is promissory rather than factual, "liability has been imposed only where there was shown a special relationship or a breach of contract." Id. The court summed up its view by saying

drawal from a savings account before the time stipulated in the account agreement was held not to estop the bank from denying the customer authority to withdraw. The bank officer's statement was one of present intention only that did not bind the bank's future conduct.

A bank's refusal to give its customer information about the customer's account was the basis for a punitive damage award in a case involving the bank's management of an investment account for the customer.[415]

In *Zion's First National Bank v. United Health Club, Inc.*,[416] the plaintiff charged the bank with providing credit information that defamed the plaintiff

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that the plaintiff had not found any New York case "ruling that liability may be imposed on a defendant for a negligent promissory misrepresentation that could not give rise to liability for either fraud or breach of contract, where there was no special relationship between plaintiff and defendant." Id. at 253.

A bank has a duty to use reasonable care in processing a home loan customer's application for a mortgage loan and also may be liable for recklessly making false statements about the customer's ability to qualify for the loan. The Equal Credit Opportunity Act does not preempt all aspects of the bank-customer credit relationship. High v. McLean Fin. Corp., 659 F. Supp. 1561 (DDC 1987) (following Jacques v. First Nat'l Bank, 307 Md. 527, 515 A2d 756 (1986)).

A bank has a duty of due care when its banking customers seek advice on investments. A bank's statement that a particular investment was sound, where the bank had information material to the risk in the investment, constituted a statement of fact, not of opinion. Under these circumstances, a fraud and negligent misrepresentation action could be brought against the bank. Hill v. Equitable Bank, 655 F. Supp. 631 (D. Del. 1987).

A bank's failure to give proper notice of dishonor made the bank liable for payment of a check drawn on insufficient funds. The bank was entitled to charge its customer's account for the overdraft caused by the check even though the bank had advised its customer that the check had been dishonored and returned NSF when the customer gave the bank a stop payment order. Brown v. Lee County Bank, 501 So. 2d 702 (Fla. Dist. Ct. App. 1987).

[415] Bank of N.Y. v. Bright, 494 NE2d 970 (Ind. Ct. App. 1986).

[416] 704 F2d 120 (3d Cir. 1983). A suit against a bank for fraud by customers who guaranteed a debt to the bank was not successful in Reeves v. Habersham Bank, 254 Ga. 615, 331 SE2d 589 (1985) (overruled on other grounds, Emmons v. Burkett, 256 Ga. 855, 353 SE2d 908 (1987). The customers claimed the bank misrepresented the financial condition of the debtor whose obligation they guaranteed. The court, however, held that the bank's statements were "merely statements of opinion or expectation, and thus were not representations regarding an existing fact." The court also found that the reliance of the customers on the bank's opinion was misplaced, as the customers were in as good a position as the bank to analyze the debtor's financial condition. The customers' "failure to investigate the matter showed a lack of due diligence."

In General Motors Acceptance Corp. v. Central Nat'l Bank, 773 F2d 771 (7th Cir. 1985), the court did permit a creditor to obtain damages from a bank because of fraudulent statements the bank made about the financial condition of the creditor's borrower. In this case, the borrower was an automobile dealership that General Motors Acceptance Corporation (GMAC) was financing. The bank misrepresented to GMAC the status of loans to the dealer, the condition of the dealer's accounts, the dealership's compliance with loan repayments, and the amount of loans to the dealership. The court also regarded

and with interfering with a future business relationship. The court held that the bank was not liable under either count. The information the bank provided was accurate as well as privileged, and the elements required for interference with a prospective business relationship were not established.

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as significant the fact that the bank had an adverse relationship with GMAC because the bank's loans to the dealership were unpaid and the bank's course of action enabled it to get the proceeds to reduce the dealership's debt to the bank. In Woods v. Barnett Bank, 765 F2d 1004 (11th Cir. 1985), a bank became liable as an aider and abettor to a fraudulent underwriting scheme because the bank's loan officer wrote a letter assuring others that the underwriter engaged in the fraudulent scheme was a person of trustworthy character. By writing the letter, the loan officer assumed a special duty toward those to whom he had written. Moreover, writing the letter under the circumstances of the case was severely reckless conduct.

In Sanchez-Corea v. Bank of Am., 38 Cal. 3d 892, 701 P2d 826, 215 Cal. Rptr. 679 (1985), the California Supreme Court reinstated a $2.1 million jury award against the bank for fraud and failure to extend credit. In another California case, it has been reported that damage awards totaling more than $26 million were recovered against the Bank of America on the theory that the bank had forced the plaintiffs out of business by refusing to extend additional credit. The plaintiffs contended that the bank had made loans to them and then maneuvered them into a position where they could not repay those loans. The trial court reduced the original $26.7 million in punitive damages to $6 million, and both the bank and the plaintiffs have appealed. Kruse v. Bank of Am., 45 Wash. Fin. Rep. (BNA) 773 (Oct. 18, 1985).

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Collection and Payment of Instruments

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¶ 21.01 RESPONSIBILITIES OF BANKS IN COLLECTING PAYMENT OF CHECKS AND OTHER NEGOTIABLE INSTRUMENTS

This chapter discusses the process by which banks collect payment on negotiable instruments for their customers and the rights and duties of those involved in the collection process. The basic law governing this process is Article

4 of the Uniform Commercial Code, but the UCC is not the only source of law. A vast number of collections occur through the Federal Reserve System. The Board of Governors of the Federal Reserve System has promulgated regulations that govern its collection procedures. The UCC provides that Federal Reserve regulations are binding upon all parties concerned, whether a specific agreement exists or not, and that they supercede the provisions of the UCC. Until Congress directed the Federal Reserve Board to regulate the collection process to expedite the availability of funds to bank customers, the UCC was generally consistent with the regulations of the Board. As discussed in Chapter 14, the role of the Board in regulating the collection process greatly expanded when Congress enacted the Expedited Funds Availability Act. To implement this act, the Board adopted a new Regulation CC, "Availability of Funds and Collection of Checks," which became effective September 1, 1988, and preempts those portions of the UCC that are inconsistent with Regulation CC.

Banks also collect payments through clearinghouse associations. These associations adopt their own rules, which also are binding upon the parties and which supercede the provisions of the UCC. The emergence of electronically transmitted payment instructions and transfers has led to a new body of law. These transactions are largely outside the coverage of the UCC. Instead, the rights of the parties are established by private agreement and, to some extent, by special federal and state legislation. The UCC recognizes the effectiveness of these agreements to the extent that they may vary from its terms. Because the UCC remains the basic body of law offering a comprehensive view of the collection and payment process, this chapter primarily focuses on the relevant provisions of the UCC. Electronic fund transfers are discussed in Chapter 18.

The impact of Regulation CC on the framework established by the UCC cannot yet be fully determined. Some of the key provisions of the regulation are noted in Chapter 20 and in this chapter. Further analysis will appear in future supplements to this book. Given the new complexities created by the interplay between Regulation CC and the UCC, it is important to review both authorities on any issue involving the collection or return of checks. This is an area where it is important to obtain the advice of legal counsel.

[1] Liability of Depositary Bank for Collecting Payment

When a depositor places various items in a bank, either as deposits or as items for collection, the UCC allows the parties to make any agreement they desire to cover their relationship, provided that the agreement does not attempt to relieve the bank of responsibility for its own negligence or exercise of bad faith.[1] Contracts of this nature must be clearly set out,[2] whereas Federal Reserve

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[1] UCC § 4-103(1) (1978) (subsequent citations to the Uniform Commercial Code (UCC) refer to the 1978 official text). See New York Credit Men's Adjustment Bureau, Inc. v. Manufacturer's Hanover Trust Co., 41 AD2d 912, 343 NYS2d 538 (1973) (agree-

regulations and operating circulars, clearinghouse rules, and the like are binding on the parties whether or not they assent to them.[3]

In the absence of agreement or regulations, the UCC establishes rules governing the collection process. Regardless of the indorsement's nature or form, and whether the paper is deposited or simply given to pay the customer's obligation to the bank, the bank becomes the depositor's or customer's agent for purposes of collection unless clear contrary intent exists. The paper is still owned by the depositor and the bank handles it at the customer's risk.[4] The depositary bank, and all subsequent banks handling the paper, have all the rights of holders in due course for any liens they may have on the paper, for any advances they have made, or for covering any loss they may suffer in the collection process.[5] These rules apply even though the bank may have purchased the item and is its owner.[6]

Since the banks are agents for collection, they have certain duties that include presenting or sending the items for payment, receiving payment, and remitting the proceeds. In case of dishonor, the bank has a duty to give notice of the dishonor, to return the item with care, and to arrange for any needed protest.[7] Federal Reserve rules also apply and establish duties when a bank acts

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ment enforced requiring the depositor to give notice of forgeries within thirty days of mailing the statement of account); State ex rel. Gabalac v. Firestone Bank, 46 Ohio App. 2d 124, 346 NE2d 326 (1975) (unilateral notice on bank's statement, requiring reporting of errors within ten days, not enforced); Valley Nat'l Bank v. Tang, 18 Ariz. App. 40, 499 P2d 991 (1972) (UCC provisions against disclaimers do not apply to night depositary arrangements because they are not part of the collection and deposit process); Hy-Grade Oil Co. v. New Jersey Bank, 138 NJ Super. 112, 350 A2d 279 (1975), cert. denied, 70 NJ 518, 361 A2d 532 (1976) (agreement disclaiming liability for negligence in a night depositary service not effective).

In bank of Wyandotte v. Woodrow, 394 F. Supp. 550 (WD Mo. 1975), a payor failed to follow a Federal Reserve operating letter requiring the wiring of advice of nonpayment when a debit item of $1,000 or more was involved. The court indicated in dicta that failure to observe the Federal Reserve procedure might subject the payor bank to liability for any loss resulting from its delay in giving notice of nonpayment. Federal Reserve regulations have been held binding upon Federal Reserve System nonmembers that use Federal Reserve clearing procedures. Community Bank v. Federal Reserve Bank, 500 F2d 282 (9th Cir. 1974), cert. denied, 419 US 108 (1974), amended 525 F2d 690 (9th Cir. 1975).

[2] UCC §§ 1-102(3), 1-201(1), 1-201(3).

[3] UCC § 4-103(2).

[4] UCC § 4-201(1). See Jones v. Commonwealth Bank & Trust Co., 71 Pa. D. & C. 2d 143 (1976) (holder status of depositary bank is a question of fact to be resolved on a case-by-case basis).

[5] UCC § 4-201(1) & comment 4. See UCC §§ 4-208–4-209.

[6] UCC § 4-201(1).

[7] UCC § 4-202. For Federal Reserve rules on collecting checks and giving notice of dishonor, see ¶¶ 21.03[8], 21.11[2][d].

in collecting checks and giving notice of dishonor. The UCC has adopted the so-called Massachusetts rule.[8] According to this rule, when a check is payable in a distant city, the depositary or collecting bank is required to forward the item for collection but is not liable for any act of a bank to which the item is sent, provided the depositary or collecting bank obeys the instructions it received when taking the item.[9] When losses occur during the collection process of an instrument deposited for that purpose, the owner has a claim only against the bank causing the loss. All banks in the process of collection are subagents of the owner and are directly responsible to the owner.[10] Therefore, although the depositary bank is not liable for any other bank's negligence or insolvency while handling the item, it is liable to the depositor for its own lack of care.[11]

[2] Bank's Duties in Choosing Other Collecting Banks

Each bank in the collection chain has a duty to act with ordinary care in presenting an item for payment or in sending a check to another bank to make presentment. This duty means the bank is responsible for giving proper instructions to the intermediary banks and agents it selects and must use care to choose properly qualified intermediaries to collect the item.[12]

At common law, when an instrument was drawn or made payable on a bank in a city that had two or more banks, the paper was required to be sent to one other than the drawee or payor. If the instrument was sent directly to the drawee or payor for collection, any loss resulting from failure of the proceeds to be returned fell to the bank sending the instruments, on the theory that it was improper to ask a bank to collect from itself.[13] The UCC allows the transmitting bank to send the item directly to the drawee or to use any other reasonably prompt method of collection.[14]

[3] Duties of Intermediary

A number of banks may be involved in the process of collecting paper. For example, a buyer from Champaign, Illinois, may give a check drawn on a

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[8] UCC § 4-202, comment 4.

[9] UCC §§ 4-202(3), 4-203.

[10] *UCC § 4-202(3) & comment 4.*

[11] UCC § 4-202(1).

[12] UCC § 4-202(1)(a) & comment 4.

[13] Minneapolis Sash & Door Co. v. Metropolitan Bank, 76 Minn. 136, 78 NW 980 (1899). See Turner, "Bank Collections—the Direct Routing Practice," 39 Yale LJ 468 (1930).

[14] UCC § 4-204. The UCC also permits, in optional provisions, the direct return of dishonored items to the depositary bank. UCC §§ 4-202(1)(b), 4-212(2). Federal legislation to speed up check collection also authorizes the Federal Reserve Board to establish rules for direct presentment and return. Regulation CC of the Board contains provisions to implement this. See ¶ 21.03[8].

Champaign bank to a merchant in Winnetka. The merchant will deposit the check in his Winnetka bank, the Winnetka bank may then send it through clearings to its Chicago correspondent bank, the Chicago correspondent will send it to a second Chicago bank that is a correspondent of the Champaign drawee bank, and the second Chicago bank will then send the paper to the Champaign bank. When all or some of the banks are members of a common clearinghouse, the number of banks needed to handle the instrument may be reduced. Under the UCC, each of the collecting banks, while it has the check, is the agent of the depositor for collection.[15] The Winnetka bank is called the depositary bank and, in this example, it also is a collecting bank. The two Chicago banks are intermediary banks or collecting banks and the Champaign bank is the payor bank.[16]

Although each of the intermediary banks is directly responsible to the original depositor, each bank is in no way bound to carry out the depositor's instructions to the depositary bank.[17] Neither are the intermediary banks bound by any of the indorsements appearing on the paper, including restrictive indorsements, made by persons other than the bank that directly transfers the item to the intermediary bank.[18] The only duty of an intermediary bank is to credit the account of the transmitting bank, to follow its special instructions if any,[19] and to see that the item is forwarded to the next bank in the chain of collection in a timely manner.[20] Under the UCC, a collecting bank acts timely when it takes action before its midnight deadline, which is midnight of the next business day after receipt of the item or notice.[21] Collecting banks may obtain a security interest in an item for the amount of the credit given[22] and, even if the item is restrictively indorsed, may be holders in due course of the item.[23]

A collecting bank is directly liable to the original depositor for any losses caused by its negligence or improper handling of the item;[24] but it is not liable for losses caused by delays beyond its control.[25] A collecting bank also may extend

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[15] UCC § 4-201(1).

[16] UCC § 4-105. See the description of these definitions in ¶ 19.01.

[17] UCC § 4-203.

[18] UCC §§ 3-206(2), 3-419(4). See UCC §§ 4-203, 4-205(2).

[19] UCC §§ 4-203, 4-205(2).

[20] UCC § 4-202(2).

[21] UCC § 4-104(1)(h). See discussion at ¶ 21.02[2].

[22] UCC § 4-208(1). The security interest arises when the credit given for the item has been withdrawn or applied or certain other action occurs. Id. See the discussion of this concept in ¶ 16.01[4]. See also Citizens Nat'l Bank v. Fort Lee Sav. & Loan Ass'n, 89 NJ Super. 43, 213 A2d 315 (1965).

[23] UCC § 4-209. See UCC § 3-206(4).

[24] UCC §§ 4-103(1), 4-201, 4-202(3). On the question of causation, see Marcoux v. Van Wyk, 572 F2d 651 (8th Cir. 1978), cert. dismissed 439 US 801 (1978).

[25] UCC § 4-108(2).

any of the UCC time limits for the collection of a specific item by one additional banking day when the extension is a good faith attempt to collect payment of the item.[26]

The rules of the Federal Reserve System may vary from the provisions of the UCC. For example, such a rule affected the liability of an intermediary Federal Reserve bank in *Childs v. Federal Reserve Bank*,[27] where a Reserve bank successfully avoided plaintiff's claim for negligence in handling a check in the amount of $200,000. A Federal Reserve regulation stated that a Reserve bank acts only as the sender's agent with respect to an item and that only a bank may qualify as a sender. Moreover, the regulation also stipulated that a Reserve bank shall not act as agent or sub-agent of the owner of the item. The court held that the regulation changed the rule that otherwise exists under the UCC as to liability of collecting banks to the owner of the item being processed for collection. In this situation, the bank did not attempt to disclaim liability for good faith and ordinary care; the bank simply did not owe the owner of the items any duty of care because it was not the agent of that party.

[4] Effect of Private Agreements on Banks' Duties

The effect of specific UCC provisions can be changed by agreement between parties. The UCC, as a general policy, permits great freedom to parties to enter into contracts that vary the rules of the UCC. This policy is incorporated into the general principles that apply to all of the articles in the UCC.[28] Article 4 specifically embraces this policy in the provisions on bank collection of checks.[29] The policy for recognizing this power to vary the effect of the rules stated in the UCC itself is explained in terms of the technical nature of banks' work in clearing checks and other items, the need for flexibility to meet changing conditions, and the need to respond to improvements in operating methods. A comment to the key section concludes that "it would be unwise to freeze present methods of operation by mandatory statutory rules. This section, therefore, permits within wide limits variation of provisions of the Article by agreement."[30]

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[26] UCC § 4-108(1). The extension is available only "unless otherwise instructed." Id. See ¶ 21.02. A collecting bank is not an insurer of collection nor is it responsible for the mistakes of its customer. Madsen v. Walker Bank & Trust Co., 28 Utah 2d 438, 503 P2d 1213 (1972). See also Der Ghazarian v. Banco da Lavoura de Minas Gerais, S.A. 16 UCC Rep. Serv. (Callaghan) 771 (NY App. Term 1975).

[27] 719 F2d 812 (5th Cir. 1983). A Federal Reserve bank is the agent or subagent of the owner of the item under the current regulations and is liable to the owner for the Reserve bank's lack of good faith or failure to exercise ordinary care. 12 CFR § 210.6 (1988).

[28] UCC § 1-102(3). There also is a general proviso that the absence of language in provisions of "'unless otherwise agreed' or words of similar import" is not to be taken as expressing an inference that the provision cannot be varied by agreement. Id. § 1-102(4).

[29] UCC § 4-103.

[30] UCC § 4-103, comment 1.

There are limits to the freedom to contract granted by the UCC. There may be no variation by agreement when the act "otherwise provides."[31] A bank cannot disclaim "responsibility for its own lack of good faith or failure to exercise ordinary care . . ." and cannot limit the measure of damages, although an agreement can determine standards to measure responsibility if the standards "are not manifestly unreasonable."[32]

Federal Reserve regulations and operating circulars, as well as clearinghouse rules and similar rules, are given the force of agreements.[33] These rules and regulations "have the effect of agreements . . . whether or not specifically assented to by all parties interested in items handled."[34] This provision was included to meet the problem posed by the circumstance that banks handle so many items each day that they cannot possibly obtain the agreement of everyone who has an interest in an item being handled for collection or return.[35]

The comments to the section make clear that agreement, as defined in the UCC, has a broad meaning and includes circumstances in which a person may become bound by estoppel or ratification. An agreement may be found from legends on deposit tickets, signature cards, and similar documents.[36] But, as the comment indicates, private agreements will not bind parties, such as the owner of a check handled for collection or other parties to the instrument, unless the parties actually have agreed.[37] The provision dealing with Federal Reserve regulations and clearinghouse rules is specifically drafted to have a wider effect and bind persons not parties to the agreement. However, it is not clear how far the binding force of these Federal Reserve regulations or clearinghouse rules extend.

The Federal Reserve Board's Regulation CC on the availability of funds and collection of checks also contains provisions that permit the variation of the terms of the regulation to some extent by agreement. The part of the regulation dealing with collection of checks may be varied by agreement subject to limitations similar to those in the UCC forbidding disclaimers of good faith and ordinary care.[38] The commentary suggests the regulation should be construed to be consistent with the official comments interpreting the parallel UCC provision.[39] This commentary specifically points out the inability to bind persons who

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[31] UCC § 1-102(3). Interestingly, the "except as otherwise provided" language of § 1-102(3) does not appear in § 4-103.

[32] UCC § 4-103(1).

[33] UCC § 4-103(2).

[34] Id.

[35] UCC § 4-103, comment 3.

[36] UCC § 4-103, comment 2.

[37] Id.

[38] Regulation CC § 229.37 (1988) (to be codified at 12 CFR § 229.37).

[39] Id. § 229.37, commentary.

have not been a party to the agreement and warns that, in light of this principle, agreements "that delay the return of a check beyond the times required by this subpart may result in liability . . . to entities not party to the agreement."[40] The regulation also specifically addresses agreements that provide for check truncation, and specifies that such a truncation agreement cannot extend return times or make other changes in the duties imposed by the regulation as to "parties interested in the check that are not party to the agreement."[41]

Both the UCC and Regulation CC contain safe harbor provisions that protect banks that follow the regulations of the Federal Reserve Board. The UCC makes action by a bank approved by the UCC or Federal Reserve regulations and operating circulars sufficient to constitute ordinary care. Action in accordance with clearinghouse rules "and the like," as long as there are no specific instruments to the contrary, is prima facie to be regarded as the exercise of ordinary care.[42] Regulation CC provides that good faith action in conformance with Board rules or interpretations will not be the basis for liability under the regulation even if the rule or interpretation is later determined to be invalid.[43]

As a result of these provisions of the UCC and Regulation CC, the rights and liabilities of parties involved in the collection of checks and other items cannot be determined by reference only to the rules contained in state legislation, such as the UCC, federal legislation, or agency regulation. It is necessary also to consult clearinghouse rules and determine if other private agreements exist that validly affect the rights and duties that might otherwise be imposed as a matter of law.

¶ 21.02 FAILURE TO ACT PROPERLY IN COLLECTING THE ITEM

[1] Duty of Holder to Present Instrument Promptly

Under the UCC, the holder of a negotiable instrument has a duty to present the instrument for payment in a timely fashion. An instrument that has a stated time for payment should be presented for payment on that date.[44] When an instrument is payable on demand, as is the case with checks, if indorsers are to be held liable in the case of subsequent dishonor of the instrument, presentment for payment must be made within a reasonable time after the indorsement was

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[40] Id.

[41] Id. § 229.36(c). See also the examples of matters that might be covered by agreement in the commentary to id. § 229.37.

[42] UCC § 4-103(3).

[43] Regulation CC § 229.38(h) (1988) (to be codified at 12 CFR § 229.38(h)).

[44] UCC § 3-503(1)(c).

made.[45] In the case of uncertified checks, the UCC sets up rebuttable presumptions that presentment within thirty days after the date the check is written is a reasonable period of time within which to hold the drawer liable, and that presentment within seven days after indorsement is sufficient time for holding the indorsers liable. To meet these deadlines, the customer need only begin the process of bank collection within those periods when a check is involved. In other words, presentment on the drawee does not actually have to occur in order to meet the deadlines.[46]

The drawer of checks or drafts payable at a bank, together with the maker of notes or the acceptor of drafts payable at a bank, are, if they assign their rights against the bank to the holder, discharged from liability to the extent of any loss caused by unreasonable delay in presentment. For example, if the drawee bank should fail during the interval and pay only fifty percent on the claims of creditors, the drawer of a check or draft, the maker of a note, or the acceptor of a draft payable at the bank would be discharged from all liability by assigning his or her rights to this dividend (as against the insolvent bank) to the holder of the instrument.[47] Indorsers of checks, drafts, and notes are entirely discharged. One major consequence, then, of unreasonable delay in presenting an item for payment is that if the item is subsequently dishonored, the holder will not have recourse against prior indorsers.[48]

Delay in presentment may be excused when there is no notice that it is due, it is unreasonable to make presentment within the time available, payment on the item has been stopped, or presentment is waived.[49] A holder in due course that does not know about the delay in presentment is not bound by the prior discharge in liability.[50]

[2] Duty of Collecting Bank to Act Promptly

When a collecting bank handles an item for collection, the bank generally will be under a duty to act more promptly than the previously mentioned time periods suggest. The collecting bank has a duty to use ordinary care and to act promptly in collecting the item or forwarding it for presentment. If the bank acts before its midnight deadline (midnight on the banking day following the day it received the item), the UCC treats the bank action as timely.[51] On the other

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[45] UCC § 3-503(1)(e).

[46] UCC § 3-503(2).

[47] UCC § 3-502(1)(b).

[48] UCC § 3-502(1)(a). The discharge of liability is only on the obligation as indorser. It would not affect the liability of an indorser for breach of warranty that the signatures on the items were not forged.

[49] UCC § 3-511.

[50] UCC § 3-602.

[51] UCC § 4-202(2). In Wilhelm Foods, Inc. v. Nat'l Bank, 388 F. Supp. 1376 (SDNY

hand, if the bank delays beyond its midnight deadline, the bank will have the burden of proving that its delay was reasonable. Failure to establish the reasonableness of the delay may, to the extent of any loss caused by its delay, make the bank liable to its customer for the amount of the item.[52] In addition to liability for delay, banks have been held strictly accountable for failing to make proper presentment.[53] Of course, when the delay does not cause any loss and the item is subsequently dishonored, the bank may have rights to charge the item back to its customer's account. If there has been no discharge of indorsers, as discussed earlier, the bank may have rights against the prior indorsers.

In cases in which the item presented for collection is dishonored, it is the duty of the collecting bank to give proper notice of dishonor when it learns of the dishonor. Failure to give such notice or to return the dishonored item by the bank's midnight deadline will result in a loss of the right to charge back the customer's account.[54] Federal Reserve regulations may require the bank to follow different deadlines.

[3] Form of Payment

At common law, it was the duty of the collecting bank to collect cash or legal tender. Any other medium was taken at the risk of the collector. For example, if the collecting bank accepted credit or a check or draft on another bank, the parties secondarily liable on the instrument were discharged[55] and if the draft or check failed of collection, the collecting bank had to make good on the loss.[56] The

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1974), the court held that a bank collecting drafts on a nonbank drawee had not failed to exercise ordinary care when it retained the drafts in an effort to get payment for periods of four to twenty-five days, given the previous history of the bank's dealings with the drawee.

[52] UCC §§ 4-202(2), 4-103(5). In order for the holder of a check to recover from a collecting bank for mishandling the presentment of the check for payment (in this case delay in presenting the check for payment), the holder must prove not only mishandling, but also that there would have been "a reasonable chance of collection" of the instrument if the collecting bank had acted properly. Determining whether a reasonable chance for collection existed is a question of fact. Alioto v. United States, 593 F. Supp. 1402 (ND Cal. 1984).

[53] UCC § 4-202(1)(a). For further discussion of a bank's right to charge dishonored items back to a customer's account, see ¶ 20.11.

[54] UCC ¶ 4-212. Compare UCC § 4-202(1)(b), which makes the bank liable for loss caused by the failure to act with ordinary care in giving notice of dishonor. The UCC leaves open the possibility that a longer time might be shown to be reasonable. UCC §§ 4-202(2), 4-212(1). See discussion of deadlines for notice at ¶ 21.11[2][d]. The Federal Reserve Board has imposed significant new duties with respect to the return of dishonored checks and other items in its Regulation CC, effective September 1, 1988 (to be codified at 12 CFR pt. 229). These are discussed at ¶¶ 20.11, 21.03[8], 21.11[2][d].

[55] See Annot., "Discharge of Drawer or Indorser of Check by Holder's Acceptance Therefor of Something Other Than Money," 52 ALR 994 (1928).

[56] Virtue v. Danbury State Bank, 205 Iowa 392, 218 NW 58 (1928); Hommerberg v.

existence of custom or clearinghouse rules allowing banks to accept drafts or credit on the books of another bank was not binding on depositors who had not agreed to such methods.[57] The UCC not only makes such clearinghouse rules or private agreements effective[58] but it also specifically authorizes collecting banks to accept the following:

1. A remitting bank's check drawn on some other bank;
2. A check drawn on a remitting bank that is a member of the same clearinghouse;
3. A charge, with the collecting bank, on an account of the remitting bank; or
4. Any bank instrument, when collection is being made from a person other than a bank.[59]

Having made the collection, the bank is under the duty to remit at once to the person who sent the item for collection. Even under the UCC rule, which makes the correspondent bank liable for losses it directly causes to the owner of the item, it is a proper procedure to remit the proceeds to a solvent correspondent who sent the item.[60]

[4] Delay From Misroutings

A case decided in a federal court in New York examined in detail the obligations of a collecting bank and the relationship of Federal Reserve guidelines to the liability of the collecting bank.[61] The problem involved a fraudulent $800,000 check deposited by Goldstein in an account with the Union Trust Bank of Maryland (Union Trust). The check bore the name of the First Pennsylvania Bank of Philadelphia (First Penn) as the payor bank. The magnetic ink character recognition (MICR) numbers, however, indicated that the check should be routed to the State Bank of Albany (Albany State) for payment. As a result of these inconsistencies on the check, it was routed through five banks over the course of nearly two weeks. Every bank handling the check met its

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State Bank, 170 Minn. 15, 212 NW 16 (1927); Annot., "Liability of Collecting Bank Which Accepts Something Other Than Cash," 61 ALR 739 (1929).

[57] Federal Reserve Bank v. Malloy, 264 US 160 (1924). See cases cited in Beutel's Brannan Negotiable Instruments Law 1302 (7th ed. 1948).

[58] UCC § 1-201(3).

[59] UCC § 4-211. See discussion at ¶ 21.03[5].

[60] Id.

[61] United States Fidelity & Guar. Co. v. Federal Reserve Bank of N.Y., 590 F. Supp. 486 (SDNY 1984). Subsequent proceedings in the case are discussed at ¶ 21.05[2]. United States Fidelity & Guar. Co. v. Federal Reserve Bank of N.Y., 620 F. Supp. 361 (SDNY 1985), aff'd, 786 F2d 77 (2d Cir. 1986).

midnight deadline, but ten days expired before the depositary bank, Union Trust, was notified that neither Albany State nor First Penn would honor the check. Unfortunately, the day before notification, Union Trust (having thought that the failure to get any notice was an indication the check had been paid), permitted Goldstein to withdraw $755,000 against the check.

The check was routed through the various banks in the following manner. It was deposited May 6, 1980 at Union Trust, which forwarded the check to Philadelphia National Bank (PNB). PNB thought Albany State was the payor bank and so routed the check to the New York Fed on May 7 in anticipation of the New York Fed's sending it to Albany State. The New York Fed forwarded the check but Albany State returned it through the New York Fed on May 9 stamped "sent in error." The New York Fed sent the check on May 12 to the Philadelphia Fed (it was not clear whether this was done so the Philadelphia Fed would return the check to the depositary bank or because it intended the check to be presented to First Penn for payment). The Philadelphia Fed forwarded the check to First Penn on May 14. On May 16, First Penn discovered there was no account on which the check could be drawn and notified PNB by telephone of the dishonor. PNB promptly notified Union Trust, but the notice came too late.

Union Trust claimed that the New York Fed breached its duty to use ordinary care in handling the check under UCC §§ 4-202(1)(a) and 4-202(1)(b), contending the New York Fed failed to exercise ordinary care, since it (1) did not notify Union Trust when Albany State returned the check; (2) sent the check to the Philadelphia Fed rather than to PNB; (3) did not notify Union Trust of the delay caused by routing it to Albany State; and (4) did not wire advice of the nonpayment by Albany State.

The court held that the New York Fed was obligated to use ordinary care with respect to the routing of the check and the selection of intermediary banks or other agents. "The phrase 'ordinary care' in Article 4 of the U.C.C. is not intended to refer to a standard of care unique to the banking world. Instead, it is 'used with its normal tort meaning.'"[62] The New York Fed justified its conduct by citing a Federal Reserve operating circular. The court decided to treat the matter as one of contract, rather than of tort, after reviewing the terms of the circular. Under the circular, the bank was required to give advice by wire of the nonpayment of a check of $2,500 or more under certain circumstances. The court interpreted the circular to mean that wire notification must be given if the bank was either the payor bank on the item or if the bank itself had received notice of nonpayment from the paying bank or any other bank. Therefore, since the New York Fed had not received prior notification and was not the payor bank, it did not have an obligation to wire notification to the depositary bank.

The provisions of the UCC in Section 4-202(1)(e), referring to delays in collecting a check, were intended to apply only to delays occasioned by mishaps

[62] The court relied upon UCC § 4-103, comment 4.

in the mails, the court said, and not to problems caused by misrouting. Relying on *North Park National Bank v. Bankers Trust Co.*,[63] the court concluded, "'delay in transit' connotes some impediment to physical transportation of the item in question."

Discussing the duty of the New York Fed to send notice of dishonor of the check under UCC § 4-202(1), the court rejected the argument that the New York Fed's only duties were to send notice of dishonor or return the unpaid check to the transferor bank and that sending it to the Philadelphia Fed satisfied that requirement because the Philadelphia Fed was the equivalent of the transferor. The court said, "A paying or collecting bank has little choice upon learning of dishonor than to send notice or return the check. A message of § 4-202(1)(b) is that not only is a collecting bank to notify downstream banks of dishonor but it is to exercise ordinary care in doing so. This includes the duty to use ordinary care both in routing the check and in selecting intermediary banks."[64]

The court explained the issue as follows:

> Regardless of New York Fed's intention in sending the check to Philadelphia Fed, if the Philadelphia Fed had then returned the check to PNB the loss would not have occurred for Union Trust would presumably have received notice of Albany State's dishonor on May 14, the day before it released funds to Goldstein. The forwarding to Philadelphia Fed thus was not in and of itself negligent, nor was it necessarily a cause of Union Trust's loss. The only risk which arguably made New York Fed's action negligent was the risk which materialized: That Philadelphia Fed would not recognize the fraudulent nature of the check and would forward it to First Penn for collection. Of course, there is no guarantee that sending the check to PNB would have avoided this risk. PNB could have sent the check to First Penn as easily as Philadelphia Fed, and the total handling time would have been no shorter.
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> Whether New York Fed's behavior constituted a lapse in ordinary care thus revolves around three factors: the foreseeability of Philadelphia Fed's failure to return the check, the foreseeability of loss resulting from that action, and the feasibility, given modern banking procedures, of New York Fed's detecting the fraud discerning the risk and taking curative action.[65]

Thus, the issue became whether having a check in its hand that had not been paid and that contained inconsistent directions regarding the payor bank created a circumstance in which "it was reasonably foreseeable that Philadelphia Fed would forward such a check to First Penn for collection rather than return it to PNB, that it would be dishonored by First Penn, and that Union Trust would release funds against the check before receiving timely notice of dishonor from

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[63] 572 F. Supp. 524 (SDNY 1983).

[64] *United States Fidelity & Guar. Co.*, 590 F. Supp. at 495.

[65] Id.

First Penn."[66] If so, then there was a failure of ordinary care in routing the check without taking precautions.

In discussing what constituted ordinary care, the court noted that the system of handling checks requires swift processing and it would be "wholly unfair to impose liability on New York Fed if detection of this sophisticated fraud was wholly inconsistent with participation in the system" used for check processing. "If efforts by all banks to detect this type of fraud would bring check processing to a screeching halt, New York Fed cannot be faulted for making those efforts."[67] Thus, the court indicated that there should be an inquiry as to whether the type of fraud was such that the New York Fed should have taken exceptional precautions to detect it. If no special precautions were warranted, the court asked, should the problem have been detected and the loss of Union Trust anticipated under standard banking procedures?

¶ 21.03 PAYMENT OF ITEMS BY PAYOR BANK

When items for collection are sent to the payor bank, the bank is under a dual capacity—to act as agent for the owner to collect from itself and, also, to pay the item, as it is the drawee or other payor of that item. Whether the instrument coming to the bank is indorsed for collection or comes indorsed in blank, the payor-bank's duties are the same.

[1] Accountability of Payor Bank for Payment of Items

The UCC contains an elaborate set of rules that set time limits for payor-banks to act on items and that specify when items are regarded as paid.[68] Under the UCC, the deadlines for a payor-bank to decide whether it will pay or dishonor and return an item may be established by agreement between the parties, and Federal Reserve regulations and clearinghouse rules have the effect of such agreements.[69] If no time is provided in the relevant Federal Reserve regulations, clearinghouse rule, or agreement, then the bank, under the UCC, has until the close of business the next banking day to decide whether to pay.[70] The Board of Governors of the Federal Reserve System has rules for clearings through the Federal Reserve banks.[71] They resemble those set out in the UCC but they impose different notification rules and impose other duties to expedite

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[66] Id. at 498.

[67] Id. at 499.

[68] UCC § 4-213(1)(d). See generally Annot., "What Constitutes Final Payment Under U.C.C. § 4-213," 23 ALR4th 203 (1983).

[69] UCC § 4-103(1), (2). See note 60, infra.

[70] UCC §§ 4-213, 4-301.

[71] See Regulation J, 12 CFR part 210 (1987); Regulation CC (to be codified at 12 CFR

the availability of collected funds to customers and the return of dishonored items. In the collection provision under the UCC, the bank has until midnight of the day it receives the item to settle for it[72] and until midnight of the next business day to pay, to return it, or to send notice of dishonor.[73] (A collecting bank may grant the payor bank a one-day extension without discharging parties secondarily liable.)[74] The time may be extended for a longer period in case of emergency.[75] As previously indicated, the time may be further extended by agreement or clearinghouse rules,[76] although the matter is not entirely free from doubt.[77] If the bank fails to act within this time, it is "accountable for the amount

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part 229). See discussion at ¶ 21.11[2][d] on the deadlines for notice. Regulation CC applies to bank clearings generally, not just those involving Federal Reserve banks.

[72] UCC §§ 4-103, 4-301.

[73] UCC §§ 4-104(h), 4-302. Regulation J makes paying banks accountable for cash items (which include checks) if the bank holds the item beyond the day of receipt without paying it. 12 CFR § 210.9(a)(1) (1988). The bank may recover such a payment, however, if the bank takes proper action before its midnight deadline or other time allowed under state law. 12 CFR § 210.12(a) (1988). These rules apply to check cleared through a Reserve bank. Regulation CC imposes requirements on all banks as discussed at ¶ 21.03[8], 21.11[2][d].

[74] UCC § 4-108(1).

[75] UCC § 4-108(2). The effect of a computer breakdown upon the bank's duty to make a prompt return of dishonored checks is not clear. In Port City State Bank v. American Nat'l Bank, 486 F2d 196 (10th Cir. 1973), the delay was excused. But see Sun River Cattle Co. v. Miner's Bank, 164 Mont. 237, 521 P2d 679 (1974), supp. op. 164 Mont. 479, 525 P2d 19 (1974).

[76] See West Side Bank v. Marine Nat'l Exch. Bank, 37 Wis. 2d 661, 155 NW2d 587 (1968). A drawee bank's failure to pay a check by its midnight deadline under UCC § 4-302 was excused because the owners of the check orally authorized the bank to hold the check to determine if funds to pay the check would be wired to the bank by the next day. Although the oral agreement relieved the bank of liability for holding the check beyond its midnight deadline, the agreement gave the owners of the check a claim against the bank for breach of contract when the funds arrived and the bank refused to pay. It was up to a jury to decide if the bank had agreed to hold the check for payment as contended by the owners. The court did not discuss the application of UCC § 3-409(1) which provides that a drawee is not liable on an instrument until he accepts it (which can only be accomplished by the bank's signing the instrument, UCC § 3-410), but Section 3-409(2) allows the creation of liability based upon a contract separate from the instrument. The court agreed that consideration for the oral agreement could be found in the release of the bank from liability for holding the checks beyond its midnight deadline. Corsica Livestock Sales, Inc. v. Sumitomo Bank, 726 F2d 374 (8th Cir. 1983).

A payor bank is strictly liable for the amount of a check that it holds beyond its midnight deadline without paying or returning. The only exception to this rule is when there is delay for reasons of circumstances beyond the control of the bank. UCC § 4-108(2). There is a division of opinion on whether principles of equitable restitution may apply as discussed at ¶ 21.03[3].

[77] UCC § 4-301(1) requires the bank to act before its midnight deadline without

of" the item.[78] If the instrument is properly presented for acceptance, failure to act within the time allowed for acceptance will make the bank accountable.[79] Under the UCC, refusal to pay or to return an instrument amounts to a conversion on the part of the bank. The bank is then liable for the amount of the instrument.[80]

In a Michigan case, plaintiff claimed that defendant payor bank became accountable because it failed to meet the UCC deadlines, for dishonoring a check that plaintiff sought to collect.[81] Plaintiff claimed that the payor bank failed to meet the UCC § 4-302 deadlines for settlement and return of dishonored checks and had made final payment under UCC § 4-213 by completing the process of posting. The court held that plaintiff had the burden of proving that the payor bank failed to meet the UCC deadlines. Plaintiff could not rely upon a Federal Reserve bank stamp on the checks that indicated the checks had been received by the Federal Reserve bank three days after the payor bank received them, because the Federal Reserve stamp would have been dated the third day even as to items received by the reserve bank after a 9:30 A.M. cutoff time on the second day. Likewise, the plaintiff failed to establish that the payor bank did not "settle" in a timely fashion, because the plaintiff introduced no evidence that the adjustment of balances through the Federal Reserve bank clearinghouse had not given provisional credit. Finally, although the payor placed a paid stamp on the back of the checks, the court concluded that the process of posting had not been completed, because the checks had not been debited to the drawer's accounts and evidence showed the stamp had been applied erroneously but not that the bank had made a decision to honor the checks.

In *Idaho Forest Industries, Inc. v. Minden Exchange Bank & Trust Co.*,[82] the court held that the defendant payor bank did not become accountable for checks returned late, because the collecting bank impliedly agreed that the checks should not be handled as demand items and could be retained by the payor bank for a reasonable time until funds became available for their payment. The case involved two checks—one over $19,000 and the other over $10,000. When the

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indicating any exceptions. See also Section 4-213(4)(b). UCC § 4-103 may be viewed as modifying these limits, however. See West Side Bank v. Marine Nat'l Exch. Bank, supra note 76.

[78] UCC § 4-302; Rock Island Auction Sales v. Empire Packing Co., 32 Ill. 2d 269, 204 NE2d 721 (1965).

[79] UCC § 4-302(b).

[80] UCC §§ 3-419, 4-302; Note, "Payor Bank Liable for Retaining Check Too Long Under Uniform Commercial Code," 82 Banking LJ 241 (1965). See generally Annot., "Bank's 'Reasonable Commercial Standards' Defense Under UCC § 3-419(3)," 49 ALR4th 888 (1986).

[81] Van Senus Auto Parts, Inc. v. Michigan Nat'l Bank, 116 Mich. App. 342, 323 NW2d 391 (1982).

[82] 212 Neb. 820, 326 NW2d 176 (1982).

checks were first presented to the defendant, the defendant dishonored the checks for insufficient funds and properly returned them to the depositary bank, which, in turn, notified its customer and charged the checks back to the plaintiff customer's account. The depositary bank then stamped the checks for collection only and sent them back to the defendant with a letter requesting the defendant to "please make a separate remittance or credit for this collection as indicated below" and stating "hold ten days if necessary." Although the letter was sent on January 12, the depositary bank did not hear from the defendant until late in April after having sent several tracers on the items. The court held that under these circumstances, an agreement existed that the checks were to be held for collection and were not to be treated as demand items by the payor bank. The court reasoned that UCC § 4-103 allowed the time deadlines for the collection of checks to be varied by agreement in this fashion.[83]

[2] Legal Consequences and Timing of Payment

Under the UCC, the liability of any party is discharged to the extent of its payment or other satisfaction of the obligation, even though such satisfaction is made with knowledge of another person's claim, so long as the payor neither pays in bad faith a thief or thief's assignee, nor pays in violation of the terms of a restrictive indorsement. The only remedy of a person who has claims on such paper is to supply satisfaction indemnity or obtain an injunction against payment.[84]

The UCC provides that payment of an instrument may be made by any person, if the holder consents, including a person whose name does not appear on the instrument, and upon the surrender of the instrument the person who pays acquires the rights of a transferee.[85] The comment explains that "[u]pon payment and surrender of the paper, the payor succeeds to the rights of the holder, subject to the limitation . . ." that someone who has been a prior party to any fraud cannot improve his position.[86] An Illinois case considered the application of this section and its relationship to UCC § 3-605, which provides that the holder of an instrument may discharge any person from liability by cancelling the instrument. Defendants executed a note payable to bank. When the note fell due, plaintiff, who was related by marriage to the defendants (the defendants

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[83] Id. at 823, 326 NW2d at 179.

[84] UCC §§ 3-601(3), 3-603. For a party to be discharged by payment of an instrument, payment must be made to the holder of the instrument. UCC § 3-603(1). When a party pays someone other than the holder of the instrument, the payor assumes the risk that it may pay the wrong person. Champion Int'l Corp. v. Union Nat'l Bank, 73 NC App. 147, 325 SE2d 656 (1985), rev. denied, 313 NC 597, 332 SE2d 177 (1985). Discharge is discussed at ¶ 15.07.

[85] UCC § 3-603(2).

[86] UCC § 3-603, comment 4.

were relatives of plaintiff's wife), paid the note and got possession of it from the bank. The bank officer stamped the note paid and delivered it to the plaintiff without indorsement. The defendants continued to pay for a number of months, but stopped making payments when plaintiff separated from his wife. Plaintiff sued on the note, and the defendants claimed plaintiff's payment to the bank constituted a cancellation of the debt under UCC § 3-605. The court decided for plaintiff. The defendants continued to be liable for payment of the note because the plaintiff acquired the rights of a transferee under UCC § 3-603(2) when he paid the bank and, therefore, succeeded to the bank's right to enforce the note.[87]

In *Mercantile Bank & Trust Co. v. Vilkins*, the court held that when a note is stamped "paid," there is a presumption of payment, but the presumption is not absolute. The stamp merely shifts the burden of going forward to the payee, who can rebut the presumption by showing the note was stamped "paid" by mistake or without authority.[88]

Payor banks are bound when they also are the depositary bank, but, in situations in which a payor bank is not also the depositary bank, the bank is bound only by restrictive indorsements, as well as by the instructions of its immediate transferor.[89] In addition, a payor bank may have protection given by clearinghouse rules, Federal Reserve directives, or special contracts made with depositors.[90]

The time when payment occurs is important for a variety of reasons. It determines when a payor bank loses the right to "charge-back." It also is relevant in deciding the timeliness of stop orders, setoff, attachment, or other action against the account. Under the UCC, payment becomes final when the first of the following events happens:

- The item is paid in cash;
- The item is settled for and the right to revoke the settlement waived;
- The process of posting the item to the account of the person to be charged therewith is completed; or
- A provisional settlement is made for the item and is not revoked within the time allowed by agreement, law, or clearinghouse rules.[91]

When the payor bank is also a bank in which an item was deposited and if that item has not been paid or dishonored before the opening of the second banking

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[87] McGrew v. Mix, 112 Ill. App. 3d 14, 445 NE2d 30 (1983).

[88] Mercantile Bank & Trust Co. v. Vilkins, 675 SW2d 673 (Mo. Ct. App. 1984), later appeal, 712 SW2d 1 (Mo. Ct. App. 1986). See discussion at ¶ 15.07 on discharge of liability and ¶ 24.01[3] on cancellation of debts.

[89] UCC §§ 3-206(2), 3-206(3), 3-206(4), 3-603.

[90] UCC § 4-103.

[91] UCC § 4-213.

day following its receipt, the customer has the right to withdraw against the credit given for the item.[92]

[3] Notice to Payor From Notations on Checks

Although the payor of a check is responsible for making payment to the proper party in accordance with the order of the drawer and the indorsement of the instrument, a payor bank generally does not have notice from notations and memoranda that are not part of the contractual terms of the instrument. In a New York case that illustrates this rule,[93] plaintiff was a shareholder in a mutual fund for which the defendant bank was the transfer agent. Under the arrangements with the fund, plaintiff was entitled to switch his investment in the stock fund to a money-market fund on notice to the bank. When plaintiff sought to exercise this power, a series of events occurred that resulted in the liquidation of his stock fund and led to plaintiff's sending the bank a check for $21,000 to be invested in the money-market fund. The check contained a notation in the lefthand corner in the space provided for memoranda that it was "For Acct. 155-69-985-P RESERVE FUND." The bank applied the check to the purchase of shares in the stock fund rather than the money-market fund. After the bank and the stock fund refused to return the amount of the check, plaintiff sued both for negligence in handling the check. By this time the value of plaintiff's shares in the stock fund had fallen to $7,260.00. The court rejected the contention that the writing on the memorandum part of the check gave notice to the bank, relying on the language of an 1888 U.S. Supreme Court case:

> No bank is bound to take notice of memoranda and figures upon the margin of a check, which a depositor places there merely for his own convenience, to preserve information for his own benefit; and in such case, the memoranda and figures are not a notice to the Bank that the particular check is to be paid only from a particular fund.[94]

The Court also relied on the words of Judge Learned Hand:

> A bank's business must be done with dispatch; innumerable items pass before a teller in the course of a month. He is indeed charged with knowledge of his depositors' signatures and with the genuineness of the endorsements; but to demand of him a scrutiny of any notations upon them and

[92] UCC § 4-213(4)(b). See Edwards, "Recovery of Final Payments Under the Uniform Commercial Code." 6 Ohio NUL Rev. 341 (1979). Funds availability rules are covered in ¶ 20.11[1]. There are complex federal rules which preempt the UCC Regulation CC, "Availability of Funds and Collection of Checks" (to be codified at 12 CFR part 229). See ¶ 20.11[1].

[93] Woods v. Bank of N.Y., 806 F2d 368 (2d Cir. 1986).

[94] Id. at 371 (citing State Nat'l Bank v. Dodge, 124 US 333, 346 (1888)).

such conclusions as deliberation might require would impose undue restrictions upon the fluidity of such business.[95]

The court then found that no duty existed to "scrutinize directions placed on the memorandum portion of an incoming check." In light of the volume of checks that the bank must handle daily and the need for speed in processing them, an obligation to take notice of memoranda on a check was commercially unreasonable.[96]

[4] Effect of Payment on the Underlying Transaction

At common law, it was the general rule, in absence of agreement to the contrary, that payment of obligations by negotiable instruments was only conditional. When the instrument was not paid, the holder could revert to his or her rights against the persons liable on the original debt. When the parties agreed that a negotiable instrument was to be taken as final payment, the underlying contract or obligation for which the instrument was given was discharged by the delivery of the instrument. Thereafter, the instrument constituted the only contract between the parties.

The UCC continues the common-law rule that payment by check is conditional.[97] Under the UCC, payment of an obligation by a negotiable instrument simply suspends the operation of the contract so paid[98] and, if the check given in

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[95] Id. at 371 (citing Childs v. Empire Trust Co., 54 F2d 981, 983 (2d Cir.), cert. denied, 286 US 554 (1932)).

[96] Id. at 372.

[97] UCC §§ 2-511(3), 3-802.

[98] UCC § 3-802(1)(b). See generally Annot., "Discharge of Debtor Who Makes Payment by Delivering Check Payable to Creditor to Latter's Agent, Where Agent Forges Creditor's Signature and Absconds With Proceeds," 49 ALR3d 843 (1973).

In a case involving the refund of excess insurance premiums, a Maryland court used the doctrine of conditional payment to avoid hardship. In this case, the insurance company refunded to its beneficiary a $12.00 check supposedly representing excess premiums paid. However, the insurance company made a mistake in calculating the refund. The check was $7.50 greater than it should have been. The insurance company corrected its mistake by charging the $7.50 to the beneficiary's account and, when the beneficiary failed to pay the $7.50, canceled the insurance policy. The court held that the insurance policy could not be canceled, because the beneficiary did not owe any premium to the insurance company. The court reasoned that the obligation of the insurance company to refund money to the customer was never discharged, since the check had not been presented for payment. Ward v. Federal Kemper Ins. Co., 62 Md. App. 351, 489 A2d 91 (1985).

An important consequence of taking a negotiable instrument for an obligation is that based on the instrument, the holder acquires rights that give the holder a cause of action if the instrument is not paid. When a promissory note is given as evidence of a debt, for example, the holder obtains a cause of action on the promissory note. It will be essential to this action that the holder produce the note or evidence that the note has been lost or

payment is dishonored, the debtor may be held on either the underlying contract or the instrument. But payment by an instrument upon which a bank is drawer, maker, or acceptor where there is no recourse on the instrument against the debtor discharges the underlying contract. If the instrument is dishonored, the only recourse of the holder will be against the bank.[99]

Under the UCC, it is proper for a buyer to tender payment to the seller by means of a check when that manner of payment is "current in the ordinary course of business" unless the parties have agreed otherwise.[100] The seller does not have to accept a check as payment but the seller cannot unfairly surprise the buyer by a demand for legal tender. If the seller demands legal tender, the seller must be reasonable in allowing the buyer an extension of time to make payment by this means if that is needed.[101]

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destroyed. As discussed in the text, the holder of the note may have an alternative cause of action based upon the underlying debt itself if the note is not duly paid. Union Sav. Bank v. Cassing, 691 SW2d 513 (Mo. Ct. App. 1985).

[99] UCC § 3-802(1)(a). See Harris v. Hill, 129 Ga. App. 403, 199 SE2d 847 (1973). The person paid must accept the check as payment. See Tennant v. Satterfield, 158 W. Va. 917, 216 SE2d 229 (1975). See also Balmoral Arms v. Rutkin, 104 NJ Super. 354, 250 A2d 50 (1969); Stream v. C.B.K. Agronomics, Inc., 79 Misc. 2d 607, 361 NYS2d 110 (1974), modified 48 AD2d 637, 368 NYS2d 20 (1975); Delaware State Bank v. Patton, 513 P2d 868 (Okla. 1973). The underlying debt is discharged by acceptance of a cashier's check in payment even though the bank fails to pay the check because it is insolvent. Chen v. Roosevelt & Main St. Realty Corp., 131 Misc. 2d 572, 500 NYS2d 948 (1986).

[100] UCC § 2-511(2).

[101] UCC § 2-511(2), comment 3. A check is not legal tender and a creditor has the right to refuse to accept payment by check and to demand payment in cash. See also UCC § 2-511(2), which provides that a seller may demand payment in legal tender, rather than payment by check, as long as the seller gives the buyer any extension of time reasonably necessary to procure legal tender.

Thus, a tenant was not entitled to insist that his landlord redeposit a personal check that had been dishonored NSF because the landlord had no obligation to accept the check as payment under UCC § 2-511(2), even if the tenant had sufficient funds on deposit at the time. When the check was dishonored, the landlord had a claim against the tenant for the obligation and could insist upon payment in cash. Armfield v. Poretsky Management, Inc., 39 UCC Rep. Serv. (Callaghan) 883 (DC Super. Ct. 1984).

When a customer owes a debt to the bank, the customer does not make a proper tender of payment by making a deposit unless the deposit is an agreed upon form of payment. Citizens Valley Bank v. Douglas Robins, Inc., 69 Or. App. 711, 687 P2d 815 (1984).

In one case the question was whether a buyer had made a sufficient tender of payment under a real estate contract when he did not have sufficient funds on deposit in the account on which the check was drawn at the time of the tender. The court held that the tender was effective, since there was no requirement that there be funds on deposit. In this case, the recipient of the check refused to accept the check for reasons that were not valid, and therefore could not later argue that its duty to present the check for payment was excused. It did not learn of the insufficiency of funds for several years after the check had

Under UCC § 3-802(1), when a party has "taken" an instrument "for an underlying obligation," the obligation is suspended until the instrument is presented for payment. In one case, a check was mailed to a party who held the check without returning it or proceeding to have it presented for payment, and without objecting to payment by means of a check. The court concluded that the retention of the check constituted acceptance of payment.[102]

[5] Payment by Remittance Instrument

A collecting bank will receive "settlements" for the items it forwards to other banks. These settlements may be made through credits and debits to accounts between banks or as prescribed by clearinghouse rules or requirements of the Federal Reserve System. In cases involving "noncash" items, a collecting bank may receive payment for the item in the form of some type of remittance instrument, such as a cashier's check. The UCC allows collecting banks to take settlements for items sent for collection in a check drawn on a bank other than the remitting bank, a cashier's check of the remitting bank when it is part of the same clearinghouse as the collecting bank, or authority to charge an account of

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been tendered. McLaughlin v. Sports & Recreation Club, Inc., 356 NW2d 398 (Minn. Ct. App. 1984).

[102] Amsterdam Urban Renewal Agency v. McGrattan, 91 AD2d 792, 458 NYS2d 67 (1982), aff'd, 59 NY2d 624, 449 NE2d 1273, 463 NYS2d 195 (1983). When a person takes a postdated check and holds it until the date arrives, the obligation for which the check was given in payment is suspended, and the holder of the check cannot regard the drawer of the check as being in default on the obligation. Grumet v. Bristol, 125 NH 537, 484 A2d 1099 (NH 1984).

Actions that constitute "taking" a negotiable instrument for an obligation are matters of common law. UCC § 3-802(1) does not explain when an instrument is "taken" for an obligation. In a case where a promissory note was offered to a party for an obligation, a federal district court held that the offeree did not have to respond to the offer, and its silence did not amount to acceptance of the offer unless the circumstances could justify construing the conduct of the offeree as acceptance. Kalish & Rice, Inc. v. Regent Air Corp., 624 F. Supp. 173 (SDNY 1985). One would expect the result to be different when the offer is made to pay by check because of business practices regarding checks as customary payment instruments. See UCC § 2-511(2).

The principle in UCC § 3-802(1) that an underlying obligation is suspended when a party has "taken" an instrument for that obligation is consistent with the conclusion that the underlying obligation remains in effect, so long as the party to whom the obligation is owed has not "taken" an instrument in payment. In Lincoln Nat'l Bank & Trust Co. v. Bank of Commerce, 764 F2d 392 (5th Cir. 1985), the court held that a payee who never received physical possession of checks and who could not be regarded as having had constructive delivery of checks did not qualify as a party who had rights to the checks or as a party entitled to maintain a suit for conversion under UCC § 3-419. The payee's remedy was to pursue enforcement of the underlying obligation for which the checks originally were issued.

the remitting bank held by the collecting bank.[103] However, it also gives the collecting bank receiving payment in such media the right to charge back if the check or other credit memorandum is not ultimately paid.[104] Thus, the risk of loss by failure of payment of the check or credit given as remittance is placed squarely on the owner of the item that the bank was collecting.[105] The owner of the item has only a claim on the remitting bank or nonbank remitter that gave the remittance instrument.

The collecting bank still has reason to be careful about the type of instrument it authorizes for use by the remitting bank in settlement. If the collecting bank *authorizes* use of a nonbank obligation, a cashier's check of a remitting bank that is not part of the same clearinghouse, or other nonapproved forms of remittance, the collecting bank receives a final settlement at the time it takes the instrument.[106] This makes the collecting bank accountable to its customer for the item being collected.[107] When the collecting bank receives such an instrument from a remitting bank, but has *not authorized* the remitting bank to use it, the collecting bank may accept it in settlement without liability in case it is dishonored, so long as the collecting bank acts promptly to collect the remittance instrument. If the bank acts to collect or present the remittance instrument before its midnight deadline, the provisional settlement the collecting bank gave to its customer for the item will remain provisional until the remittance instrument is finally paid.[108]

[6] Payor Bank's Right to Cancel Payment and Recover Proceeds

Under the UCC, in certain situations a payor bank may revoke the settlement that it has given for an item presented to it for payment. It may then recover the amount of the credit or the proceeds that it has paid. However, the payor bank is not entitled to recover the amount of its payment if it has "paid cash over the counter" for the item presented to it.[109] This is treated as a "final" payment.[110]

When the bank gives a "provisional" settlement for the item presented for payment, which may be by credit or by use of a check, draft, or other remittance instrument, the bank may revoke the settlement and may recover any payment it

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[103] UCC § 4-211(1) and comments 1, 5.

[104] UCC § 4-212.

[105] See comments to UCC §§ 4-211–4-212.

[106] UCC § 4-211(3)(b).

[107] UCC § 4-213(3).

[108] UCC § 4-211(3)(a). Delay beyond the midnight deadline in collecting or presenting the remittance instrument will make the collecting bank accountable to its customer. UCC § 4-211(3)(c).

[109] UCC § 4-301(1).

[110] UCC § 4-213(1)(a).

has made if it acts in a timely fashion.[111] The bank must act before it has done anything that could be regarded as final payment.[112] It also must act before its midnight deadline (midnight of the banking day following the bank's receipt of the item) by either returning the item or giving written notice of dishonor when it is impossible to return the item.[113] Under the UCC, the bank's right to revoke the settlement that it has given appears to be absolutely barred if the bank does not meet these deadlines. Opinion differs on whether a bank might under some circumstances have the right to recover a payment made by mistake or under circumstances giving rise to an equitable claim based on unjust enrichment. In UCC § 3-418 payment is final only when made to a holder in due course or other person who acted in reliance. Because the provisions of Article 4 are controlling when there is a conflict with Article 3, the difference of opinion centers on whether the finality policy of Section 3-418 also applies to bank payments under Article 4.[114]

The UCC in Article 4 seems to establish a rule of final payment for payor banks that permits the bank to recover payments only when it can demonstrate breach of warranty[115] on the part of prior transferors of the instrument. The relevant section, UCC § 4-302, makes a payor bank accountable for the item if the bank fails to give timely notice of dishonor. There are no other exceptions stated in the statute. The payment is final under the terms of the section regardless of any reliance on the payment by the party receiving payment. Notwithstanding these UCC provisions, some cases have recognized additional situations in which the bank will be permitted to recover a payment made by mistake in order to prevent unjust enrichment. The UCC gives little guidance in this area and the case law is divided.[116]

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[111] UCC § 4-301(1).

[112] For further discussion of final payment, see ¶¶ 21.03[2], 21.03[7].

[113] UCC § 4-301(2).

[114] UCC §§ 3-418, 4-301–4.302. See H. Bailey, Brady on Bank Checks Ch. 15 (6th ed. 1987); White & Summers, Uniform Commercial Code 613–618 (2d ed. 1980). See cases cited infra note 116. See generally Annot., "Recovery by Bank of Money Paid Out to Customer by Mistake," 10 ALR4th 524 (1981); Note, "Uniform Commercial Code—Article 3 and 4—Bank Required to Disburse Funds After Final Payment," 64 Marq. L. Rev. 408 (1980).

[115] The final payment rule permits recovery of payment when there is a breach of warranty made to the payor. UCC §§ 3-418, 4-302. Warranty liability is discussed at ¶ 15.03. See also ¶¶ 20.08, 20.09.

[116] See generally Annot., "Recovery by Bank of Money Paid Out to Customer by Mistake," 10 ALR 4th 524 (1981); Annot., "What Constitutes Change of Position by Payee-Bank so as to Preclude Recovery of Payment Made Under Mistake," 40 ALR2d 1009 (1955). When a bank mistakenly pays a check drawn on an account with insufficient funds, can the bank obtain restitution from the party receiving payment if there has been no detrimental reliance upon the payment? Some commentators have argued and some courts have accepted that UCC § 4-213, which describes when payment becomes final, expresses a rule that such a mistaken payment cannot be recovered (except for breach of

Collecting banks, which give a provisional settlement to their customers for items they are handling for collection, also have the right to revoke the settle-

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one of the warranties made on presenting the check for payment) even when traditional equitable claims for recovery, such as unjust enrichment, exist. These authorities take the position that the midnight deadline rule for payor banks in UCC § 4-302 "displaced common law equitable principles." State & Sav. Bank v. Meeker, 469 NE2d 55 (Ind. App. 1984). But a federal Court of Appeals has taken the contrary view and held that the payor bank could invoke restitutionary principles to recover the payment. The court reasoned that UCC § 3-418, which prevents recovery of payment only when there is payment to a holder in due course or to a person who made a good faith change in position in reliance on the payment, should not be read as being limited by Section 4-213 when the payor is a bank. The court stated: "§ 4-213 'is oriented toward time of payment, not legal effect of payment.' ... The purpose of section 4-213 is 'to determine *when* settlement for an item or other action with respect to it constitutes final payment.' ... Section 4-213 determines *when* the final payment rule of section 3-417 comes into effect, not what the rule is supposed to mean." National Sav. & Trust Co. v. Park Corp., 722 F2d 1303, 1306 (6th Cir. 1983), cert. denied, 466 US 939 (1984).

The basis for recovering payment made by mistake also was tested in a case involving two bearer notes of the Manville Corporation for $5 million each. The defendant, American Savings and Loan Association, purchased the notes through the Chase Manhattan Bank who was an agent of the issuer of the notes, Morgan Guarantee Trust Company of New York. Prior to payment of the notes, the Manville Corporation became bankrupt. Morgan had established special procedures to handle the payment of items for which Manville was responsible. When Chase presented the notes for payment through the New York Clearinghouse, Morgan personnel tried to obtain instructions on how to deal with the notes. Morgan was one hour late in giving notice of dishonor because it received its instructions late. Acting on the theory that the notes had been paid, Chase transferred $10 million credit to American. Morgan then sued American claiming entitlement to the money based upon theories of conversion and unjust enrichment. The court held that Morgan could not recover its payment. Morgan failed to meet the Clearinghouse deadline for giving notice of dishonor of the instruments, and American was a payee who qualified as a holder in due course. Thus, regardless of whether UCC § 4-213 by itself establishes a rule of final payment, UCC § 3-418 was satisfied, and the payment to American was final. The Ninth Circuit reversed. Over a dissent that the opinion undermined the finality of such transactions by opening the possibility of allowing a payor to recover a mistaken payment after months had elapsed, the majority found the case presented a situation different from the usual UCC § 3-418 circumstances because the maker of the note, Manville Corporation, was bankrupt. Although the bankruptcy laws do not prohibit recovery of the payment, the court believed that the policy of treating creditors similarly argued for denying a windfall gain to American that would favor American at the expense of the other creditors. This policy, combined with the fact that American was aware of Manville's bankruptcy, distinguished the case from the normal UCC § 3-418 circumstances. As the court said:

> [I]f both parties to a transaction know that the payee is not entitled to payment on an instrument, the rationales behind § 3-418 are inapplicable. The payee who receives payment aware that he is not entitled to it does not have the same expectation of finality as an innocent payee and the payor bank in this circumstance does not have superior knowledge. A party who accepts payment of an instrument knowing that the payor was entitled to dishonor it justifiably receives less favorable treatment by a court of equity than a payee ignorant of any problem.

ment and, if they act in a timely fashion, to recover any payments that have been made.[117] When the collecting bank receives a negotiable instrument as payment for the item it has presented, the settlement given by the collecting bank to its customer does not become final until the instrument given in payment is actually paid. If that instrument is dishonored when it is presented for payment, the

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Morgan Guar. Trust Co. of N.Y. v. American Sav. & Loan Ass'n, 804 F2d 1487 (9th Cir. 1986), cert. denied, 107 S. Ct. 3214 (1987).

In Town & Country State Bank v. First State Bank, 358 NW2d 387 (Minn. 1984), a check-kiting scheme existed involving a number of banks. First State was the central bank where the person who committed the fraudulent scheme maintained his main accounts. One of the other banks involved sued First State, claiming that First State acted in bad faith because it knew of the existence of the check-kiting scheme but did not inform the other banks because it wanted to shift the losses to the other banks. The court held that good faith was an issue for the trier of fact and affirmed a finding of good faith. It was reasonable for the officers of First Bank to extend some time to its customer to cure the customer's overdraft problems because of the bank's past experience with the customer in correcting problems of this nature. The test of good faith is a subjective one and the proper course of action is not always easy to determine.

The other banks also sued First State, claiming that they should be able to recover payments on checks they had made to First State because the payments were not final. The court held that final payment under Article 4, Section 4-213, does not require the person to whom payment is made to be either a holder in due course or one who has changed position in reliance on the payment. Section 3-418 does not apply to the recovery of bank payments under Article 4. The court admitted that there was a conflict on this question and that the UCC provisions were unclear, but it held in favor of a finality rule because it believed finality of payment was an important policy in the bank collection process.

In Reynolds-Wilson Lumber Co. v. People's Nat'l Bank, 699 P2d 146 (Okla. 1985), the court held that the term "accountable," as used in UCC § 4-302, "has been uniformly construed to mean strict liability for the full amount of the draft, with no requirement that there be proof of actual damage." Thus, when the bank retained a draft beyond its midnight deadline because it had agreed to wait for funds that never were forthcoming, the bank became liable for the amount of the draft. Lack of good faith on the part of the person presenting the instrument for payment is not a defense to the payor bank's failure to give notice of dishonor or return the instrument by its midnight deadline unless the lack of good faith in some way caused the payor bank to breach its obligation under UCC § 4-301 to return the check. Toronto-Dominion Bank v. Central Nat'l Bank & Trust Co., 753 F2d 66 (8th Cir. 1985) (dicta).

An equitable defense based upon unjust enrichment was permitted to a payor bank in Starcraft Co. v. C.J. Heck Co., 748 F2d 982 (5th Cir. 1984). In this case, the bank became liable to pay a check because it failed to give notice of dishonor before its midnight deadline. However, as a result of a release that the payee had executed to the drawer of the check, the drawer did not owe an obligation to the payee. The court noted that if the bank paid the payee the amount of the check, the payee would be unjustly compensated, since it would have been paid twice. If the bank charged the payment of the check back to the drawer, the drawer would be able to recover the payment from the payee on the grounds of the unjust enrichment. Because of this possibility, the court held that the bank ought to be subrogated to the drawer's claim for restitution against the payee. This gave the bank a valid defense to the action by the payee for payment of the check.

[117] UCC § 4-212.

collecting bank will be able to revoke the settlement it originally gave to its customer for the item presented for payment.[118]

[7] Application of Final Payment Rule

When a payor bank pays a check that contains a forged or unauthorized indorsement, the final payment rules may apply. If the payor bank has committed any of the acts that constitute final payment, it loses the right to revoke the settlement it gave and recover the amount paid. Once the payment becomes final, any attempt by the payor bank to charge back and revoke credit given to prior collecting banks will be ineffective. It has been held that a prior collecting bank, upon receipt of such an ineffective notice of chargeback has no right to revoke the settlement it gave to its customer.[119] Although a bank has no right to revoke the settlement given after payment is final, it may have a claim against the prior collecting banks and the presenting customer for breach of warranty of title. If the check has an unauthorized or forged necessary indorsement, the parties presenting the check may have breached the warranty of good title.[120] These matters are discussed in Chapter 20.

When a check is made payable to two joint payees, and only one of the payees has agreed to the retention of the check beyond the payor bank's midnight deadline, does the other joint payee have a claim against the payor bank? This question arose in a 1985 Montana case in which a check for over $41,000 was payable jointly to Iverson and the Montana Livestock Production Credit Association (MLPCA). The payor bank had dishonored it twice and stamped the check "payment refused twice—present for collection only." MLPCA sent the check back a third time with a memorandum instructing the payor bank to hold it for longer than the usual period. After one month, the payor bank returned the check at the request of MLPCA. The bank officer had violated bank policy in waiving the bank's midnight deadline on this instrument because he lacked authority to grant such a waiver for checks over $500. In a suit by Iverson against the bank, the court held that the bank was not accountable for missing its midnight deadline under UCC § 4-302 because the memorandum accompanying the check did not demand payment immediately but only when funds were available; thus, the check was not a "demand item" under the terms of UCC § 4-302. The court also ruled that Iverson could not pursue a claim against the bank for violating the midnight deadline, since Iverson had not presented the check but had transferred it to MLPCA, and the bank had acted within the allowable time as to MLPCA, the party presenting the check, because of the accompanying

[118] UCC §§ 4-211(2), 4-212(1).

[119] First Nat'l Bank v. Nunn, 628 P2d 1110 (Mont. 1981). But a contrary result was reached in Yoder v. Cromwell State Bank, 478 NE2d 131 (Ind. Ct. App. 1985).

[120] First Nat'l Bank v. Nunn, 628 P2d 1110 (Mont. 1981).

memorandum. Finally, the court found that the memorandum by MLPCA amounted to an agreement varying the effect of provisions of UCC § 4-103.[121]

The burden of proving that the final payment deadline had expired, because the payor bank did not return a check by its midnight deadline, usually will fall upon the party asserting final payment occurred. This burden had to be met even in a case in which the returned items were received well after the normal mailing time for return of the items.[122]

A payor bank is not excused from returning a check before its midnight deadline because the check had pencil marks and an encoding error that made it impossible to process the check by computer. The court held that these were not circumstances beyond the control of the bank that justified extending the midnight deadline.[123] The bank must be prepared to handle the check even when it cannot be processed by computer.[124]

The requirements that a payor bank must satisfy in order to return a dishonored item differ from those for collecting banks. One important difference is that a payor bank must return a demand item, such as a check, before its midnight deadline or give notice of dishonor before its midnight deadline.[125] A collecting bank, on the other hand, must act in collecting the item within a reasonable time. If it acts before its midnight deadline, the action will be reasonable. A longer time may be reasonable, but the bank has the burden of proving that it was reasonable.[126] This difference became important in a case involving the collection of drafts that a seller drew on its customers' accounts for payment of goods sold. In a transaction similar to those involving document drafts, but which the parties stipulated did not involve documentary drafts,[127] the seller loaded a freight car with merchandise, obtained a bill of lading for the carriage of the goods, drew a sight draft on the customer to whom the goods were shipped, and gave the draft and bill of lading to his bank for collection. The local bank gave credit to the seller and forwarded the draft to the bank in the customer's home town for collection. The draft named both the customer and the bank in the customer's town as the drawee. The buyer became bankrupt, and the seller sued the bank named as drawee for payment on the theory that the bank became liable on the draft because it held the draft past its midnight deadline.

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[121] Iverson v. First Bank,, 712 P2d 1285 (Mont. 1985).

[122] Whalen & Sons Grain Co. v. Missouri Delta Bank, 496 F. Supp. 211 (ED Mo. 1980), aff'd mem., 657 F2d 274 (8th Cir. 1981).

[123] See UCC § 4-108(2).

[124] Bank Leumi Trust Co. v. Bank of Mid-Jersey, 499 F. Supp. 1022 (DNJ 1980), aff'd mem., 659 F2d 1065 (3d Cir. 1981).

[125] It also must settle for the item before midnight of the day of receipt unless it is the depositary bank. UCC § 4-302(a).

[126] UCC § 4-202(2).

[127] The stipulation by the parties was important because the payor bank's midnight deadline for paying drafts does not include documentary drafts. UCC § 4-302(a).

Although the customer had an account with the drawee bank, the court held that the bank should not be viewed as a payor bank because the buyer had not given authority to the bank to pay the draft. The court held that the defendant bank should be treated as a collecting bank which, under the UCC, could hold the draft for an extended period of time if the bank could demonstrate that it was reasonable under the circumstances. In this case, a prior course of dealing between the bank and the seller supported the determination that holding the draft for fifty-two days while waiting for payment from the buyer was reasonable.[128]

When a payor bank makes arrangement with another bank to process checks drawn on the payor bank, there should be a clear understanding as to the status of the bank that will be processing the checks. If not, a substantial legal question arises over the time limits the bank will have to return checks, as was illustrated by *Catalina Yachts v. Old Colony Bank & Trust Co.*[129] The payor bank, Old Colony of Boston, entered into an agreement with First National Bank to have First process Old Colony's checks. When checks drawn on Old Colony came into the hands of the Federal Reserve Bank of Boston, the Federal Reserve bank debited the account of First and sent the checks to First. First then sent the checks to Old Colony. Under the arrangement between Old Colony and First, First had no authority to make a decision to pay the checks. Thus, the court held that the time for computing Old Colony's midnight deadline began when Old Colony physically obtained receipt of the checks. It was argued that the arrangement could be viewed as a presentment authorized by Old Colony at a place other than the bank's premises, namely at First National Bank, but this argument was not accepted, as First had no authority to decide to pay the checks.[130] The court also suggested that in arrangements of this nature the parties could vary the terms of the UCC by agreement.[131]

[8] Method of Return of Items Not Paid Under UCC and Federal Reserve Board Rules

When items given the payor bank fail of final settlement, the UCC gives the payor bank two alternatives. It may reverse the process of collection by returning the items through the channels by which they came,[132] or the bank may return the items directly to the depositary banks if such return is authorized either by law or by agreement. When there is a direct return the depositary bank will be required

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[128] Southern Cotton Oil Co. v. Merchants Nat'l Bank, 670 F2d 548 (5th Cir. 1982).

[129] 497 F. Supp. 1227 (D. Mass. 1980).

[130] But see Capitol City First Nat'l Bank v. Lewis State Bank, 341 So. 2d 1025 (Fla. Dist. Ct. App. 1977), cert. denied, 357 So. 2d 186 (Fla. 1978).

[131] UCC § 4-103.

[132] UCC §§ 4-212, 4-301. An intermediary bank that receives a returned check has the same alternatives when it returns the item under the UCC. UCC § 4-212.

to pay the returning bank for the amount of the item. A method for accomplishing this is by having the returning bank draw a draft for the amount of the returned item on the depositary bank. The depositary bank then pays the draft and charges its customer.[133] Clearinghouse credits previously set up or credits entered seriatim between the collecting banks in forwarding the item are not disturbed. The section of the UCC authorizing such direct returns was made optional, but it has been adopted in most jurisdictions.

Regulation CC changes the rules for check returns. It imposes a duty of "expeditious return" on paying and returning banks.[134] The regulation anticipates that to meet this duty, banks may choose not to return checks by retracing the chain of banks used in forwarding the item to the payor bank but will use more rapid methods of return, including direct return to the depositary bank.[135] These provisions displace some of the provisions of the UCC and Regulation J that otherwise would determine the method and timeliness for the return of checks.

Under Regulation CC, the depositary bank is obligated to accept returned checks and written notices of nonpayment at locations specified by the regulation,[136] and it also must pay the amount of the check to the bank returning the check before the close of business on the banking day it received the returned check.[137] Payment is final and must be by a method that credits an account of or makes the proceeds of the payment available to the returning or paying bank on the payment date.[138] The returning and paying banks make warranties as the check is transferred from bank to bank in returning it which operate similarly to

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[133] UCC § 4-212(2).

[134] Regulation CC §§ 229.30(a), 229.31(a) (1988) (to be codified at 12 CFR §§ 229.30(a), 229.31(a)). See infra ¶ 21.06.

[135] Regulation CC § 229.30(a) & commentary (1988) (to be codified in 12 CFR § 229.30(a) & appendix). As the commentary notes, this regulation affects the UCC. It means that direct returns are authorized in all jurisdictions, not just those with the optional UCC § 4-212(2) provision. It means that a paying bank may send a returned check directly to the depositary bank or a returning bank rather than as limited in UCC § 4-301(4). The time limits for return may be affected by the "expeditious return" duty. When a check is returned, the settlement for it will be final rather than by a series of provisional settlements that are revoked on the return of the item. Id. See Regulation CC § 229.31(c) (1988) (to be codified at 12 CFR § 229.31(c)) on the duty of banks to settle for the returned check. The settlement is final. Id. Also, the expeditious return rules modify the UCC's midnight deadline rules for return in some instances. For example, a paying bank may extend the deadline for return in order to use a method that normally would be faster, such as return by a courier who leaves after midnight. Regulation CC § 229.30(c) (1988) (to be codified at 12 CFR § 229.30(c)). The rules also affect how a bank should route returns. Retracing the process of collection is not enough to satisfy the bank's return duty.

[136] Regulation CC § 229.32(a) (1988) (to be codified at 12 CFR § 229.32(a)).

[137] Regulation CC § 229.32(b) (1988) (to be codified at 12 CFR § 229.32(b)).

[138] Id. The payment methods are specified: (1) debit to an account of the depositary bank on the books of the returning or paying bank; (2) cash; (3) wire transfer; or (4) any other form agreed to by the returning or paying bank. Id.

the warranties made in the forward collection process.[139] The regulation imposes a liability on banks that handle checks for either forward collection or return to pay any bank subsequently handling the check that fails to obtain payment for the check. Thus, if the depositary bank fails to pay for the returned check because of insolvency or other reason, the returning bank may recover from prior banks and so forth down the chain of return and collection until the loss ultimately comes to rest on the bank that took the check in collection from the depositary bank.[140]

The Federal Reserve System is developing new services to assist banks in complying with the expeditious return duties and notification of nonpayment requirements.

¶ 21.04 INSTRUMENTS PAYABLE AT OR THROUGH BANKS

It is common business practice to make notes or drafts payable at certain banks. The UCC has changed the pre-UCC rules by specifically providing that a statement on an instrument using the words "payable through" (a certain bank) simply designates the named bank as a collecting agent and does not authorize it to pay the instrument.[141] The bank, in such a case, will have the rights and duties

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[139] Regulation CC § 229.34 (1988) (to be codified at 12 CFR § 229.34). Paying banks and returning banks make the following warranties when they transfer a returned check and receive a settlement or some other consideration for it. The warranties run to the banks' immediate transferee, any subsequent returning bank, the depositary bank, and the owner of the item: (1) the paying bank returned the check within its deadline; (2) the bank is authorized to return the check; (3) the check has not been materially altered; and (4) if a notice of nonpayment is sent in lieu of the check, as permitted under the regulation, a warranty that the original check will not be returned. Id. § 229.34(a). A paying bank also makes warranties with respect to the notice of nonpayment that (1) the bank will return the check within its deadline; (2) the bank is authorized to send the notice; and (3) the check has not been materially altered. Id. § 229.34(b). There are no warranties with respect to state and local government checks, and there are only the first group of warranties above with respect to U.S. Treasury checks. Id. §§ 229.34(a), 229.34(b).

[140] Regulation CC § 229.35(b) (1988) (to be codified at 12 CFR § 229.35(b)). The commentary suggests that circuity of action may be avoided by permitting the returning bank to recover directly from the first collecting bank although the text of the regulation does not specifically authorize this. After the collecting bank takes up the check, it would have rights of recourse under the UCC against indorsers and other parties to the check.

[141] UCC § 3-120. Regulation CC uses the term "paying bank." This term differs from the UCC's "payor bank" in a number of ways. A significant difference is the inclusion of certain "payable through" banks in the definition of a paying bank. Regulation CC § 229.2(z) (1988) (to be codified at 12 CFR § 229.2(z)). For an article discussing the differences between the requirements in Regulation J, which seem to give the status of payor bank to a bank that acts as a payable through bank and the provisions of the UCC, see Kreig & Pressman, "Dishonored Payable-Through Drafts: Deadline for Return," 103 Banking LJ 357 (1986).

of a collecting bank.[142] When a draft or note is payable at a bank, the maker-drawer or acceptor is discharged to the extent of the loss caused by the failure to present on time.[143] Federal Reserve regulations, however, take a different view from the UCC and give payable through banks in certain situations the duties of paying banks.[144]

If a note or acceptance states that it is "payable at" a bank, the UCC allows states to adopt two possible alternatives. Under the first option, it is equivalent to a draft drawn on the bank that is payable when due out of any funds of the drawer or maker available in current account or otherwise available for payment. In the second option, the statement does not create an order or authorization to the bank to pay it but merely designates a place of payment.[145]

In *Friendly National Bank v. Farmers Insurance Group*,[146] an insurance company issued a draft, drawn on itself, that stated that it was "upon acceptance payable through Commerce Bank of Kansas City." The payee on the draft deposited the instrument with her bank which, in turn, forwarded it to Commerce Bank. Commerce Bank returned the check without payment with the notation that the insurance company declined payment. The depositary bank, Friendly National Bank, then sued the insurance company for payment of the draft. The court held that Friendly National Bank was a holder in due course and entitled to recover against the insurance company. Friendly gave value by allowing its customer to draw checks against the amount provisionally credited to her account. The fact that the draft was payable through another bank did not constitute notice of any possible defense to the draft. It "was merely to designate the Commerce Bank of Kansas City as a collecting bank to make presentment."[147] Also, the language of the draft reading "upon acceptance pay . . ." did not give the defendant insurance company "any greater right to stop payment than if the words 'upon acceptance' had not been included in the draft."[148] Because the insurance company had signed the draft as the drawer of the instrument, it had made a drawer's contract and was bound to honor the draft. Likewise, the statement on the draft that it was a "claims draft" did not put the bank on notice of any possible defense to the instrument.

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[142] See Wilhelm Foods, Inc. v. National Bank, 382 F. Supp. 605 (SDNY 1974). On the liability of such banks for breach of warranty when an endorsement is forged, see Montgomery v. First Nat'l Bank, 265 Or. 55, 508 P2d 428 (1973); 238 E. 34th St. Corp. v. Continental Ins. Co., 75 Misc. 2d 493, 347 NYS2d 618 (1972).

[143] UCC § 3-502(1)(b).

[144] See definition of "paying bank." Regulation CC § 229.2(z) (1988) (to be codified at 12 CFR § 229.2(z).

[145] UCC § 3-121.

[146] 630 P2d 318 (Okla. 1981).

[147] Id. at 321.

[148] Id.

In *Horney v. Covington County Bank*,[149] the court considered the status of a draft used for payment in the cattle business. The buyers used a draft that contained the language, "upon acceptance pay to the order of." The buyer would sign the draft and fill in the blanks indicating the draft was addressed to "Cattle Company, 610-627-7, Covington County Bank, Collins, Miss." When Covington County Bank received the draft, it checked with the cattle company before paying. When the cattle company became unable to pay drafts it had drawn, the sellers sued the Covington County Bank, claiming the draft was a demand item, the bank was a payor bank, and the bank was liable on the draft for the face amount because it held the draft past its midnight deadline. The bank argued it was not liable because the draft was not a "demand item" that it was obligated to pay or return by its midnight deadline under UCC § 4-302. The bank argued that the words "upon acceptance" on the draft conditioned the order to pay so that it could not be regarded as a demand item. The court said:

> We hold that the words "upon acceptance" do not affect the order to pay. If "acceptance" were used in its technical sense under 75-3-410, i.e., "the drawee's signed engagement to honor the draft," it is nonsensical since it would mean that the plaintiff would be paid if the Bank agreed to guarantee payment, something no one would expect the Bank to do. If it meant the "acceptance" by Bank's customer, it is superfluous since by signing, Cervantes [the drawer of the draft and company to which the instrument was addressed] through his agent accepted the instrument.
>
> We also note that the bank created this instrument. It could easily have made its status clear simply by using language such as "payable through" or "payable at" with the effect discussed below.[150]

The court concluded that the bank should be regarded as a drawee on the draft and therefore subject to the liability of a payor bank for failing to return the item before its midnight deadline. The bank could have indicated it only acted as a conduit for payment by using the special words "payable through" or "payable at" or similar language. As no such words were used, the bank could not bring itself within UCC § 3-121 on instruments that are payable through a bank.

¶ 21.05 ERRORS IN HANDLING COMPUTER-ENCODED CHECKS

Today, most checks are encoded with magnetic ink to enable electronic

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[149] 716 F2d 335 (5th Cir. 1983).

[150] Id. at 338. The court concluded it did not have to decide if the draft was "negotiable" because the bank was liable under UCC § 4-302 for failing to act before its midnight deadline with respect to a non-negotiable as well as a negotiable "demand item." Id. at 337. See generally Krieg & Pressman, "Dishonored Payable-Through Drafts: Deadlines for Return," 103 Banking LJ 357 (1986).

machinery to read the checks without manual handling and visual decision making. The encoded numerals identify the bank against which the check is drawn, the account to be charged, and, usually, the number of the check. When the check is presented for deposit, it is encoded by the depositary bank to identify the amount of the check. Thereafter, the check can be electronically handled for collection. Although this method does not protect against forgeries or matters that might be revealed by a visual inspection of the check, banks may well decide that the savings to be obtained through greater efficiency in processing the checks more than offset the losses that may occur as a result of failing to make a visual inspection of individual checks. However, a bank's reliance upon the encoding will not relieve it from the liability, established under the UCC, for paying instruments that are forged or altered. Regardless of the coding, the check would not be properly payable.[151]

[1] Errors in Check Amounts

It is possible for a bank to make an error in encoding the amount of the check. The encoded amount may be either more or less than the amount of the check itself. As between the payor bank and its customer, the UCC rule seems clear: the bank may only charge its customer's account to the extent the check is "properly payable."[152] If an error was made in encoding the check in a large amount, the bank would be obligated to credit the account for the excess that was charged. By the same token, absent special circumstances in which the customer changes its position in reliance upon the error of the bank, the payor bank should be able to charge its customer when it mistakenly debits the account for an amount less than the actual amount of the check. The check is a direction to the bank to pay the amount of the check and entitles the bank to charge the customer for it even when it constitutes an overdraft.[153]

The ability of a payor bank to recover against prior collecting banks when it suffers a loss as a result of an error in encoding is more problematic. When the payor bank has paid an excess amount to the collecting bank, it has been suggested that it might be entitled to recover the excess amount on a theory of restitution. This approach has its difficulties, however, because the collecting bank will not have been responsible for the mistake and probably will no longer be holding the funds. There would be no breach of the warranties of transfer or presentment in this situation either.[154] Perhaps recovery could be had against the bank that made the encoding error, on general equitable principles recognized under the UCC as long as those principles are not in conflict with the UCC.[155]

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[151] UCC § 4-401.

[152] Id.

[153] Id.

[154] See UCC § 4-207.

[155] UCC § 1-103.

In a case in which the payor bank had, because of an encoding error, charged its customer for less than the true amount of the check, the bank likely will become liable to prior parties for the full amount of the check because the check will have been finally paid. The bank will not have given notice of dishonor in time.[156] If the bank is unable to recover the excess amount from either its customer or prior collecting banks, can it recover from the bank who made the encoding error? The UCC does not offer a solution although, again, equitable principles might suggest placing the loss on the bank that made the error.[157]

When a customer deposits a check and his bank makes an error in encoding it, the customer may have an action against the bank for failure to exercise ordinary care in handling the item for collection.[158] In any event, if the item is finally paid, the depositary bank will become accountable to the customer for the amount of the check.[159] If the depositing customer obtains a greater credit than he would be entitled to as a result of the encoding error, perhaps the depositary bank will have an action in restitution against the depositing customer. Again, the UCC offers no solution, but general equitable principles can supplement the provisions of the UCC.[160]

[2] Errors in Routing Directions

In *Citizens State Bank v. Martin*,[161] the Shawnee State Bank issued its customer, Martin, checks that had an encoding error in the bank routing number. Although the bank became aware of the error, it did not insist upon return of the checks. Instead, Shawnee State Bank instructed Martin to destroy them. Several years later, Martin used one of the checks with the encoding error to deposit $41,000 in an account he had at Citizens Bank. Because of the erroneous routing number, the check was delayed in reaching Shawnee State Bank for payment by a number of days. During this interval, Martin withdrew the $41,000 deposited at Citizens Bank. Shawnee State Bank dishonored the check and, again, there was a delay in its return to Citizens Bank. Citizens then filed suit against Shawnee State Bank and others, claiming Shawnee was liable for its negligent failure to recall the erroneously encoded checks from Martin. The Supreme Court of Kansas held that the trial court erred in entering summary judgment against Citizens Bank on this claim. As a member of the Kansas City Clearing House Association, Shawnee had a duty to other member banks,

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[156] UCC § 4-301.

[157] See N. Penney & D. Baker, the Law of Electronic Fund Transfer Systems, § 1.02(2) (1980 & Supp. 1987).

[158] UCC § 4-402.

[159] UCC § 4-213(3).

[160] UCC § 1-103. There are excellent discussions of the problems presented by encoding errors in H. Bailey, Brady on Bank Checks, ¶¶ 19.2–19.9 (6th ed. 1987); N. Penney & D. Baker, The Law of Electronic Fund Transfer, ¶ 1.02(2) (1980 & Supp. 1987).

[161] 227 Kan. 580, 609 P2d 670 (1980).

including Citizens, to protect against loss from the use of checks that could not be processed by machine, because the clearinghouse rules required members to use their best efforts to reduce the use of non-machine-processed items. In the court's view, Shawnee had breached its duty to protect the other banks belonging to the clearinghouse from the likelihood that they or some other third person could be injured by the delay in processing checks it knew could not be machine processed.

United States Fidelity & Guaranty Co. v. Federal Reserve Bank of New York[162] was a major case involving the fraudulent manipulation of the magnetic numerals used for routing the check. Plaintiff was the depositary bank, Union Trust Company of Maryland. Goldstein opened an account at Union Trust with a cash deposit and then deposited a check for over $880,000. The check eventually came back to Union Trust as uncollectible, but Goldstein had withdrawn a substantial sum and disappeared before Union Trust learned the check had been dishonored. Union Trust then sued the collecting and payor banks. The check was drawn on an account at First Penn by a company called Metropolitan Investment Corporation. Although the teller at Union Trust was supposed to notify the branch manager when a check of this size was deposited, the teller failed to do so. Nonetheless, the manager discovered the deposit in the course of his normal review of account fluctuations. The manager then sought information about Goldstein but learned that there was no record of his business nor any such account at First Penn. Union Trust had this information by May 9, within four days of the deposit. On May 12, Goldstein tried to arrange a wire transfer of funds from the account under rather unusual circumstances that, among other things, involved giving a bottle of expensive champagne to a bank officer. The officer declined to make the transfer because there had not been a sufficient time period in which to collect the check. Goldstein returned two days later and accomplished a wire transfer and cash withdrawal. The transfer was to a Maryland coin dealer. The officer, who was aware of the information the bank had received from First Penn, checked for holds on the check before making the transfer, but the computer did not report any. Further, while Goldstein tried to obtain the coins from the dealer, Union Trust was informed of the return of the check by First Penn. These various circumstances could be viewed as negligence by Union Trust in handling the account.

There was an added complication because the MICR number was not printed in magnetic ink and was the wrong size, which required the check to be hand processed. As a result, the check was sent to PNB for processing. PNB used the routing number to forward the check to the processing center in Utica, New

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[162] United States Fidelity & Guar. Co. v. Federal Reserve Bank of N.Y., *620 F. Supp.* 361 (SDNY 1985), aff'd, 786 F2d 77 (2d Cir. 1986). For a prior decision at an earlier stage in this case, see 590 F. Supp. 486 (SDNY 1984). That opinion is discussed at ¶ 21.02[4]. See generally, Fairfax & Fry, "*MICR Fraud: A Systems Approach to Foiling the Felon's Fun*," 40 U. Miami L. Rev. 737 (1986); Note, "Assessing Liability for MICR Fraud," 37 Ala. L. Rev. 145 (1985).

York for forwarding to Albany State Bank. Albany State received the check on May 9 and returned it to the processing center stamping it "Sent in Error." By then it was May 12, and on May 13 the Utica processing center sent the check to the Federal Reserve Bank of New York. Notwithstanding discrepancies in the check described as "glaring," that office did not detect the fraud and sent the check on May 14 to the Federal Reserve Bank of Philadelphia, which presented it for payment to First Penn on May 14. First Penn dishonored the check but did so later than its midnight deadline, on the morning of May 16. Union Trust received notice of dishonor later that afternoon but by then Goldstein had collected the coins and vanished.

The defendant banks moved for summary judgment. The court applied by analogy the preclusion rule of UCC § 3-406 that deals with negligence contributing to an alteration of an instrument. After saying that it was not "particularly clear that depositary banks are best situated in all, or even most, cases to detect MICR fraud," the court went on to note that it was appropriate to apply the spirit of UCC § 3-406 by analogy to the apportionment of loss due to MICR fraud because:

> The depositary bank, like the drawer of the check, is well situated to protect the system against MICR fraud. The depositary bank has an opportunity to examine the check free of the time pressures which prevent collecting banks from giving checks more than a cursory glance. Perhaps more important, the depositary bank is in the unique position of being able to examine both the depositor and the check. No other bank in the collecting chain can examine the depositor, a crucial disadvantage given the seemingly difficulty of detecting this type of fraud.[163]

Union Trust's suit against the collecting banks was based on breach of duty under UCC § 4-202. Following the reasoning discussed previously, the court concluded that "if those banks can demonstrate that the negligence of the depositary bank played a substantial role in the success of the fraud," the collecting banks were entitled to impose the preclusion rule. The court then gave summary judgment to the defendant collecting banks. The action against the payor bank charged failure to return the check before the midnight deadline, but the court also held for defendant, First Penn. The court observed that the midnight deadline under UCC § 4-302 "does not shift the burden of loss to a payor bank which misses its deadline if the payee was already aware when presenting the check that it would not be accepted or paid except by mistake." As Union Trust had been advised by First Penn that there was no such account on which the check had been drawn, Union Trust had no reason to expect the check to be collected and should not profit from First Penn's mistake in missing the midnight deadline.

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[163] *United States Fidelity & Guar. Co.*, 620 F. Supp. at 372.

¶ 21.06 COLLECTION AND RETURN OF CHECKS UNDER FEDERAL RESERVE BOARD REGULATION CC

Regulation CC, effective September 1, 1988, contains important provisions dealing with banks' responsibilities in handling checks for collection and return.[164] These provisions supercede any provision of the UCC that is in conflict with the regulation "but only to the extent of the inconsistency."[165] As a result, the regulation does not completely displace the UCC, and the law governing check collection and return must be gleaned from the interplay between these two bodies of law. As has been the case with other Board regulations, bankers can expect a continuing stream of revisions, additions, and interpretations as experience with the regulation is obtained. The regulation applies to bank collections generally and is not limited to collections that involve the Federal Reserve system.

Regulation CC uses a vocabulary that is different from the UCC to some extent. Its definition of "bank" includes various types of depositary institutions as defined in the Federal Reserve Act.[166] Because "account" is defined to mean a transaction account, certain types of depositary institutions that do not have transaction accounts will not be subject to the provisions dealing with expeditious return of checks, notice of nonpayment, and other duties.[167] The regulation uses the term "paying bank" rather than the UCC term "payor bank." A paying bank is a broader term and includes banks designated on checks as "payable at" or "payable through" banks under certain circumstances.[168] A "returning bank" is a bank that handles a returned check or notice in lieu of return, but does not include a paying bank or depositary bank.[169] The definition of check is more extensive than the UCC, but does not include a "noncash item."[170] The regulation distinguishes between a "banking day," which is when a bank is open to the public for business, and a "business day," which is a calendar day other than Saturday, Sunday, and certain specified holidays.[171] Time limits in the regulation are figured sometimes in banking days and sometimes in business days.

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[164] Regulation CC (1988) (to be codified as 12 CFR part 229). The regulation is divided into 3 subparts. Subpart A contains definitions and other general provisions. Subpart B on the availability of funds and disclosure of funds availability policies is discussed in Chapter 20. Subpart C is the part that deals with bank collections and returns and is the only part discussed in this section. The regulation became effective as this book went to press. Consequently, only a brief outline of the regulation is provided here. Future supplements will examine the regulation in more detail.

[165] Id. § 229.41.

[166] Regulation CC § 229.2(e) (1988) (to be codified at 12 CFR § 229.2(e)).

[167] Id. § 229.2(a), 229.30(e), and 229.31(e).

[168] Id. § 229.2(z).

[169] Id. § 229.2(cc).

[170] Id. § 229.2(k).

[171] Id. § 229.2(f)–229.2(g).

The regulation imposes a duty on paying banks when a check is not paid to make "expeditious return."[172] There are several alternative ways this duty may be met. A "two-day/four-day test" is established under which the paying bank will meet its duty if the returned check would normally have been received by the depositary bank under the return method used by the bank within the time constraints of the test.[173] *If it is a local check, the returned check must be received* by the depositary bank not later than the cutoff hour on the second business day following the banking day on which the check was presented. If it is a nonlocal check, four business days are allowed.[174]

Alternatively, the bank may use a "forward collection test," which generally requires handling the return check in the same manner that "a similarly situated bank would normally handle a check" for forward collection that was drawn on the depositary bank.[175]

When the bank cannot identify the depositary bank, there are procedures for the bank to simply return the check through the collection path used, and the expeditious return duty then does not apply.[176] The bank is entitled to rely on the routing number designating the depositary bank that is encoded on the check.[177] Certain provisions permit the bank to extend the time for return or giving notice of nonpayment under the UCC or Regulation J if the extension permits return by a more expeditious procedure.[178] With the exception of this extension provision, the paying bank still must comply with the midnight deadline rules of UCC §§ 4-301-4-302, and the bank becomes "accountable" if it does not comply with the deadlines as the UCC provides.[179]

The return rules contemplate return directly to the depositary institution or to other banks, which may or may not have been involved in the forward collection of the check, who agree to make expeditious return.[180] The Federal Reserve System is expected to offer a return check service that could be used under these provisions.

There also is an expeditious return duty for returning banks.[181] Returning banks have alternatives for meeting this duty that are similar to those for paying banks. These alternatives may require returning banks to act more quickly than they would otherwise have to under the UCC. There is a procedure for encourag-

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[172] *Id. § 229.30.*

[173] Id. § 229.30(a)(1).

[174] Id.

[175] Id. § 229.30(a)(2).

[176] Id. § 229.30(b).

[177] Id. § 229.30(g).

[178] Id. § 229.30(c).

[179] Id. § 229.30, commentary.

[180] See discussion of method of return in ¶ 21.03[8].

[181] Regulation CC § 229.31 (1988) (to be codified at 12 CFR § 229.31).

ing returning banks to expedite returns by using magnetic ink encoding technology to make the return check a "qualified return check."[182] Returning banks may charge for handling returned checks.[183]

Because the return process will not usually retrace the forward collection chain, Regulation CC makes substantial changes in the UCC scheme for collection based on provisional and final settlements between banks. Settlements between banks, both in the forward collection process and in the return process, are final.[184] However, certain provisions allow a bank engaged in the return process to charge back to prior banks if a bank is unable to obtain payment of the item being returned.[185] As a result, the UCC provisions dealing with when a bank becomes accountable or is regarded as having made "final payment" still have some relevance.[186] The regulation treats the return process in a manner similar to the forward collection process, and there are warranties made when a paying bank or returning bank transfer a check in the course of its return.[187]

To speed up returns, Regulation CC imposes a standard for bank indorsements.[188] It seeks to reduce the need for certain "boilerplate" indorsements by giving a bank a chargeback right against prior banks in the collection and return route, regardless of whether the bank has indorsed the check.[189] By stipulating that after a bank indorses a check only a bank can become a holder of it until it has been specially indorsed to someone who is not a bank, Regulation CC also assists bank customers.[190] A bank may be liable for losses caused by delay as a result of failure to follow the indorsement procedures.[191]

The regulation imposes duties on depositary banks. When checks are returned, the depositary bank has a duty to make payment in a manner that makes the proceeds of the payment available promptly.[192] There is a duty to accept returned checks at locations specified in the regulation,[193] as well as a duty to act promptly when a returned check erroneously has been routed to it.[194]

Regulation CC expands the Board's rules regarding notice of nonpayment

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[182] Id. § 229.31(a).

[183] Id. § 229.31(d).

[184] Id. §§ 229.31(c), 229.36(d).

[185] Id. § 229.35(b).

[186] See id.; 229.35, commentary (b).

[187] Id. § 229.34. See discussion ¶ 21.03[8].

[188] Id. § 229.35 & Appendix D.

[189] Id. § 239.35(b).

[190] Id. § 229.35(c).

[191] Id. § 229.38(d).

[192] Id. § 229.32(b). See discussion ¶ 21.03[8].

[193] Id. § 229.32(a).

[194] Id. § 229.32(c).

of large dollar checks in amounts of $2500 or more.[195] It contains rules on the presentment of checks for payment, including the recognition of truncation agreements.[196] The regulation also provides special rules applicable to collections and returns when a bank becomes insolvent and when bank mergers occur.[197] The expeditious return rules and notice of nonpayment rules generally do not apply to U.S. Treasury checks, U.S. Postal Service money orders, and checks drawn upon state and local governments that are not payable through or at a bank.[198]

Other parts of this chapter discuss the provisions in Regulation CC on varying the regulation's effects by agreement, presentment, notice of nonpayment for large checks, and liability. Chapter 20 discusses the provisions related to funds availability.

¶ 21.07 USE OF CENTRAL DATA PROCESSING CENTER FOR PAYMENT OF CHECKS BY BANK WITH MULTIPLE BRANCHES

When a bank uses a central computerized data-processing center for determining whether to pay checks that have been drawn upon all of its branches, does the central operation constitute "final payment" to foreclose the bank from later reversing the entry and charging back the amount of the check to the presenter? This question was raised in *Idah-Best, Inc. v. First Security Bank.*[199] In this case, the plaintiff was the payee of a check drawn upon the Haley branch of First Security Bank. The plaintiff deposited the check in its account in the Twin Falls Bank, an unrelated bank. Twin Falls, pursuant to an arrangement it had established with First Security, sent the check for collection to the First Security office in Boise. First Security's Boise office maintained a data-processing center for all the First Security branches. The Boise data-processing center utilized a computer bookkeeping procedure to enter checks in the individual accounts held by the customers of all of the branches of First Security Bank. This computer center was located in Salt Lake City. Plaintiff's check was duly sent to the Salt Lake City computer center. The computer center then returned the check to the Boise office indicating the check was drawn against an account with insufficient funds. The processing center in Boise prepared a return check notice and forwarded the check and the return notice to the Haley branch. The Haley branch checked the signatures on the check, checked with its tellers to determine

[195] Id. § 229.33. These rules are discussed at ¶ 21.11[2][d].

[196] Id. § 229.36. See discussion at ¶ 21.10.

[197] Id. §§ 229.39 (insolvency), 229.40 (mergers).

[198] Id. § 229.42.

[199] 99 Idaho 517, 584 P2d 1242 (1978).

if a deposit had been made overnight to cover the check and, finding none, stamped the check as not paid. The Haley branch then returned the check to the Boise office. Ultimately, the check was returned to the plaintiff payee two weeks after the check had been deposited. The plaintiff claimed that First Security could not charge back the amount of the check because it delayed too long in doing so. Plaintiff argued the receipt of the check by the data processing center constituted presentment on the payor bank which began the time running within which the bank had to act to revoke the initial settlement given when plaintiff made its deposit. In addition, plaintiff argued that the actions taken by the data center constituted completion of the process of posting which would be final payment. The court held for the defendant, First Security Bank. The court first noted that the activities of the processing center in Boise were like those of a collecting bank. The Boise branch indorsed the arriving checks, sorted them through the processing center according to the banks on which they were drawn, and encoded them with magnetic ink characters to allow computer processing. It also prepared the checks for physical delivery to the branches. The court said that when those actions are "performed for the Boise branch at the data processing center, the Boise branch is truly acting as a collecting bank." The court also recognized, however, that the use of the central computer meant that the Boise branch data processing center also was performing one of the steps employed by a payor bank in recording payment of a check.

The court concluded that the receipt of the check at the Boise branch could not constitute a presentment upon the payor bank. Firstly, it noted that the Boise branch was not acting under any express delegation of authority from the Haley branch to act as its agent for the purposes of payment.[200] Secondly, the court observed that the Boise branch was not in a position to verify the authenticity of the check because the signatures were maintained at the Haley branch. In view of this comment, it is important to note that the Haley branch did include a physical check of signatures in its process of determining whether to pay the check. Finally, the court said that although the process of posting obviously began with the activities of the data processing center and there were entries made to the individual account through use of the computer records, there was no decision made to pay until the check arrived at the Haley branch. Therefore, the process of posting had not been completed and no final payment occurred.

In arriving at its conclusion, the court found some comfort from UCC § 4-106. The Idaho legislature had not included the bracketed language in Section 4-106 that required a branch to maintain its own deposit ledgers in order to have the benefit of that section.[201] The court said that this was done deliberately to allow branch offices of a bank to use central record keeping systems. Finally, the

[200] See UCC § 4-204.

[201] UCC § 4-106 states: "A branch or separate office of a bank [maintaining its own deposit ledgers] is a separate bank for the purpose of computing the time within which and determining the place at or to which action may be taken or notices or orders shall be given

court said that its decision would promote efficient handling of checks by encouraging banks to use modern computer record-keeping systems rather than the old methods of individual handling of checks.[202]

The court reached a result contrary to *Idah-Best* in *Central Bank of Alabama v. Peoples National Bank*,[203] rejecting the argument that UCC § 4-104 gave the branch office of the payor bank status as a separate bank for the purpose of computing the bank's deadline for charging back. The court took the view that the central computer processing facility that received the check prior to its delivery to the office of the branch should be viewed as the place where presentment occurred.

In *Chrysler Credit Corp. v. First National Bank & Trust Co.*,[204] the court ruled that the failure of the payor bank to return a check before its midnight deadline after receipt at the bank's data processing center made the bank liable for the amount of the check. The court concluded the computer center should be viewed as the payor bank when (1) the center is the designated place of presentment for checks drawn upon the bank's branch office; (2) the center performs services specifically for the branch; (3) the branch does not customarily perform the services provided by the center; (4) the services are an integral part of the branch's processing of checks; and (5) the center does not send the checks to the branch but only transmits computerized information.[205]

In *Lawrence v. Bank of America*,[206] the holder of two checks presented them for payment at Branch *A* of the Bank of America, where the holder had a personal checking account. The checks were drawn on Branch *B* of Bank of America. Branch *A* cashed the checks after first determining through the bank's computer that there were sufficient funds in the account on which the checks were drawn. Four days later, the bank notified the holder that payment had been stopped after the checks were cashed, that it was debiting the account of the holder for the amount of the checks, and that it was returning the checks to him. The court held that under the California version of the UCC, the two branches were separate banks for the purposes of the time when action may be taken or notice is received under UCC § 4-106. The court rejected the argument that the centralized computer system of the bank should make the two branches a single entity for purposes of determining if the stop payment order had been made prior to payment of the check.

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under this Article and under Article 3." The bracketed language is optional and had not been adopted by the state of Idaho.

[202] The court remanded the case for a determination of when the payor bank had "settled" for the check. In Idah-Best, Inc. v. First Sec. Bank, 101 Idaho 402, 614 P2d 425 (1980), the court upheld the determination that a timely final settlement had been made.

[203] 401 So. 2d 14 (Ala. 1981).

[204] 746 F2d 200 (3d Cir. 1984).

[205] Id. at 204.

[206] 163 Cal. App. 3d 431, 209 Cal. Rptr. 541 (1985).

Many of the issues discussed in this section are addressed in the Federal Reserve Board's Regulation CC. The regulation contains rules on the presentment of checks and clarifies when a paying bank will be deemed to have received a check for the purposes of triggering the bank's duties to return the check expeditiously or give notice of nonpayment. The rules specifically permit checks to be presented on the basis of the route encoded on them, deal with the branch bank issue, and authorize presentment at places the paying bank requests. The duties of a paying bank apply to banks that are designated as "payable through or payable at" banks in addition to paying banks. These matters are covered in the section of this chapter dealing with presentment.[207]

¶ 21.08 PAYMENT OF LOST OR STOLEN CHECKS

To obtain payment of a check or other negotiable instrument, the instrument itself must be presented to the payor. Any party to whom presentment is made may demand surrender of the instrument when it is paid.[208] When the instrument is lost, destroyed, or stolen, there is no instrument for the owner to present. The UCC gives the owner of such an instrument the right to maintain an action to collect it from any party who may be liable on the instrument after the owner proves his ownership and the circumstances that prevent physical production of the instrument.[209] The owner must also prove the terms of the instrument, of course.[210] Because the owner is not in possession of the paper, the owner will not be aided by the UCC's presumptions regarding proof of the validity of signatures on the instrument.[211]

Because a person who pays someone who claims to be the owner of a lost instrument runs a risk that the instrument will surface later in the hands of a holder in due course, if the instrument was lost or stolen while indorsed in blank or otherwise in bearer form, the UCC provides that a court may condition the owner's claim for recovery upon the supplying of indemnity to protect the payor against subsequent claims.[212] A New Jersey case explored some of the problems involved with this approach.[213] Plaintiff received a cashier's check of over $15,000 that named him as the payee. He testified that he mailed the check to his father in Puerto Rico but the check was lost in the mail. The plaintiff made a demand upon the issuing bank to refund the money or issue another cashier's

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[207] See ¶ 21.10 on presentment for payment under the UCC and the Federal Reserve Board rules.

[208] UCC § 3-505(1)(d). See ¶ 21.10 on the requirements for presentment.

[209] UCC § 3-804.

[210] Id.

[211] UCC § 3-804 comment.

[212] UCC § 3-804.

[213] Santos v. First Nat'l State Bank, 186 NJ Super. 52, 451 A2d 401 (1982).

check but the bank refused. The bank had issued the cashier's check to the plaintiff in 1978. Two years later, the plaintiff brought suit to recover his money from the bank. The bank had offered to reimburse or issue another check if the plaintiff would post a bond indemnifying the bank against possible loss, but the plaintiff did not have enough money to obtain the bond. According to the plaintiff, he did not indorse the check and so it could not come into the hands of a party who would qualify as a holder in due course and thereby have a better claim to the check than the plaintiff. The court held that the plaintiff's testimony on this point should not be relied upon, because the bank should not be put to the risk that someone might appear claiming that the plaintiff had authorized someone else to make the indorsement. (And, of course, the bank also is at risk if the testimony proves to be false.) Because over four years had elapsed from the time the check was issued until the case was heard by the court, the court thought it highly unlikely that a holder in due course ever would appear who could demand payment. Nevertheless, the court did not want to impose the risk of this possibility occurring on the bank. The plaintiff could not assert his rights to the check by enjoining the bank from paying it, because he could not bring an action in which the bank, the plaintiff, and the holder of the check were under the jurisdiction of the same court, since the holder of the check, if one existed, was not known.[214]

The court solved the dilemma by requiring the bank to establish a certificate of deposit that would be available to plaintiff after the six-years' statute of limitation for actions to enforce payment of the check expired. If no claimant appeared during this time to present the check, the certificate would be paid to the plaintiff. In the interim, the bank was to pay interest on the certificate of deposit quarterly to the plaintiff until either a claimant appeared or the limitation period expired. The court left open for the trial court to determine if it would be appropriate to award interest to the plaintiff for any period prior to the entry of the court's judgment. In leaving this question open, the court suggested that the award might be justified under the theory that at least a portion of this prior time period could be regarded as a time when payment of the check would have been unlikely.[215]

The holder may use UCC § 3-804, on proof of ownership, to sue on the instrument when the note has been mistakenly returned to the maker and the maker refuses to give it back. Recovery may be had even against persons liable on the instrument, such as indorsers, other than the person to whom the instrument was mistakenly surrendered.[216]

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[214] See UCC § 3-802.

[215] *Santos*, 186 NJ Super. at 66, 451 A2d at 415.

[216] Guaranty Bank & Trust Co. v. Dowling, 4 Conn. App. 376, 494 A2d 1216, cert. denied, 197 Conn. 808, 499 A2d 58 (1985). Refusal to pay or return an instrument presented for payment may constitute conversion as well. See UCC § 3-419(1).

¶ 21.09 JURISDICTION IN LAWSUITS INVOLVING CHECK COLLECTION AND OTHER TRANSACTIONS

Checks and other negotiable instruments are freely transferred across state lines and are often handled by banks and parties in more than one state. When the collection of the check breaks down and one party seeks to assert legal rights over another through a lawsuit, the choice of the jurisdiction in which to bring the lawsuit can raise difficult legal problems. These questions of jurisdiction to sue are generally beyond the scope of this handbook,[217] although a 1982 case involving interstate check collection is worth noting here. In this case,[218] checks were drawn on a Chicago bank and made payable to an Iowa corporation whose principal place of business was in Iowa. A forger obtained the checks, forged the payee's indorsements, and cashed the checks at an Iowa bank. The Iowa bank sent the checks for collection through its clearinghouse to the Chicago bank. The true payee then sued the Chicago bank in a federal district court in Illinois. The Chicago bank then sought to bring the clearinghouse into the lawsuit and the clearinghouse moved to bring the Iowa bank into the lawsuit. The court held that it lacked personal jurisdiction over the Iowa bank. The Iowa bank could not reasonably have foreseen that by cashing the checks concerned that it might be required to respond in an Illinois court for its actions. Because all the activities relevant to the liability of the Iowa bank took place in Iowa and would be premised upon Iowa law, the court said, "it is therefore difficult to imagine any special interest that Illinois could have in the resolution of the dispute between two Iowa banks—the depositary bank and the clearinghouse bank—about facts and law alien to Illinois." In the view of the court, granting personal jurisdiction over the Iowa bank "would positively *hinder* the underlying policies of the several states that favored the free flow of commerce and of interstate banking transactions in particular."

An Ohio court has interpreted its long-arm statute to hold that there is jurisdiction in Ohio to sue a New York bank that was engaged in factoring accounts of a California company that sold goods to a business in Ohio.[219] Gold Circle Stores, an Ohio business, bought goods from Bel Sales. Bel Sales, a California corporation, sold all of its accounts receivable to Chemical Bank, a New York bank that the parties stipulated does not contract to supply services or goods in Ohio. The court held that the Bank's entering into the factoring agreement and accepting the benefits under it, including direct payments from the Ohio firm on the accounts receivables, constituted the transacting of business in

[217] A complete description of these problems is contained in the multivolume treatise, C. Wright and A. Miller, Federal Practice and Procedure (1969–1987).

[218] Froning & Deppe, Inc. v. Continental Ill. Bank & Trust Co., 695 F2d 289 (7th Cir. 1982).

[219] Gold Circle Stores v. Chemical Bank—Dommerich Div., 4 Ohio App. 3d 10, 446 NE2d 194 (1982).

Ohio within the state long-arm statute. These activities were enough to support jurisdiction over the bank without denying the bank due process of law. The court relied upon the circumstance that the factoring agreement gave the bank title to the merchandise sold by Bel Sales and involved the bank in the sale of the merchandise to a degree "much greater than that of an assignee of an existing account receivable." The particular case arose when the Ohio firm tried to collect for merchandise returned to Bel Sales. As to this transaction, the court stated, "Chemical Bank's contracts are essentially the same as those of Bel Sales."

¶ 21.10 PRESENTMENT FOR PAYMENT UNDER UCC AND FEDERAL RESERVE BOARD RULES

Prior to September 1, 1988, when Regulation CC of the Federal Reserve Board became effective,[220] the major source of law governing the presentment, collection and payment of checks was the UCC with some impact from the Board's Regulation J. Regulation CC, which broadly covers many aspects of the collection and return of checks, now also plays a significant role. Some of the rules in Regulation CC address issues relating to the presentment of checks that are discussed in this section. Because of the importance of Regulation CC, a brief overview of the scope of its provisions relating to presentment of checks is set forth here before examining the traditional law represented by the UCC.

Regulation CC contains rules on how to determine the places where checks may be presented for payment. Under the regulation, a check will be considered received by the paying bank when it is received (1) at the location requested by the paying bank; (2) at the address associated with the routing number on the check; (3) at any branch of the head office if the check does not give a specific address for the bank; or (4) at any branch, head office, or other location "consistent with the name and address of the bank on the check . . ." if the bank is identified on the check by name and address.[221] The paying bank must accept presentment of checks at any of the locations specified in the regulation, and so this rule varies the provisions of the UCC that call for presentment to occur at a place specified in the instrument or requested by the payor bank.[222] These rules clarify that presentment can be made based on the routing instructions encoded on the check. They also clarify that receipt at a processing center the paying bank has designated amounts to receipt by the paying bank itself.

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[220] Regulation CC § 229.36 (1988) (to be codified at 12 CFR § 229.36).

[221] Id. § 229.36(b).

[222] Id. § 229.36 commentary (c). The UCC rule making the place specified in the instrument controlling is Section 3-504(2)(c). UCC § 4-204(3) goes further and permits presentment at a place the payor bank requests.

When there is a truncation agreement with the paying bank, a bank may present a check by transmitting the information called for in the agreement without presentation of the check itself.[223] There are limitations on the extent to which a truncation agreement may vary the return times and other duties placed on the banks by the regulation. The agreement cannot affect parties who are interested in the check but who have not been a party to the truncation agreement.[224]

Receipt of the check in accordance with these rules triggers the running of the time for the paying bank to meet its duties of expeditious return and notice of nonpayment.[225] These duties will fall on banks identified as banks for which checks are "payable at or payable through" because these checks are considered to be drawn on the bank so identified for purposes of the expeditious return and notice of nonpayment duties.[226]

Regulation CC also changes the UCC scheme by which collecting banks in forwarding a check make provisional settlements that subsequently either are reversed in the event the check is dishonored or become final when the check is paid. Under the Board's regulation, settlements in the forward collection of the check are "final when made."[227] This is consistent with the regulation's approach of anticipating direct return of dishonored checks to the depositary bank or other bank, which would bypass some of the intermediary banks that handled the check in the forward collection process.[228] The regulation recognizes that collecting banks may be liable to prior banks and the owner of the check for failure to exercise due care in the forward collection process.[229] This preserves the UCC approach of regarding the banks as the agent or sub-agent of the owner of the check for purposes of liability.[230] The regulation also provides a duty on banks to settle when a check is returned for nonpayment[231] and to make payment to the extent a bank that subsequently handles a check does not receive payment

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[223] Id. § 229.36(c).

[224] Regulation CC § 229.36(c) (1988) (to be codified at 12 CFR § 229.36(c)).

[225] Regulation CC § 229.36 commentary (b) (1988) (to be codified at 12 CFR § 229.36 appendix). See id. §§ 229.30(a), 229.33. The duties of expeditious return and notice of nonpayments are discussed at ¶¶ 21.03[8], 21.11[2][d].

[226] Regulation CC § 229.36(a) (1988) (to be codified at 12 CFR § 229.36(a)). See also the definition of "paying bank." Id. § 229.2(z). The regulation does not mean that a check sent for payment or collection to a payable through or payable at bank should be treated as drawn on that bank for purposes of the final payment and midnight deadline rules of UCC § 4-301 according to the Board's commentary. Regulation CC § 229.30, commentary.

[227] Id. § 229.36(d).

[228] See the discussion of methods of return at ¶ 21.03[8].

[229] Regulation CC § 229.36(d) (1988) (to be codified at 12 CFR § 229.36(d)).

[230] Id. § 229.36 commentary (d).

[231] See id. § 229.31(c), on the duty of the returning bank to settle, and id. § 229.32(b), on the duty of the depositary bank to pay.

for it.[232] These provisions appear to give paying banks and banks that have handled the check for collection and return rights that are similar in effect to those under the UCC scheme based on provisional and final settlements.

Although Regulation CC preempts provisions of the UCC to the extent of any inconsistency,[233] the regulation is written against the general backdrop of negotiable instruments law and bank collection rules established by the UCC. Thus, it is still important to consider the framework established by the UCC. In addition, there are instruments that do not involve the application of the Regulation CC rules, such as the collection of promissory notes and drafts that do not involve banks. The material in the remainder of this section describes the UCC treatment of presentment. As it is reviewed, it is important to keep in mind that Regulation CC should also be consulted for possible applicability in any situation involving the collection or return of checks.

[1] Liability of Primary and Secondary Parties

Liability on negotiable instruments payable in money can be primary or secondary. Makers of notes and acceptors of drafts are primarily liable. Indorsers, and all other parties, are secondarily liable. Their liability is conditional. Drawers of checks and drafts, although they are classed in the UCC as "secondary parties,"[234] are subject to a sort of liability that has combined characteristics of both primary and secondary liability.

No special formality is necessary for charging parties *primarily* liable.[235] Except for the liability in warranty arising from the transfer of instruments, parties *secondarily* liable can usually be held to their conditional liability only if the holder meets certain formalities at maturity of the instrument. These formalities are known as presentment, protest, and notice of dishonor. The requirements of the law must be followed strictly in these respects or the right of recourse against the parties secondarily liable may be lost (unless they have waived the requirements either before or after maturity).

[2] When Instruments Mature

Demand paper is mature the moment of issue and the maker is liable to pay it at any time within the statute of limitations.[236] When a date of maturity is

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[232] Id. § 229.35(b).

[233] Id. § 229.41.

[234] UCC § 3-102(1)(d).

[235] UCC § 3-413(1); cf. UCC § 3-502(1). See Farber v. Sackett, 255 Mass. 569, 152 NE 54 (1926); Union Bank v. Sullivan, 214 NY 332, 108 NE 558 (1915).

[236] UCC §§ 3-108, 3-122, 3-503. See First Nat'l Bank v. Capps, 208 Ala. 235, 94 So. 112 (1922).

stated, the instrument matures on the date indicated.[237] Drafts are sometimes payable "at sight." In such a case, the paper matures as soon as it is shown to the person required to make payment. If the instrument is payable a certain number of days after date, after sight, or after happening of a specific event, maturity is calculated by excluding the day from which the time is to begin to run and by including the day of payment.[238] For example, an instrument dated January 5 and payable in thirty days matures on February 4. When an instrument contains no date of maturity and no time for payment is expressed, it is payable on demand.[239] However, when an instrument payable a definite number of days after date is issued with that date blank, it will be considered as an incomplete instrument; under the UCC, it cannot be enforced until completed. When it is completed by filling in that which normally would be the date of issue, in accordance with the authority given, the instrument can be enforced.[240]

Time paper must be presented for payment on the date stated as payable. Demand paper must be presented for payment within a reasonable time after the attachment of drawer's and indorsers' liability.[241]

In *Yahn & McDonnell, Inc. v. Farmers Bank*,[242] the court considered when a certificate of deposit becomes due. Under UCC § 3-122(1), the cause of action on a certificate of deposit accrues when a demand is made for payment even when the certificate is one that bears a specific time of maturity. The certificate of deposit is treated differently from demand notes because such certificates are often held for a long period of time that may exceed the period of the statute of limitations. The district court had held that the certificate either matured on its stated date or that after the stated date it became a demand instrument that the transferee had acquired after a reasonable length of time. The court remanded the issue back to the district court for reconsideration in light of the circumstances surrounding the issuance and acquisition of the certificate.

[3] Saturdays, Sundays, and Holidays

When the maturity date of an instrument falls on a Sunday or on a holiday, the instrument is payable on the successive business day. When a time instrument matures on a Saturday, which is not a full business day, it should be

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[237] UCC § 3-503(1)(c). If the instrument is not paid when due, there is a cause of action against the maker or acceptor, which accrues on the day after maturity. UCC § 3-122(1)(a).

[238] See UCC § 3-503(1)(a). Although the UCC has no provision for the computation of time, no change from prior law was intended. UCC § 3-503 comment 1.

[239] UCC § 3-108. Keister v. Wade, 191 AD 870, 182 NYS 119 (1920).

[240] UCC §§ 3-114 & comment 2, 3-115.

[241] UCC §§ 3-503(1)(c), 3-503(1)(e).

[242] Yahn & McDonnell, Inc. v. Farmers Bank, 708 F2d 104 (3d Cir. 1983).

presented for payment on the successive full business day.[243] Some states have special legislation governing holiday and Saturday bank transactions.[244] When Regulation CC of the Federal Reserve Board applies, it contains its own set of deadlines for the collection and return process as discussed previously.[245]

[4] Time to Make Presentment for Payment

Presentment for payment is not required for holding the parties primarily liable on negotiable instruments but it is necessary for holding indorsers and, in some instances indicated below, for holding drawers.

If an instrument is not payable on demand, it must be presented on the day it falls due.[246] Presentment the day before is not sufficient and presentment after maturity also will be untimely if there is no excuse for the delay.[247] When there is an unexcused delay, indorsers are discharged, and other parties may be discharged if loss occurs as a result of bank insolvency because of the delay.[248]

Demand instruments must be presented a reasonable time after their issue to hold the drawers and a reasonable time after indorsement to hold the indorsers. Reasonable time is determined by the nature of the business and the particular circumstances involved.[249]

Checks, since they are intended for immediate payment according to the usual business custom, should be presented the next business day after receipt. The UCC sets deadlines of seven days and thirty days for initiating the collection of a check to count on holding indorsers and the drawer liable.[250] Failure to properly present a check or begin collection within seven days completely discharges indorsers but a drawer is discharged only when presentment is delayed more than thirty days *and* the drawer is deprived, by the insolvency of the drawee bank, of funds to pay the draft and, even then, the drawer is only

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[243] UCC § 3-503(3).

[244] California, for example, has adopted a non-uniform UCC § 3-123. Many states have special statutes that authorize bank transactions on Saturdays, Sundays, and holidays. See H. Bailey, Brady on Bank Checks ¶ 14.13 (6th ed. 1987).

[245] See ¶ 21.06 and the definition of "banking day" and "business day" in the regulation. Regulation CC § 229.2 (1988) (to be codified at 12 CFR § 229.2).

[246] UCC § 3-503(1)(c).

[247] See UCC § 3-511.

[248] UCC § 3-502.

[249] UCC § 3-503(2).

[250] Id. What constitutes a reasonable length of time is determined by commercial practice. The UCC sets a presumption that a check must be presented within a week after indorsement, or collection must be started, to hold an indorser; the presentation or collection of a check within thirty days after issue is necessary to hold the drawer. The presumption, of course, may be rebutted by proving contrary current business practices. It is therefore wise to start both checks and demand drafts in the process of collection the day after they are received.

discharged if he assigns his rights against the bank to the holder.[251] For example, if a check for $100 is held for an unreasonable length of time, during which time the drawee bank fails and pays a dividend on liquidation of only forty percent, the indorsers are completely discharged and the drawer will be discharged upon assigning, to the holder, his right to a claim of $100.[252] If the drawee bank was solvent but the check was dishonored for other reasons, the indorsers still would be discharged because of the delay but the drawer would remain liable.

Demand notes and certificates of deposit, although mature as issued, are obviously intended to run for some time. Although they may be presented at once, the holder will not lose his or her rights against the indorsers if he or she holds them for some time. The length of time elapsing between the issue of such paper and the date on which it must be presented in order to hold the parties secondarily liable depends upon the custom of the particular locality in which the paper is circulated. If a note is payable on demand, the cause of action against the maker accrues on its date, and this will begin the statute of limitations running.[253]

When overdue paper is still in circulation after maturity, it is held subject to the same rules as any other demand paper. If time paper is held beyond maturity, without being presented, the indorsers are discharged; but anybody indorsing thereafter may be held by presentment, within a reasonable time after such indorsement. The same rule applies to stale checks. For example, if a check with one indorser is held by Jones for sixty days, the indorser is already discharged as indicated above. If Jones then indorses to a bank, which presents the check to the drawee on the next day, the prompt presentment gives the bank the right to hold Jones on his indorsement but should not revive the liability of the first indorser unless the bank takes without notice of Jones's delay. Under the UCC, persons indorsing after maturity are not entitled to presentment and notice of dishonor.[254] No one who takes an instrument with notice that it is overdue can be a holder in due course.[255]

[5] Formalities of Presentment

To complete presentment, a number of formalities must be carefully observed. The instrument must be presented by the holder or by someone acting on his or her behalf, such as an agent or a collecting bank.[256] Presentment must be

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[251] UCC § 3-502. See Grist v. Osgood, 90 Nev. 165, 521 P2d 368 (Nev. 1974).

[252] UCC §§ 3-501–3-502.

[253] UCC § 3-122(1) & comment 1. The cause of action on a demand certificate of deposit does not accrue until there has been a demand for payment. Id.

[254] UCC § 3-501(4).

[255] UCC §§ 3-302(1)(c), 3-304(3).

[256] UCC § 3-504. See UCC §§ 3-505, 4-210.

made to the person who is the payor of the instrument, which may be the maker, acceptor, drawee or other payor.[257] Presentment to the drawer of a check is not proper. The place for presentment is the place specified in the instrument, and if no place is mentioned, presentment should be made at the place of business or residence of the party who is to pay.[258]

At the time of presentment, the instrument must be exhibited to the person required to make payment and, at the same time, a definite payment demand must be made upon him.[259] Mere informal talks or requests over the telephone are not sufficient presentment. Under the UCC, presentment by mail, through the clearinghouse, or by any means agreed upon or determined by commercial custom, is sufficient. The reason the instrument must be exhibited is because the payor is entitled to proof the person demanding payment is a holder who has a right to payment and, further, by paying the instrument, to take possession of it and cancel it, or, in the case of a partial payment, to have the payment noted on the instrument.[260]

Presentment must be made at a reasonable hour on a business day. For example, if it is payable at a bank, it must be presented during banking hours or during the customary time for clearing, if such customary time takes place after banking hours.[261]

An invalid presentment was found when a bank attempted to present a group of checks in bulk over the counter to the payor bank. Two banks in Florida, Citizens and Florida National,[262] had previously informally exchanged in bulk checks drawn on each other until Florida National changed to a computer processing system. Although Florida National had stopped the manual exchange, Citizens appeared with a two-inch stack of checks drawn on Florida National and demanded payment. Florida National refused to pay unless each check was individually indorsed but offered to permit Citizens to deposit the checks. Florida National quoted a two dollar per item processing fee for presentment in bulk for payment over the counter. Citizens then made arrangements with a correspondent bank for the collection of the checks at a cost of from $0.040 to $0.055 per item plus the costs of delay. Citizens then sued Florida National for damages from its refusal to pay over the counter. The court ruled for Florida National. Although over the counter presentment was allowed under UCC § 3-504, it was obsolete, and Florida National was fully within its rights under UCC § 3-505 in requiring Citizens to exhibit each check individually and to indorse a receipt for payment on the check. Furthermore, Citizens had no

[257] UCC § 3-504(1).

[258] UCC § 3-504(2)(c).

[259] UCC § 3-505.

[260] UCC § 3-505(1)(d).

[261] UCC §§ 3-503(4), 3-504(2)(b).

[262] Florida Nat'l Bank v. Citizens Bank, 474 So. 2d 852 (Fla. Dist. Ct. App. 1985).

right to insist upon receipt of provisional payment from Florida National without exhibiting the checks individually to determine whether they were properly payable. Because Citizens had not properly presented the checks, it was not entitled to damages.

Collecting banks (but not nonbank parties) are authorized to present items at any place designated by the payor bank.[263] This allows use of a central processing center or other arrangement for check truncation.[264]

When the instrument has been lost, the owner may recover from those liable for it upon proof of ownership.[265] In such a case, the payor is entitled to a bond to indemnify him against possible loss through demand by some other holder.

[6] When Presentment Is Excused

There are a number of instances in which delay or failure to make presentment may be excused. When delay is caused by circumstances beyond the control of the holder and is not due to his default, misconduct, or negligence, late presentment may be sufficient if it is made as soon as the cause of the delay ceases to operate.[266] Presentment may be dispensed with entirely when, after the exercise of reasonable diligence, presentment is impossible.[267] It may also be excused if the drawee is a fictitious person[268] or if presentment has been waived.[269]

There are also certain cases in which the parties secondarily liable are not entitled to presentment, even though it can be made. Thus, presentment for payment is not required for charging the drawer when he or she has no right to

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[263] UCC § 4-204(3).

[264] See Idah-Best, Inc. v. First Sec. Bank, 99 Idaho 517, 584 P2d 1242 (1978); aff'd after remand, 101 Idaho 402, 614 P2d 425 (1980). Regulation CC applies when checks are being presented. It has rules on where and how checks may be presented to the paying bank as discussed at ¶¶ 21.06, 21.10.

[265] UCC § 3-804. See Household Finance Corp. v. Johnson, 56 Ohio App. 2d 14, 381 NE2d 215 (1978) ("preponderance of evidence" test applied).

[266] UCC § 3-511(1).

[267] UCC § 3-511(2)(c).

[268] UCC § 3-511(2)(b).

[269] UCC § 3-511(2)(a). Presentment for payment was excused in a case where the bank informed the holder that the check would not be honored when the parties to the underlying transaction had a specific agreement that the bank had to "honor" the check in order for it to constitute payment. Prevo v. McGinnis, 142 Ariz. 298, 689 P2d 557 (Ariz. Ct. App. 1984). However, telephone advice from the payor bank that it has insufficient funds to pay a check does not amount to a presentment of the check for payment. Without a presentment, there cannot be a dishonor; absent dishonor, the underlying obligation for which the check was taken remains suspended and not in default. Rose v. U.S. Nat'l Bank, 218 Neb. 97, 352 NW2d 594 (1984). Moreover, when the check is forwarded to the payor bank for payment with the instructions to hold the check until sufficient funds become available, this is not a presentment, and there is no dishonor of the check. Id.

expect or to require that the drawee or acceptor will pay the instrument.[270] For example, when the drawer has stopped payment or has no money on deposit with the drawee-bank, and when no arrangement has been made for payment and the drawer knows of these facts, the drawer is not entitled to have the instrument presented.[271] It is not clear what circumstances are required for insufficient funds to excuse presentment for purposes of holding the drawer liable.[272]

An indorser who has indorsed the instrument after maturity is neither entitled to presentment nor is he entitled to notice of dishonor.[273]

[7] Duty of Payor Bank to Pay

[a] When Payment May be Refused Without Dishonor. The UCC does not provide for any "days of grace," which existed under former law in some jurisdictions, but it does recognize some situations in which payment may be refused without the occurrence of dishonor of the instrument. The bank has a right to defer payment pending "reasonable examination to determine whether it is properly payable."[274] It may require identification of the person making presentment and proof of his authority to act.[275] It can require production of the instrument.[276] Payment may properly be delayed under emergency conditions.[277] A collecting bank can agree to extend the time for payment in good faith attempt to obtain payment.[278] There are also special rules for documentary drafts and letters of credit.[279]

[b] What Is Dishonor? An instrument is dishonored by nonpayment when it is duly presented for payment and payment has been refused or cannot be obtained.[280] When, as indicated previously, presentment is excused and the

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[270] UCC § 3-511(2)(b).

[271] Id.

[272] See UCC § 3-511(2). This section appears to excuse presentment if the insufficient funds are a circumstance where the drawer should be viewed as having no reason to expect payment. See generally H. Bailey, Brady On Bank Checks, ¶ 14.14 at 14–18 (6th ed. 1987). See also cases cited note 269, supra.

[273] UCC § 3-501(4).

[274] UCC § 3-506(2).

[275] UCC § 3-505.

[276] Id.

[277] UCC § 4-108(2).

[278] UCC § 4-108(1).

[279] UCC §§ 4-502, 5-112.

[280] UCC § 3-507.

instrument is overdue and unpaid, it must be treated as dishonored.[281] After an instrument has been dishonored, notice must be given at once to charge parties secondarily liable. When an instrument is dishonored, the holder may sue either on the instrument or on the underlying obligation for which the instrument was given.[282]

[8] Presentment for Acceptance

Acceptance of a draft by a drawee constitutes a legal contract to pay the draft and occurs when the drawee signs it.[283] There are certain situations in which instruments must be presented for acceptance in order to hold the parties. Thus, if an instrument is payable after sight or after presentment, it must be presented for acceptance or negotiated within a reasonable time.[284] If a draft is payable elsewhere than at the residence or place of business of the drawee, or if the draft so stipulates, it must be presented for acceptance.[285] The holder of a draft payable at a stated date is not required to present the draft for acceptance, but has the option of presenting it on or before the date it is payable.[286] If the holder exercises the option to present the draft for acceptance and acceptance is refused, dishonor of the draft has occurred and the holder will need to give notice of dishonor.

The formalities of presenting an instrument for acceptance are the same as those required for presentment for payment, except that the party to whom presentment for acceptance is made may wait until the close of the next business day without dishonoring the instrument.[287] The holder may extend the time for acceptance one more business day without dishonor occurring.[288] Intentional failure to return the instrument within the time allowed will make the bank liable for the instrument.[289]

When an instrument has been presented properly and dishonored by nonacceptance, the holder has an immediate right of recourse against the drawers and indorsers and presentment for payment is not necessary.[290] Once the instrument has been dishonored by failure to accept, the holder must take prompt action to

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[281] UCC §§ 3-507(1)(b), 3-511(3).

[282] UCC §§ 3-410–3-411, 3-413–3-414, 3-802(1)(b). See ¶ 21.03[4].

[283] UCC §§ 3-410–3-411, 3-413.

[284] UCC § 3-503(1)(b).

[285] UCC § 3-501(1)(a).

[286] UCC §§ 3-501(1)(a), 3-503(1)(a).

[287] UCC § 3-506(1).

[288] UCC § 3-506(2).

[289] UCC § 3-419(1).

[290] UCC §§ 3-507(2), 3-511(4).

give notice of dishonor to indorsers and other secondary parties.[291] If proper notice has been given at nonacceptance, subsequent presentment for payment is not necessary.[292]

¶ 21.11 PROTEST AND NOTICE OF DISHONOR

To hold parties secondarily liable, such as indorsers and drawers, it is necessary for the person holding the instrument at maturity to meet all the requirements of presentment, protest (when necessary), and notice of dishonor. Failure in any one of these particulars automatically releases indorsers. The circumstances under which drawers are released from liability are more limited, but even drawers may be discharged. For example, under the UCC, failure to make a necessary presentment discharges the drawer when the drawee becomes insolvent during the delay,[293] and failure to make a necessary protest is a complete discharge.[294]

[1] Protest

Protest is a formal declaration by a holder that an instrument has been dishonored. It is rarely necessary. The UCC requires protest only of drafts that, on their face, are drawn or payable outside of the United States, its "territories, dependencies, and possessions," and Puerto Rico.[295] There are procedural advantages in making a protest because it creates presumptions of dishonor and notice of dishonor. Banks, however, can obtain the benefit of these presumptions without the formality of protest through the use of any official stamp or writing on the instrument, or any accompanying writing, that states the instrument is dishonored and gives a sufficient reason therefor.[296]

Although protest is usually made before a notary public, it can be made by any United States consul, vice consul, or other person authorized by the law of the place where the instrument is dishonored.[297]

The formality of protest is not necessary when the bank exercises its right to revoke a provisional settlement and charges back its customer's account for items that have not been paid.[298]

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[291] UCC § 3-501(2) & comment 3.

[292] UCC § 3-511(4).

[293] UCC §§ 3-501(1)(c), 3-501(2)(b), 3-502(1)(b).

[294] UCC §§ 3-501(3), 3-502(2).

[295] UCC § 3-501(3).

[296] UCC § 3-510(b).

[297] UCC § 3-509. Compare UCC § 3-508 on notice of dishonor. See also ¶ 21.11[2].

[298] Mercantile Bank & Trust Co. v. Hunter, 31 Colo. App. 200, 501 P2d 486 (1972).

The protest is a written statement, made under seal.[299] It must identify the dishonored instrument, certify that either due presentment was made or state why presentment was excused, and certify that the instrument was dishonored by nonacceptance or nonpayment.[300]

[2] Notice of Dishonor

[a] When Notice of Dishonor Is Necessary. Whether the instrument requires protest or not, notice of dishonor must be given to each indorser liable on the paper unless legally excused, and anyone to whom such notice is not given cannot be held on his conditional secondary liability[301] unless he has waived this condition. Unlike protest, no special form of notice is required. Anything that is sufficient to bring the dishonor to the attention of the parties secondarily liable is satisfactory.[302] The notice itself may be written or merely oral, but it must identify the instrument and state that the instrument has been dishonored.[303] If the instrument was protested, a copy of the protest is sufficient.[304] Notice may be given personally, by telephone, or through the mail,[305] and the form is immaterial so long as it conveys the necessary information.[306] Unless a bank is involved, the notice may be oral. Banks, however, should give written notice of dishonor.

When a bank exercises its right to revoke a provisional settlement and charge back its customer account for an item that is dishonored, it must give notice of dishonor as well.[307] When a payor bank exercises the right to charge back, it must either return the item or send written notice of dishonor.[308] When

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[299] UCC § 3-509.

[300] Id.

[301] UCC § 3-501(2). Brannons Number Seven, Inc. v. Phelps, 665 P2d 860 (Okla. Ct. App. 1983) (indorser not liable unless notice of dishonor given). The Federal Reserve System has its own regulations regarding notice of dishonor. These are discussed in ¶ 21.11[2][d]. See also ¶ 21.03[8].

[302] UCC § 3-508.

[303] UCC § 3-508(3). When oral, it must be given in a reasonable manner. Compare UCC §§ 4-212(1), 4-301(1)(b) on notice by collecting and payor banks. These rules are discussed below.

[304] UCC § 3-510(a).

[305] UCC § 3-508(3).

[306] Id.

[307] UCC §§ 4-212(1), 4-301(1)(b).

[308] UCC § 4-301(1)(b). See Available Iron & Metal Co. v. First Nat'l Bank, 56 Ill. App. 3d 516, 371 NE2d 1032 (1977); Security Trust Co. v. First Nat'l Bank, 79 Misc. 2d 523, 358 NYS2d 943 (1974); Security Bank & Trust Co. v. Federal Nat'l Bank & Trust Co., 554 P2d 119 (Okla. Ct. App. 1976) (Federal Reserve rules allowing oral notice control).

When a payor bank dishonors a check and returns it, UCC § 3-508(3) requires the bank to give notice of dishonor in a reasonable manner. Sending the dishonored check to the collecting bank at a city where there is no branch of the collecting bank is not

the collecting bank charges back, the UCC is not clear whether the notice must be written.[309] There are requirements imposed by Regulation J and Regulation CC for giving notice of nonpayment. These are in addition to the UCC and are discussed in the following sections.

[b] Giving Notice. Notice may be given by the holder of a dishonored instrument, by an agent of the holder, or by any other person who brings the facts to the attention of the parties secondarily liable.[310] The notary who protests the instrument is also a proper person to give notice.[311] When a bank is agent for collection, it may give notice.[312] When such notice comes to the attention of prior parties within the proper time, it is effectual for the benefit not only of the person on whose behalf it was given but also for all persons who have rights against the parties who have received the notice.[313]

[c] Who Should Be Notified. Notice is effective when given to the person whose name appears on the instrument or to any agent acting on his behalf.[314] Notice left with a third person, however, who is not the agent of the party to be charged, is not sufficient. In the case of partnership paper, notice to any one of the partners is notice to all of the partners.[315] When persons are not partners but are jointly liable on the paper, however, each individual, unless one of them has authority to act for the others, must be given notice.[316] In such a case, only the indorsers actually notified can be held to have received adequate notice.[317] The UCC has general rules on when notice is received and how an organization receives notice.[318]

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reasonable. Financial Universal Corp. v. Mercantile Nat'l Bank, 683 SW2d 815 (Tex. Ct. App. 1984). Federal Reserve Board Regulation CC now imposes return duties on banks that return checks. See ¶ 21.03[8].

[309] UCC § 4-212(1). See Laurel Bank & Trust Co. v. Sahadi, 32 Conn. Supp. 172, 345 A2d 53 (CP 1975) (oral notice effective); Valley Bank & Trust Co. v. First Sec. Bank, 538 P2d 298 (Utah 1975) (written notice required). Oral notice of dishonor from a bank clearinghouse to the depositary bank was held to be effective in Greer v. White Oak State Bank, 673 SW2d 326 (Tex. Ct. App. 1984). Because the depositary bank waited until it received written notification, it lost the right to hold its customer to liability on his indorsement as well as the right to charge back to its customer's account under UCC § 4-212.

[310] UCC § 3-508(1).

[311] UCC §§ 3-509(1), 3-509(3).

[312] UCC § 3-508(1).

[313] UCC § 3-508(8).

[314] UCC § 3-508(1).

[315] UCC § 3-508(5).

[316] See UCC § 3-508(1).

[317] UCC §§ 3-502(1)(a), 3-508(1).

[318] UCC §§ 1-201(26)–1-201(27), 3-508(4).

[d] Deadlines for Notice Under UCC and Federal Reserve Board Rules. The time and manner for giving notice is set by law. Under the UCC, notice may be given immediately after the dishonor and must be sent within the prescribed time.[319] Notice given after the prescribed time has elapsed is ineffective unless excused.

Under the UCC, the time allowed for banks to give notice is before their midnight deadline (midnight of the next business day following dishonor).[320] Individuals have until midnight of the third business day after dishonor.[321] These rules are also subject to change under the UCC provisions for bank collections, which may give collecting banks a longer time, when provided by agreement, by clearinghouse rules, by Federal Reserve regulations, or when the bank can establish reasonableness under certain circumstances.[322] There are Federal Reserve regulations, explained later in this chapter, which supersede the UCC deadlines to some extent.

Delay in giving notice of dishonor, like delay in presentment, may be excused by circumstances beyond the control of the holder and not caused by the holder's default or misconduct. But when the cause of the delay is removed, notice must be given with reasonable diligence.[323] Unforeseen employee absenteeism does not automatically trigger this provision.[324] Nor do delayed returns of dishonored items caused by employee illnesses, Christmas overloads, or machine breakdown, none of which alone or in combination constitute "circumstances beyond [the] control" of the bank.[325]

When an individual who is secondarily liable on an instrument receives notice, he or she has three business days after receiving notice of dishonor to give notice to prior parties. A bank must give notice of dishonor before its midnight deadline.[326]

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[319] UCC § 3-508(2).

[320] UCC §§ 3-508(2), 4-104(1)(h).

[321] UCC § 3-508(2).

[322] UCC §§ 4-202(2), 4-212.

[323] UCC § 3-511.

[324] Rich v. Franklin Sav. Bank, 18 UCC Rep. Serv. (Callaghan) 451 (NY Sup. Ct. 1975).

[325] Blake v. Woodford Bank & Trust Co., 555 SW2d 589 (Ky. Ct. App. 1977). Computer malfunction and/or electrical power failure may justify a bank's failure to return a check before the bank's midnight deadline under UCC § 4-302 if the bank exercises diligence. Whether these circumstances constitute an emergency or other circumstance beyond the control of the bank within UCC § 4-108 is a question of fact. Congress Factors Corp. v. Extebank, 34 UCC Rep. Serv. (Callaghan) 1258 (NY Sup. Ct. 1982).

[326] UCC §§ 3-508(2), 4-212(1), 4-301. The deadline is midnight on the banking day following the banking day when the bank dishonored or received notice of dishonor. UCC § 4-104(1)(h). Federal Reserve Board Regulations J and CC also apply and impose different deadlines which are discussed later in this section.

For example, if a bank that is a collecting agent gives notice of dishonor only to the person depositing the instrument, the depositor, in turn, can give notice to prior indorsers and can hold them liable even though the bank failed to notify them. Every person receiving notice of dishonor should immediately give such notice to prior parties who might be liable, otherwise, they may be discharged by failure to receive notice.[327] When timely notice has been given by any party, the notice operates for the benefit of all parties who have rights on the instrument against the party notified.[328]

In *Lufthansa German Airlines v. Bank of America National Trust & Savings Association*,[329] the customer of a depositary bank claimed that the bank could not charge back a check to the customer's account because the bank failed to give timely notice to the customer of its dishonor. A check for over $63,000 was deposited by the customer and forwarded to the drawee bank, who dishonored it. Following Federal Reserve rules, the drawee bank gave notice by telephone to the depositary bank of its dishonor of the check. The telephone message was received on June 21, but the bank did not give notice of the dishonor to its customer until it received the check on June 28, which was timely if it was proper to calculate the time for giving notification from the date the check was received by the depositary bank. The court upheld the ruling of the trial judge that the customer received timely notice. The telephone call to the depositary bank did not create a duty to advise the customer of the dishonor because the telephone message did not identify the branch where the check was deposited or the customer who deposited it.[330]

In a different case, the payor bank gave timely notice of dishonor to the collecting bank when the payor bank orally told the collecting bank that a $30,000 check was drawn against insufficient funds. This triggered an obligation on the collecting bank to notify its customer of the dishonor. Since the collecting bank did not give notice before its midnight deadline, the indorsers on the check were discharged from liability. The collecting bank could not avoid responsibility for giving notice of the dishonor by instructing the payor bank to continue to hold the check in the hope that it eventually would be paid.[331]

A depositary-collecting bank became liable for failing to give its customer notice of dishonor of a check deposited by the customer. The customer pre-

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[327] UCC §§ 3-502(1), 3-508(1), 3-508(8).

[328] UCC § 3-508(8).

[329] 652 F2d 835 (9th Cir. 1981).

[330] The telephone message did give the depositary bank the amount of the dishonored check, the reason for the dishonor, the date of the Federal Reserve cash letter, the name of the maker of the check, and the routing number. Id. at 836. Regulation CC, discussed below, places a duty on a depositary bank to give notice of nonpayment to its customer by the bank's midnight deadline or "a longer reasonable time." Regulation CC § 229.33(d) (1988) (to be codified at 12 CFR § 229.33(d)). The duty is not limited to checks of $2,500 or more, although that is the regulation that creates the duty. Id.

[331] Clements v. Central Bank, 155 Ga. App. 27, 270 SE2d 194 (1980).

sented a classic showing of loss because the customer shipped goods for which the dishonored check had been given in payment and would not have released the goods if it had received timely notice of the dishonor. The depositary bank received notice of the dishonor of the check on April 2nd, but the bank did not give notice to its customer. Noting that the customer did not have enough in its account to cover the check and believing that the payor bank had been late in returning the check, the depositary bank sent the check back to the payor bank. A month later, the payor bank again returned the check to the depositary bank. Then, for the first time, on May 20th the depositary bank advised its customer of the situation. The court held that the delay in payment had caused the loss to the customer and further held that a provision in the bank's regulations that it had discretion to "resubmit returned checks" did not excuse the bank from its negligence in failing to notify its customer of the dishonor.[332]

When a collecting bank charges back its customer's account because the account was credited for a check that was subsequently dishonored, UCC § 4-212(1) requires the bank to act by its midnight deadline or "within a longer reasonable time." One court found that a circumstance justifying delay beyond the midnight deadline was the intervention of the Christmas holiday between the time the bank received notice the check had been dishonored and the time the bank took action to notify its customer.[333] The bank satisfied the requirements of this section by giving oral notice of the charge-back and dishonor to its customer.[334]

A payor bank has no duty to notify the payee that it will dishonor checks drawn on its customer's account even in circumstances in which the payor bank knows that numerous checks are being returned to the payee for insufficient funds. The bank satisfies its standard of care by returning the checks in a timely fashion (before its midnight deadline).[335] Although a Federal Reserve regulation required the payor bank to give notice by wire to the Federal Reserve bank when it returned items in excess of a specified amount, the failure of the payor bank to give this notice, while amounting to lack of ordinary care under UCC § 4-103(5), did not result in the bank's liability to the payee to whom the dishonored checks were returned. The payee could not show how the failure of the bank to give notice to the Federal Reserve bank had harmed the payee's chances of collecting the dishonored checks.[336] However, the Federal Reserve Board has adopted regulations since this decision in which paying banks may have liability to a payee for lack of due care.

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[332] United Ky. Bank, Inc. v. Eagle Mach. Co., 644 SW2d 649 (Ky. Ct. App. 1983).

[333] Bank of Commerce v. De Santis, 114 Misc. 2d 491, 496, 451 NYS2d 974, 979 (N.Y. Civ. Ct. 1982).

[334] Id. at 497, 451 NYS2d at 980.

[335] Whalen & Sons Grain Co. v. Missouri Delta Bank, 496 F. Supp. 211, 214 (ED Mo. 1980), aff'd mem., 657 F2d 274 (8th Cir. 1981).

[336] Id. at 215.

The Federal Reserve Board in Regulation J requires payor banks to give notice directly to the depositary institution when they dishonor checks or other cash items of $2,500 or more that are processed through the Federal Reserve System. The notice must be *received* by the depositary institution by midnight of the second banking day following the day on which the payor bank dishonored the check. Failure to provide proper notification will result in liability to the depositary institution for losses sustained up to the amount of the check.[337]

A paying bank that fails to act in good faith in giving notice as required by Regulation J may be liable for other consequential damages of the depositary bank as well. In the event of litigation between the paying bank and depositary bank over the notice requirements, the prevailing party may recover court costs and attorney fees.[338] The contents of the notice and the method by which it is given to the depositary bank are governed by the Board's regulations and the operating circulars of the Reserve bank of the paying bank.[339] The paying bank's liability under the regulation for failure to use ordinary care in giving notice runs only to the depositary bank.[340]

The notification and return responsibilities of payor and collecting banks have been greatly enlarged by the Board's Regulation CC, effective September 1, 1988.[341] Regulation CC places a duty of "expeditious return" on paying banks that decide not to honor a check[342] and on the returning banks that participate in the return process.[343] These rules apply to all depositary institutions, not just to banks who use the check collection services of the Federal Reserve System. The rules preempt any provisions of the UCC that are inconsistent, to the extent of the inconsistency,[344] and establish new deadlines and procedures for banks to follow in returning checks.[345]

Regulation CC expands the requirement that paying banks give direct notice to the depositary institution when checks of $2,500 or larger are not paid.[346] The duty to give notice now exists for all depositary institutions that the

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[337] 12 CFR § 210.12(c) (1987). Effective September 1, 1988, the Regulation CC notification provisions discussed later have replaced the Regulation J rule. 53 Fed. Reg. 21,985 (1988).

[338] 12 CFR § 210.12(c)(6) (1988) (deleted and replaced by Regulation CC effective Sept. 1, 1988).

[339] 12 CFR §§ 210.12(c)(2)–210.12(c)(3) (1988). In contrast to the UCC, the deadline in the regulation is based on when the notice is *received*. 12 CFR § 210.12(2) (1988).

[340] 12 CFR § 210.12(c)(6) (1988) (deleted and replaced by Regulation CC effective Sept. 1, 1988). See Childs v. Federal Reserve Bank, 719 F2d 812 (5th Cir. 1983), discussed at ¶ 21.01[3].

[341] To be codified at 12 CFR part 229.

[342] Regulation CC § 229.30(a) (1988) (to be codified at 12 CFR § 229.30 (a)).

[343] Regulation CC § 229.31(a) (1988) (to be codified at 12 CFR § 229.31(a)).

[344] Regulation CC § 229.41 (1988) (to be codified at 12 CFR § 229.41).

[345] These procedures are discussed at ¶ 21.03[8].

[346] Regulation CC § 229.33(a) (1988) (to be codified at 12 CFR § 229.33(a)).

regulation classifies as paying banks and not just institutions who pay checks that have been collected through Federal Reserve System facilities.[347] The deadline for giving notice has been shortened. Notice of nonpayment must be received by the depositary bank by 4:00 P.M. local time "on the second business day following the banking day on which the check was presented to the paying bank."[348] The content and manner of notification are specified in the regulation. Timely return of the check to the depositary bank is effective on notice.[349] Upon receipt of the notice or returned check, the depositary bank has a duty to promptly notify its customer of the nonpayment of the check.[350]

The liability rules of Regulation CC makes all banks liable for failure to exercise ordinary care or act in good faith in carrying out the duties established by the regulation.[351] Liability runs to "the depositary bank, the depositary bank's customer, the owner of a check, or another party to the check."[352] The damages recoverable by the injured party for lack of due care are "the amount of the loss incurred, up to the amount of the check, reduced by the amount of the loss that party would have incurred even if the bank had exercised ordinary care."[353] When there is failure to act in good faith, damages may include other consequential damages.[354] There is, however, a comparative negligence rule so that negligence or bad faith attributable to the injured party will diminish that party's recovery.[355] The regulation specifically preserves liability that a paying bank might have under the UCC or Regulation J or other parts of the Regulation CC for failure to comply with the deadlines under such laws for check return, and, although the matter is not clear, the commentary suggests it preserves the liability of a collecting bank under the UCC § 4-202 as well.[356]

[e] When Notice of Dishonor Is Received. The UCC provisions provide that written notice is given "when sent."[357] It does not have to be received to have

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[347] Board of Governors of the Federal Reserve System, Press Release p. 24 (May 13, 1988).

[348] Regulation CC § 229.33(a) (1988) (to be codified at 12 CFR § 229.33(a)).

[349] Id.

[350] Regulation CC § 229.33(d) (1988) (to be codified at 12 CFR § 229.33(a)). The depositary bank must "send notice to its customer of the facts by midnight of the banking day following the banking day on which it received the returned check or notice, or within a longer reasonable time." Id.

[351] Regulation CC § 229.38(a) (1988) (to be codified at 12 CFR § 229.38(a)).

[352] Id.

[353] Id.

[354] Id.

[355] Regulation CC § 229.38(c) (1988) (to be codified at 12 CFR § 229.38(c)).

[356] Regulation CC §§ 229.38(a), 229.38(b), & commentary (a), (b) (1988) (to be codified at 12 CFR § 229.38(a) & Appendix).

[357] UCC § 3-508(4).

been timely and to have been "given" properly by the bank.[358] (The Federal Reserve regulations, discussed in the previous sections, take a different approach.) When the party to be notified has become insolvent after the instrument is issued, the UCC permits notice to be given to the party, to the bankruptcy trustee, or to any other representative of the estate.[359] When the party is dead or incompetent, notice may be sent to his last known address or may be given to his personal representative.[360] In other cases, the general rule under the UCC is that notice should be sent "in the case of an instrument to an address specified thereon or otherwise agreed, or if there be none, to any address reasonable under the circumstances."[361] In giving notice, the bank must act reasonably in a manner calculated to inform the person concerned.[362] To send written notice the bank must "deposit in the mail or deliver for transmission by any other usual means of communication with postage or cost of transmission provided for and properly addressed. . . ."[363]

As indicated previously, it is not necessary that the person actually have knowledge of the facts.[364] If a person actually receives the notice within the time allowed, the notice is effective, even though it was improperly sent or there were other defects in the manner of giving it.[365]

[f] When Notice of Dishonor Is Excused. Although it is safer to give notice of dishonor in all cases, the UCC does not require giving notice of dishonor to the drawer when the drawer has no right to expect or require that the drawer or acceptor will honor the instrument, as, for example, when the drawer has no account in the drawee bank or when the drawee has stopped payment.[366] When the drawer is the person to whom the instrument is properly presented for payment, no further notice is needed.[367]

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[358] Id. The motion of nonpayment of large amount checks by paying banks must be *received* by the depositary bank by the stated hour on the second business day following the banking day on which the check was presented. Regulation CC § 229.33(a) (1988) (to be codified at 12 CFR 229.33(a)). The depositary's duty to its customer is to *send* notice by its midnight deadline. Id. § 229.33(d). The expeditious return duties are different. See ¶ 21.03[8].

[359] UCC § 3-508(6).

[360] UCC § 3-508(7).

[361] UCC § 1-201(38).

[362] UCC § 1-201(26).

[363] UCC § 1-201(38).

[364] UCC §§ 1-201(26), 3-508(4).

[365] UCC § 1-201(38).

[366] UCC § 3-511(2)(b).

[367] Id.

Indorsers need not be given notice of dishonor when the indorser has "no reason to expect or right to require that the instrument be accepted or paid."[368] Notice of dishonor is excused when, after the exercise of reasonable diligence, such notice does not reach or cannot be given to the parties sought for charging.[369]

[3] Presentment of Previously Dishonored Checks

Authorities disagree on the rules on dishonor of re-presented checks. One school of thought says that if the item was properly dishonored the first time, the payor bank is not bound by its midnight deadline when the item is re-presented.[370] The other school believes little reason exists for treating the re-presented item any differently from the originally presented item. It would apply the same rules and time constraints to both situations, since to do otherwise would put the depositary bank at a true disadvantage.[371]

[4] Waiver of Presentment, Notice, and Protest

Any or all of the steps required in presentment, protest, and notice of dishonor may be waived.[372] Waivers may be embodied in the instrument. If the waiver is "embodied in the instrument itself," it binds all parties, whether their signatures appear on the face or the back of the instrument.[373] When the waiver is written above the signature of a particular indorser, however, it binds only that indorser.[374]

[5] Consequence of Failure to Give Notice of Dishonor to Drawer

Under the UCC, it is necessary to give notice of dishonor to hold the drawer to secondary liability, but, like failure of presentment for payment, failure to give notice of dishonor discharges the drawer of a check or draft only to the extent of the loss caused by the insolvency of the bank upon which the instru-

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[368] Id.

[369] UCC § 3-511(2).

[370] Leaderbrand v. Central State Bank, 202 Kan. 450, 450 P2d 1 (1969); Goodman v. Norman Bank of Commerce, 551 P2d 661 (Okla. Ct. App. 1976).

[371] Wiley v. People's Bank & Trust Co., 438 F2d 513 (5th Cir. 1971); Financial Universal Corp. v. Mercantile Nat'l Bank, 683 SW2d 815 (Tex. Ct. App. 1984); Blake v. Woodford Bank & Trust Co., 555 SW2d 589 (Ky. Ct. App. 1977); Sun River Cattle Co. v. Miners Bank, 164 Mont. 237, 521 P2d 679 (1974).

[372] UCC § 3-511(2)(a).

[373] UCC § 3-511(6).

[374] Id.

ment is drawn.[375] In such a case, the drawer must assign his or her rights in the account in the defunct drawee bank to the holder, as would the maker of a note or the acceptor of a draft payable at the bank. This must be in the amount of the draft and will relieve the drawer from further liability. Otherwise, the drawer will remain liable on the draft.[376]

¶ 21.12 COLLECTION OF U.S. GOVERNMENT CHECKS

Checks issued by the U.S. Treasury are property of the United States and are governed by federal law, not by the UCC, which is state law. Although courts will look to the general law of negotiable instruments to assist in resolving issues in which the statutory or regulatory law of the United States gives incomplete direction, and the UCC as the statement of the general law applicable in all of the states should be a primary source of guidance when such situations arise, there are significant differences when U.S. government checks are involved. The Secretary of the Treasury is authorized to issue checks or drafts on the Treasury for the payment of debts of the United States, and the Secretary also may designate a depositary to issue checks to pay obligations of the U.S.[377] Federal statutes cover some, but not all, aspects of the rights and duties associated with payment by U.S. Treasury check, and the Secretary has issued regulations.[378]

The rights associated with fiscal agency checks are different from those for U.S. Treasury checks. Fiscal agency checks are those issued by a Federal Reserve bank in its capacity as fiscal agent of the United States. These are checks issued on behalf of the United States for payments in connection with U.S. Securi-

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[375] UCC §§ 3-501(2)(b), 3-502(1)(b).

[376] UCC §§ 3-501(2)(b), 3-502(1)(b). See Beutel, "The Liability of 'Secondary Parties' Under the Uniform Commercial Code, Drawers and Indorsers," 1 Rut.-Cam. LJ 15 (1969).

[377] 31 USC § 3327 (1982). See discussion at ¶ 3.04[1] of federal depositories.

[378] Some of the key statutes are 31 USC § 3328, as amended by the act, (paying checks and drafts); Section 3329 (withholding checks to be sent to foreign countries); Section 3330 (payment of Veterans' Administration checks for the benefit of individuals in foreign countries); Section 3331 (substitute checks); Section 3332 (checks payable to financial organizations designated by government officers and employees); Section 3333 (relief for payments made without negligence); Section 3334, as amended by the act, (cancellation and proceeds distribution of Treasury checks); Section 3712(a) (claims over forged or unauthorized indorsements). Some of the key regulatory provisions are 31 CFR pt. 235 (settlement checks for forged checks); part 240 (indorsement and payment of checks drawn on the Treasury); pt. 245 (issue of substitutes of lost, stolen, destroyed, mutilated and defaced checks drawn on the Treasury); pt. 248 (issue of substitutes of lost, stolen, destroyed, mutilated and defaced checks drawn on depositary banks); pt. 355 (fiscal agency checks) (1987). The Secretary also has regulations covering direct payments to financial institutions or through automated clearinghouse systems. 31 CFR pts. 209–210 (1987).

ties.[379] The drawer of a fiscal agency check is the United States and the drawee is a Federal Reserve bank.[380] The rules for fiscal agency checks are contained in Regulation J of the Board of Governors of the Federal Reserve System,[381] and "to the extent not otherwise inconsistent with these regulations [31 CFR part 355] and Regulation J, the Uniform Commercial Code. . . ."[382]

Detailed rules on the indorsement of government checks restrict the opportunities for persons other than the designated payee or payees to indorse the government check on behalf of the payee or payees. Even a person with authority to act as agent for the payee, can indorse a government check on behalf of the payee only by indorsing in the manner prescribed in the regulations and in the circumstances permitted by the regulations. Otherwise, as discussed in the next section, the indorsement may be treated as a "forgery" or as "unauthorized" and "unacceptable," with all the consequences of responsibility based on breach of the indorser's and presenting banks' guaranty of title to the check.[383]

The regulations make the indorsers and the presenting bank guarantee to the Treasury "that all prior indorsements are genuine whether or not an express guaranty is placed on the check."[384] Also, when the first indorser on a check is someone other than the payee personally, the indorsers and presenting bank guarantee as a matter of law "that the person who so indorsed had unqualified capacity and authority to indorse the check in behalf of the payee."[385] The regulations establish procedures for the Treasury to reclaim amounts paid out on checks with unauthorized indorsements or a "material defect or alteration" that was not discovered before being paid.[386] The Treasury has a procedure for offsetting charges against presenting banks when a specified period of time elapses after the Treasury has sought reclamation of the amount of the item.[387]

The regulations specify that the Treasury "shall have the usual right of a drawee to examine checks presented for payment and refuse payment of any checks, and shall have a reasonable time to make such examination. Checks shall be deemed to be paid by the United States Treasury only after first examination has been fully completed."[388] Payment of a Treasury check may be deferred,

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[379] 31 CFR § 355.0 (1987).

[380] Id.

[381] 12 CFR pt. 210 (1987).

[382] 31 CFR § 355.1 (1987).

[383] The definition of "presenting bank" in the regulations is somewhat different from that in the UCC as the regulations use the term to mean "a financial institution which, either directly or through a correspondent banking relationship, presents checks to and receives credit from a Federal Reserve bank . . ." 31 CFR § 240.2(h) (1987).

[384] 31 CFR § 240.4 (1987).

[385] Id.

[386] 31 CFR § 240.5 (1987).

[387] 31 CFR § 240.7 (1987).

[388] 31 CFR § 240.3 (1987).

pending settlement, when checks are presented where there is a "doubtful question of law or fact."[389]

[1] Indorsement, Transfer, and Collection of Government Checks

There are extensive regulations on the indorsements of U.S. government checks. Under the regulations, the only manner in which one person can indorse a government check on behalf of another person who is the named payee is by using a form that identifies that the "indorser is indorsing on behalf of the named payee or payees, pursuant to authority expressly conferred by or under law or other regulation," and the indorsement must contain the signature of the person who indorses.[390] The regulation gives as an example an indorsement reading: "John Jones by Mary Jones," but states that this is only the minimum required and in some circumstances the regulations require more than this minimum to be acceptable. It is not acceptable for a person other than the named payee to indorse by only signing the name of the payee. If this occurs, the indorsement, "regardless of the relationship between the indorser and the named payee or payees, will be rebuttably presumed to be a forgery and is unacceptable."[391] When there is an indorsement by one purporting to act for the named payee by indorsing in the name of the payee and giving the indorser's signature with "no indication of the indorsing person's representative capacity, there is a rebuttable presumption that the indorsing person was not authorized to indorse for the named payee(s)."[392] The bank will be responsible for the authority of the indorser in this case.

The regulations provide guidelines for some specific situations which recur frequently. When a payee has been declared an incompetent, the indorsement by a legal guardian or fiduciary should indicate the legal capacity with which the signer is acting, as in "John Jones by Mary Jones, guardian of John Jones."[393]

Similarly, when the payee is deceased, an executor or administrator may indorse by showing the legal capacity under which the indorser is acting as in "John Jones by Mary Jones, executor of the estate of John Jones."[394] An executor or administrator can indorse only when the right to payment of the government check does not terminate with the death of the payee and only includes payments which are (1) payments for the redemption of currencies or for principal or

[389] Id.

[390] 31 CFR § 240.10 (1987).

[391] Id.

[392] 31 CFR § 240.10(c)(2) (1987).

[393] 31 CFR § 240.11 (1987). The regulations indicate that only in the case of certain classes of checks may a guardian or fiduciary indorse for an incompetent payee without submitting the check with proof of authority to act to the government, but the regulations do not identify what these classes are. Id. § 240.11(b).

[394] 31 CFR § 240.12(a)(1) (1987).

interest on U.S. securities; (2) payments for tax refunds; and (3) payments for goods and services.[395] In all other cases, the checks must be returned to the government for a decision whether payment is due and, if it is, to whom.

In the case of checks issued to minors to pay principal or interest on U.S. securities, either parent with whom the minor resides, or the person who provides the minor's chief support when the minor does not reside with a parent, may indorse for the minor by presenting a signed statement giving the minor's age, stating that the payee either resides with the parent or receives the chief support from the indorser, and certifying that the minor will receive the benefit of the proceeds of the check.[396]

When a social security benefit check is issued jointly to two or more individuals of the same family and one of the payees dies after the check issues, before the check may be negotiated, it should be returned to the appropriate Social Security or Treasury office where payment to the surviving payee may be authorized by having the check stamped with a legend that redesignates the payee as the survivor. The check then may be indorsed as if it were issued in the name of the persons who are designated as the survivors.[397]

There are provisions dealing with signatures of government checks made under powers of attorney. When the check is issued for payment for the redemption of currencies or for principal or interest on U.S. securities, for tax refunds, or for goods and services, the indorsement of the payee may be made under a general power of attorney "in favor of an individual, financial institution or other entity . . . "[398] There are certain additional circumstances prescribed by the Comptroller General whereby classes of checks may be negotiated under a special power of attorney that names a financial institution as "attorney in fact, and recites that it is not given to carry into effect an assignment of the right to receive payment, either to the attorney in fact or to any other person."[399] The attorney in fact must indicate such capacity in the indorsement. All types of powers of attorney are revoked by the death of the person who granted the authority, and the person granting the authority may expressly revoke it at any time by notice "to the parties known, or reasonably expected, to be acting on the power of attorney." Giving notice to the Treasury ordinarily will not be adequate to revoke a power of attorney. The regulations provide standard forms for use with powers of attorney.[400]

Financial institutions have special authority to indorse. When a financial institution has authority from the payee to credit a check to the payee's account,

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[395] 31 CFR § 240.12 (1987).

[396] 31 CFR § 240.13 (1987).

[397] 31 CFR § 240.10(f) (1987).

[398] 31 CFR § 240.14 (1987).

[399] CFR § 240.14(c) (1987).

[400] 31 CFR § 240.14(h) (1987).

the institution may indorse in language substantially like "Credit to the account of the within-named payee in accordance with the payee's or payees' instructions. XYZ."[401] By using this indorsement, the institution guarantees to "all subsequent indorsers and to the Treasury that it is acting as an attorney-in-fact for the payee or payees, under the payee's or payees' authorization, and that this authority is currently in force and has neither lapsed nor been revoked either in fact or by the death or incapacity of the payee or payees."[402]

When U.S. government checks are payable directly to the financial institution to be deposited for the account of a person who designated payment to be made in this manner, the financial institution may simply indorse the check in the institution's name as payee in the usual manner. These checks subject the financial institution to the regulations dealing with direct payments.[403]

When a government check is indorsed "for collection" or "for deposit only to the credit of the within named payee or payees," the regulations state the indorsement is "acceptable without any signature."[404] Without a signature, however, the bank guarantees its good title to the check to the Treasury and to subsequent indorsers.[405]

There also is a procedure provided in the regulation for the issuance of substitute checks when a government check is not received, lost, destroyed, mutilated or defaced. The owner making claim for a substitute may be required to post indemnity.[406]

[2] Deadlines for Payment of Government Checks and for Making Claim to Recover Payments for Checks With Forged or Unauthorized Indorsements

In Title X of the Competitive Equality Banking Act of 1987, Congress adopted rules on the payment of U.S. Treasury checks. Under the new legislation, the Treasurer cannot be required to pay a Treasury check that is negotiated to a financial institution after twelve months from the date on which the check was issued.[407] The Act then directs the Secretary to establish a procedure for

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[401] 31 CFR § 240.10(d) (1987).

[402] Id.

[403] See 31 CFR pt. 209 (1987).

[404] 31 CFR § 240.10(c)(1) (1987).

[405] Id.

[406] 31 CFR part 245 (1987) (implementing 31 USC § 3331). See also id. at part 248.

[407] Competitive Equality Banking Act of 1987, Public L. No. 100-86, tit. X, § 1002(a), 101 Stat. 552 (hereinafter CEBA), amending 31 USC § 3328(a)(1). This rule applies to Treasury checks issued after the effective date of this section, which is 6 months after the date the act was enacted or when the Secretary of the Treasury prescribes. CEBA, § 1006. For previously issued checks, the Secretary of the Treasury is not required to pay when the

cancellation of checks that are more than twelve months old and return of the proceeds to the agency concerned.[408]

The legislation also places a time limit on the period that the Secretary of the Treasury has to assert a claim based upon a forged or unauthorized indorsement. When the Secretary seeks to reclaim the amount of the check from the presenting bank or from a prior indorser who has breached its guaranty of indorsements, the claim must be made before the end of one year running from the date the check was paid.[409]

Corresponding with the bar on claims by the Secretary to recover for breach of warranty with respect to forged or unauthorized indorsements, the act establishes a one year limit on claims on account of a Treasury check. A claim for payment is barred unless the claim is presented "to the agency that authorized the issuance of such check within one year after the date of the issuance of the check. . . ."[410] Although the claim based upon the Treasury check will be barred if the claim is not presented within one year, this bar on obtaining payment of the check does not affect the underlying obligation of the United States or any agency of the United States that was the basis for issuing the check.[411]

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check is negotiated to a financial institution more than twelve months after the effective date of this section of the act. CEBA, § 1002(a).

[408] CEBA, § 1003, amending 31 USC § 3334(a).

[409] CEBA, § 1004, amending 31 USC § 3712(a). In the case of claims received under 31 USC § 3702, the Secretary has an additional period of time. Id.

[410] CEBA, § 1004, amending 31 USC § 3702(c)(1).

[411] CEBA, § 1004(b), amending 31 USC § 3702(c)(2).

III

Security Transactions in Personal Property and Related Credit Practices

22

Creation of Security Interests in a Debtor's Personal Property

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¶ 22.01 SECURITY INTERESTS IN PERSONAL PROPERTY UNDER THE UCC

When a creditor takes an interest in a debtor's personal property as collateral to secure an obligation owed by the debtor to the creditor, the transaction, in most cases, is a secured transaction governed by Article 9 of the Uniform Commercial Code. The term "personal property" is used in the same sense here that it has in the legal classification of all property as either real property, which involves interests in land, or personal property, which involves everything else, including chattels and intangible things.[1] Because many different kinds of property can serve as collateral for obligations, the law relating to these transactions is complex, and must account for the different characteristics of the collateral concerned. Before the UCC, and depending on the type of collateral involved, there were many separate statutes that applied, including the Uniform Trust

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[1] The scope of the UCC's treatment of security interests in personal property is discussed at ¶ 22.01[1]. For an excellent discussion of the legal system's classification of property as "real" or "personal," see R. Cunningham, W. Stoebuck & D. Whitman, The Law Of Property § 1.4 (1984).

Receipts Act, the Uniform Conditional Sales Act, Chattel Mortgage Acts, Factors Lien Acts, Assignment of Accounts Receivable Acts, and others. All of this prior legislation is superseded by the UCC. Sometimes the terms used under the former statutes continue to be used in business transactions. This does not impair the validity of the security interests created, because the UCC applies regardless of the terminology used.[2] As long as the parties intend a security transaction, it does not matter whether their agreement is called a chattel mortgage, a conditional sales agreement, or a trust agreement.[3]

The UCC provisions on secured transactions were extensively revised in 1972. All but a handful of states have adopted the 1972 amendments. Table 14-1 in Chapter 14 lists the states that have adopted the changes, along with their effective dates. This book discusses the UCC as revised by the 1972 amendments. The major changes made by these amendments are mentioned where they are relevant to an understanding of the reasons for the changes. Where changes have occurred in the law, it is important to note whether decided cases or transactions in dispute are controlled by the current version of the UCC.[4]

[1] Scope of UCC on Security Interests

The general policy of the UCC is to provide a comprehensive framework for all transactions involving security interests in personal property. Any transaction that creates a security interest in any kind of personal property (goods, bills of lading, warehouse receipts, instruments, accounts, contract rights, etc.) falls within the scope of Article 9, unless specifically excluded.[5] A security interest is defined simply as "an interest in personal property or fixtures which secures payment or performance of an obligation."[6] This definition includes a seller's retention of title until the seller obtains payment for goods sold. It also includes transactions which, according to their form, do not state that they are security transactions but which are "intended" to create security interests.[7]

When a seller reserves title to goods that the seller has delivered to a buyer, Article 9 treats the seller's interest as a security interest. Often the seller will attempt to argue that a relationship other than that of buyer and seller existed between the parties with respect to the goods. For example, in one case, a

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[2] UCC § 9-102(2). All UCC references are to the Uniform Commercial Code 1978 Official Text (West 1978).

[3] Id.

[4] There is a special transition section, Article 11, of the UCC that specifies when the 1972 amendments apply to transactions having some relation to the period before the state in question adopted those amendments.

[5] UCC § 9-102(1)(a).

[6] UCC § 1-201(37).

[7] UCC §§ 9-102(1)(a), 1-201(37). See additional discussion of creation of a security interest infra ¶ 22.01[2].

question arose as to whether the debtor held cattle as a bailee with an option to purchase or as a buyer under a conditional sale arrangement.[8] If the latter, the debtor would have an ownership interest in the collateral in the debtor's possession, to which the secured party's security interest could attach. If the former, that the cattle were held by the debtor as a bailee, the debtor would have no ownership interest to which the secured party's security interest could attach. The correct characterization of the debtor's interest in the cattle would depend on the parties' intent.[9] The UCC applies "to any sale of accounts or chattel paper" unless one of the exceptions applies.[10] Thus, a financer who buys the accounts of a business or takes an absolute assignment, without right of recourse against the assignor, is subject to the rules of the UCC. The definition of account is broad and includes many types of payment obligations, not just those rights often referred to as "accounts receivables."[11] Likewise, a bank or other financer who purchases chattel paper is engaging in a transaction controlled by UCC rules.

There are twelve transactions to which the UCC does *not* apply. They are as follows:

1. *Security interests governed by federal statutes.* Federal statutes governing mortgages on ships, liens on aircraft, assignments of copyrights, and assignments of patents prevail over the UCC. In some cases, these federal statutes may not regulate all the rights of the parties and the UCC may, in part, be used for guidance.[12]

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[8] Rohweder v. Aberdeen Prod. Credit Ass'n, 765 F2d 109, 111–112 (8th Cir. 1985).

[9] Id. at 113. See Horizon Processing Co. v. Charter Int'l Oil Co. (In re Charter Co.), 49 Bankr. 513 (Bankr. MD Fla. 1985). A seller had oil in the storage tanks of the buyer, having previously sent the oil to the buyer for processing and holding. The seller reserved title to the goods in the agreement with the buyer. The seller argued that no delivery of the goods had occurred, because the parties to the arrangement had agreed that title would not pass until the buyer paid for the goods. The court held that as the parties were contracting with respect to goods that were not going to be moved from their place of storage at the time of contracting, the delivery of the goods occurred at the time of contracting, since the seller had not retained control over the delivery process. Thus, the court found that the reservation of title by the seller, in the goods already in the buyer's possession, constituted a security interest. 49 Bankr. at 517.

[10] UCC § 9-102(1)(b). See infra ¶ 22.07[4] for a definition of chattel paper.

[11] See infra ¶ 22.07[1] on accounts.

[12] UCC § 9-104(a). In CIM Int'l v. United States, 641 F2d 671 (9th Cir. 1980), the court considered the Federal Aviation Act scheme for recordation of aircraft ownership and creditors' liens. The court held that "A security interest in an aircraft is not necessarily invalid against all parties for all purposes and under all conditions solely because it is not filed with the FAA." 641 F2d at 680. A federal statute let UCC principles govern subrogation rights in cases involving federal tax liens. 641 F2d at 676. In Gary Aircraft Corp. v. General Dynamics Corp. (In re Gary Aircraft Corp.), 681 F2d 365 (5th Cir. 1982), cert. denied, 462 US 1131 (1983), the court held that Congress did not intend to displace state law assignment of priorities to interests in aircraft when it enacted the

2. *Landlord liens.* These liens are created under other state law. The UCC has no application to their creation or enforcement.[13]

3. *Liens for services or materials provided.* These liens, such as garagemen's liens or warehousemen's liens, are not covered by Article 9 except to the extent that they may conflict with interests created under Article 9.[14]

4. *Assignments of claims for wages, salary or employment compensation.* These are not covered by the UCC.[15]

5. *Transfers by governmental agencies.* The creation of security interests in property of governmental bodies is not covered by the UCC.[16]

6. *Certain isolated sales of accounts or chattel paper.* When the sale of accounts occurs as part of a sale of a business, when an assignment is made for the purpose of collection only, when a right to payment under a contract is assigned to the person who is going to perform the contract, or when a "single account" is assigned to satisfy a prior debt, the UCC does not apply.[17]

7. *Insurance policies.* Generally, insurance policies are not affected by the UCC. There are limited circumstances, when insurance policies insure collateral subject to a security interest,[18] in which the UCC applies.

Federal Aviation Act. After an extensive review of the authorities, the court concluded that "the main concern of Congress was to create a central filing system, leaving the effect of filing to the states." Holding that the act "does not preempt state law on priorities," it applied UCC § 9-307(1) to find that the purchaser of the airplanes had the rights of a buyer in the ordinary course of business. 681 F2d at 372, 376. For a case discussing the methods for perfecting a security interest in an aircraft under the Federal Aviation Act, see Armstrong v. State Bank (In re Gelking), 754 F2d 778 (8th Cir.) cert. denied, 473 US 906 (1985). The Armstrong case held that the debtor had sufficient rights in the collateral to enable the secured party to perfect a security interest when the debtor had an equitable interest, but not full legal title, in the aircraft. 754 F2d at 781.

A security interest in a patent may be perfected by the filing of a financing statement. According to one court it is not necessary to record an interest with the patent office in order to perfect the security interest. In re Transportation Design & Technology, Inc., 48 Bankr. 635, 639 (Bankr. SD Cal. 1985).

An Article 9 filing has been held to be sufficient to perfect a security interest in a trademark or tradename registered under the federal Lantham Act (15 USC §§ 1051–1127). In re TR-3 Indus., 41 Bankr. 128, 131 (Bankr. CD Cal. 1984).

See generally Note, "The Choateness Doctrine and the Federal Loan Programs—A Plea for Federal Legislation," 33 Me. L. Rev. 269 (1981).

[13] UCC § 9-104(b).

[14] UCC § 9-104(c). See § 9-310.

[15] UCC § 9-104(d).

[16] UCC § 9-104(e).

[17] UCC § 9-104(f).

[18] UCC § 9-104(g). See infra ¶ 22.07[8]. Unearned insurance premiums that were refunded to the debtor, as a result of the cancellation of certain insurance policies, did not

8. *Judgments.* The UCC does not apply to rights based upon judgments.[19]

9. *Rights of setoff.* The UCC does not apply to rights of setoff.[20]

10. *Real estate interests.* Except as related to fixtures, the UCC has no application to real estate interests such as leases, rights to rent, or other transfers of real property.[21] There is considerable disagreement in the cases as to what constitutes a real estate interest subject to this exclusion.[22]

11. *Tort claims.* The UCC does not apply to tort claims or to the transfer of any interest in them.[23] Thus, Article 9 would not allow a creditor to take a security interest in a debtor's personal injury action or libel suit.

12. *Bank accounts.* Except as bank accounts may constitute proceeds of collateral, the UCC does not apply.[24]

[2] Leases and Consignments as Security Transactions

[a] Leases. Sometimes a lease functions like a security transaction. In some situations, a lease may be an alternative to buying equipment on credit terms. The lease may be arranged to give the lessee enjoyment of the equipment during its useful life, while also offering a deferred payment similar to that which might be required under an installment purchase or conditional sales plan. The lease may provide that the lessee assume the burdens, normally assumed by the owner, of maintaining and insuring the equipment and may further provide that the equipment become the property of the lessee, for little additional payment, at the end of the lease. In such cases, it is reasonable to view the lease essentially as a security transaction. When this is so, Article 9 of the UCC applies. The lessor

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constitute collateral in which a secured party had a security interest. There could be no security interest in the premiums, because UCC § 9-104(g) provides that Article 9 does not apply to the transfer of an interest in a policy of insurance. Because Article 9 did not apply, the court turned to the common law. Under that approach, the court classified the interest as a future intangible and held for the trustee. The court reasoned that the debtor had no property interest in the refund until it became due on cancellation of the insurance policy. At the time of cancellation, the trustee was entitled to the property. In re Duke Roofing Co., Inc., 47 Bankr. 990, 993 (Bankr. ED Mich. 1985).

[19] UCC § 9-104(h).

[20] UCC § 9-104(i). See ¶ 22.07[7]. See generally Annot., "Effect of U.C.C. Art. 9 Upon Conflict, as to Funds in Debtor's Bank Account, Between Secured Creditor and Bank Claiming Right to Setoff," 3 ALR4th 998 (1981).

[21] UCC § 9-104(j).

[22] See discussion infra ¶ 22.07[9] for a discussion of security interests in real estate related interests.

[23] UCC § 9-104(k).

[24] UCC § 9-104(l). See infra ¶ 22.07[7] for a discussion of security interests in bank accounts.

is regarded as a secured party; the lease agreement is treated as a security agreement; and the lessee has the rights of a debtor. This arrangement has the very serious consequence of making the transaction subject to UCC requirements for perfection of security interests. Unless the secured party/lessor takes action to perfect the security interest (normally by filing a financing statement), the lessor/secured party will have an unperfected security interest, which will be subordinate to the claims of lien creditors, trustees in bankruptcy, or other secured parties.[25] Additionally, the UCC provisions on remedies when there is a default will apply, and the secured party will need to comply with those notices and other rules.[26]

Not every lease of personal property is a security transaction. This depends on the facts of each case.[27] While there are two guidelines regarding these

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[25] See ¶ 23.01 for a discussion of priority rules.

[26] If a lease is found to be a security agreement, the secured party must be careful to comply with the Article 9 positions for repossessing the collateral, when default occurs. See Las Vegas Auto Leasing, Inc. v. Davis, 98 Nev. 169, 643 P2d 1217 (1982); BJL Leasing Corp. v. Whittington, Singer, Davis & Co., 204 NJ Super. 314, 498 A2d 1262 (App. Div. 1985) (when default occurred under a lease that was a disguised security agreement, the lessor had to follow Article 9 procedures for repossession and disposition of the collateral). Although court found an equipment lease was not intended for security, it applied UCC standards of commercial reasonableness to the lessor's repossession and sale of the equipment by drawing an analogy to UCC § 9-504. W.L. Scott, Inc. v. Madras Aerotech, Inc., 103 Idaho 736, 653 P2d 791, 795–797 (1982). See also United Counties Trust Co. v. Mac Lum, Inc., 643 F2d 1140 (5th Cir. 1981), where the court applied UCC § 9-206 on waiver of defense clauses to a lease that the court found was not intended for security.

[27] UCC § 1-201(37). See generally Coogan, "Is There a Difference Between a Long-Term Lease and an Installment Sale of Personal Property?" 56 NYU L. Rev. 1036 (1981); Leary, "The Procrustean Bed of Finance Leasing," 56 NYU L. Rev. 1061 (1981); Annot., "Equipment Lease as Security Interest Within Uniform Commercial Code," 76 ALR3d 11 (1977).

Defendant claimed that its construction equipment lease was a security agreement subject to Article 9. In form, the transaction was set up as a lease. The defendant attempted to prove that the transaction was a security agreement by using parol evidence to show it included an option to buy. The trial court excluded the evidence on the grounds that it violated the parol evidence rule and the statute of frauds. The Supreme Court of Utah reversed. Colonial Leasing Co. v. Larsen Bros. Constr. Co., 731 P2d 483, 486–487 (Utah 1986). The court concluded that the statute of frauds in UCC § 2-201(1) did not apply. If a transaction is a security transaction, UCC Article 2 does not apply to such a transaction. UCC § 2-102. Furthermore, the statute of frauds does not prevent a party from proving the true nature of an agreement when that is at issue, rather than enforceability. In this case, the defendant was not attempting to enforce the agreement but rather had invoked the protective provisions of Article 9 relating to disposition of the collateral. The court also said the trial court must first determine whether the agreement was an integrated agreement. "The parol evidence rule applies only if the writing was intended by the parties to represent the full and complete agreement . . ." Although the terms of the lease agreement were specific, the character of the agreement was in dispute, and so the trial court needed to hear evidence on that issue. 731 P2d at 486-487.

leases,[28] the UCC does not give guidelines for all possible circumstances. The UCC states:

> Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.[29]

Before a bank accepts as collateral any paper that, on its face, appears to be an equipment or other lease of personal property, careful consideration should be given as to whether the lease might be a security transaction. It is possible, under the UCC, to file a financing statement perfecting a security interest in leased goods, without admitting that the transaction is a security transaction

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[28] UCC § 1-201(37). In In re Tulsa Port Warehouse Co., 690 F2d 809, 811 (10th Cir. 1982), the court treated a lease as a security agreement, although it did not contain an option to purchase, because the lease was the economic equivalent of a purchase agreement. See also Steele v. Gebetsberger (In re Fashion Optical, Ltd.), 653 F2d 1385 (10th Cir. 1981). In Aoki v. Shepherd Mach. Co. (In re J.A. Thompson & Son, Inc.), 665 F2d 941 (9th Cir. 1982), the court found that when a lease contains an option to purchase for no additional consideration or for nominal consideration, the lease "is conclusively presumed to be 'intended as security', without reference to other facts from which the opposite inference might be drawn." 665 F2d at 947. In American Standard Credit, Inc. v. National Cement Co., 643 F2d 248 (5th Cir. 1981), the court discussed the effect that should be given to a filing of a financing statement and self-serving recitals in the lease agreement in characterizing the transaction as a lease or security arrangement.

In trying to decide whether "an option to purchase under a lease made the lease one entered into for security," another court noted that an option to purchase at the end of the lease for the fair market value of the leased goods is consistent with a true lease but does not automatically save the lease from being a lease "intended for security." The court further ruled that in deciding whether the purchase price was a "nominal consideration" under UCC § 1-201(37), the court would compare the price under the option with the value of the goods to the lessee for future use, salvage, or resale. The court said, "nominal consideration should mean that the leased equipment is worth considerably more to the lessee for future use, salvage, or resale than the amount of the option price." In re Celeryvale Transp., Inc., 44 Bankr. 1007, 1014 (Bankr. ED Tenn. 1984), aff'd, 822 F2d 16 (6th Cir. 1987).

A lease term that gave the lessee the functional equivalent of an equity interest in equipment at the end of the term, although not an option to purchase, could be regarded as a factor indicating that the lease was intended as a security arrangement. Wentworth & Irwin, Inc. v. United States Nat'l Bank, 80 Or. App. 500, 503, 723 P2d 1016, 1019 (1986).

[29] UCC § 1-201(37). A new Article 2A on leases has been approved for inclusion in the UCC. This addition amends the definition of security interest, § 1-201(37), to provide more guidance on when a lease is for security. Uniform Commercial Code 1987 Official Text § 1-201(37) (West 1987).

rather than a true lease.[30] This may be useful when other considerations indicate that a lease is preferable to a secured transaction, as for example, when the provisions of the Internal Revenue Code or the Bankruptcy Act affect the transaction. Further, it is possible to use the UCC provisions for assigning security interests to help protect the financer's position in such situations.[31] Finally, consideration also should be given as to whether the papers of the lease agreement fall within the UCC definition of chattel paper, so that the secured party will be able to take steps to protect an interest in the chattel paper as well as the equipment.[32]

[b] Consignments. Similar problems exist for those who sell goods on consignment.[33] However, even when a consignment is not treated as a security transaction under Article 9 of the UCC, it is advisable to follow the UCC rules on filing a financing statement to protect the consignor against the claims of other creditors of the consignee.[34] This does not mean that filing a financing statement constitutes an admission that the consignment is a security transaction.[35]

Consignments are covered by special provisions of their own regardless of whether they are intended as security transactions.[36] The consignment provisions make goods delivered to a buyer on consignment for purposes of resale subject to the claims of the buyer's creditors while the goods are in the buyer's possession.[37] Further, when goods are delivered to a person who sells goods at a place of business under a name other than the name of the person who has consigned the goods, the creditors of the person who is engaged in reselling them will have a claim to those goods that can defeat the claim of the owner or consignor, unless the consignor takes one of three steps to give notice of the interest he or she claims in the goods. One of these procedures is to file a financing statement on the goods using the Article 9 procedures.[38]

Manger v. Davis[39] discusses the applicability of the UCC to consignments. The court found that a true consignment had been established where the con-

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[30] UCC § 9-408.

[31] See discussion on transfer of security interests at ¶ 22.03[4].

[32] See discussion of chattel paper at ¶ 22.07[4].

[33] UCC §§ 9-102, 1-201 (37). See generally Winship, "The 'True' Consignment Under the Uniform Commercial Code, and Related Peccadilloes," 29 Sw. LJ 825 (1975).

[34] UCC §§ 2-326, 9-114.

[35] UCC § 9-408.

[36] UCC § 1-201(37). "Unless a . . . consignment is intended as security, reservation of title thereunder is not a 'security interest' but a consignment is in any event subject to the provisions on consignment sales (§ 2-326)."

[37] UCC § 2-326(2).

[38] UCC § 2-326(3), 9-408.

[39] 619 P2d 687, 691 (Utah 1980).

signee was only an agent without authority to sell or pledge the collateral. In the court's view, such true consignments were not governed by UCC §§ 2-401 and 2-403 on passage of title, as there was no transaction of purchase between the consignor and consignee. The consignee did not even acquire voidable title to the goods. Because the consignee in this case was not a person who maintained a place of business where he dealt in goods of that kind, UCC § 2-326(3) on consignment sales did not apply. The court then turned to agency law, as found in *Restatement (Second) of Agency* § 201, and held that the pledge of the goods by the consignee could not affect the consignor's interest in the goods, because the pledge was a transaction of a different kind than what was contemplated by the consignment.[40]

A Nevada case illustrates a different type of consignment problem. A dealer in mobile homes financed its inventory through General Electric Credit Corporation (GECC), who had a perfected security interest in the inventory. When the dealer sold a mobile home, a local savings association, Homes Savings Association (HSA), financed the purchase. The savings association would take a perfected security interest in the mobile home by following the procedures contained in the motor vehicle title statutes that applied to mobile homes. When a purchaser of a mobile home defaulted on the financing agreement, the savings association would repossess the unit, and, under an agreement with the dealer, would give the unit to the dealer to hold, recondition, and resell. However, when the dealer defaulted on its financing arrangement with GECC, GECC claimed all the inventory, including the mobile homes that had been repossessed by HSA and entrusted to the dealer. In the dispute between GECC and HSA, the Nevada Supreme Court ruled in favor of GECC. The court reasoned that the act of giving the repossessed units to the dealer constituted a consignment not for security that was governed by UCC § 2-326. Under that section, the consignor (HSA) had to perfect its interest using the methods provided there, which did not include the procedure in the state's motor vehicle laws that HSA followed.[41]

¶ 22.02 CREATING A SECURITY INTEREST

[1] The Security Agreement

The UCC makes a security agreement effective between the parties, against purchasers of the collateral and against creditors, unless the UCC provides to the contrary.[42] Thus, the general rule is that security agreements are enforceable. When the collateral is not in the possession of the secured party, the agreement,

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[40] Id. at 692.

[41] Homes Sav. Ass'n v. General Elec. Credit Corp., 101 Nev. 595, 600–601, 708 P2d 280, 285–286 (1985).

[42] UCC § 9-201.

with a description of the collateral, must be in writing and must be signed by the debtor.[43] When the collateral is crops or timber, the security agreement must also describe the related land.[44] Possession of the collateral by the secured party, as in the case of a pledge, constitutes a substitute for a signed, written agreement.[45]

Three conditions must be met to have an enforceable security interest:

1. There must be a written security agreement signed by the debtor or the secured party must have possession of the collateral;
2. The secured party must have given value (which may be either the advance of funds or only a binding commitment to advance funds);[46] and
3. The debtor must have rights in the collateral.[47]

When these three events occur, the security interest is said to "attach," and it becomes enforceable. The terms of enforcement depend on the provisions of the security agreement and on the rights granted under the UCC. This is discussed further in Chapters 23 and 24.

When the debtor does not have title to the goods, the debtor may not be able to give a secured party any rights to the goods. In a 1981 case, for example, a debtor corporation had agreed to sell two automobiles prior to entering into a security agreement granting the secured party a security interest in the vehicle.[48] The court held that according to UCC § 2-401(3), title to the vehicles passed to the purchaser at the time of contracting, because the purchaser was in possession. Although formal transfer of the certificate of title had not taken place, title to the goods could pass without compliance with the motor vehicle certificate of title procedures. Thus, the debtor had no rights in the collateral to which a security interest could attach. The debtor, however, need not have absolute ownership. In *Armstrong v. State Bank*,[49] the court held that the debtor's rights in the collateral were sufficient to qualify as a security interest, when the debtor had an equitable interest in the property, but not full legal title.[50]

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[43] UCC § 9-203(1)(a).

[44] Id. See First Nat'l Bank v. First Sec. Bank, 721 P2d 1270 (Mont. 1986) (a description of collateral in a security agreement as livestock located at a certain place did not have to identify the location to be effective, but when the location was included it had the effect of limiting the security interest to livestock only at the place).

[45] UCC § 9-203(1)(a).

[46] UCC § 1-201(44).

[47] UCC § 9-203(1). See generally Sanford, "Debtor's Rights in Collateral as a Requirement for Attachment of a Security Interest Under the Uniform Commercial Code," 26 SDL Rev. 163 (1981).

[48] Montco, Inc. v. Glatzer (In re Emergency Beacon Corp.), 665 F2d 36 (2d Cir. 1981).

[49] (In re Gelkins, Inc.), 754 F2d 778, 781 (8th Cir. 1985), cert. denied, 473 US 906 (1985).

[50] See also Weld Colo. Bank v. E & E Constr., Inc., 653 P2d 758 (Colo. Ct. App. 1982). The court held that a secured party with a security interest in the debtor's accounts did not

The parties to the security agreement may agree to defer the time at which the security interest attaches by an "explicit agreement" postponing the time of attaching.[51] In *Allegaert v. Chemical Bank*,[52] the court held that there must be "an unequivocal showing of an explicit agreement" to effect a postponement of the attachment, because the "ordinary expectation" is that a security interest will attach immediately and automatically.[53]

According to the definitions, a "security agreement" must be an "agreement which creates or provides for a security interest."[54] When the written agreement does not say in so many words that the debtor grants to the secured party a security interest, parties have questioned whether a security interest has been created. Resolution of this issue has been treated as a matter of ascertaining the parties' intent,[55] but a well-drafted security agreement should leave no room for

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acquire a security interest in funds placed in escrow, pending resolution of a controversy between debtor and a party against whom the debtor had a claim, because the debtor had not established a right to the fund. The case arose under the pre-1972 UCC provisions on "accounts." Id. at 760. In Walter E. Heller & Co. v. Riviana Foods, Inc., 648 F2d 1059, 1061-1062 (5th Cir. 1981), the court held that a security interest granted by the debtor in all of its inventory did not attach to goods that the debtor warehouse held as a bailee. The rules on "sale or return" in UCC § 2-326 did not apply because the debtor had no authority to sell the goods. In In re Cook, 63 Bankr. 789, 797-798 (DND 1986), the debtor did not have sufficient "rights in the collateral" to create a security interest because the collateral were cattle in the possession of debtor but owned by another, who neither gave authority nor was estopped from denying authority in the debtor to encumber them.

Under Kansas partnership law, a partner may not convey an interest in specific partnership property without all of the partners joining in the transfer. A partner may assign his or her profits from the operation of the partnership, however. In Wellsville Bank v. Nicolay, 7 Kan. App. 2d 172, 638 P2d 975 (1982), one partner assigned his rights to receive benefits under a contract of the partnership to the plaintiff. The assignment was made as security for a loan plaintiff made to the partner. A second partner in the partnership claimed the assignment was void because it attempted to convey specific partnership property, the contract. The court rejected this analysis and held that the first partner had not assigned specific partnership property. He had only transferred to plaintiff his rights to profits and surplus from the partnership attributable to that partnership asset. 7 Kan. App. 2d at 175, 638 P2d at 978. This interest constituted personal property in which an Article 9 security interest could be created. 7 Kan. App. 2d at 176, 638 P2d at 979.

[51] UCC § 9-203(2).

[52] 657 F2d 495 (2d Cir. 1980).

[53] 657 F2d at 503.

[54] UCC § 9-105(l).

[55] In WYHY Fed. Credit Union v. Burchell, 643 P2d 471 (Wyo. 1982), the court found that the parties had entered into an effective security agreement although the documents did not expressly contain language formally granting a security interest in the collateral to the secured party. The court applied the test that "[i]f an intention to provide a security interest can be found from the parties' course of dealings, then, so long as the minimal formal requirements are satisfied, a security interest exists." 643 P2d at 474. See also United Va. Bank/Seaboard Nat'l v. B.F. Saul Real Estate Inv. Trust, 641 F2d 185 (4th

doubt. The description of the collateral in the written security agreement does not have to be a specific description,[56] and it is not necessary to the validity of the

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Cir. 1981), holding that a security interest can be created by a document that lacks express language granting a security interest. When there is language in a promissory note stating that certain property constitutes "collateral" security, and there is a filed financing statement identifying the same property, it is logical to infer that the note creates a security interest in the property listed. Eames & Woodcock Ins. Agency, Inc. v. Alles, 40 UCC Rep. Serv. (Callaghan) 1438, 1442–1443 (Mass. Super. Ct. 1984). However, a financing statement, together with a note that had no reference to the collateral or to the financing statement, was not sufficient to qualify as a security agreement. The documents lacked language indicating an intent to create a security interest. In re Modafferi, 45 Bankr. 370, 373 (Bankr. SDNY 1985).

In Pontchartrain State Bank v Poulson, 684 F2d 704 (10th Cir. 1982), on the other hand, the court found that the document did not establish that the parties had agreed to create a security interest. In this case the creditor argued that the execution of a promissory note and a letter to the bank could be construed in combination to show that a security interest was intended. After reviewing the case law on this question, the court held that the document must "specifically grant a security interest" to the secured party. 684 F2d at 707. Although a financing statement may qualify as a security agreement, where the parties intended to create a security agreement, parol evidence is not admissible to establish this intent according to the court in In re Shinville Assocs., Inc., 46 Bankr. 352, 354 (Bankr. WD Mich. 1985).

See generally Boyd and Saxon, "The A-9: A Program for Drafting Security Agreements Under Article 9 of the Uniform Commercial Code," 1981 Am. B. Found. Res. J. 637 (1981); McLaughlin, "'Add on' Clauses in Equipment Purchase Money Financing: Too Much of a Good Thing," 49 Fordham L. Rev. 661 (1981); Walker, "Creation, Perfection, and Enforcement of Security Interest Under the 'Tennessee' Commercial Code," 48 Tenn. L. Rev. 819 (1981); Note, "The Formal Requirements of Uniform Commercial Code § 9-203(1)(a) Are Satisfied When a Financing Statement, a Promissory Note and the Course of Dealing Between the Parties Collectively Reveal an Intent to Create or Provide for a Security Interest (In re Bollinger Corp., 614 F2d 924 (3d Cir. 1980))," 50 U. Cin. L. Rev. 225 (1981).

The drafters of the UCC stated that the requirement for a security agreement "is not intended to reject, and does not reject, the deeply rooted doctrine that a bill of sale, although absolute in form, may be shown to have been in fact given as security." UCC § 9-203, comment 4. In Beard v. Newsome, 76 NC App. 476, 333 SE2d 527, 529 (1985), parol evidence was permitted to show that a transfer of personal property that was absolute on its face was in fact a transfer for security purposes.

[56] UCC § 9-110. The court refused to cure defects in a security agreement relating to the description of the collateral by construing the security agreement together with the financing statement in In re Permian Anchor Servs., Inc., 649 F2d 763, 766 (10th Cir. 1981). A description of the collateral in a security agreement as "all farm personal property" was not an effective description because it was too general. In re Becker, 46 Bankr. 17, 19 (Bankr. WD Wis. 1984), aff'd, 53 Bankr. 450 (WD Wis. 1985). On the other hand, a description of livestock as collateral in a security agreement did not have to meet the requirements of the state livestock bill of sale law in order to be an effective description. Moffat County State Bank v. Producers Livestock Mktg. Ass'n, 598 F. Supp. 1562, 1566 (D. Colo. 1984), aff'd, 833 F2d 908 (10th Cir. 1987).

See In re Deeb, 47 Bankr. 848, 851–852 (Bankr. ND Ala. 1985), where the court held that a security agreement, giving the secured party a security interest in an individually

agreement that the collateral be described item by item. It is enough that the description "reasonably identifies what is described." The comments make clear that requirements under pre-UCC law for detailed, serial-number types of descriptions have been eliminated.[57]

The security agreement may provide for a broad blanket security interest that reaches property acquired by the debtor after the security agreement is executed and that secures advances made by the secured party after the making of the agreement, regardless of whether the secured party was bound to make those advances.[58] However, the secured party cannot obtain an automatic inter-

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named horse, without referring to products of the collateral or otherwise indicating that any interest was to be created in offspring of the horse, was nevertheless effective in creating a security interest in foals that were born after the security interest had been perfected in the mare. The court relied on a pre-UCC case, Meyer Bros. v. Cook, 85 Ala. 417, 5 So. 147 (1888).

Boilerplate language granting a security interest in "all property" of debtor was not effective in creating a security interest. In re Wolsky, 68 Bankr. 526 (DND 1986).

[57] UCC § 9-110 and comment. The secured party was engaged in providing financing for the debtor's restaurant business. The financing statement identified the collateral as "furniture, fixtures, and small wares." The court viewed this description as ambiguous because two different classes of property could be referred to as fixtures: (1) true fixtures, which had a relationship to the real estate, and (2) trade fixtures, which would be classified as personal property. The court held that the general reference in the financing statement to "fixtures" was sufficient to cover trade fixtures. However, the use of the same general language in the security agreement would not suffice. The court imposed a stricter standard of specificity for the description of the property in the security agreement. In re FR of ND, Inc., 54 Bankr. 645 (DND 1985).

Both the financing statement and the security agreement described the cattle subject to plaintiff's security interests as livestock branded "-W on right ribs with an orange ear tag right ear." The court held that this description was adequate to identify the collateral and to create a security interest in cattle with the "W" brand. Although the cattle did not have the ear tag, the court said that the plaintiff has a perfected security interest because the ear tag clause was nothing more than an additional or surplus identification. American Indian Agric. Credit Consortium, Inc. v. Fort Pierre Livestock, Inc., 379 NW2d 318, 320 (SD 1985).

[58] UCC § 9-204. See generally "Priorities of 'Future Advances' Under Previously Perfected Security Interests and Article 9 of the UCC," 58 Marq. L. Rev. 759 (1975). When a debtor signs a security agreement that includes a clause under which future advances are also secured by the collateral, how does a court determine what obligations are covered by the "future advances" clause? This question was discussed in In re Sunshine Books, Ltd., 41 Bankr. 712, 714 (Bankr. ED Pa. 1984), where the court concluded that check overdrafts were within the purview of the future advances provision. The court discussed the application of a "relatedness rule." For an example of confusion over whether a refinancing was secured by collateral provided for in the first agreement, see Nutting v. Bradford Nat'l Bank (In re Nutting), 44 Bankr. 233 (Bankr. D. Vt. 1984).

When a secured party enters into a financing arrangement with a debtor, in addition to agreeing on the amount of the loan the debtor will be obligated to repay; the parties may also agree that the debtor will undertake additional obligations, such as the payment of interest on the unpaid loan, the obligation to pay attorney fees and other costs in the event

est in property acquired by a consumer more than ten days after receiving value from the secured party.[59] Thus, it is not necessary to have separate security agreements for each advance the creditor makes. One agreement may cover all future advances, whether obligatory or optional, but it is advisable to have appropriate evidence of each advance the agreement secures. Similarly, when the collateral constantly changes, there is no need to execute a new security agreement with each change in the collateral. A single master agreement can cover all property, whenever acquired, as long as the agreement properly describes the collateral.[60]

The UCC's liberal provisions relating to the requirements for describing the collateral may cause uncertainties, when other parties wish to determine what property of the debtor is subject to the security interest of the secured party. There is a procedure in the UCC that permits the debtor to send a statement, including the amount the debtor believes to be the unpaid indebtedness and the collateral covered, to the secured party. The secured party need only approve or correct the statement submitted.[61] (Third parties need to be careful about relying on such statements. Doubtless, common-law estoppel principles could arise, but the UCC itself does not make the secured party's approval of the statement binding as to third parties.)[62]

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of collection, and indemnity obligations. When a lien creditor obtains a judicial lien on the property of the debtor after the security interest was perfected, but before the obligations to pay interest, attorney fees, and other costs came due, does the lien have priority over these later maturing obligations? A lien creditor argued that only future advances that fell within the exact language of UCC § 9-301(4) were entitled to protection, and that obligations such as attorney fees for collection of the debt could not be classified as "advances." The court rejected this interpretation in Dick Warner Cargo Handling Corp. v. Aetna Business Credit, Inc., 746 F2d 126, 133 (2d Cir. 1984) (Friendly, J.). It stated that there had been a drafting failure because the language of Section 9-301 did not cover such obligations, but there was no reason to believe that the drafters of the UCC intended to give the lien creditor priority. Although the obligations did not mature until later, they were incurred as part of the original transaction, which was well before the judicial lien was attached. In the court's opinion, UCC § 9-301(4) does not apply to all types of obligations, but only to those that represented "sums put at the disposal of the borrower—not expenditures made by the lender for his own benefit." 746 F2d at 130. The types of obligations involved in the case, such as legal expenses in enforcing the debt, ought not to be analyzed under UCC § 9-301(4). These obligations fall under the traditional rule of UCC § 9-301(1)(b), which protects the priority of the secured party if a perfected security interest was obtained before another party became a lien creditor. The case also raised the issue of how to treat monthly charges for interest and commissions, but the court did not have to resolve it. 746 F2d at 135.

[59] UCC § 9-204(2).

[60] Although the agreement is effective to create a security interest, there still may be significant priority questions. See Chapter 23.

[61] UCC § 9-208.

[62] UCC § 9-208(2). See UCC § 1-103.

A security agreement automatically gives the secured party a security interest in any proceeds that derive from the sale or transfer of the collateral.[63]

[2] Purchase Money Security Interests

The UCC contains special rules that favor purchase-money security interests. A purchase-money security interest can arise in two ways: (1) when the seller of the collateral takes a security interest in the goods or other property sold to secure its price[64] or (2) when a third-party financer makes advances or

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[63] UCC § 9-203(3). Proceeds that derive from the sale or transfer of collateral are discussed at ¶ 23.03[1].

[64] UCC § 9-107(a). To qualify as a purchase money security interest it is necessary that the secured party give value either by making advances or "incurring an obligation." In United States v. Cahall Bros., 674 F2d 578, 581 (6th Cir. 1982), the court held that a secured party gave such value by giving a binding commitment to extend credit. Therefore, although the disbursement of funds may have been delayed until some time after the loan agreement was entered into, the commitment to make credit available constituted value. The subsequent disbursement of funds would be merely tendering money pursuant to a preexisting legal duty. On the other hand, if there had been no prior commitment, the disbursement of the funds would constitute value. (It is not clear why the court felt compelled to remand the case to the district court to determine when value was given by the secured party. It is not a requirement to the creation of a purchase money security interest under Section 9-107 that value be given at a certain time, so long as it is used by the debtor to acquire rights in the collateral. The court did not discuss whether the funds were actually so used, but it appears that this was the case.) It is necessary, however, under the purchase money priority provision in UCC § 9-132(4) to *perfect* the purchase money security interest within ten days. Value must be given to perfect the security interest. UCC §§ 9-203(1)(b), 9-303(1). The case was unique because there could be two parties with separate purchase money security interests in the collateral. The court assumed, without discussing, that the first of these secured parties to file would prevail. 674 F2d at 581.

In one case, a bankruptcy trustee argued that a secured party could obtain a purchase money security interest in a right to payment under a contract (an "account" under the classification scheme of Article 9). The court did not decide whether a purchase money security interest could exist in assets other than "goods," but ruled that the money advanced by the creditor was not used to enable the debtor to "acquire rights in" the contract but simply provided funds for the performance of the contract. In re Woodworks Contemporary Furniture, Inc., 44 Bankr. 971, 973 (Bankr. WD Wis. 1984). In coming to this conclusion, the court cited Northwestern Nat'l Bank v. Lectro Sys., Inc., 262 NW2d 678 (Minn. 1977), which drew a distinction between the expenditure of funds used to purchase an identifiable asset and that used to enable the debtor to conduct business under a contract already in existence.

Defendant held a blanket security interest in equipment of the debtor under a security agreement, which also contained an after-acquired property clause. The debtor, without authority, traded in some of the equipment in which defendant had a perfected security interest to dealer to purchase new equipment. Defendant claimed that because equipment used as trade-in was equipment in which it had a perfected security interest, defendant should be viewed as having a purchase money security interest in the new equipment. The court rejected this argument. The court said that the defendant "cannot,

otherwise provides value so that the debtor may acquire rights in collateral.[65] An example of this situation is a bank loan enabling the debtor to purchase a car from an automobile dealer. If the bank has the debtor enter into a security agreement, which gives the bank a security interest in the car, the bank's interest is a purchase money security interest because the loan was used by the debtor to buy the car. It is important in cases of this second type that the value given by the third party "in fact" be used to enable the debtor to obtain rights in the collateral.[66] One way of accomplishing this is to disburse the funds of the loan directly to the seller of the collateral. Under the UCC, purchase money security interests are often favored over other types of security interest. (See discussion on priorities in Chapter 23 and discussion on perfection of security interests in consumer goods later in this chapter.)

Because of the liberal rules in Article 9, which permit collateral to serve as security for antecedent debt and for advances made in the future, if the parties agree to such arrangements, and permit cross-collateral provisions where the collateral serves as security for its own purchase price and for the price of other collateral, it is possible for a security interest in the same collateral to have both a purchase money aspect and a non-purchase-money aspect. This has stirred debate as to whether the security interest must be viewed as unitary, so that the non-purchase-money obligation might be regarded as tainting the entire security interest and preventing it from being classified as a purchase money interest, or may be viewed as divisible, so that the collateral may be subject to both a purchase money interest and a non-purchase-money interest.[67]

In re Manuel[68] concluded that a purchase money security interest did not exist in furniture that the debtor bought and financed under arrangements where both the furniture and a television purchased subsequently served as security for the total obligation until it was paid in full.[69] This reasoning was rejected in a Third Circuit decision.[70] The Third Circuit held that a purchase money security interest in consumer goods does not lose its quality as a purchase money interest when the debtor subsequently purchases additional goods on credit, where the

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therefore, transform its prior non-purchase money security interest into a purchase money security interest in satisfaction of the antecedent debt owed by" its debtor. John Deere Co. v. Production Credit Ass'n, 39 UCC Rep. Serv. (Callaghan) 1882, 1884 (NY Sup. Ct. 1984).

[65] UCC § 9-107(b).

[66] Id.

[67] See Note, "Preserving the Purchase Money States of Refinanced or Commingled Purchase Money Debt," 35 Stan. L. Rev. 1133 (1983).

[68] In re Manuel, 507 F2d 990, 993 (5th Cir. 1975).

[69] See In re Norrell, 426 F. Supp. 435 (MD Ga. 1977), In re Coomer, 8 Bankr. 351 (Bankr. ED Tenn. 1980), In re Slay, 8 Bankr 355 (Bankr ED Tenn. 1980), In re Simpson, 4 UCC Rep. Serv. (Callaghan) 243 (Bankr. WD Mich. 1966).

[70] Pristas v. Landaus of Plymouth, Inc., 742 F2d 797, 800–801 (3d Cir. 1984).

additional debt is "added on" to the debt secured by the original collateral. UCC § 9-107 defines a purchase money security interest as being such an interest "to the extent" that it secures all or part of the price of goods, which, to the court, meant that the security interest could have a dual status, with both a purchase money and a non-purchase-money aspect.[71] In a nonconsumer goods financing context, however, a court has held that (1) a secured party has a purchase money security interest in inventory, notwithstanding that the security agreement provided that after-acquired collateral would also secure the debt as well, and that (2) existing collateral would secure future advances. In this case all of the credit extended by the secured party was for goods purchased on conditional sale.[72]

¶ 22.03 PERFECTION, TERMINATION, AND TRANSFER OF SECURITY INTERESTS

In general, a security interest must be perfected in order to be superior to the

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[71] Id. The court also discussed how the debtor's payments should be allocated among the different items of collateral to determine to what extent a purchase money security interest existed in each item of collateral. It included within its definition of "purchase price" "not only the actual cost of the goods but also financing charges and sales tax." *Pristas*, 742 F2d at 800. A similar problem arose in the case of In re Mason, 46 Bankr. 119 (Bankr. ED Mich. 1985). In this case debtor originally financed the purchase of a stereo by a loan from Household Finance Corporation. This was a purchase money transaction. About a year later, the loan was rewritten, the original loan was retired, and additional funds were made available to the debtor. The lender took a security interest in the stereo and other household goods. The court held that the new loan could not be treated as a purchase money transaction. Therefore, Household Finance did not have a perfected security interest, since it had not filed or taken possession of the goods. 46 Bankr. at 121. The court said further that it would not examine the transaction to determine if a portion of the loan should be viewed as a purchase money transaction, because the loan agreement itself contained no provisions for the allocation of payments. In the court's view, the preferred approach would be to view the transaction as a non-purchase-money transaction, as long as there was no statutory basis or contractual formula for apportioning the transaction into purchase money and non-purchase-money parts. 46 Bankr. at 121. See also in re Matthews, 724 F2d 798 (9th Cir. 1984). A bankruptcy court held that a creditor's purchase money security interests in consumer goods remained intact for purposes of determining bankruptcy exemptions, even though the consumer debtor had later consolidated the purchase money debt with other debts in which there were non-purchase-money security interests. In re Klanish, 56 Bankr. 184, 185–186 (Bankr WD Penn. 1986).

Sears, Roebuck & Co. obtained a perfected purchase money security interest in consumer goods purchased by debtors under its revolving charge account plan by including appropriate provisions in its basic charge agreement and sales slip documentation. The charge agreement gave Sears a security interest in goods purchased, and the sales slips generated at the time of purchase required a consumer signature, had a statement that referred to the basic charge agreement, and gave notice of Sears security interest in merchandise charged. This documentation was held to be adequate to create a perfected security interest in the consumer goods purchased pursuant to this plan. In re Orecchio, 54 Bankr. 685, 686–687 (DNJ 1985).

[72] In re Mid-Atlantic Flange Co., 26 UCC Rep. Serv. (Callaghan) 203, 204 (Bankr. ED Pa. 1979).

claims to the collateral of third-party purchasers and creditors. Although a security agreement is enforceable unless the UCC provides to the contrary,[73] the rights of many third-party creditors and purchasers are superior to the right of a secured party who holds an unperfected security interest. As a result, although a secured party may enforce an unperfected security interest against the debtor, perfection of the security interest is necessary for priority over most third party rival claimants, including the trustee in bankruptcy. Since perfection is usually a simple procedure, failure to perfect a security interest is usually the product of a mistake rather than a considered legal decision. (See Chapter 23.)

A perfected security interest is one that has attached, as described in an earlier section, and for which the secured party has completed the additional steps required for perfection under the UCC. There are three ways in which a security interest may be perfected under the UCC. The first is by filing a financing statement at the public office designated by state law; the second is by the secured party's taking possession of the collateral; and the third is when the transaction qualifies as one where perfection occurs automatically.[74] The classification of the collateral will determine which method of perfection is applicable. Some types of collateral may be perfected by more than one method. Goods, for example, may be perfected either by filing or by possession and, in a proper case, perfection may arise automatically. Security interests in other types of collateral may be perfected only by one of these methods. For example, the only way to perfect a security interest in an account is by filing. The proper methods for perfecting security interests in the different types of collateral are discussed in later sections of this chapter.

[1] Filing Requirements

The UCC requires secured parties to file a financing statement to perfect security interests in certain types of collateral, to provide notice to creditors, buyers, or other third parties who deal with the debtor.[75] Possession of the collateral is permitted as an alternative method of perfection for some types of collateral, because the drafters of the UCC believed that creditors and other third parties would obtain notice of the possible interest of the secured party from the fact of the secured party's possession of the collateral.

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[73] UCC § 9-201.

[74] UCC § 9-303.

[75] See UCC § 9-402, comment 2. See generally Hogan, "Bankruptcy Reform and Delayed Filing Under the U.C.C.," 35 Ark. L. Rev. 35 (1981).

For an example of a case where the court upheld the comprehensive scope of the Article 9 filing system and refused to regard a separate state registration law relating to persons in the business of operating feedlots as overriding the filing provisions of Article 9, see In re Black & White Cattle Co., 46 Bankr. 484, 488 (Bankr. 9th Cir. 1984).

The place for filing a financing statement depends on the type of collateral involved. There are three alternative provisions in the UCC, so the procedure for filing varies according to the alternative adopted in a particular state. Filing may need to be at a central office of the state, such as the Secretary of State, at a county office, or at the office where real estate records are kept.[76] The latter provision applies when the collateral is fixtures, timber, minerals, or the like. In some states, filing in two offices is necessary.[77] The proper place of filing may be determined by the debtor's residence, the place of business, or the location of the collateral. Because of these variations, the law is not uniform from state to state as to where filings should be made, and local counsel should be consulted.

Once a filing is made in the proper place or places, a subsequent change in residence of the debtor, location of the collateral, or debtor's place of business does not destroy the perfection of the security interest.[78] This rule applies only to different filing offices within the same state. It does not cover circumstances where more than one state may be involved in the transaction.[79] An alternative provision makes the filing effective for only four months after the change. When the debtor's name changes or, in the case of an organization, its "name, identity, or corporate structure" changes, there are circumstances in which a secured

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[76] UCC § 9-401. The rules governing the place where a financing statement must be filed are discussed infra ¶ 22.03[5], which contains tables on the filing requirements of various states.

When a secured transaction affects more than one state, the UCC provides rules to determine which state law the secured party must follow in order to perfect a security interest. These rules vary, depending on the type of collateral. See UCC § 9-103. Often, the best solution and the safest approach is to perfect the security interest in all possible concerned jurisdictions. A 1984 Massachusetts case illustrates the type of problem that may arise. The secured party held a purchase money security interest in two printing presses owned by the debtor corporation, a New York corporation located in New York State. The debtor installed the presses at the plant of its wholly owned subsidiary in Springfield, Massachusetts. Under the Massachusetts filing rule, a financing statement had to have been filed at the debtor's "place of business," which was Springfield, Massachusetts. Because the secured party failed to file in Massachusetts, the security interest was not perfected, and the trustee in bankruptcy of the debtor corporation had an interest in the presses that prevailed over the secured party. Trans Union Leasing Corp. v. Alithochrome Corp. (In re Alithochrome Corp.), 751 F2d 88, 89 (2d Cir. 1984).

[77] UCC § 9-401.

[78] UCC § 9-401(3).

[79] UCC § 9-401, comment 6; see Section 9-103. When collateral subject to a security interest is moved from one state to another, if a filing is needed to perfect a security interest in the collateral the secured party must refile within four months after the removal of the collateral to the new state. If the secured party does not refile, the security interest becomes unperfected. When the secured party only gives notice to the debtor within the four-month grace period of its security interest and demands the return of the collateral, this action is not sufficient to keep the security interest from becoming unperfected at the end of the four-month period. United States v. Handy & Harman, 750 F2d 777, 783 (9th Cir. 1984).

party needs to make a new filing to assure perfection of the security interest in all of the debtor's collateral. (This is discussed later in this chapter.)

When a secured party makes a filing in good faith but files in the wrong office, the filing will be effective as to any collateral for which it is proper.[80] It is also effective to create a perfected security interest in the collateral against persons who have actual knowledge of the contents of the financing statement.[81]

A financing statement is considered filed when it has been accepted for filing by the appropriate filing officer and when the filing fee has been tendered.[82] In general the filing remains effective for a period of five years, after which time it lapses.[83] (Some states have adopted different periods.) When the filing lapses, the security interest becomes unperfected as of that date, unless some other method of perfection applies.[84] The period of perfection may be

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[80] UCC § 9-401(2). The Georgia Supreme Court has held that oral notice to a lien creditor that a holder of an unperfected security interest was claiming a security interest in the property is not the equivalent of knowledge of the "contents" of the financing statement within the meaning of UCC § 9-401(2). United States v. Waterford No. 2 Office Center, 246 Ga. 475, 477, 271 SE2d 790, 792 (1980).

[81] UCC § 9-401(2).

[82] UCC § 9-403(1). Failure to comply with state law requiring documentary tax stamps when a financing statement is filed does not invalidate the filing. The filing is effective to perfect a security interest. Associate's Commercial Corp. v. Sel-o-rak Corp., 746 F2d 1441, 1444 (11th Cir. 1984).

A continuation statement is effectively filed on proper presentation to the filing officer, notwithstanding the officer's return of the continuation statement to the secured party, as long as the statement substantially complies with Article 9 requirements when it is presented. Multi-Mart Branch Office, First State Bank v. Appliance Buyers Credit Corp., 757 F2d 1573, 1578 (5th Cir. 1985).

[83] UCC § 9-403(2). Absent an agreement to provide for a shorter termination period, the financing statement remains effective throughout the statutory period as to all advances made by the secured party, which are secured by collateral covered by the financing statement. The financing statement does not lapse when the debtor pays in full the obligation owed the secured party regardless of whether future advances are mentioned in the financing statement or security agreement. Credit Alliance Corp. v. Jebco Coal Co., 688 F2d 10, 13–14 (3d Cir. 1982). Although the court suggested it might take a view contrary to the *Credit Alliance* court on the effectiveness of a financing statement to cover future advances not provided for in the original security agreement, it avoided reaching this issue by finding that the second advance was a refinancing of the original debt and, therefore, covered by the original filing. Blue v. H-K Corp., 629 P2d 790, 792 (Okla. Ct. App. 1981).

[84] UCC § 9-403(2). See generally Zaretsky, "Lapse of Perfection in Secured Transaction: A Search for a Consistent Approach," 22 BCL Rev. 247 (1981). See Avant Petroleum, Inc. v. Banque Paribas, 652 F. Supp. 542 (SDNY 1987). Paribas has a perfected security interest in accounts receivable of its debtor Crysen. Another creditor, BP, garnished funds due Crysen from Avant that were covered by the Paribas security interest. Avant filed an interpleader action and paid the funds to court. While the court had custody of the funds, the financing statements of Paribas lapsed because of failure to file continuation statements before the end of five years. The court held UCC § 9-403(2) did

extended by filing a continuation statement within six months before the filing lapses.[85] The continuation statement must identify the original statement by file number, must state that it is still effective, and must be signed by the secured party. It is not necessary to have the signature of the debtor on a continuation statement.[86] The continuation statement extends the effectiveness of the original statement for five additional years, and then lapses, unless another continuation statement is filed.[87]

The filing officer is required to index the financing statements according to the name of the debtor and to make available for public inspection the document itself or a microfilm of it.[88] An optional provision of the UCC requires the filing officer to provide copies of statements on file.[89]

[2] Requirements of Financing Statements

The UCC adopts a philosophy of "notice filing." Under this approach, it is not necessary to make public all the terms of the security agreement between the secured party and the debtor. It is sufficient notice to third parties to file an abbreviated statement with less information. In UCC terminology, this statement is what is referred to as a "financing statement."[90] The financing statement ordinarily is a different document than the written security agreement, but a security agreement may be filed as a financing statement when it contains all of the information the UCC requires for financing statements.[91]

[a] Information Requirements. A financing statement must give the names of the debtor and the secured party, must be signed by the debtor,[92] must give an

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not apply, and BP could not claim that its interest in the fund became superior to Paribas whose security interest had become unperfected as a result of the lapse. It would defeat the purpose of the interpleader to give effect to the lapse after the funds had been placed in the custody of the court. 652 F. Supp. at 548.

[85] UCC § 9-403(3). In a continuation statement, the omission of a reference to the file number of the original financing statement was a technical error that was not seriously misleading, because the continuation statement did refer to an amendment to the original financing statement that contained a proper reference to the original statement. In re Edwards Equip. Co., 46 Bankr. 689, 691-692 Bankr. WD Okla., 1985).

[86] UCC § 9-403(3). A typewritten name constituted an effective signature on a financing statement. Multi-Mart Branch Office, First State Bank v. Appliance Buyers Credit Corp., 757 F2d 1573, 1577 (5th Cir. 1985).

[87] UCC § 9-403(3).

[88] UCC § 9-403(4).

[89] UCC § 9-407.

[90] UCC § 9-402.

[91] UCC § 9-402(1).

[92] Id. Note, "Financing Statement Signature Requirements (In re Save-on-Carpets of Arizona, Inc., 545 F2d 1239, 9th Cir. 1976)," 3 U. Dayton L. Rev. 211 (1978).

address of the secured party from which information about the security interest may be obtained, and must contain "a statement indicating the types, or describing the items, of collateral."[93] By requiring only a description of the "types" of the collateral, the UCC expressly permits the parties to use general classifications and to avoid the detailed, item-by-item description of the collateral. An extensive body of law deals with what constitutes an adequate description.[94] The financing statement must give additional information for special types of collateral. When the collateral is crops, a description of the land must be given to provide notice to parties who deal with the real estate involved.[95] When the collateral is timber, minerals, oil and gas, or, in some circumstances, fixtures, the financing statement must also describe the real estate.[96] In some states, the financing statement must contain a legal description of the real estate,[97] must recite that the financing statement will be filed in the real estate records relating to the property, and, when the debtor does not have an interest of record in the real estate, must show the name of the record owner.[98] A real estate mortgage covering items of personal property or fixtures may be effective as a financing statement if it satisfies the UCC requirements for a financing statement.[99]

Failure of the debtor to sign the financing statement was fatal in Hobart Corp. v. North Cent. Credit Serv., Inc., 29 Wash. App. 302, 304–305, 628 P2d 842, 844-845 (1981).

The officer of the debtor corporation signed the financing statement for the corporation prior to its being incorporated, but the signature was effective for purposes of Article 9. The court reasoned that the signature was sufficient to give notice. Moreover, the debtor corporation could be said to have ratified it. John Deere Co. v. First Interstate Bank, 147 Ariz. 256, 258–259, 709 P2d 890, 892–893 (Ct. App. 1985).

[93] UCC § 9-402(1).

[94] See B. Clark, The Law of Secured Transaction Under the Uniform Commercial Code ¶ 2.9[5] (1980). A Texas court has held that the statement "all fixed assets" of the debtor is not a sufficient description in the financing statement of collateral by "types." In re Volpe Enters., Inc., 42 Bankr. 90, 93 (Bankr. SD Fla. 1984).

A financing statement stated the wrong number of bushels of grain in which the secured party held a security interest, but the court still held the financing statement to be effective. The statement had effect because it correctly identified the debtor, the secured party, and the nature of the collateral. In re Nelson, 45 Bankr. 443, 444 (Bankr. DND 1984).

[95] UCC § 9-402(1). In Gold Kist, Inc. v. Farmers & Merchants Bank, 425 So. 2d 452, 453 (Ala. 1983), the Alabama Supreme Court held that a financing statement describing the collateral as "all crops grown and harvested in 1980 . . . on land rented or leased in Baldwin County, Alabama" was not a sufficient description of the real estate.

[96] UCC § 9-402(5).

[97] Id. A bankruptcy court has held that a street address is substantial compliance with a requirement for a legal description of the real estate in fixture transactions. In re Mistura, Inc., 13 Bankr. 483, 484 (Bankr. D. Ariz. 1981).

[98] UCC § 9-402(5).

[99] UCC § 9-402(6).

The proper name to use of the debtor is the individual, partnership or corporate name. It is not necessary to use trade names or the names of individual partners.[100] A court provided a useful analysis of the cases dealing with improper names in a 1985 bankruptcy decision:[101]

> The cases adjudicating the effects of improper names on financing statements are legion and they arrive at widely divergent results. The apparent unpredictability of the holding of these cases is often attributable to an insensitivity to the principle that these decisions are—or should be—based on determinations other than the mere discrepancy between two names. The decisions should not be predicated on a sterile and abstract comparison between two names but rather on "whether a reasonable searcher would find the financing statement or would be put on notice to inquire elsewhere about it." [citations omitted.] . . . . The resolution of the question cannot be made simply by comparing two names, but must be settled with an eye toward the intended operation of the UCC indexing system in which the errors are manifest. A reasonable searcher properly using the index is looking for the name of the debtor amid a host of similar names. The system may contain hundreds or millions of names, depending on the size of the index. The extent to which a reasonable searcher may correctly identify an erroneous listing as that of the debtor is dependent, of course, on the size of the index. Analogizing the UCC index to a telephone book is apt. Searching under an erroneous name would be much more difficult with the Manhattan phone book than with an eight page phone book for some rural county.
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> The question of whether the disparity of names is seriously misleading is likewise dependent on the distinctiveness of the names at issue. If the debtor's name and the spurious name are significantly different from the bulk of the names in the index—for instance, because of the highly stylized name of the debtor or because its ethnicity is in stark contrast with the other listings from that locale—the searcher is more likely to succeed in finding the accurate listing. Furthermore, the type of index in use is a pertinent concern. The "file box" method, the standard bearer of indexing for generations, with drawers full of cards that allowed a searcher to riffle through myriad cards, is becoming outmoded. The vanguard, of course, is the computer retrieval system, which in its simplest form would allow for no "riffling" through related names. The entry of a single name into the system may well cause the computer to cite only those financing statements on which the name is identical to the name entered. No similar names would surface. These and a plethora of other factual concerns are imaginable to illustrate the need for a factual record to support a determination of whether an error between names is seriously misleading.[102]

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[100] UCC § 9-402(7). This is a clarification made by the 1972 Amendments.

[101] In re McGovern Auto Specialty, Inc., 51 Bankr. 511 (ED Pa. 1985).

[102] Id. at 514. There are numerous cases dealing with the identification of the debtor. In McCauley's Reprographics, Inc. v. Alaska Nat'l Bank (In re McCauley's

When the debtor changes his or her name or when a debtor organization changes its identity, the financing statement filed under the old name remains effective as to any collateral acquired by the debtor before the change and also for new collateral acquired within four months thereafter.[103] A new financing statement may be filed by the secured party before the four month period expires, to assure perfection as to subsequently acquired collateral.[104]

[b] Other Requirements as to Effectiveness. A photocopy, carbon, or other reproduction of a financing statement (or a qualifying security agreement) may be used as a financing statement when the security agreement allows copies to be filed or when the original document already has been filed in the state.[105] This should make it easier for secured parties to file financing statements in multiple offices within the same state, when there is a question as to which is the proper office.

Reprographics, Inc.), 638 F2d 117 (9th Cir. 1981), the secured party mistakenly identified a predecessor partnership, McCauley's Reprographics and Mapping, as the debtor rather than the corporation with whom it dealt. Because there was no indication in the financing statement that the debtor was a corporation, rather than the partnership, the court did not apply the traditional standard for determining whether the financing statement was seriously misleading. 638 F2d at 119. In this case, it would not be enough that someone searching the records could find that a financing statement was executed by an individual named McCauley on behalf of the partnership because there would be no indication that the corporation was the debtor. Moreover, in this case, even if the search led to the underlying security agreement, the same error would have misled the searcher.

In In re Glasco, Inc., 642 F2d 793 (5th Cir. 1981), the financing statement identified the debtor as "Elite Boats, Division of Glasco, Inc." The legal corporate name of the debtor was "Glasco, Inc." Because the company only did business under its trade name, Elite Boats, the court held that the notice purposes of the statute were satisfied and treated the error as not seriously misleading. 642 F2d at 796. The case arose under the Florida version of the UCC, which was the pre-1972 version. The current version of UCC § 9-402(7) contemplates that the corporate name rather than the trade name should be used although it does not resolve if use of the trade name alone would be a minor error that is not seriously misleading.

In Records & Tapes, Inc. v. Argus, Inc., 8 Kan. App. 2d 255, 256, 655 P2d 133, 134 (1982), the court found the financing statement contained an error that was not seriously misleading when it incorrectly identified the debtor as "Argus Tapes and Records" although the correct corporate name was "Argus, Inc."

In In re McGovern Auto Specialty, Inc., 51 Bankr. 511, 514 (ED Pa. 1985), the financing statement named the debtor as "McGovern Auto & Truck Parts, Inc." rather than McGovern Auto Specialty, Inc.," the correct name. The court concluded that the failure to use the correct name was seriously misleading, so the security interest was not perfected.

[103] UCC § 9-402(7).

[104] Id.

[105] UCC § 9-402(1).

In some situations the secured party may file a financing statement without the signature of the debtor. This is permitted under the following circumstances:

1. The collateral is brought into the state from another state or the location of the debtor within the state has changed. (The financing statement must explain these circumstances.)
2. The filing is made to perfect a security interest in proceeds when the original collateral was subject to a perfected security interest. (The financing statement must describe the original collateral in this case.)
3. A previous filing on collateral has lapsed.
4. A new filing is necessary because of a change of name or a change in identity of the debtor.[106]

The UCC permits the parties to file a financing statement in advance, before they enter into a security agreement and before they take any of the other steps required for attachment of the security interest.[107] This allows the secured party to make an early filing of a financing statement to establish a priority date for subsequent transactions. One filing is enough, as long as the collateral is adequately described; it is therefore unnecessary to refile on each of a series of transactions. The financing statement may encompass transactions "not in existence and not contemplated at the time the notice was filed, if the description of collateral in the financing statement is broad enough to encompass them."[108] For the same reasons, the financing statement will be effective to cover after acquired property and any future advances under the security agreement. The financing statement does not have to state that future advances or after acquired property is covered;[109] nor does it have to say that proceeds are covered.[110]

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[106] UCC § 9-402(2).

[107] UCC § 9-402(1).

[108] UCC § 9-402, comment 2.

[109] Id. Although the UCC does not require a financing statement to describe the amount of the debt, a secured party who filed a financing statement that did describe the amount of the loan was unable to claim a security interest greater than the amount stated. The financing statement constituted a representation to the public of the size of the debt. McLemore v. Farmer's Home Admin. (In re Davis), 40 UCC Rep. Serv. 1133, 1134–1135 (MD Tenn. 1985).

When the security agreement expressly covers after-acquired property, it is not necessary for the financing statement to mention after-acquired property. In re Taylor, 45 Bankr. 643, 646 (Bankr. MD Pa. 1985).

[110] UCC §§ 9-306, 9-402.

The UCC drafters intended that the financing statement be effective "even though it contains minor errors which are not seriously misleading."[111] There is a growing body of law on what constitutes a minor error under this provision.[112]

Sometimes the question arises as to whether a filed financing statement should be effective as a method of perfection for a subsequent transaction. The UCC in Section 9-402(1) permits a secured party to file a financing statement before a security agreement is made. UCC §§ 9-403 and 9-405 establish procedures for the secured party to file continuation statements and to disclose assignments. Similarly, the UCC, in Sections 9-402(2)(d) and 9-402(7), provides a method for the secured party to make a filing in the new name of a debtor that has changed its name, identity, or corporate structure.

Generally, a financing statement continues to be effective, notwithstanding a change of name or identity of the debtor, as to collateral the debtor acquired before the change.[113] However, the secured party must proceed carefully, as a Texas case indicates. In *Barr v. White Oak State Bank*,[114] the bank held a security interest perfected by filing in the debtor's equipment and inventory. When the debtor sold the business, the bank executed a new security agreement and filed a new financing statement with the buyer as debtor. The original debtor guaranteed the loan made by the bank to the buyer of the business, and the old loan was canceled although the original financing statement remained on file. When default occurred and the bank foreclosed on the property, it discovered that there was another creditor with a security interest in the inventory perfected by a financing statement that had been filed between the filing dates of the two financing statements filed by the bank. The court held that the other creditor prevailed under the "first to file" rule. The bank's security interest could not relate back to the first financing statement covering the obligation of the original debtor because the security interest terminated on the payment of that obligation. Although the original debtor guaranteed the bank's loan to the buyer, the loan to the buyer was a new transaction and the guarantee did not cause the original security interest to remain effective.

[3] Termination Statements and Partial Releases of Collateral

When the debtor has no outstanding obligation to the secured party and the transaction is over, the debtor is entitled to make a written demand for a termination statement from the secured party to state that the secured party no longer claims an interest in the property of the debtor.[115] On proper demand, the

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[111] UCC § 9-402(8).

[112] See B. Clark, supra note 94, ¶ 2.10; J. White & R. Summers, Uniform Commercial Code § 23-16 (2d ed. 1980).

[113] UCC § 9-402(7).

[114] 677 SW2d 707 (Tex. Ct. App. 1984).

[115] UCC § 9-404(1).

secured party must send the debtor such a termination statement, disclaiming a security interest in the collateral covered by the financing statement concerned; the statement is identified by the file number of the original financing statement. The debtor is entitled to a termination statement for each office in which the original financing statement was filed.[116]

When the financing statement covers consumer goods, the secured party's responsibilities extend further. Within one month after discharge of the obligation, the secured party must file a termination statement with each office at which the original financing statement was filed. When the debtor makes a written demand for a termination statement, it must be filed sooner than otherwise—within ten days of the demand.[117] Failure to satisfy these responsibilities will subject the secured party to liability for $100, plus any loss caused by violation of these rules.[118]

Financing statements may be amended. Both the debtor and the secured party must sign a writing containing the amendment.[119] An amendment, unlike a continuation statement, does not extend the period of effectiveness of the financing statement.[120] When the amendment adds new collateral to the financing statement, it is effective as to the added collateral only from the date of filing of the amendment.[121] In contrast, it is possible to release the collateral from the financing statement on file. The statement of release need only be signed by the secured party but it must contain a description of the collateral being released, the name and address of the debtor, the name and address of the secured party, and the file number of the original financing statement.[122]

[4] Transfer of Security Interests

Security interests may be transferred or assigned. When the security interest is a perfected security interest, it is not necessary to take further steps to continue the perfection against creditors of and transferees from the original debtor.[123] In

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[116] Id.

[117] Id.

[118] Id.

[119] UCC § 9-402(4).

[120] UCC § 9-402(4). In re Vermont Fiberglass, Inc., 44 Bankr. 505, 509 (Bankr. D. Vt. 1984).

[121] UCC § 9-402(4).

[122] UCC § 9-406. In In re Pacific Trencher & Equip., Inc., 27 Bankr. 167 (Bankr. 9th Cir. 1983), aff'd, 735 F2d 362 (9th Cir. 1984), the secured party mistakenly filed a termination statement when he intended to file a partial release. The effect of the mistake was to cause the security interest in the remaining collateral to lapse, and a junior secured party was elevated to priority. The court refused to treat the mistake as not seriously misleading under UCC § 9-402(8) or to utilize common law equitable doctrines of mistake under UCC § 1-103 to protect the secured party from his mistake. 27 Bankr. at 169.

[123] UCC § 9-302(2).

many situations, however, the secured party who is the assignee may want to take further steps to obtain protection against parties who might deal with the assignor without knowing of the assignment of the security interest. For example, the assignor could take action with respect to the collateral or transfer the assignor's interest to another or be subject to claims by the assignor's own creditors. A secured party who acquires a security interest in collateral by assignment will want to have the security interest perfected in the secured party's own name, if perfection is by filing, or by taking possession, in cases where that is appropriate. When the security interest has been perfected by filing, the UCC permits the parties to assign all or part of the secured party's rights under the financing statement by filing a notice of the assignment in the place at which the original financing statement was filed.[124] Upon filing of the assignment, the assignee becomes the secured party of record.[125] After this filing, only the assignee will be able to file a termination statement, a release, or an amendment to the financing statement.

When there is an assignment of an account, contract, chattel paper, or general intangible, the assignee may want to give notice to the party who was obligated to make payment under the account or other obligation. If there is no notice that payment must be made to the assignee, a debtor may continue to pay the assignor.[126] Moreover, unless the agreement between the account debtor and the assignor provides to the contrary, the assignee will be subject to any defense or claim, accrued before notice of the assignment, by the account debtor against the assignor.[127] Such defenses may be waived by agreement, however.[128] The assignment cannot prevent the account debtor and the assignor from modifying their contract in good faith, insofar as it involves any right to payment that has not yet been fully earned by performance.[129] The modification, if in good faith and if in accordance with reasonable commercial standards, will be effective notwithstanding notice of the assignment, but the good faith requirement will probably sharply curtail the parties' freedom to make modifications.[130]

Assignments of some obligations are classified under Article 9 as secured transactions. An assignment of accounts, for example, is a secured transaction.[131] When the seller of goods sells an item to a purchaser, retaining a security interest in the goods sold, the paper taken by the seller that contains the security agreement and the obligation of the buyer to pay constitutes chattel paper. The

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[124] UCC § 9-405(2).

[125] UCC § 9-405(3).

[126] UCC § 9-318(3).

[127] UCC § 9-318(1)(b).

[128] UCC § 9-318(1).

[129] UCC § 9-318(2).

[130] Id.

[131] UCC § 9-102. See ¶¶ 22.01[1], 22.07[1] for a discussion of when an assignment is treated as a secured transaction.

assignment of this chattel paper to the assignee also is a secured transaction under the UCC.[132] In such transactions, the assignee needs to take the appropriate steps to perfect a security interest in the accounts and chattel paper to protect the assignee against the claims of creditors and other transferors from the assignor. When the collateral is chattel paper, the safest procedure, of course, is for the secured party to take possession of the paper.[133]

[5] Place of Filing UCC Financing Statement

As discussed earlier in this chapter, the filing of a financing statement is a method for perfecting a security interest in some types of collateral. Within each state, the place of filing varies according to the type of collateral, the variation of the UCC enacted by the state, and any local modifications to the UCC rules. There is probably less uniformity in the law on *where* to file a financing statement than in any other part of the UCC. Thus, it is essential for the bank officer to consult with local counsel before entering into any secured transaction that has contacts with a state whose filing requirements are unfamiliar to the bank officer. In addition, federal legislation, effective December 24, 1986, affects the steps needed to perfect a security interest in farm products against certain purchasers and others who deal with those products. These rules are explained in Chapter 23.

The complexity in state filing practices initially stems from the provisions of the UCC itself. The relevant provision is UCC § 9-401(1). The drafters of the UCC offered the states three alternative versions of this paragraph, from which each state was to select one. When Article 9 was extensively revised by the 1972 amendments (mentioned at the outset of this chapter), UCC § 9-401(1) continued to offer three alternatives, paralleling the approach taken in the original UCC § 9-401(1). However, the 1972 amendments revised each alternative to some extent. As a result, there are a total of six possible uniform variations (three under the original UCC § 9-401(1) and three under the 1972 version of that section). Each alternative contains blanks, which are a further source of variation, for the state to designate its filing office. Additionally, states have liberally revised the language of UCC § 9-401(1) to deal with local concerns and practices.

To address this complexity, this section presents a series of tables describing the filing systems adopted by each state. It is hoped that these tables will be useful to the bank officer in checking to determine if transactions comply with local law. It must be stressed, however, as mentioned at the outset, that this is an area of extensive local variation so that consultation with local counsel is important. These tables are intended to provide only a general view of the local law to be used as an initial step in investigating filing requirements.

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[132] UCC § 9-102(1)(b).

[133] UCC § 9-308. See ¶ 22.07[4] for a discussion of chattel paper.

Because the place of filing depends initially on which of the six UCC alternatives a state has adopted, these are set forth in Table 22-1. Table 22-2, which follows, indicates for each state the alternative that has been adopted. This table also contains some brief and general notes on the extent to which the version enacted by the state departs from the uniform version. The following table, Table 22-3, should be consulted to determine the state filing office. This table lists each state office for each of the six UCC alternatives. To facilitate use of Table 22-3, the superscripts [a] through [v] have been assigned first to the bracketed material and blanks in the text herewith of UCC § 9-401(1) and then to their corresponding items in the table. The special rules governing farm products are covered in Chapter 23.

(continued page 22-47)

TABLE 22-1 **1972 and Pre-1972 Versions of UCC**

1972 VERSION OF UCC

§ 9-401. Place of Filing; Erroneous Filing; Removal of Collateral

First Alternative Subsection (1)

(1) The proper place to file in order to perfect a security interest is as follows:

(a) when the collateral is timber to be cut or is minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or when the financing statement is filed as a fixture filing (Section 9-313) and the collateral is goods which are or are to become fixtures, then in the office where a mortgage on the real estate would be filed or recorded;

(b) in all other cases, in the office of the [Secretary of State[a]].

Second Alternative Subsection (1)

(1) The proper place to file in order to perfect a security interest is as follows:

(a) when the collateral is equipment used in farming operations, or farm products, or accounts or general intangibles arising from or relating to the sale of farm products by a farmer, or consumer goods, then in the office of the ....[b] in the county of the debtor's residence or if the debtor is not a resident of this state then in the office of the ....[c] in the county where the goods are kept, and in addition when the collateral is crops growing or to be grown in the office of the ....[d] in the county where the land is located;

(b) when the collateral is timber to be cut or is minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or when the financing statement is filed as a fixture filing (Section 9-313) and the collateral is goods which are or are to become fixtures, then in the office where a mortgage on the real estate would be filed or recorded;

(c) in all other cases, in the office of the [Secretary of State[e]].

Third Alternative Subsection (1)

(1) The proper place to file in order to perfect a security interest is as follows:

(a) when the collateral is equipment used in farming operations, or farm products, or accounts or general intangibles arising from or relating to the sale of farm products by a farmer, or consumer goods, then in the office of the ....[f] in the county of the debtor's residence or if the debtor is not a resident of this state then in the office of the ....[g] in the county where the goods are kept, and in addition when the collateral is crops growing or to be grown in the office of the ....[h] in the county where the land is located;

(b) when the collateral is timber to be cut or is minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or when the financing statement is filed as a fixture filing (Section 9-313) and the collateral is goods which are or are to become fixtures, then in the office where a mortgage on the real estate would be filed or recorded;

(c) in all other cases, in the office of the [Secretary of State[i]] and in addition, if the debtor has a place of business in only one county of this state, also in the office of ....[j] of such county, or, if the debtor has no place of business in this state, but resides in the state, also in the office of ....[k] of the county in which he resides.

Note: *One of the three alternatives should be selected as subsection (1).*

PRE-1972 VERSION OF UCC

Section 9-401. Place of Filing; Erroneous Filing; Removal of Collateral

First Alternative Subsection (1)

(1) The proper place to file in order to perfect a security interest is as follows:

(a) when the collateral is goods which at the time the security interest attaches are or are to become fixtures, then in the office where a mortgage on the real estate concerned would be filed or recorded;

(b) in all other cases, in the office of the [Secretary of State[l]].

Second Alternative Subsection (1)

(1) The proper place to file in order to perfect a security interest is as follows:

(a) When the collateral is equipment used in farming operations, or farm products, or accounts, contract rights or general intangibles arising from or relating to the sale of farm products by a farmer, or consumer goods, then in the office of the .... [m] in the county of the debtor's residence or if the debtor is not a resident of this state then in the office of the .... [n] in the county where the goods are kept, and in addition when the collateral is crops in the office of the .... [o] in the county where the land on which the crops are growing or to be grown is located;

(b) when the collateral is goods which at the time the security interest attaches are or are to become fixtures, then in the office where a mortgage on the real estate concerned would be filed or recorded;

(c) in all other cases, in the office of the [Secretary of State[p]]

Third Alternative Subsection (1)

(1) The proper place to file in order to perfect a security interest is as follows:

(a) when the collateral is equipment used in farming operations, or farm products, or accounts, contract rights or general intangibles arising from or relating to the sale of farm products by a farmer, or consumer goods, then in the office of the .... [q] in the county of the debtor's residence or if the debtor is not a resident of this state then in the office of the .... [r] in the county where the goods are kept, and in addition when the collateral is crops in the office of the .... [s] in the county where the land on which the crops are growing or to be grown is located;

(b) when the collateral is goods which at the time the security interest attaches are or are to become fixtures, then in the office where a mortgage on the real estate concerned would be filed or recorded;

(c) in all other cases, in the office of the [Secretary of State[t]] and in addition, if the debtor has a place of business in only one county of this state, also in the office of .... [u] of such county, or, if the debtor has no place of business in this state, but resides in the state, also in the office of .... [v] of the county in which he resides.

Note: *One of the three alternatives should be selected as subsection (1).*

TABLE 22-2 **State Filing Systems for Article 9 Security Transactions (UCC § 9-401)***

	1972 Amendments Adopted			*Pre-1972 Amendments Adopted*			
State	*1st Alt.*	*2nd Alt.*	*3rd Alt.*	*1st Alt.*	*2nd Alt.*	*3rd Alt.*	*Notes on Variation From UCC § 9-401*
Ala.		X					Omits "minerals or the like". Subsec. 5 refers to subsecs. (3), (4) and (5)(a) of section 9-302.
Alaska		X					Only slight rewording; no substantive change.
Ariz.		X					No change; for notice of disposition of collateral not contained in UCC, see Ariz. Rev. Stat. § 47-9409.
Ark.			X				No substantive change.
Calif.		X					Omits any special scheme for farm products, etc. (subsec. (1)(a)); adds crops to subsec. (1)(b). Subsec. (1)(b) omits fixtures; adds subsec. 7 which calls for fixtures filings to be filed in office where real estate mortgage would be filed.
Colo.		X					Modification in filing location for subsec. (1)(b).
Conn.	X						No change; for requirements of filing pursuant to subsec. (1)(a), not contained in UCC, see Conn. Gen. Stats. § 42a-9-409.
Del.	X						Subsec. (3), alternative subsection adopted.
D.C.	X						*File in all cases in Office of Recorder* of Deeds; omits subsecs. (5) and (6).
Fla.		X					Various modifications; subsec. (1)(a) omits reference to consumer goods; defines place of business for filing purposes. For filing requirements not contained in UCC, see Fla. Stats. § 679.4011; due to reference to place of business in (1)(a), replaces subsec. (6) with language

*Table 22-2 was revised based on materials available to the author on July 15, 1987.

State	1972 Amendments Adopted			Pre-1972 Amendments Adopted			Notes on Variation From UCC § 9-401
	1st Alt.	2nd Alt.	3rd Alt.	1st Alt.	2nd Alt.	3rd Alt.	
							that validates statements filed only with the Department of State during the period 1-1-80 until 7-1-81, but upon expiration new financing statements as required by UCC 11-106(4) must be filed as described in ¶ (1)(a). At the beginning of subsecs. (2) and (3) insert the words: "except as provided in 9-313 (2)"; subsec. (5) omits second sentence.
Ga.	X						Adds reference to crops in subsec. (1)(a); defines place of business in subsec. (1)(b); omits subsecs. (5), (6).
Hawaii							Hawaii Rev. Stat. § 490: 9-401 (1): Proper place to file in order to perfect a security interest is with the registrar of conveyances, Bureau of Conveyances. (2) Reserved. (3) Reserved.
Idaho	X						No substantive change.
Ill.		X					No substantive change.
Ind.		X					Adds "corporations" to subsec. (1)(a). Filing for corporations in office of county recorder and secretary of state. Adds subsections (7)-(12), which deal with the payment of judgments against filing officers and fees. For filing requirements and criteria, not contained in UCC, see Ind. Code §§ 26-1-9-408 through 26-1-9-412.
Iowa	X						Adds paragraph to subsec. (1) for filing location for consumer goods when debtor resides in state.
Kan.		X					In subsec. (1)(a) filing is to be made with the registrar of deeds only when the collateral is consumer goods effective 1-1-84.
Ky.						X	Subsec. (1)(c) has modest change of wording.
Me.	X						Subsec. (1)(a) adds reference to crops. Omits sec. (6).

(continued)

TABLE 22-2 *(cont'd)*

State	*1972 Amendments Adopted*			*Pre-1972 Amendments Adopted*			Notes on Variation From UCC § 9-401
	1st Alt.	*2nd Alt.*	*3rd Alt.*	*1st Alt.*	*2nd Alt.*	*3rd Alt.*	
Md.			X				Subsec. (5) filing is with Maryland State Department of Assessments and Taxation. Subsec. (7) adds "as used in this section 'County' includes Baltimore City." Adds new § 9.401.1 dealing with modification statements.
Mass.			X				Subsec. (1)(a) changes "county" to "town"; omits reference to crops; subsec. (1)(c) also uses "town."
Mich.		X					No substantive change; adds at end of subsec. (1)(a): ", but shall not be recorded in the real estate records of the county."
Minn.		X					Subsec. (1)(a) adds reference to motor vehicles that are not covered by a certificate of title; differentiates between resident debtor individuals and resident debtor corporations, partnerships, or other organizations; subsec. (3) deals with subsequent changes in debtor's residence; subsec. (7) defines motor vehicle and adds the words "and vehicles that are inventory of licensed dealers."
Miss.			X				Subsec. (1)(a) requires filing with Secretary of State as well as Chancery Clerk where collateral is farm products or crops growing or to be grown and debtor is non-resident.
Mo.						X	Modifies subsec. (1)(b) to indicate that filing is to be for record; see Mo. Rev. Stat. § 400.9-408 for additional requirements.
Mont.		X					In subsec. (1), insert "except for financing statements filed pursuant to 30-9-409," at the beginning thereof. Deletes references to farm equipment, products, and accounts, and "crops growing or to be grown" from subsec. (1)(a). Omits subsec. 5.

State	*1972 Amendments Adopted*			*Pre-1972 Amendments Adopted*			*Notes on Variation From UCC § 9-401*
	1st Alt.	*2nd Alt.*	*3rd Alt.*	*1st Alt.*	*2nd Alt.*	*3rd Alt.*	
Neb.		X					Subsec. (1)(a) adds farm products which become inventory of a person engaged in farming and crops growing or to be grown.
Nev.		X					Subsec. (1)(a) deletes reference to farm equipment, farm products or accounts or general intangibles arising from or relating to the sale of farm products by a farmer.
N.H.			X				Subsecs. (1)(a) and (1)(c) substitute "town" for "county."
N.J.		X					Subsec. (1)(a) adds sentence defining "recording officer." Omits subsec. 5.
N.M.		X					No substantive change.
N.Y.			X				Omits reference to non-resident debtor in subsec. (1)(a); additional paragraphs in subsec. (1) are definitional.
N.C.			X				Omits crops. Farm products require additional filing with Secretary of State.
N.D.		X					Reference to crops in subsec. (1)(a) is diverted to subsec. (1)(b), which includes reference to crops; collateral brought into state from another jurisdiction is subject to rules in N.D. Cent. Code § 41-09-03 (see subsec. (4)).
Ohio			X				Subsec. (1) adds paragraph pertaining to consumer goods.
Okla.		X					Subsec. (1)(a) includes livestock. For requirements of filing not contained in UCC, see Okla. Stats. tit. 1A, § 9-401A. Optional subsec. (3) adopted.
Ore.	X						For multiple state transactions, see subsec. (4); for filing requirements not contained in the UCC, see Ore. Stat. §§ 79.4015 and 79.4025.
Pa.			X				No substantive change.
R.I.		X					Subsec. (1)(a) omits consumer goods. Filing in subsec. (1)(a) is with the recorder of deeds in the city or town.

(continued)

TABLE 22-2 *(cont'd)*

	1972 Amendments Adopted			*Pre-1972 Amendments Adopted*			
State	*1st Alt.*	*2nd Alt.*	*3rd Alt.*	*1st Alt.*	*2nd Alt.*	*3rd Alt.*	*Notes on Variation From UCC § 9-401*
S.C.					X		Filing can be in office of register of mesne conveyances or clerk of court in county.
S.D.		X					Subsec. (1)(a) repealed. Omits subsec. 6.
Tenn.		X					No substantive change.
Tex.		X					Subsec. (1)(a) deals only with consumer goods. Omits subsec. (5). Adds a subsec. (f) dealing with farm products, equipment, accounts, and general intangibles. Adopts alternative subsec. (3).
Utah	X						Subsec. (1)(a) is subdivided into two paragraphs; (1)(a)(i) is substantially the same as subsec. (1)(a) of UCC with slight change in description of filing office; subsec. (1)(a)(ii) sets out separate filing location for a secured party that is a seller or purchase money lender.
Vt.						X	Subsec. (1)(a) substitutes "town" for "county"; slight word change with no substantive change; subsec. (1)(c) also uses "town" for "county."
Va.			X				Subsec. (1)(a) uses "county or city" for "county"; subsec. (1)(b) omits "filed"; subsec. (1)(c) substitutes "county or city" for "county." Additional filing with State Corporation Commission required when crops are grain (defined as including corn, wheat, rye, oats, barley, milo, soybeans and sunflower). New subsec. (1)(d) provides for continuation of security interests in grain perfected before January 1, 1984.
Wash.	X						No substantive change.
W. Va.			X				No substantive change; adopts alternative subsec. (3).

State	*1972 Amendments Adopted*			*Pre-1972 Amendments Adopted*			*Notes on Variation From UCC § 9-401*
	1st Alt.	*2nd Alt.*	*3rd Alt.*	*1st Alt.*	*2nd Alt.*	*3rd Alt.*	
Wis.		X					No substantive change.
Wyo.			X				Subsec. (1)(a) substantial changes; for accounts, filing is with Secretary of State, and County where assignor has principal place of business. Subsec. (1)(b) refers only to goods which are to become fixtures—file where real estate mortgage is filed. Subsec. (1)(c) filing is with clerk of county where debtor has principal place of business, otherwise debtor's residence, or Secretary of State for nonresidents. Uses first sentence of alternative subsec. (3) without four-month limitation.

TABLE 22-3 **State Filing Locations for Article 9 Security Transactions (UCC § 9-401)***

A. JURISDICTIONS ADOPTING 1972 AMENDMENTS

FIRST ALTERNATIVE/ SUBSEC. (1)(b)

Connecticut
Bracketed material:[a] Secretary of State
Variation: No change.

Delaware
Bracketed material:[a] Secretary of State
Variation: No change.

District of Columbia
Bracketed material:[a] Recorder of Deeds
Variation: See Variation Note, Table 8.

Georgia
Bracketed material:[a] Office of Clerk of Superior Court
Variation: See Variation Note, Table 8.

Idaho
Bracketed material:[a] Secretary of State
Variation: No change.

Iowa
Bracketed material:[a] Secretary of State
Variation: See Variation Note, Table 8.

Maine
Bracketed material:[a] Secretary of State
Variation: No change.

Oregon
Bracketed material:[a] Secretary of State
Variation: No change.

Utah
Bracketed material:[a] Division of Corporations and Commercial Code
Variation: No change.

Washington
Bracketed material:[a] Department of Licensing
Variation: No change.

SECOND ALTERNATIVE/ SUBSEC. (1)(a)

Alabama
1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: Judge of Probate
Variation: See Variation Note, Table 8.

Alaska
1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: Office of Recorder
Variation: No change.

Arizona
1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: County Recorder
Variation: No change.

California
1st[b] *and 2nd*[c] *blanks*: County Recorder
Variation: See Variation Note, Table 8.

Colorado
1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: Office of the County Clerk and Recorder
Variation: See Variation Note, Table 8.

Florida
1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: Office of the Clerk of the Circuit Court
Variation: See Variation Note, Table 8.

Illinois
1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: Recorder
Variation: No change.

*Table 22-3 was revised based on materials available to the author on July 15, 1987.

Indiana

1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: County Recorder

Variation: See Variation Note, Table 8.

Kansas

1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: Register of Deeds

Variation: See Variation Note, Table 8.

Michigan

1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: Register of Deeds

Variation: See Variation Note, Table 8.

Minnesota

1st[b] *and 3rd*[d] *blanks*: Office of the County Recorder

2nd[c] *blank*: Secretary of State

Variation: See Variation Note, Table 8.

Montana

1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: County Clerk and Recorder

Variation: See Variation Note, Table 8.

Nebraska

1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: County Clerk

Variation: See Variation Note, Table 8.

Nevada

1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: County Recorder

Variation: See Variation Note, Table 8.

New Jersey

1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: Recording Officer

Variation: See Variation Note, Table 8.

New Mexico

1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: Office of the County Clerk

Variation: No change.

North Dakota

1st[b] *and 2nd*[c] *blanks*: Register of Deeds

Variation: See Variation Note, Table 8.

Oklahoma

1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: County Clerk

Variation: No change.

Rhode Island

1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: Recorder of Deeds

Variation: See Variation Note, Table 8.

South Dakota

Variation: See Variation Note, Table 8.

Tennessee

1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: Office of the Register

Variation: No change.

Texas

1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: County Clerk

Variation: No change.

Wisconsin

1st,[b] *2nd,*[c] *and 3rd*[d] *blanks*: Register of Deeds

Variation: No change.

SECOND ALTERNATIVE/ SUBSEC. (1)(c)

Alabama

Bracketed material:[a] Secretary of State

Variation: No change.

Alaska

Bracketed material:[a] Department of Natural Resources

Variation: No change.

Arizona

Bracketed material:[a] Secretary of State

Variation: No change.

California
Bracketed material:[e] Secretary of State
Variation: No change.

Colorado
Bracketed material:[e] Secretary of State
Variation: No change.

Florida
Bracketed material:[e] Department of State
Variation: No change.

Illinois
Bracketed material:[e] Secretary of State
Variation: No change.

Indiana
Bracketed material:[e] Secretary of State
Variation: See Variation Note, Table 8.

Kansas
Bracketed material:[e] Secretary of State
Variation: No change.

Michigan
Bracketed material:[e] Secretary of State
Variation: No change.

Minnesota
Bracketed material:[e] Secretary of State
Variation: No change.

Montana
Bracketed material:[e] Secretary of State
Variation: No change.

Nebraska
Bracketed material:[e] Secretary of State
Variation: No change.

Nevada
Bracketed material:[e] Secretary of State
Variation: No change.

New Jersey
Bracketed material:[e] Secretary of State
Variation: No change.

New Mexico
Bracketed material:[e] Secretary of State
Variation: No change.

North Dakota
Bracketed material:[e] Secretary of State
Variation: No change.

Oklahoma
Bracketed material:[e] County Clerk of Oklahoma County
Variation: No change.

Rhode Island
Bracketed material:[e] Secretary of State
Variation: No change.

South Dakota
Bracketed material:[e] Secretary of State
Variation: No change.

Tennessee
Bracketed material:[e] Secretary of State
Variation: No change.

Texas
Bracketed material:[e] Secretary of State
Variation: No change.

Wisconsin
Bracketed material:[e] Secretary of State
Variation: No change.

THIRD ALTERNATIVE/ SUBSEC. (1)(a)

Arkansas
1st,[f] *2nd,*[g] *and 3rd*[h] *blanks*: Clerk of the Circuit Court and Ex-Officio Recorder
Variation: No change.

Maryland

1st,[f] *2nd,*[g] *and 3rd*[h] *blanks*: Office of the Clerk of the Circuit Court

Variation: See Variation Note, Table 8.

Massachusetts

1st,[f] *2nd,*[g] *and 3rd*[h] *blanks*: Office of the Clerk of the Town

Variation: See Variation Note, Table 8.

Mississippi

1st,[f] *2nd,*[g] *and 3rd*[h] *blanks*: Chancery Clerk

Variation: See Variation Note, Table 8.

New Hampshire

1st,[f] *2nd,*[g] *and 3rd*[h] *blanks*: Office of the Clerk of the Town

Variation: No change.

New York

1st[f] *and 3rd*[h] *blanks*: Office of the Filing Officer

Variation: See Variation Note, Table 8.

North Carolina

1st,[f] *2nd,*[g] *and 3rd*[h] *blanks*: Register of Deeds

Variation: See Variation Note, Table 8.

Ohio

1st,[f] *2nd,*[g] *and 3rd*[h] *blanks*: County Recorder

Variation: No change.

Pennsylvania

1st,[f] *2nd,*[g] *and 3rd*[h] *blanks*: Office of Prothonotary

Variation: No change.

Virginia

1st,[f] *2nd,*[g] *and 3rd*[h] *blanks*: Office of the Clerk of the court in which deeds are admitted to record

Variation: See Variation Note, Table 8.

West Virginia

1st,[f] *2nd,*[g] *and 3rd*[h] *blanks*: County Clerk

Variation: No change.

Wyoming

1st,[f] *2nd,*[g] *and 3rd*[h] *blanks*: Secretary of State and County Clerk

Variation: See Variation Note, Table 8.

THIRD ALTERNATIVE/ SUBSEC. (1)(c)

Arkansas

Bracketed material:[i] Secretary of State

1st[j] *and 2nd*[k] *blanks*: Clerk of the Circuit Court and Ex-Officio Recorder

Variation: No change.

Maryland

Bracketed material:[i] State Department of Assessments and Taxation

1st[j] *and 2nd*[k] *blanks*: Office of the Clerk of the Circuit Court

Variation: See Variation Note, Table 8.

Massachusetts

Bracketed material:[i] State Secretary

1st[j] *and 2nd*[k] *blanks*: Office of the Clerk of the Town

Variation: See Variation Note, Table 8.

Mississippi

Bracketed material:[i] Secretary of State

1st[j] *and 2nd*[k] *blanks*: Chancery Clerk

Variation: No change.

New Hampshire

Bracketed material:[i] Secretary of State

1st[j] *and 2nd*[k] *blanks*: Office of the Clerk of the Town

Variation: See Variation Note, Table 8.

New York

Bracketed material:[i] Department of State

1st[j] *blank*: Office of the Filing Officer

Variation: See Variation Note, Table 8.

North Carolina

Bracketed material:[i] Secretary of State

1st[j] *and 2nd*[k] *blanks*: Register of Deeds

Variation: No change.

Ohio

Bracketed material:[i] Secretary of State

1st[j] *and 2nd*[k] *blanks*: County Recorder

Variation: See Variation Note, Table 8.

Pennsylvania

Bracketed material: Secretary of the Commonwealth

1st[j] *and 2nd*[k] *blanks*: Office of Prothonotary

Variation: No change.

Virginia

Bracketed material:[i] State Corporation Commission

1st[j] *and 2nd*[k] *blanks*: Office of the Clerk of the court in which deeds are admitted to record

Variation: See Variation Note, Table 8.

West Virginia

Bracketed material:[i] Secretary of State

1st[j] *and 2nd*[k] *blanks*: County Clerk

Variation: No change.

Wyoming

Bracketed material:[i] Secretary of State

1st[j] *and 2nd*[k] *blanks*: County Clerk

Variation: See Variation Note, Table 8.

B. JURISDICTIONS NOT ADOPTING 1972 AMENDMENTS

SECOND ALTERNATIVE/ SUBSEC. (1)(a)

South Carolina

1st,[m] *2nd*[n] *and 3rd*[o] *blanks*: Register of Mesne Conveyances, *or* Clerk of Court

Variation: No change.

SECOND ALTERNATIVE/ SUBSEC. (1)(c)

South Carolina

Bracketed material:[p] Secretary of State

Variation: No change.

THIRD ALTERNATIVE/ SUBSEC. (1)(a)

Kentucky

1st,[q] *2nd,*[r] *and 3rd*[s] *blanks*: Office of the County Clerk

Variation: See Variation Note, Table 8.

Missouri

1st,[q] *2nd,*[r] *and 3rd*[s] *blanks*: Recorder of Deeds

Variation: No change.

Vermont

1st,[q] *2nd,*[r] *and 3rd*[s] *blanks*: Town Clerk

Variation: See Variation Note, Table 8.

THIRD ALTERNATIVE/
SUBSEC. (1)(c)

Kentucky

1st,[u] *and 2nd*[v] *blanks*: Office of the County Clerk

Variation: See Variation Note, Table 8.

Missouri

Bracketed material:[t] Secretary of State

1st,[u] *and 2nd*[v] *blanks*: Recorder of Deeds

Variation: No change.

Vermont

Bracketed material:[t] Secretary of State

1st[u] *and 2nd*[v] *blanks*: Town Clerk

Variation: See Variation Note, Table 8.

¶ 22.04 SECURITY INTERESTS WHEN THE SECURED PARTY HAS POSSESSION OF THE COLLATERAL

[1] The Pledge

The pledge is a security arrangement with ancient roots. Under this arrangement, the debtor delivers property to the secured party to be held as collateral security for the obligation owed. The property pledged can be of many different types. Common examples are stocks and bonds that are in certificate form, chattel paper, and goods. Whatever property is used as the collateral, the common thread to this transaction is that the secured party takes possession of the property and holds it until the obligation is discharged. The rights of the secured party and the debtor in this arrangement are determined by their agreement and by the UCC.

[a] Creating a Security Interest by Pledging Collateral. Under the UCC, a pledge is one permissible method of creating a security interest.[134] Moreover, when the secured party has possession of the collateral, the formal rules for creating an enforceable security interest are relaxed. It is not necessary to have a written security agreement signed by the debtor.[135] To have a valid pledge, however, the secured party must have obtained possession of the collateral by *agreement* with the debtor—involuntary seizure by the secured party is not recognized as a pledge.[136] Agreement, of course, is desirable for evidentiary purposes and to reduce subsequent disputes between the secured party and the debtor over the terms of their transaction.

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[134] UCC §§ 1-201(37), 9-102(2).

[135] UCC § 9-203(1)(a).

[136] Id. The 1972 amendments clarified the UCC in this respect. Accord Bank of Wallowa County v. Gary Mac, Inc., 49 Or. App. 403, 408, 619 P2d 1310, 1315 (1980).

The UCC does not define "possession" of the collateral.[137] Under cases prior to the UCC, problems arose when the secured party was lax in exercising dominion over the collateral, as in cases in which the debtor was allowed to continue to use and dispose of the collateral. The UCC does not change any of the prior common-law rules, which limited the extent to which the debtor could have access to and control of the collateral without jeopardizing the secured party's possession. (Of course, when the collateral is property in which a security interest may be perfected by filing, the secured party may do so, and the debtor's control over the collateral will then have no effect on the validity or perfection of the security interest.)

[b] Perfecting the Security Interest in Pledged Collateral. Possession of the collateral is not just a means for creating a security interest that substitutes for a formal written security agreement; it is also a permissible method of perfecting a security interest in that collateral. When the security interest is perfected in this manner, it is not necessary to file a financing statement.[138] It is important to note, however, that there are some types of collateral in which it is not possible to perfect a security interest by possession. The kinds of collateral in which security interests may be perfected by possession include goods, checks, negotiable notes, instruments, money, negotiable bills of lading, negotiable warehouse receipts, and chattel paper.[139] A security interest in a letter of credit can only be obtained by taking possession of the writing.[140] Security interests in securities (stocks and bonds, etc.) are subject to special rules discussed later in this chapter.

The secured party may take possession of the collateral through an agent.[141] One form of agency is a bailment. When the collateral is held by a bailee, notification to the bailee of the secured party's interest in the collateral is sufficient to perfect a security interest in that collateral, as long as the property held by the bailee is not subject to a negotiable document of title (such as a

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[137] UCC § 9-205 comment 6. Where a warehouseman obtained possession of crops but the possession was for the purpose of storing the crops and selling them at the direction of the debtor, the warehouseman did not have sufficient possession to perfect a security interest. The court said that the quality of possession needed to perfect a security interest must be possession that demonstrates an ownership interest and indicates the person in possession has a perfected security interest. It is a substitute for a filing and must satisfy the requirement that notice be given to other creditors. Because the debtor retained the authority to determine what crops to sell, at what price to sell the crops and to whom the crops should be sold, the warehouseman did not have apparent control of the collateral, and there was sufficient notice to other creditors. Harton v. Rogers, 39 UCC Rep. Serv. (Callaghan) 1878, 1880 (WD Ky. 1984).

[138] UCC § 9-302(1)(a).

[139] UCC § 9-305.

[140] UCC §§ 5-116, 9-305.

[141] UCC § 9-305, comment 2.

negotiable bill of lading or a warehouse receipt).[142] When the property is covered by a negotiable document of title, the only way to perfect a security interest in the goods is to perfect a security interest in the document of title.[143] In some cases, a security interest in a negotiable document of title may be perfected by filing; however, it is safer to take possession of the documents.

In one case, a security interest in an instrument was not perfected because the person holding the writing could not qualify as a bailee.[144] The person with possession of the instrument was an interested stake holder who had a perfected security interest in the obligation in its own right. In explaining why an interested party could not be a bailee for purposes of perfecting the security interests claimed by another, the court said:

> The reasoning for this distinction is clear although not expressly stated in the cases which address the point. By requiring the bailee to have no interest in the instrument in its possession, the danger of the bailee trying to pass the instrument off as his own is averted. The commercial world can rely upon an independent agent to represent accurately that the liens on the instrument do, in fact, exist. To require an interested party to inform the world of all other lien claimants, without an express agreement, would be a duty which the case law does not impose for the reason that the interested lien holder, who is also a bailee, would communicate conflicting signals to the commercial world, for he would exercise unilateral control over the instrument while supposedly holding it for the benefit of another secured party. These are inconsistent positions that would cause chaos in commercial transactions.[145]

The court found it significant that there was no agreement under which the secured party was holding the note for the other secured parties.

Placement of the collateral in the possession of an escrow agent, who serves as agent both for the secured party and the debtor, should be an effective means of perfecting a security interest in the collateral. The arrangement gives notice of

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[142] UCC § 9-305. For an explanation of how documents of title work, see ¶ 14.05[1]. The court held that equipment was in the possession of a bailee and, therefore, a security interest had been perfected by possession in Ingersoll-Rand Fin. Corp. v. Nunley, 671 F2d 842, 845 (4th Cir. 1982). Although there was no actual contract creating a bailment, the court recognized a constructive bailment. The case is potentially far-reaching because it, in effect, treats an agent of the debtor, who was using and paying for the equipment pursuant to a contract with the debtor, as the bailee. 671 F2d at 845. Compare In re Phillips, 24 Bankr. 712, 714 (Bankr. ED Cal. 1982), where the court held that the possession of property by a state-appointed receiver pursuant to the secured party's action in a state court does not constitute possession by the secured party for purposes of perfection of the security interest, because the receiver acts as an agent of the court and not as an agent of the secured party.

[143] UCC §§ 9-304, 9-305.

[144] In re Coral Petroleum, Inc., 50 Bankr. 830 (Bankr. SD Tex. 1985).

[145] Id. at 839-840.

the secured party's interest. At least one court, however, held that such an arrangement is not effective.[146]

Further, there are certain kinds of collateral in which a security interest may not be perfected by possession. If the collateral falls within the UCC classification as an account or a general intangible, a secured party may perfect a security interest only by filing a financing statement.[147] It makes no difference whether the agreement was called a pledge or whether one party took possession of a writing that purported to be something other than an intangible.

Once a security interest is perfected by possession, that perfection continues only for as long as the secured party retains possession of the collateral, or, in cases where other methods of perfection are possible, the secured party perfects the security interest in some other way. While there are certain narrow circumstances where there may be a temporary period of perfection in the absence either of filing or of possession,[148] these exceptions operate only in special circumstances. A security interest that is perfected by possession of the collateral becomes perfected at the time that possession is taken. It does not relate back to an earlier time.[149] When the collateral is such that a security interest may be

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[146] Stein v. Rand Constr. Co., 400 F. Supp. 944, 948 (SDNY 1975). See also In re Dolly Madison, 351 F. Supp. 1038 (ED Pa. 1972), aff'd, 480 F2d 917 (3d Cir. 1973); Note, "Attachment Under Section 9-204 and Perfection Under Section 9-305 of the Uniform Commercial Code of Pennsylvania: Explicit Language Delaying Attachment and Escrow as Satisfaction of Possession," 5 Rut.-Cam. LJ 336 (1974). But cf. In re Hinds Estate, 10 Cal. App. 3d 1021, 89 Cal. Rptr. 341 (1970); 1 Gilmore, Security Interests in Personal Property § 7.2 (1965).

An escrow account was established between a buyer and seller of farm land. Under the contract, the buyer made payments to satisfy a note held by the escrow agent. The seller subsequently assigned to the bank his interest in the proceeds due from the sale of the farm land. Bank notified the escrow agent of the assignment but did not give any notification to the buyer of the land. The court held that UCC § 9-318(3) applied to the assignment and that because the bank had failed to instruct the buyer to make payments directly to the bank, the buyer was authorized to make payments directly to the seller and could, if the seller agreed, terminate the escrow arrangement. First Fidelity Bank v. Matthews, 692 P2d 1255, 1260 (Mont. 1984).

A person who was entitled to the debtor's funds that had been placed in an escrow account under an agreement between the party and the debtor was entitled to the funds against the debtor's trustee in bankruptcy. The trustee argued that the party had an unperfected security interest only. The court held that the party had a perfected security interest because the party had given notice to the escrow agent of the interest asserted. The court reasoned that the collateral involved was money that the escrow agent was holding as a bailee under UCC § 9-305. (The court rejected an argument that the collateral should be classified as a general intangible.) Notice to the bailee constituted an appropriate method for perfecting the security interest. In re O.P.M. Leasing Servs., Inc., 46 Bankr. 661 (Bankr. SDNY 1985).

[147] UCC §§ 9-302(1), 9-305 & comment 1. For a discussion of perfection by filing, see ¶¶ 22.03 and 22.05.

[148] UCC § 9-304(5).

[149] UCC § 9-305 & comment 3.

perfected by filing as well as by possession, there is nothing to prevent the secured party from perfecting a security interest in both ways. Doing so may have some advantage for the secured party, in case possession is ever relinquished. Moreover, doing so will give the secured party the benefit of the general priority rule that dates the priority of the security interest under Section 9-312(5)(a) from the time the filing is first made or the security interest is first perfected, whichever is first, as long as there is no gap in the period where there is neither filing nor perfection.[150]

[2] Field Warehouse Systems

One variant of the pledge is the field warehouse arrangement. This form of security, which arose prior to the UCC, was often used to obtain a security interest in goods in the process of manufacture. Under this scheme, unfinished goods in the process of manufacture, as well as finished goods not yet sold, were put in the possession of a separate bailee or trustee. Normally, the place at which the goods were held was the factory where they were being processed or the company's usual warehouse for storing the goods before sale. The theory of the field warehouse arrangement was that the trustee took possession of the collateral on behalf of the secured party—the debtor had access to the goods only under the control of the secured party according to the specific terms of the security agreement. For the field warehouse to be a valid security arrangement, the transaction had to create a valid bailment or entrustment. This required that possession of the collateral be in the trustee or bailee rather than the debtor. The existence of possession by the bailee often could be attacked when the secured party was lax in enforcing control over the goods, thereby allowing the debtor free access to the collateral and rights to use and dispose of it.[151]

Under the UCC, the field warehouse system still may be an appropriate method of obtaining a security interest in collateral. As discussed in the previous section, the pledge, in which the secured party takes possession of the collateral, is a method recognized under the UCC for obtaining and perfecting a security interest. Possession may be by a bailee or an agent, as well as by the secured party personally.[152] The UCC does not define what constitutes "possession," either by the secured party or by an agent. The comments to the UCC indicate that the prior law on what constitutes possession continues to be relevant.[153] In most cases, it will be to the advantage of the secured party to perfect a security interest by filing a financing statement, rather than to rely on the uncertainties of establishing a possession that satisfies the common law rules. When the security interest is perfected by filing, it makes no difference whether the debtor has access to or use of the collateral.[154] Of course, allowing the debtor access to the

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[150] UCC § 9-312(5)(a). The priority rules are discussed in ¶ 23.01.

[151] See UCC § 9-205, comment 6.

[152] UCC § 9-305 & comment 2.

[153] UCC § 9-205, comment 6.

[154] UCC § 9-205.

collateral may create a risk that the debtor might transfer the collateral to a good-faith purchaser, who would obtain rights in the collateral superior to those of the secured party.

[3] Duties of a Pledgee

When collateral is in the possession of a secured party, the secured party has a duty to use reasonable care in its custody.[155] When there is a failure of reasonable care, the secured party is liable to the debtor for any loss caused thereby.[156] Failure to exercise reasonable care does not result in a loss of the security interest in the collateral.[157]

When the collateral is an instrument or chattel paper, reasonable care includes taking steps necessary to preserve rights against prior parties.[158] A secured party may have to collect periodic interest, take steps to collect instruments, preserve rights against parties secondarily liable on the instrument, and take other steps to maintain the value of the collateral.[159]

The parties may enter into an agreement as to the terms under which the secured party will hold the collateral. In the absence of such an agreement, the secured party is entitled to recover reasonable expenses incurred in caring for the collateral.[160] The expenses incurred by the secured party are secured by the collateral.[161] If the collateral is accidentally lost or damaged without fault of the secured party, the risk of loss is on the debtor, to the extent that it is not covered by insurance. Thus the debtor has the responsibility of insuring the collateral.[162] When the collateral produces further profits or increases in value, this additional value may be held by the secured party as additional security,[163] but, if the profits are money, the money must either be applied to reduce the obligation owed, or be remitted to the debtor.[164]

The secured party has a duty to keep the collateral in an identifiable form, unless it is of a fungible nature.[165] The secured party is permitted to repledge the collateral, but the terms of any repledge may not impair the debtor's right to redeem the collateral when the debtor fulfills the obligations owed the secured party.[166]

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[155] UCC § 9-207(1).

[156] UCC § 9-207(3).

[157] Id.

[158] UCC § 9-207(1).

[159] See generally B. Clark, The Law of Secured Transactions Under The Uniform Commercial Code ¶ 7.14 (1980).

[160] UCC § 9-207(2)(a).

[161] Id.

[162] UCC § 9-207(2)(b).

[163] UCC § 9-207(2)(c).

[164] Id.

[165] UCC § 9-207(2)(d).

[166] UCC § 9-207(2)(e).

¶ 22.05 AUTOMATIC PERFECTION AND PERFECTION OF SECURITY INTERESTS IN COLLATERAL GOVERNED BY SYSTEMS OTHER THAN THE UCC

As discussed previously, filing a financing statement is one method of perfecting a security interest in certain kinds of collateral. Security interests in collateral classified as accounts or general intangibles may be perfected only by filing.[167] When the collateral is goods, chattel paper, or negotiable documents, a secured party may perfect a security interest either by filing a financing statement[168] or by taking possession of the collateral.[169] In some cases, taking possession is the preferred method, to reduce the risk that third-party transferees or other claimants may obtain superior rights to those of the secured party.[170] When the collateral is money or instruments (notes, drafts, checks, etc.), it is generally not possible to perfect a security interest by filing. Except for several narrow exceptions, the method of perfecting a security interest in such collateral is by taking possession of it, because it is so negotiable.[171] Filing also may be important to assure the secured party of a perfected security interest in proceeds arising from the collateral.[172]

However, there are certain other transactions for which the UCC defers to other filing or registration systems and makes these alternative systems the equivalent of filing a financing statement under the UCC.[173] In some states, for example, motor vehicles are covered by a certificate of title. To obtain a security interest in a vehicle covered by such a certificate of title, the state law often requires that the secured party note the security interest on the certificate. When this is required, compliance with the certificate of title regulations is, under the UCC, the equivalent of filing a financing statement.[174] Similar results are obtained for collateral that would be covered by registration systems established under federal law or treaties of the United States.[175]

Additionally, in a few limited situations, a secured party's security interest will be automatically perfected, without either filing a financing statement or taking possession of the collateral. These situations occur as follows:

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[167] UCC §§ 9-302, 9-305.

[168] UCC § 9-302.

[169] See UCC § 9-305.

[170] See Chapter 23.

[171] UCC § 9-304(1). The exceptions concern situations where there is temporary perfection, UCC § 9-304, and where the proceeds rules operate, UCC § 9-306. See ¶¶ 22.07[3], 23.03[1], 23.02[3] for a discussion of security interests in instruments and proceeds.

[172] UCC § 9-306. See ¶ 23.03[3] on proceeds.

[173] UCC § 9-302(4).

[174] UCC § 9-302(3)(b).

[175] UCC § 9-302(3)(a).

1. A security interest is temporarily perfected in certain transactions involved instruments, documents, and proceeds.[176]
2. A security interest involves the assignment of a trust or a decedent's estate.[177] (In jurisdictions where trusts are used as commercial financing devices, this rule may present problems.)[178]
3. The security interest is a purchase money security interest in consumer goods (other than motor vehicles, which are subject to registration requirements and fixtures).[179]
4. An assignment of accounts is made, which, by itself or with other assignments to the same assignee, does not transfer "a significant part of the outstanding accounts of the assignor."[180] This has the effect of permitting isolated assignments, for which no financing statement is filed, to be made without the risk that they might be viewed as unperfected security interests, which would be unenforceable against lien creditors and good-faith purchasers.
5. The security interest of a collecting bank in checks and other items that are in the process of collection and certain security interests that arise under other Articles of the UCC.[181] For these other provisions, there may be requirements or procedures that must be met in such cases.
6. An assignment is made for the benefit of all creditors of the transferor.[182]

¶ 22.06 SECURITY INTERESTS IN GOODS AND CHATTELS

Security interests in goods may be perfected either by filing or by taking possession of the collateral.[183] In the case of a purchase money security interest in certain kinds of consumer goods, perfection occurs automatically, without either filing or possession.[184] Even when the collateral is consumer goods, filing

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[176] UCC § 9-302(1)(b).

[177] UCC § 9-302(1)(c).

[178] In Arizona, there is a nonuniform variation that requires the filing of a financing statement to perfect a security interest in a subdivision trust, which is a special financing device used in some real estate transactions. Compare Ariz. Rev. Stat. Ann. § 47-9302(A)(3) (1988) with UCC § 9-302(1)(c). The Arizona statute accomplishes this by deleting the exception for a beneficial interest in a trust.

[179] UCC § 9-302(1)(d).

[180] UCC § 9-302(1)(e).

[181] UCC § 9-302(1)(f).

[182] UCC § 9-302(1)(g).

[183] UCC §§ 9-302, 9-305.

[184] UCC § 9-302(1)(d). For an explanation of purchase money security interests, see supra ¶ 22.02.

is necessary if the collateral is a motor vehicle subject to a state law registration requirement. Filing also is necessary when the collateral is a fixture and is governed by the special rules on security interests in fixtures.[185]

Under the UCC, goods are defined as all things that are movable.[186] Goods do not include money, documents, instruments, accounts, chattel paper, general intangibles, minerals, or the like. Goods do include standing timber that is to be cut, growing crops, and animals both born and yet to be born.[187]

Under the UCC, goods are classified in the following four categories: consumer goods, equipment, farm products, and inventory.[188] Additionally, there are special rules for fixtures and for goods subject to separate registration schemes, such as motor vehicles. The rules for perfection of security interests and determining priorities vary depending on the classification of the goods. Classification depends on the holder's particular use of the goods and each classification is exclusive of the others. Thus, an automobile would be inventory in the hands of the car dealer, equipment in the hands of a business that bought the car for use by its sales force, and consumer goods in the hands of someone who purchased the car for personal travel.

[1] Consumer Goods

Consumer goods are those that are "used or bought for use primarily for personal, family or household purposes."[189] In most cases, goods that fall into this category are easy to classify, but borderline situations do arise. The drafters of the UCC indicate that "in borderline cases—a physician's car or a farmer's jeep which might be either consumer goods or equipment—the principal use to which the property is put should be considered as determinative."[190]

When a purchase money security interest is obtained in consumer goods, it is neither necessary to file a financing statement nor to take possession of the goods to perfect a security interest in the goods. Only when the consumer goods consist of a motor vehicle or a fixture to be attached to the real estate is filing possibly required.[191] Thus, any person dealing with property owned by a consumer should be certain to investigate whether that property is subject to an outstanding security interest, even though there is no financing statement on file. Although the purchase money security interest in consumer goods will be perfected without filing, there may be situations involving large value consumer

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[185] Id.

[186] UCC § 9-105(1)(h).

[187] Id.

[188] UCC § 9-109. See ¶¶ 22.06[1]–22.06[4].

[189] UCC § 9-109(1).

[190] UCC § 9-109, comment 2.

[191] UCC § 9-302(1)(d).

items, where the secured party may want to file anyway. The filing of a financing statement gives the secured party greater protection against persons who might be regarded as good faith purchasers of the collateral from the debtor. When a financing statement is on file, these purchasers may not take free of the secured party's interest in the goods.[192]

When the collateral is consumer goods, the secured party is limited in the extent to which he or she may claim after-acquired property as additional security for the obligation. An after-acquired property clause is effective against a consumer only when the consumer-debtor acquires rights in this property within ten days after the secured party has extended value to the consumer.[193] Consumer transactions are subject to many further consumer protection laws, both federal and state. Chapter 26 discusses some of the special credit regulations applicable in consumer transactions.

[2] Equipment

Goods are classified as equipment if they are "used or bought for use primarily in business." Business includes farming or one of the professions. When the debtor is a nonprofit organization or a governmental agency, the goods are also classified as equipment.[194] When goods do not fall within the definitions of the other three classifications (inventory, farm products, or consumer goods) they are to be treated as equipment.[195] Security interests in equipment may be perfected either by the secured party taking possession of the collateral or by filing a financial statement.[196]

[3] Farm Products

Farm products include crops, livestock, supplies used in farming operations, and products of crops or livestock in their unmanufactured state. The goods must be in possession of a debtor who is engaged in some form of

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[192] UCC § 9-307(2).

[193] UCC § 9-204(2).

[194] UCC § 9-109(2).

[195] Id.

[196] UCC §§ 9-302, 9-305. Before the 1972 amendments to Article 9, it was unnecessary to file a financing statement to perfect a purchase money security interest in farm equipment with a purchase price not in excess of $2,500. See UCC § 9-302(1)(c). This provision was eliminated by the 1972 amendments, and a financing statement must be filed to perfect all security interests in farm equipment. See also UCC § 9-307(2), which in its pre-1972 version treated a good faith purchaser of farm equipment similarly to the good faith purchaser of consumer goods.

farming.[197] Farm products may not be equipment or inventory.[198] In some cases, farm products may be difficult to distinguish from equipment. (Equipment includes goods used in the business of farming.) In such cases, the only safe course is to follow the rules for both kinds of collateral.

Since farm products are goods, the secured party may perfect a security interest by taking possession or by filing.[199] In some cases, as for example when the collateral consists of crops growing or to be grown, or timber to be cut, for the secured party to have an enforceable security interest the security agreement must contain a description of the land involved.[200] Also, the financing statement may have to contain a description of the real estate, as is required when the collateral consists of crops growing or to be grown, or timber to be cut.[201] Depending on the jurisdiction, when the collateral is growing crops, the financing statement may have to be filed with the county office where the land is located. Filings as to standing timber, minerals, and some fixtures must be in the office for recording real estate mortgages.[202]

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[197] UCC § 9-109(3). In United States v. Newcomb, 682 F2d 758 (8th Cir. 1982), the court rejected the argument of a creditor who held an interest in the debtor's real estate that real estate law, rather than Article 9 of the UCC, should govern security interests in crops that are still growing. The court read UCC §§ 9-104(j), 9-105(h), 9-109(3), 2-107, as classifying growing crops as "personal property, not real estate," and therefore Article 9 applies to govern security interests in such collateral. 682 F2d at 761. The competing creditor could not rely upon pre-UCC law holding that growing crops unsevered from the land are subject to the lien of a deed of trust on the land.

Grains in a cooperative warehouse, although still owned by the farmer, but held by a warehouse as bailee, are inventory. The court reasoned that they were not farm products because the farmer did not have possession, but the PCA obtained a security interest that was properly perfected by filing when the grain was a farm product in the possession of the farmer. The security interest continued to be perfected notwithstanding the change in its classification. In re Walkington, 62 Bankr. 989, 994–997 (WD Mich. 1986).

[198] UCC § 9-109(3). An $800,000 registered quarter horse stallion, that the debtor acquired primarily for the purpose of selling syndicated shares of ownership but subsequently used for the purpose of providing breeding services, was not collateral that was intended to be used in farming operations. Therefore, it did not constitute either a farm product or equipment used in farming operations. (The answer might be different if the debtor who owned the stallion intended to breed mares and raise the offspring himself.) Thus, the stallion must be classified as either equipment or inventory used in a business enterprise. In re Butcher, 43 Bankr. 513, 521–522 (Bankr. ED Tenn. 1984).

[199] UCC §§ 9-302, 9-305. A California registration law relating to feedlot operators does not override Article 9 of the UCC. Article 9 gives a secured party who has financed the cattle business of the owner of the collateral a perfected security interest in cattle subsequently transported to the feedlot. In re Black & White Cattle Co., 46 Bankr. 484, 489 (Bankr. 9th Cir. 1984).

[200] UCC § 9-203(1)(a). See generally Annot., "Sufficiency of Description of Crops Under U.C.C. § 9-203(1)(b) and 9-402(1)," 67 ALR3d 308 (1975).

[201] UCC §§ 9-402(1), 9-402(5).

[202] UCC § 9-401.

Persons who purchase farm products from a person engaged in farming operations must exercise caution. Although purchasers in the ordinary course of business generally take free of any security interest created by their seller, buyers from farmers are not so protected. The secured party's interest in the farm products is effective even against a buyer in the ordinary course of business.[203] However, if the secured party authorizes the sale, expressly or otherwise, the buyer will take free of the security interest.[204] Protection of such purchasers is now a matter for which federal law may override the UCC. As discussed later in Chapter 23, the Food Security Act of 1985 contains new rules for buyers and dealers in farm products.

[4] Inventory

Goods are inventory when they are held by a person for sale or lease or are to be furnished under a contract of service.[205] Inventory also includes raw materials, work in process, or materials used or consumed in a business.[206] Inventory is not equipment.

A security interest in inventory may be perfected by the secured party's taking possession of the collateral or filing a financing statement. In most cases, however, the debtor will want to retain possession of the inventory to make it available for sale. Thus, the only practical method available, unless some form of field warehousing is adopted (discussed earlier in this chapter) is to perfect the security interest by filing. The UCC's liberal rules, which allow the security agreement to cover after-acquired property and to extend to future advances, enable the parties to execute a single security agreement that will create a security interest in all of the inventory of the debtor, whenever acquired. Similarly, it is necessary to file only one financing statement to perfect the security interest in the collateral, whenever acquired.[207]

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[203] UCC § 9-307(1). See ¶ 23.02[1] for a definition of "buyers in ordinary course." Buyers of farm products under the Food Security Act of 1985 are discussed at ¶ 23.02[2].

[204] UCC § 9-306(2).

[205] UCC § 9-109(4). An interesting problem in classifying collateral was presented in In re Ronco, Inc., 46 Bankr. 444, 451–452 (ND Ill. 1984), appeal dismissed, 793 F2d 1295 (7th Cir. 1986). In this case, the debtor's business involved shipping goods to out-of-state retailers for resale. The nature of the arrangements under which the debtor supplied the goods to the retailers affected the classification of the property under the UCC's perfection rules. If the transaction were a "sale-or-return," the property that served as collateral would consist of a series of accounts with the various retailers. On the other hand, if the transaction were viewed as a delivery on consignment, the collateral would be the goods themselves, which would remain as the inventory of the debtor.

[206] UCC § 9-109(4).

[207] See supra ¶ 22.02 on creation of security interest and ¶ 22.03 on financing statements. The owner of a tractor gave the tractor to his local dealership for sale and lost his ownership interest in the tractor to the dealer's inventory financer. The court regarded the

Persons who engage in financing inventory must take into account that allowing the debtor to sell the inventory to purchasers gives the debtor the power to cut off the security interest of the secured party in the collateral. Any transfer of the collateral that the secured party authorizes in the security agreement "or otherwise" will result in the transferee or buyer taking the collateral free from the security interest.[208] Regardless of the terms in any written agreement between the secured party and the debtor, when the secured party permits the debtor to exercise control over the inventory (as is normally the case) and to make sales to buyers, the secured party is likely to be regarded as having "authorized" the sale of the collateral, and the buyers of the collateral will take free of any interest claimed by the secured party.[209] In any event, the UCC protects buyers in the ordinary course of business, regardless of what the secured party authorizes.[210] A person who buys in the ordinary course of business takes free of any security interest created by the seller, even though the buyer knows that the goods were subject to the security interest.[211] A buyer in the ordinary course of business is someone who buys in good faith from someone who is in the business of selling goods of that kind.[212]

Because the financing of inventory often involves the sale of the collateral, this form of financing usually involves security interests in the proceeds of the collateral as well, including accounts, money, instruments, chattel paper, and other property produced when the inventory is sold. There are special rules, discussed in Chapter 23, that govern the security interests in proceeds.

Although the UCC recognizes that goods may be delivered on consignment to persons who are in the business of selling such goods, under terms that do not qualify as creating security interests within the UCC's definition, there are rules that the consignor must follow to preserve the consignor's interest against other creditors of the consignee.[213] Under UCC § 2-326, when goods on consignment are delivered to a person who maintains a place of business where such person "deals in goods of the kind involved, under a name other than the name of the person making delivery," the consignor must take certain steps to ensure that notice is given of the consignor's interest in the goods. The UCC makes the

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owner's delivery of the tractor to the dealer as a transaction that constituted a sale or return under UCC § 2-326(3). Because the owner did not file a financing statement or otherwise comply with the conditions in Section 2-326, the interest of the owner was subordinate to the interest of the dealer's financer who held a perfected security interest in all of the dealer's inventory. Logan Paving Co. v. Massey-Ferguson Credit Corp., 172 Ga. App. 368, 323 SE2d 259 (1984).

[208] UCC § 9-306(2).

[209] Id. See discussion at ¶ 23.02.

[210] UCC § 9-307(1).

[211] Id.

[212] UCC § 1-201(9).

[213] See UCC §§ 1-201(37), 2-326, 9-114, 9-302(1)(f), 9-408.

goods on consignment for sale subject to the claims of the consignee's creditors, while the goods are in the consignee's possession, unless the consignor can demonstrate that one of three circumstances applies: (1) the consignor complied with a local law providing for the consignor's interest to be evidenced by a sign on the consignee's premises or the like; (2) the consignor establishes that the consignee is "generally known by his creditors to be substantially engaged in selling the goods of others . . . ;" or (3) the consignor makes a filing as permitted for secured transactions under Article 9.[214]

Because these provisions, if not followed, make the goods subject to the claims of the consignee's creditors, persons with a security interest in the consignee's goods who are creditors of the consignee will have a claim to the goods that is superior to that of the consignor. When the consignor must make an Article 9 filing to protect the consignor's interest in the goods against creditors, the consignor must give notice in writing, to secured parties who are creditors of the consignee and who would have had a perfected security interest in the goods if the goods were the property of the consignee, in a manner similar to the notification rules that apply to purchase money security interests in inventory.[215] Given the complexity of the consignment provisions, a prudent course would be for a consignor to take all the steps necessary to perfect a security interest in the goods, as if the transaction were one that created a security interest under Article 9. As mentioned earlier in this chapter, a consignor may file a financing statement without admitting that the transaction creates a security interest.[216]

A consignment transaction may be a transaction that creates a security interest.[217] When it does, the rules in Article 9 with respect to creation and perfection of security interests should apply. When perfection occurs by filing, the consignor needs to take all the steps, including notification to prior secured parties, that a normal inventory financer must make.[218] Additional confusion exists because of the language used in UCC § 1-201(37) that even when a consignment may be "intended as security" so that the consignment creates a security interest, "a consignment is in any event subject to the provisions on consignment sales (§ 2-326)."[219] This language could be construed as requiring that the consignor comply with both the Article 9 rules for creation and perfection of a security interest and the rules in Section 2-326 for protection against creditors generally. As UCC § 2-326 permits a consignor to protect against the claims of the consignee's creditors by complying with the filing provisions of

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[214] UCC § 2-326(3).

[215] UCC § 9-114. For a discussion of the inventory rules, see ¶ 23.01.

[216] UCC § 9-408. For a discussion of filing of financing statements, see supra ¶ 22.05.

[217] See UCC §§ 1-201(37), 9-114, 9-408, all of which contemplate a consignment, may create a security interest. See ¶ 22.01[2][b].

[218] See UCC § 9-312(3).

[219] UCC § 1-201(37).

Article 9, perhaps the potential problems arising from the direction to comply with both sets of provisions may be harmonized by a finding that Article 9 compliance is satisfactory for the purposes of Section 2-326, as well.[220]

[5] Fixtures

Fixtures are goods that have become so related or connected to real estate that, under the real estate law of the jurisdiction, persons who have an interest in the real estate also acquire an interest in the goods.[221] Since transactions involving fixtures have some features that are close to real estate transactions, the UCC has special rules for fixtures. Security interests in fixtures are created in the same way that security interests are created in other personal property, although to perfect a security interest in fixtures a "fixture filing" is sometimes necessary.[222] A fixture filing is one that is made in the office where real estate mortgages are filed or recorded.[223] The financing statement must meet special requirements, such as the requirement that a description of the involved real estate be included.[224]

The UCC rules governing fixtures were extensively revised by the 1972 amendments. Prior to these amendments, the only way that a security interest in fixtures could be perfected was by a fixture filing. Under the new amendments, there are certain categories of fixtures in which a security interest may be perfected by ordinary Article 9 methods. When the goods are "readily removable factory or office machines," the security interest may be perfected by an ordinary filing.[225] Similarly, when the fixtures are "readily removable replacements of domestic appliances which are consumer goods," the security interest may be perfected by any method, including the automatic perfection for purchase money security interests in consumer goods[226] allowed by the UCC for perfecting security interests in consumer goods. To the extent that the secured party is concerned only about conflicting interests in the fixtures arising from

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[220] There is an excellent discussion in J. White & R. Summer, Uniform Commercial Code § 22-4 (2d ed. 1980), which gives a detailed analysis of the potential problems in reconciling UCC § 2-326 and the Article 9 rules.

[221] UCC § 9-313(1)(a). The parties to a financing transaction may enter into an agreement that a given structure is to be classified as personal property for the purposes of their transaction. The agreement binds the parties to the agreement, but it cannot bind other persons who have no notice of the arrangement. In re Trestle Valley Recreation Area, Inc., 45 Bankr. 458, 460 (Bankr. DND 1984).

[222] UCC § 9-313(1)(b).

[223] Id.

[224] UCC § 9-402(5).

[225] UCC § 9-313(4)(c).

[226] Id.

liens obtained by judgment creditors or other legal proceedings on the real estate, perfection by the ordinary means of filing under the UCC is sufficient.[227]

Complex rules govern priorities between secured parties who claim an interest in fixtures and other persons who claim an interest as owners of the real estate, or creditors with an interest in the real estate. These rules were extensively revised by the 1972 amendments. Counsel should be consulted before one engages in any transaction involving fixtures.[228]

[6] Motor Vehicles

Motor vehicles require registration in most states and are the subject of special state legislation that provides for the issuance of a certificate of title showing the ownership interests in the vehicle. When this is the case, the UCC rules on perfection of security interests are modified to accommodate the certificate-of-title requirements.[229] Security interests in the motor vehicle will be perfected only by notation of the security interest, in compliance with the certificate-of-title law of the jurisdiction,[230] on the certificate of title. Compliance with the special certificate-of-title requirements is regarded by the UCC as "equivalent to the filing of a financing statement" and so perfects the security interest in the vehicle. The UCC, however, continues to govern the transaction, as it applies to questions involving the validity and enforceability of the security interest, to priorities between the secured party and other creditors, and to rights of purchasers of the collateral.[231] Prior to the 1972 amendments, the UCC was

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[227] UCC § 9-313(4)(d). A filing in the place where financing statements are filed to perfect a security interest in personal property is effective to perfect a security interest in a fixture against the claims of the trustee in bankruptcy that are based on the trustee's power as a hypothetical lien creditor. It is not necessary to file in the real estate records, so long as the competing claimant to the property is someone with a claim against the unsecured chattels of the debtor, rather than someone claiming to be a bona fide purchaser of the real estate or a creditor with a real estate interest. In re Trestle Valley Recreation Area, Inc., 45 Bankr. 458, 462-463 (Bankr. DND 1984).

[228] The UCC fixtures rules and a description of the changes made by the 1972 amendments are described in detail in Schroeder, "Security Interests in Fixtures," 1975 Ariz. St. LJ 319. See generally Note, "Leases in Fixtures (*Courtright Cattle Co. v. Dolsen Co.*, 94 Wash. 2d 645, 619 P2d 344 (1980))," 17 Gonz. L. Rev. 209 (1982).

[229] UCC § 9-302(3). See generally Note, "*In re Littlejohn*: Equitable Departure From State Certificate of Title Act Filing Requirement (*In re Littlejohn*, 519 F.2d 356 (10th Cir. 1975))," 1975 Utah L. Rev. 726–739 (1975); Note, "Interstate Movement of Motor Vehicles: Certificates of Title Acts and the Uniform Commercial Code," 9 Creighton L. Rev. 373 (1975).

[230] UCC § 9-302(4).

[231] Id. The provisions of UCC § 9-402(8) that a filing of a financial statement is effective notwithstanding minor errors that are not seriously misleading has been held to apply to perfection of a security interest by compliance with certificate of title legislation. In re Circus Time, Inc., 641 F2d 39, 42 (1st Cir. 1981). See Yampolsky v. White Motor

unclear as to the extent to which its provisions should give way to the requirements of the motor vehicle laws.

Motor vehicles are not the only type of collateral subject to certificate-of-title statutes. Statutes of this nature also apply to mobile homes, boats, farm tractors, trailers, and similar items. The UCC provisions are drafted so that the rules discussed in this section apply to any type of collateral that is covered by a certificate of title.[232] Financing this type of collateral involves the interplay of two sets of laws and, often, substantial questions arise relating to interstate conflicts. Counsel should be consulted for guidelines on how to proceed.

¶ 22.07 SECURITY INTERESTS IN INTANGIBLES AND LIKE PROPERTY

[1] Accounts

An account is any "right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance."[233] A security interest in an account may be perfected only by filing, except in the limited situations in which perfection arises automatically.[234] Prior to the 1972 amendments, the UCC recognized a classification of obligations called "contract rights."[235] A contract right was any right to payment under a contract not yet earned by performance.[236] This classification was eliminated by the 1972 amendments, and what formerly were classified as contract rights were not classified either as accounts or as general

Credit Co. (In re Angier), 684 F2d 397 (6th Cir. 1982) (applying a similar standard of compliance without reference to UCC § 9-402 (8)).

[232] UCC § 9-302(3)(b).

[233] UCC § 9-106. Airline tickets are not "instruments," and money collected in payment for the sale of airline tickets constitutes proceeds of "accounts." In re Air Fla. Sys., Inc., 49 Bankr. 321, 324–325 (SD Fla. 1985).

[234] See UCC § 9-302. See supra ¶ 22.05.

[235] UCC § 9-106.

[236] Id. Under the pre-1972 definition of "account," problems arose because of difficulty in classifying certain rights to payment. These right might fall within the definition of "contract right," "general intangible," or "account" in that version of the UCC. The classification given to the right could affect the enforceability or perfection of a security interest if the security agreement and financing statement did not recognize the possible definitional problems. In Utica Nat'l Bank & Trust Co. v. Associated Prod. Co., 622 P2d 1061, 1064 (Okla. 1980), for example, the court was called upon to decide at what point a right under a contact had been earned by performance so the collateral had ripened from a "contract right" into an "account." Similar problems existed under the pre-1972 UCC, when the amount due under the account was not fixed because subject to dispute. The classification of claims for damages for breach of contract or other liability also has been an issue. See Merchants Nat'l Bank v. Ching, 681 F2d 1383 (11th Cir. 1982).

intangibles. As a result, the definition of an account, under the UCC, is much broader than what might traditionally be thought of as an "account receivable" by accountants.[237]

As discussed at the start of this chapter, most transactions involving the sale, transfer, or assignment of accounts in any form will fall within the scope of the UCC, which is broadly drafted to apply to transfers of accounts that are absolute in form.[238] Unless the transaction may clearly be classified as one that falls under an exemption from Article 9 coverage, it should be treated as within the scope of the article.[239]

Accounts often are proceeds of inventory.[240] For such accounts, security interests that have been created in the inventory may continue into the accounts that arise from the sale of the inventory. However, situations may be created in which there are conflicting claims made by two or more secured parties. These conflicts and their resolution are discussed in Chapter 23.

Article 9 contains provisions governing the rights of the parties to an account when the account is assigned.[241] There are three parties to this transaction: the original account debtor; the assignor who is the party to whom the account is originally owed; and the assignee to whom the right to payment is transferred. When an account is assigned, the original agreement between the account debtor and the assignor may provide for a waiver of defenses that the account debtor otherwise would have against the enforcement of the obligation by the assignee.[242] Such waivers are discussed in Chapter 16. When there is no waiver of defenses by the account debtor, the UCC provides that "the rights of an assignee are subject to (a) all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom; and (b) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives notification of the assignment."[243]

In *Michelin Tires (Canada), Ltd. v. First National Bank*,[244] an account debtor claimed it had the right to recover affirmatively from the assignee payments that the debtor mistakenly made. The case involved a construction contract. Michelin agreed to make progress payments as work was done when the contractor, JCC, submitted proper certification. JCC assigned the right to these payments to First National Bank (FNB). Michelin made payments as the work

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[237] See UCC § 9-106. See e.g., Sun Bank v. Parkland Design & Dev. Corp., 466 So. 2d 1089 (Fla. Dist. Ct. App. 1985) (obligation to pay a real estate commission is an account).

[238] UCC § 9-102(1)(b).

[239] See supra ¶ 22.01[1] on the scope of Article 9.

[240] UCC § 9-306(1).

[241] See UCC §§ 9-206, 9-318.

[242] UCC § 9-206(1).

[243] UCC § 9-318(1).

[244] 666 F2d 673 (1st Cir. 1981).

was completed, upon receipt of the certifications, only to discover that JCC had failed to pay its subcontractors and had submitted false certifications. Michelin sued FNB to recover the payments, claiming a right to restitution for unjust enrichment under general common law equitable principles, as well as under UCC § 9-318(1)(a).

The court held that Section 9-318 did not give an account debtor a right to recover affirmatively from an assignee. In the court's view, the stated section "concerns only the preservation of defenses" that the account debtor might have when the assignee presses claims against the account debtor.[245] The section does not prohibit the assertion of claims against an assignee, but any such recovery depends on the common law of restitution, not the UCC. The court recognized that cases did exist which allowed recovery by the account debtor, but it distinguished such cases on the grounds that in those cases "the assignee actively participated in the transactions to a degree not approached here."[246] The assignee was not liable under principles of restitution as set forth in *Restatement of Restitution*, § 28(d) (1937). For the assignee to be liable, it had to have notice that Michelin had no duty to pay, because JCC had submitted fraudulent certifications or had failed to pay subcontractors. Under UCC § 1-201(25), although the bank was aware of JCC's financial struggles and difficulty in paying creditors, the bank could not be charged with notice of JCC's non-payment of subcontractors or with notice of the fraudulent certifications. As noted by the court, imposing a duty on the bank to discover those aspects of JCC's business would have required the bank "to initiate an investigation of JCC's business practices under the Michelin contract, not aimed at determining the company's financial health for purposes of the bank's continued financing, but aimed at verifying JCC's compliance with the Michelin contract . . . . We are willing to impose such a responsibility on lenders."[247]

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[245] 666 F2d at 680.

[246] Id. at 679. See Benton State Bank v. Warren, 263 Ark. 1, 562 SW2d 74 (1978); Farmers Acceptance Corp. v. DeLozier, 178 Colo. 291, 496 P2d 1016 (1972); Firestone Tire & Rubber Co. v. Central Nat'l Bank, 159 Ohio St. 423, 112 NE2d 636 (1953); K Mart Corp. v. First Pa. Bank, 29 UCC Rep. Serv. (Callaghan) 701 (Pa. Ct. CP 1980). Cases supporting the court's interpretation are: James Talcott, Inc. v. Brewster Sales Corp., 16 UCC Rep. Serv. (Callaghan) 1165 (NY Sup. Ct. 1975); Meyers v. Postal Fin. Co., 287 NW2d 614 (Minn. 1979).

[247] 666 F2d at 682–683. See also ¶ 16.01[2].

UCC § 9-318(a) makes the rights of an assignee of an account subject to any defense or claim that arises from the contract between the account debtor and the assignor. A contract for the purchase of pipe for $300,000 was assigned by the seller to the defendant bank. The bank notified the buyer of the assignment and buyer completed all payments on the contract made directly to the bank. After making the payment on the contract, buyer discovered the pipe was defective and brought a claim under Section 9-318(a) against the bank as assignee of the contract. The court held that Section 9-318(a) did not give an account debtor, such as the buyer, the right to make an affirmative claim against the

A more traditional problem was presented in *First National Bank v. Master Auto Service Corp.*[248] Bank had made loans to IRI, a tire manufacturer, secured by the manufacturer's accounts receivables. Master Auto purchased tires from IRI for resale under a dealer agreement that permitted Master Auto to make adjustments with its customers for defective tires and receive credit from IRI. As a result of adjustment of defective tires sold its customers, Master Auto had a claim of over $265,000 against IRI. When Master Auto was notified of the assignment of its account debt to the bank, IRI asserted its claim for the warranty adjustments it gave the customers. The court held that under UCC § 9-318(1)(a) the bank's ability to recover on the account against Master Auto was subject to the $265,000 claim. The adjustments were authorized under the dealer agreement between IRI and Master Auto. Finding that Master Auto had complied with all the requirements of the dealer agreement, the court held that the bank was not entitled to recover any sum from Master Auto, because the $265,000 recoupment claim exceeded the debt on the account to IRI.

UCC § 9-318(4) clarifies the transferability of accounts. Early in the development of the law of contracts, a term in a contract prohibiting the assignment of proceeds under the contract was effective. Section 9-318(4) now flatly abolishes that rule. It makes ineffective any term in a contract between an account debtor and an assignor that purports to prohibit assignment of the account or to

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assignee. Phil Greer & Assocs., Inc. v. Continental Bank, 614 F. Supp. 423, 426-427 (ED Pa. 1985).

Under UCC § 9-318, the account debtor may continue to pay the assignor, even though the account debtor knows the account has been assigned, so long as the assignee has not given notice to the account debtor to make payment directly to the assignee. Vacura v. Haar's Equip., Inc., 364 NW2d 387, 391 (Minn. 1985).

Warrington v. Dawson, 798 F2d 1533, 1538 (5th Cir. 1986), found that the notice given to the account debtor to make payments directly to assignee as joint payee was not in a manner reasonably required to inform the account debtor. UCC §§ 9-318(3), 1-201(26). The assignor gave notice by having debtor, a farmer, sign a letter containing the notice while he was engaged in farm work on a tractor in the field, without his reading glasses. The assignor failed to leave a copy of the letter with the debtor, and the assignee did not object to not receiving the payments directly.

[248] 693 F2d 308 (4th Cir. 1982). In Business Fin. Servs., Inc. v. AGN Dev. Corp., 143 Ariz. 603, 694 P2d 1217 (Ct. App. 1984), the account debtor was allowed to set off payments made to third parties for materials and labor against the obligation that had been assigned to the assignee. Under the terms of the original contract between the account debtor and the assignor, the contract gave the account debtor the right to make payments directly to persons who supplied material and labor and to deduct those payments from the amounts due the assignor. Furthermore, the contract did not permit the assignor to enforce payment unless the assignor presented proof of satisfaction of the obligations of such third party laborers and materialmen. Because of these terms, when the assignor assigned the contract to the assignee, UCC § 9-318 made the rights of the assignee subject to the terms of the contract. 143 Ariz. at 606–607, 694 P2d at 1220–1221. Accord Business Fin. Servs., Inc. v. Butler & Booth Dev. Co., 147 Ariz. 510, 711 P2d 649 (Ct. App. 1985).

prohibit creation of a security interest in a general intangible for money due or to become due, or a term in such a contract, that conditions such an assignment or security interest upon the consent of the debtor.[249]

As discussed earlier in this chapter, a secured party who has possession of collateral must use reasonable care in its custody and preservation. However, the assignee of accounts does not have a comparable duty to police provisions in the contract, which has been assigned according to one court. The case concerned a requirement in the contract of sale of the goods that required the account debtor to maintain insurance on the goods. After the contract was assigned to the secured party, the goods were destroyed by a fire while uninsured. The assignor of the contract contended that the secured party could not exercise its recourse rights against the assignor, because the secured party had failed to monitor the contract to make sure that the goods were insured. The court rejected the argument. In this case, the assignor was in at least as good a position, if not a better one, to supervise the insurance requirement.[250]

The assignee of an account may claim no better right to the amount owing on the account than that of the assignor, absent a waiver of defenses by the account debtor. In *United Parcel Service, Inc. v. Weben Industries, Inc.*,[251] the court applied this principle to a bank's perfected security interest in funds owed its debtor under a construction contract. The bank's debtor, a contractor, became bankrupt. Both the bank and a subcontractor, who had filed a materialmen's lien, claimed entitlement to a fund retained by the owner, who had contracted with the debtor. The court held that the subcontractor was entitled to the funds. The owner was entitled to withhold the money owed to the contractor because the contractor had failed to pay the subcontractor, and the bank could not assert a right to the fund superior to its debtor, the contractor. Although the materialmen's lien did not extend to the fund, the state law of construction trust

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[249] UCC § 9-318(4) & comment 4. Aetna Casualty & Sur. Co. v. Bedford-Stuyvesant Restoration Constr. Corp., 90 AD2d 474, 475, 455 NYS2d 265, 266 (1982).

Federal or state law may prohibit the debtor's rights of assignment or encumbrance. For example, government benefits for health and welfare may be so restricted. In one case, the bank took a security interest in the accounts of debtor, a nursing home operator. The accounts included payments from medicare and medicaid. Although federal law limits the assignability of such payments the court ruled the bank's arrangement did not violate the statute. 42 USC § 1396a. Texas had adopted a broader prohibition, but the court found that this conflicted with the federal scheme. Wilson v. First Nat'l Bank (In re Missionary Baptist Foundation of America, Inc.), 796 F2d 752, 759 (5th Cir. 1986).

[250] Forest-All Corp. v. New England Merchants Nat'l Bank, 31 UCC Rep. Serv. (Callaghan) 183, 187 (D. Mass. 1981). The court also expressed doubt that the impairment of collateral rule in UCC § 3-606(1)(b) applied at all, because the secured party did not have possession of the goods. 31 UCC Rep. Serv. at 186–187, See UCC § 9-207. The duties of a secured party in possession of collateral under UCC § 9-207 are discussed in ¶ 22.04[3].

[251] 794 F2d 1005, 1009–1010 (5th Cir. 1986).

gave the subcontractor an interest in the fund that was superior to the perfected security interest of the bank. Under the state version of UCC § 9-310, a perfected security interest has priority over a materialmen's lien, but the court held that this statute was not applicable to the construction trust interest asserted by the subcontractor.

[2] General Intangibles

A general intangible is any personal property that is not within the classifications of goods, accounts, chattel paper, documents, instruments, or money. Thus, a general intangible is what is left over when the other classifications of the UCC do not apply.[252] It includes legal claims. Examples of general intangibles are goodwill, literary rights, rights to perform, and other miscellaneous contract rights.[253] The only way in which a security interest in a general intangible may be perfected is by filing.[254]

The court considered the scope of a security interest in general intangibles in *Capital National Bank v. McDonald's Corp.*[255] Bank financed debtor's McDonald's franchise under a security agreement that broadly gave a security interest in accounts, contract rights, instruments, general intangibles, furniture,

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[252] UCC § 9-106. Reasoning that a restaurant liquor license is not personal property, one court concluded that the license could not be property in which a security interest may be created. In re Revocation of Liquor License No. R-2193, 72 Pa. Commw. 367, 456 A2d 709, 711 (1983). Another court, however, held that a secured party may obtain a security interest in a liquor license because it is classified as property that is a general intangible. Although the law of North Dakota prohibited the transfer of a liquor license to a new person without complying with the statutory requirements for a transfer, the court held that a security interest in the license in favor of a creditor did not amount to a transfer of the license to the creditor. The debtor was not called upon to give up its license to the creditor and the creditor did not have to foreclose on the license such that a transfer had occurred. The statutory policy is not offended by permitting a creditor to assert a right to have its security interest recognized by payment of the debt owed to the creditor out of proceeds from the sale of the liquor license. Crew v. Dorothy (In re O'Neill's Shannon Village), 750 F2d 679, 683 (8th Cir. 1984). See also Donnelly v. Boufsko, Inc. (In re Boufsko), 44 Bankr. 98 (Bankr. ED Mich. 1984) (discussing whether, under the law of Michigan, a creditor may obtain a security interest in a liquor license). See also In re Ratcliff Enters., Inc., 44 Bankr. 778 (Bankr. ED Mich. 1984) (holding that a security interest could be obtained in a liquor license under Michigan law).

A trade name and the goodwill it represents is intangible property, which UCC classifies as a general intangible. Reis v. Ralls, 250 Ga. 721, 723, 301 SE2d 40, 42 (1983). A court has held that a newsletter entitled "Day Care and Child Development" is a general intangible for which a financing statement must be filed to perfect a security interest in the property. In re Washington Communications Group, Inc., 10 Bankr. 676, 678 (Bankr. DDC 1981).

[253] UCC § 9-106.

[254] UCC §§ 9-302, 9-305.

[255] 625 F. Supp. 874 (SDNY 1986).

fixtures and equipment, and all other personal property, including inventory. The bank claimed that this broad security agreement gave it the right to pursue legal claims of the debtor under antitrust and other laws that the bank claimed debtor had against McDonald's for wrongful termination of the franchise. In ruling that the debtor had not assigned these causes of action to the bank under the security agreement, the court reasoned that the debtor did not have such causes of action in existence when the parties entered into the security agreement. (Under traditional Article 9 analysis, a security agreement can create rights in after acquired property, but the court did not discuss this.) The court also argued that the parties had not intended to assign the causes of action to the bank, when they used ordinary language in their security agreement, because the type of property involved is not customarily used as commercial security within the scope of the ordinary security agreement.

[3] Instruments

An instrument includes all those things that constitute negotiable instruments (e.g., checks, drafts, notes, and certificates of deposit). It also includes a certificated security. In addition, an instrument includes "any other writing which evidences a right to the payment of money" but which is not a security agreement or lease, as long as the writing "is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment."[256] This definition of "instrument" is broader than that given in UCC Articles 3 and 4 on negotiable instruments. It obviously covers instruments that are not negotiable.

A secured party may perfect a security interest in an instrument by taking possession of the instrument or by filing. In certain limited circumstances, perfection may occur automatically, for a temporary period of up to twenty-one days.[257] Unless the secured party takes possession of the instrument, however, a security interest that is perfected by filing or that is under the temporary perfection rules may be cut off by the debtor's transfer of the interest to good-faith purchasers or to other transferees. Under the UCC, any person who purchases an instrument for new value and in the ordinary course of business will be free from

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[256] UCC § 9-105(1)(i). An ownership interest in a cooperative apartment evidenced by a share of stock and a proprietary lease has been classified as an instrument rather than a general intangible. Superior Fin. Corp. v. Haskell, 556 F. Supp. 199, 201 (SDNY 1983).

A writing that did not qualify as a negotiable instrument was treated as an "instrument" for purposes of perfecting a security interest under Article 9. Because the secured party failed to take possession or establish a valid bailment, the secured party's security interest was not perfected and was voidable by the bankruptcy trustee. In re Coral Petroleum, Inc., 50 Bankr. 830, 841 (Bankr. SD Tex. 1985). The court classified it as an instrument because it was the type of writing that would be delivered with endorsements and assignments when transferring an interest in it. 50 Bankr. at 838.

[257] UCC §§ 9-304(4), 9-305.

the security interest, if such purchaser acts without knowledge that the instrument is subject to a security interest.[258] A purchaser under the UCC includes someone who obtains a security interest in the instrument, so a second lender may obtain rights superior to those of the first secured party by taking possession of the instrument.[259] If the instrument is negotiable, it may be negotiated to a holder in due course, who also would take free of any security interest claimed by a filing made by a secured party.[260]

Although a secured party may take possession of a negotiable instrument to protect a security interest in that instrument, the secured party will not be a holder and, therefore, may not be a holder in due course, unless the instrument is payable to the order of the secured party or is payable in blank. This may present problems for the secured party. In one case, a bank took as collateral for a loan a note that was the obligation of a third party and that had been indorsed payable to the bank's debtor. The bank took possession of the note and held a written assignment as well. However, the bank could not qualify as a holder under the indorsement to its debtor. The bank's debtor retained an ownership interest in the note and could deal with the obligor under the note to modify the terms of the instrument. Because the bank had not given notice to the obligor of its interest and did not qualify as a holder in due course, the modifications were binding on the bank.[261]

[4] Chattel Paper

Chattel paper is a writing or group of writings that contains both a debt and a security interest in goods or a lease of goods. For example, when a consumer purchases a refrigerator from a seller on credit, and signs a promissory note along with a separate security agreement giving the seller a security interest in the refrigerator, the note and security agreement together constitute chattel paper. By itself, the note would be classified as an "instrument"; in combination with the security agreement, the note is treated as "chattel paper."[262]

As the previous example illustrates, chattel paper is likely to be assignable and transferable and may share many of the aspects of negotiability that instruments have. Accordingly, many of the rules for chattel paper are similar to those for instruments. A security interest in chattel paper may be perfected either by filing a financial statement or by taking possession of the paper.[263] Also, as in the case of instruments, the secured party will be in a safer position by taking

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[258] UCC § 9-308.

[259] UCC §§ 1-201(32), 1-201(33), 9-308.

[260] UCC § 9-309.

[261] In re Governor's Island, 39 Bankr. 417, 421 (Bankr. EDNC 1984).

[262] UCC § 9-105(1)(b).

[263] UCC §§ 9-304(1), 9-305.

possession of the chattel paper. This is because the purchaser of chattel paper who gives new value for it and who takes possession of it in the ordinary course of the purchaser's business will take free of any security interest perfected only by filing in the chattel paper, as long as the purchaser acts without knowledge that the paper is subject to a security interest.[284] If the purchaser has notice of the security interest or of assignment to the secured party, the purchaser will only be able to acquire an interest in the chattel paper that is subject to the secured party's interest.[285]

When a secured party takes chattel paper as security, the secured party may find it advisable to give notice to the person obligated on the chattel paper to make payment directly to the secured party. Until such notice is given, the account debtor may continue to make payment to the assignor of the paper.[286]

[5] Documents of Title

The UCC uses the term "document" to mean a document of title that is a bill of lading, dock receipt, warehouse receipt, order for the delivery of goods, or similar document.[287] The definition is not limited to these specific types of documents. A document of title is any document which in regular business transactions would be regarded as adequate evidence that the person who has the document "is entitled to receive, hold and dispose of the document and the goods it covers."[288] A document of title may be negotiable or nonnegotiable. Because a document of title frequently represents commodities in storage or transportation, it sometimes is referred to as commodity paper, by persons who deal in such paper, to distinguish it from "money paper," such as notes and investment securities.[289]

While the goods are in the possession of a bailee who has issued a *negotiable* document covering the goods, the only way to perfect a security interest in the

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[284] UCC § 9-308(a). A creditor who purchases chattel paper through a setoff of preexisting unsecured debts does not give new value. In re Dr. C. Huff Co., 44 Bankr. 129, 132 (Bankr. WD Ky. 1984). In this case, the creditor purchased the chattel paper by paying both a portion of the price in cash and paying the remainder of the price through a setoff of preexisting debts. The court held that the creditor had given new value "only to the extent of the cash given" to the debtor. 44 Bankr. at 133. Because the court held that it ultimately lacked jurisdiction over the matter, the comments by the court were dicta. 44 Bankr. at 135.

[285] UCC § 9-308 & comment 3.

[286] UCC § 9-318(3). See supra ¶ 22.07[1].

[287] UCC §§ 1-201(15), 9-102(1)(a), 9-105(1)(f). See 7-201(2).

[288] UCC § 1-201(15). The definition further requires that a document of title "must purport to be issued by or addressed to a bailee and purport to cover goods in the bailee's possession which are either identified or are fungible portions of an identified mass." Id. See id., comment 15.

[289] See UCC § 7-104 comment.

goods is to perfect a security interest in the document.[270] Of course, to the extent that the goods were subject to a valid security interest before creation of the bailment, that security interest will continue. Once the goods are in the possession of the bailee and a negotiable document of title issued, the document of title controls the goods. A perfected security interest in the document may be obtained either by filing or by taking possession of the document.[271] Failure to take possession of the document of title and reliance on filing alone may result in a loss of the security interest, however, because when the document is duly negotiated to a transferee who purchases it in good faith without notice of any defense or claim to it and for value in the regular course of business or financing, the transferee takes free of the security interest.[272] When the goods are in the possession of a bailee who has not issued a negotiable document covering the goods, a security interest may be perfected by (1) notifying the bailee of the secured party's interest; (2) having the bailee issue a document in the secured party's name; or (3) filing as to the goods.[273]

[6] Securities

Stocks and bonds and similar instruments are classified as securities by the UCC. Prior to 1977, the UCC, by applying its rules on security interests,[274] treated a security as an "instrument." As such, except for brief periods of temporary perfection, the only manner in which a security interest could be perfected was by taking possession of the security.[275] The typical way for establishing a security interest in securities was through a pledge.[276]

Under the pre-1977 UCC, a secured party could obtain a security interest in securities of the debtor without taking possession of the securities, when there was a signed security agreement, but that security interest would be unperfected.[277] In such a case, absent competing claims of third-party purchasers

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[270] UCC § 9-304(2). When a person who holds a security interest in goods acquiesces in the issuance of a document of title that covers the goods, that person runs the risk of losing his or her interest in the goods to a party who obtains a superior interest, based upon rights in the document of title. In re Jamestown Farmers Elevator, Inc., 49 Bankr. 661, 664 (Bankr. DND 1985).

[271] UCC §§ 9-304, 9-305.

[272] UCC §§ 7-501(4), 9-309. Documents of title are discussed further in ¶¶ 14.05[1], 23.02[3].

[273] UCC § 9-304(3).

[274] UCC § 9-105(1)(i).

[275] UCC §§ 9-304(1), 9-305. Physical possession of a stock certificate was sufficient to create an enforceable and perfected security interest. Rafoth v. Smith & Schmidt Assocs., Inc. (In re Swedenborg), 55 Bankr. 820, 825 (ND Ohio 1985).

[276] See ¶ 22.04[1]. See generally Haydock, "When Is the Broker a Bailee or Is an Interest in Securities a General Intangible?" 35 Ark. L. Rev. 10 (1981).

[277] UCC §§ 9-203, 9-303.

and other creditors, the secured party could enforce the security interest against the debtor.[278] However, the claims of a creditor who had only an unperfected security interest would be subordinated to the claims of any other secured party, who had perfected a security interest by taking possession of the security, or to the claims of any bona fide purchaser of the security.[279]

While the system previously described for perfecting security interests in securities assumes that the security is represented by a tangible certificate that can be transferred and held by the secured party, that is not always the case. Spurred by the technological revolution in electronic data processing and by the need for speed and efficiency in handling large volumes of paper transactions involving securities, there has been a growing use of arrangements that give persons an interest in a company or describe an obligation of the company that is not evidenced by a paper certificate, but is only registered on the books of the enterprise or of an agent or a broker.[280] To deal with this development, the UCC's Article 8 on investment securities was amended extensively in 1977. As a result, it now distinguishes between "certificated securities," which are represented by a tangible instrument, and " uncertificated securities," which are not represented by such an instrument, and the transfer of which is simply registered upon books maintained by or on behalf of the issuer.[281] As of the writing of this book, many states have adopted the official Article 8 revisions (see Table 14-1), but there are some states that continue to abide by the pre-1977 version.

Under the 1977 amendments to the UCC, Article 8, not Article 9, controls most aspects of security interests in securities.[282] Article 8 governs the enforceability, attachment, perfection, and termination of security interests in securi-

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[278] UCC § 9-201. An unperfected security interest in shares of stock was enforced between the parties in Lojek v. Pedler, 22 Ohio St. 3d 71, 488 NE2d 864, 866 (1986), a case arising under the pre-1977 UCC. The security interest was enforceable even though the stock was issued subject to conditions that restricted its transfer.

[279] UCC §§ 9-301, 9-309. See also UCC § 9-308, which gives a purchaser, in the ordinary course of business, rights superior to those claiming an interest in the security by temporary perfection, either by taking possession or by establishing an interest in proceeds of inventory.

[280] An example is the recommendation, on September 15, 1975, of the American Bar Association's section of Corporation, Banking, and Business Law, to amend the Model Business Corporation Act to permit the issuance of corporate stock in uncertificated form. The reporters for the amended Article 8 noted that Federal Reserve banks operate the most significant uncertificated securities system in operation for handling transactions in U.S. bonds. Reporters Comment, Uniform Commercial Code, App. 1 (West 1978).

[281] UCC §§ 8-102(1)(a), 8-102(1)(b). For an analysis of Article 8, see Coogan, "Security Interests in Investment Securities Under Revised Article 8 of the Uniform Commercial Code," 92 Harv. L. Rev. 1013 (1979).

[282] UCC § 9-203(1); see also UCC §§ 9-302(1)(f), 9-304(1), 9-304(4), 9-305, 9-309.

ties.[283] Article 9 governs in other respects, such as in its rules on the responsibilities of a pledgee.[284]

[a] Certificated Securities. Certificated securities are stocks, bonds, and the like. The 1977 version of Article 8 defines them as interests "represented by instruments" that are issued in "bearer or registered form"; that are of the type commonly traded on securities exchanges or markets or recognized as a medium for investment; that are one of a class or series; and that provide evidence of a share, a participation, or another interest in an issuer's property enterprise, or obligation.[285] While certificated securities are negotiable instruments,[286] they are governed by the UCC's Article 8 on investment securities rather than by the articles on negotiable instruments.[287]

The definition of certificated security is sufficiently broad so that it may sweep under its coverage instruments that, on first impression, might not be thought of as securities. The definition does not require that the interest in question actually be traded upon a securities exchange or other market. It is enough, as the comments indicate, that the interests are "'of a type' commonly traded in those markets."[288] When the interest is classified as a security, it is governed by Article 8, rather than by Article 9, on questions of enforceability and perfection of security interests. The rules in Articles 8 and 9 for perfecting security interests in instruments and securities are generally comparable, as they both require possession, but there are some differences.

As a general rule, a security interest in a certificated security is perfected in the same way as under the prior version of the UCC. The secured party must take possession, or, when the security is in the hand of a bailee, must give notice to the bailee.[289] It is possible for a security interest to be temporarily perfected, as was the case under the former version of the UCC,[290] for a period of twenty-one days without possession by a secured party. When the certificated security is transferred outright to the secured party, no written security agreement signed by the debtor is needed to make the security interest enforceable.[291] A written security agreement signed by the debtor and describing the collateral is required when the security is in the possession of a bank or broker holding the security in an

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[283] UCC § 8-321.

[284] UCC § 8-321(3).

[285] UCC § 8-102(1).

[286] UCC § 8-105(1).

[287] UCC § 8-102(1)(c).

[288] UCC § 8-102, comment 2.

[289] UCC §§ 8-313(1)(a), 8-313(1)(c), 8-313(1)(e), 8-313(1)(h), 8-321(1).

[290] UCC §§ 8-321(2), 8-321(4). Compare UCC § 9-304.

[291] UCC § 8-321(3)(b).

account for the debtor (who is the banker's or broker's customer), or when the security is held by some other third person.[282]

The new Article 8 makes a significant change in requiring that the secured party or the secured party's agent possess the certificated security, not only to perfect a security interest (in cases where the temporary perfection rules do not apply) but also for the security interest to attach and to be enforceable.[283] Under the previous version of Article 8, although the security interest would not be perfected until the secured party took possession, the secured party would have in the security an unperfected security interest, which could be enforced against the debtor as long as a sufficient written security agreement existed and there were no third parties with superior rights to the collateral.[284]

[b] Cases Involving Certificated Securities. In a case decided under the pre-1977 version of Article 8 of the UCC, the court was required to decide whether the plaintiff was a bona fide purchaser of securities.[285] The plaintiff, the Louisiana State School Lunch Employees Retirement System, sued the Irving Trust Company for conversion of bonds the plaintiff claimed belong to it. Irving Trust served as a clearinghouse for a dealer in government securities, Legel, Braswell Government Securities, Inc., from whom the plaintiff bought the bonds. Plaintiff contracted with Legel, Braswell to buy the bonds in a transaction, which so described the securities that they only could be bonds evidenced by a Certificate No. 92, which Legel, Braswell was scheduled to repurchase from another customer. Legel Braswell instructed the defendant, Irving Trust, to acquire Certificate No. 92 from the customer and to pay the customer for the certificate. Soon thereafter Legel, Braswell became bankrupt. Irving Trust, who was in possession of Certificate No. 92, prepared to mail the certificate to the plaintiff but, after the certificate had been placed in an envelope in the mailroom with a registered mail receipt attached, Legel, Braswell instructed Irving Trust not to send the certificate. In the subsequent bankruptcy proceedings, Irving Trust claimed the bonds on the theory that it had a security interest in them to secure the money advanced to Legel, Braswell to pay for them. The plaintiff claimed to be a bona fide purchaser. Under the pre-1977 version of the UCC, if plaintiff qualified as a bona fide purchaser, plaintiff had rights in the bonds superior to Irving Trust.[286]

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[282] UCC §§ 8-313(h)(i), 8-313(h)(ii) & comments 2, 3. Compare UCC § 8-313(1)(e), which does not require a written security agreement when the security is held by a third person other than a bank or a broker who acknowledges that he or she is holding for the secured party.

[283] UCC § 8321(1).

[284] UCC §§ 9-201, 9-203.

[285] Louisiana State School Lunch Employees Retirement Sys. v. Legel, Braswell Gov't Sec. Corp., 699 F2d 512 (11th Cir. 1983).

[286] UCC §§ 8-301(2), 9-309.

Plaintiff's status as a bona fide purchaser depended on the bonds having been delivered to plaintiff. The court held that delivery had occurred, because, under the UCC, delivery could take place without the purchaser taking physical possession of the securities. Under UCC § 8-313(1)(c), delivery to a purchaser occurs when the broker sends a purchaser confirmation, and also identifies "by book entry or otherwise" a "specific security in the broker's possession" as belonging to the purchaser. The court regarded this requirement as having been satisfied when Legel, Braswell confirmed the sale to plaintiff, although Certificate No. 92 was not specifically identified. In any event, the court believed that when Irving Trust put the certificate in the envelope, this constituted an identification under the "or otherwise" method for identification permitted by this section. As Irving Trust acted as Legel, Braswell's agent, the possession of the certificate by Irving Trust was sufficient to satisfy the possession requirements of the section.

Finally, the court rejected the argument that Legel, Braswell had authority to rescind the transaction and could cancel it by instructing Irving Trust not to mail the certificate. In the court's view, UCC § 8-313(1)(c) does not require physical delivery of the certificate to the purchaser, so the attempt at cancellation by Legel, Braswell was not effective. The court further noted that this case presented a dispute simply between Irving Trust and the plaintiff. The trustee in bankruptcy did not assert a claim to the securities under the Bankruptcy Act. Therefore, the court was not called upon to consider whether the trustee in bankruptcy might be in a position to object to the transfer as violating the Bankruptcy Act or that the transfer occurred while Legel, Braswell was without legal authority to transfer the security.[287]

A second case involving Legel, Braswell and Irving Trust had Irving Trust contending to be a bona fide purchaser of a security. In this case, Plano Savings and Loan Association gave Legel, Braswell a $300,000 GNMA certificate to secure an obligation Plano had to Legel, Braswell. Plano sent the certificate to Irving Trust for deposit, with a letter of instructions that it was to be held for the account of Legel, Braswell on deposit for Plano. Plano sent an assignment form that permitted the certificate to be assigned to Legel, Braswell, but a portion of the form authorizing reregistration of the certificate was deleted. Acting on instructions from Legel, Braswell, Irving Trust reregistered the certificate. When Legel, Braswell became bankrupt, Irving Trust claimed the certificate, because Irving Trust had advanced money to Legel, Braswell and had a security interest in all of Legel, Braswell's properties and securities in Irving's possession. Irving Trust claimed to be a bona fide purchaser under UCC § 8-302, free from the claim of Plano.

The question for decision was whether Irving Trust acted in good faith and without notice of an adverse claim. Irving Trust argued that the repledge of

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[287] 699 F2d at 515.

securities is commonly allowed by owners of securities, so it should not be held to have notice that Legel, Braswell's actions in pledging Plano's certificate with Irving Trust were improper, unless Irving Trust had notice that repledging the security was wrongful. While the court held that Plano's action in not authorizing reregistration of the certificate was not enough to give notice of Plano's adverse claim, because the certificate could be transferred without change in registration, the court also held that there were suspicious circumstances that constituted bad faith. In the court's view, the critical facts were (1) that Irving Trust knew Plano claimed an interest in the certificate, from the letter of transmittal; (2) that Irving Trust knew Plano acted to indorse the certificate to Legel, Braswell specifically rather than in blank; and (3) that Irving Trust knew that the action it took at the request of Legel, Braswell to reregister the security violated Plano's instructions. Irving Trust could have learned the facts by telephoning Plano, but did not.[298]

In *Jones v. Central States Investment Co.*,[299] an owner of stock in a grazing association effectively transferred the securities by indorsing them in blank and delivering them to the attorney for the purchaser. Although the grazing association's rules required the board of directors to approve stock transfers, the owner's failure to obtain approval from the board did not prevent the valid transfer of the ownership of the shares.

New Jersey Bank v. Bradford Securities Operations, Inc.[300] discussed the liability of a firm acting as a transfer agent for securities that were stolen in blank, forged, and pledged as collateral to a bona fide purchaser. In this case, Bradford Securities (BSOI) served as an agent in executing transfers of Southern California Edison stock. BSOI stored blank stock certificates bearing facsimile signatures of Southern California Edison's corporate officers. The signature spaces for the transfer agent and the registrar remained blank, however. A number of certificates were stolen from BSOI and eventually traced to New Jersey Bank, which was holding them as collateral for a loan. Following seizure of the forged certificates by the federal government, New Jersey Bank demanded that BSOI either accept the certificates or pay their face value to it. New Jersey Bank asserted claims under both the UCC and negligence theories.

In dealing with the bank's claim under the UCC, the court first acknowledged that it was not certain the certificates constituted a "security" under Article 8, because the UCC defines a security as an instrument that is "issued" in

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[298] In re Legel, Braswell Gov't Sec. Corp., 695 F2d 506 (11th Cir. 1983). To be a good faith purchaser of securities held as collateral, a bank must satisfy the requirement of due diligence in investigating the validity of the securities. First National Bank of Cicero v. United States, 625 F. Supp. 926 (ND Ill. 1986), on reconsideration, 653 F. Supp. 1312 (ND Ill. 1987).

[299] 654 P2d 727, 733 (Wyo. 1982).

[300] 690 F2d 339 (3d Cir. 1982).

bearer or registered form.[301] To be "issued," there must be a "voluntary transfer of possession," and the theft of the certificates from BSOI should not be viewed as a voluntary transfer of possession by the issuer.[302] The court did not decide this issue, however, because it ruled on alternative grounds that BSOI had a defense to the claim under the UCC even if the certificates were assumed to be securities.

New Jersey Bank's claim under the UCC failed, in the court's view, because UCC § 8-202(3) provided that lack of genuineness of a security is a complete defense, even against a bona fide purchaser, except as otherwise provided in the UCC. The exception to this general defense, which makes the issuer liable to a bona fide purchaser "if, but only if, the unauthorized signature is that of an employee or agent of the issuer entrusted with the signing of the certificates or with the responsible handling of such document,"[303] was not available to New Jersey Bank, because New Jersey Bank could not show that the unauthorized signatures were those of BSOI employees. Thus, the court stated the extent of liability under the exception as follows:

> This exception to the lack-of-genuineness defense, as we interpret it, protects an innocent third party from losses occasioned by a dishonest employee of the issuer or transfer agent. But the issuer or its agent bears the risk of loss only when employees within its control are responsible for the unauthorized signatures; when a person outside this group commits the forgery, even a bona fide purchaser must succumb to the familiar principle of *caveat emptor*.[304]

Although the UCC claim failed, the court upheld a judgment that BSOI had been negligent in safeguarding the blank securities. BSOI argued that the UCC rules constituted New Jersey Bank's exclusive remedy and thus eliminated any liability based on negligence. The court rejected this theory, reasoning that recognition of a remedy in tort actually advanced the policy of Article 8 and that placement of the risk of loss on the party most able to minimize that risk promoted the negotiability of securities.[305] The possibility of a third party's theft of the blank certificates should have been reasonably foreseen by BSOI, and thus BSOI could not defend on the grounds that the loss was caused by the intervening criminal conduct of some third party.[306] Nor was New Jersey Bank contributorily negligent. There was credible testimony that standard banking practice

[301] UCC § 8-102 (pre-1977 version; see UCC App. I § 8-102).

[302] 690 F2d at 343. UCC §§ 1-201(14), 3-102(1).

[303] 690 F2d at 343–344.

[304] Id. at 345.

[305] Id. at 347. See UCC § 1-103.

[306] 690 F2d at 347–348.

did not require New Jersey Bank to conduct an independent investigation of the authenticity of the certificates pledged as collateral.[307]

[c] Uncertificated Securities. The major change wrought by the 1977 amendments to Article 8 is the treatment given "uncertificated securities." The scope and application of the new rules are complex, and banks should seek the advice of counsel as to their precise requirements. In general, the amendments take the position that there are two means by which a security interest in an uncertificated security may be perfected. The first method is to actually have the interest transferred to the secured party, on the books of the company that issued the security.[308] There are provisions in the UCC that govern the procedures for accomplishing this registration and that specify the duties of the issuer to register the transfer.[309] The second method is by registration of pledge.[310] This method involves procedures similar to those for outright transfer, but it preserves the rights of the security's registered owner to vote and to exercise certain other powers.[311]

Although the definition of an uncertified security[312] parallels that of a certificated security, there are two key differences. Firstly, the interest is one that is not represented by an instrument; instead, it is registered on the books of the issuer or on books maintained "on behalf of the issuer." Secondly, the interest must be one that is of a type commonly dealt in on securities exchanges or markets. It is not enough that the interest is recognized as a medium for investment, as is true of the certificated security.[313] Omission of the "media of investment" language from the definition was intended to prevent the definition from being too broad. However, if this language had been included in the definition, interests such as bank accounts might have fallen within it. They do not, however, fall within the definition of an uncertificated security, because they are not of a type commonly traded.[314]

Prior to the 1977 amendments to Article 8, the rules applicable to perfection of a security interest, in what is now defined as an uncertificated security, were not clear. The definition of security in Article 8 contemplated a security that was

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[307] 690 F2d at 349.

[308] UCC §§ 8-313(1)(b), 8-321(1).

[309] UCC §§ 8-308(4), 8-308(7), 8-401, 8-408.

[310] UCC §§ 8-321(1).

[311] UCC §§ 8-108, 8-207, 8-308, 8-401, 8-408.

[312] UCC § 8-102(1)(b). See generally, Note, "Uncertificated Securities, Article 8 and 9 of the U.C.C. and the Texas Business Corporation Act: A New System to Accommodate Modern Securities Transactions," 11 Tex. Tech. L. Rev. 813 (1980).

[313] UCC § 8-102(1)(a)(ii).

[314] UCC § 8-102, comment 2.

evidenced by a certificate.[315] It is possible that such interests (in uncertificated securities) would have been viewed as general intangibles under Article 9.[316] However, a security interest in a general intangible is perfected by the filing of a financing statement[317]—a procedure that has obvious deficiencies, since it does not provide actual notice to the issuer of the security. A safer approach might be the outright transfer of the interest to the secured party, on the books of the issuer, although even that approach, if the secured party fails to file a financing statement, might be attacked as one creating an unperfected security interest in general intangibles. Obviously, one should employ great care when dealing with interests that might qualify as "uncertificated securities" under new Article 8 or under the former version.

[d] U.S. Securities. As discussed in Chapter 14, federal law governs the rights associated with securities issued by the United States and by federal agencies. There are special laws and regulations relating to such securities.[318] U.S. securities increasingly are held in uncertificated form. The Federal Reserve System has facilities that permit the wire transfer of such securities.[319]

[7] Bank Accounts

Although the UCC excludes from Article 9 coverage the transfer of interests in bank accounts, this exclusion is a limited one only.[320] It is possible for a security interest to exist in a bank account when that bank account consists of "proceeds" of collateral.[321] A bank account is treated as cash proceeds.[322] As long as funds in the account may be identified as those derived from the sale or exchange of collateral, a security interest in the original collateral will continue,

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[315] UCC § 8-102(1)(a).

[316] UCC § 9-106.

[317] UCC § 9-302(1).

[318] See 31 CFR subch. 13 (1987); see also ¶ 8.02 on the Government Securities Act of 1987.

[319] See discussion in ¶ 3.04[5] of the role of the Federal Reserve System in transfers of U.S. securities.

[320] UCC § 9-104(1). The assignment of a deposit in a bank as security for a debt is treated as a common law pledge not subject to the UCC by some courts. Because the UCC does not apply, there is no need to file a financing statement to perfect a security interest. Thus, a trustee in bankruptcy cannot avoid the pledge under the powers granted the trustee to set aside unperfected security interests. In re Tigert Printing Co., Inc., 648 F2d 364, 367 (5th Cir. 1981). Accord Duncan Box & Lumber Co. v. Applied Energies, Inc., 29 UCC Rep. Serv. (Callaghan) 1731, 1736 (W. Va. 1980).

[321] UCC § 9-104(1).

[322] UCC § 9-306(1).

and will follow the proceeds into the bank account.[323] The security interest will be a perfected security interest, so long as the interest in the original collateral was a perfected security interest.[324]

The language is specific that for the security interest to continue into the bank account, the interest in the bank account must be "identifiable" as cash proceeds of the collateral.[325] However, the UCC does not define what is "identifiable." It has been argued that any commingling of proceeds with funds not constituting proceeds destroys the identifiability of the proceeds.[326] An argument can be made, and has been accepted by some courts, that tracing methods used in the law of trusts may apply in this instance to enable the secured party to identify that portion of a bank account which constitutes proceeds.[327] From the standpoint of the secured party who wants to protect a security interest in proceeds deposited in a bank account, the safe procedure would be to require that the bank account contain only proceeds, thus eliminating any question as to the identifiability of funds in the account as proceeds.

The security interest that can arise in a bank account may conflict with the depository bank's right of setoff. The UCC states that its provisions on secured transactions do not apply to any right of setoff.[328] The matter is not clear, however, since the UCC also states that a security agreement generally will be effective against all other creditors, unless specifically provided to the contrary.[329] This latter approach has been accepted by some courts.[330]

When a debtor becomes insolvent, the UCC has special rules that permit the secured party to claim an interest in bank accounts into which proceeds from

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[323] UCC §§ 9-306(2), 9-306(3).

[324] UCC § 9-306(3)(b).

[325] UCC §§ 9-306(2), 9-306(3)(b).

[326] See 2 G. Gilmore, supra note 146, § 24.4.

[327] Brown & Williamson Tobacco Corp. v. First Nat'l Bank, 504 F2d 998, 1003 (7th Cir. 1974); Universal C.I.T. Credit Corp. v. Farmers Bank, 358 F. Supp. 317, 326 (ED Mo. 1973). See B. Clark, supra note 94, ¶ 10.3.

[328] UCC § 9-104(1). Setoff by a bank when the customer becomes bankrupt is discussed in ¶ 25.09[3]. The UCC's exclusion of a bank's right of set off from the coverage of Article 9 does not mean the bank's set off right will always be superior to a conflicting security interest of another party. In one case, a court gave priority over the bank's right of set off to a holder of a perfected purchase money security interest in a vehicle, when proceeds from the sale of the vehicle were deposited with the bank. The purchase money security interest continued into the proceeds and gave the secured party rights superior to the bank. Coachmen Indus., Inc. v. Security Trust & Sav. Bank, 329 NW2d 648, 650 (Iowa 1983).

[329] UCC § 9-201.

[330] See Citizens Nat'l Bank v. Mid-States Dev. Co., 177 Ind. App. 549, 380 NE2d 1243 (1978); Annot., "Effect of U.C.C. Article 9 Upon Conflict, as to Funds in Debtor's Bank Account, Between Secured Creditor and Bank Claiming Right of Setoff," 3 ALR4th 998 (1981).

collateral have been deposited.[331] In such situations, the bank's right of setoff is superior in those accounts in which proceeds have been commingled with other funds.[332] The validity of this provision against the trustee in bankruptcy is disputed.

The UCC rules discussed above, governing proceeds and security interests in bank accounts, were the result of substantial revisions made by the 1972 amendments. Before the amendments, it was still possible for a security interest to be claimed in bank accounts. The revisions made by the 1972 amendments clarify the rights of the secured party.

[8] Insurance Policies

Although the UCC generally excludes from its coverage of secured transactions any application to insurance policies, a security interest may arise in an insurance policy to the extent that amounts payable under the policy by reason of loss or damage to the collateral are treated as proceeds.[333] The amounts

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[331] UCC § 9-306(4). UCC § 9-306(d)(4) contains a formula for computing the extent to which a secured party may claim a security interest in a bank account in which proceeds have been commingled with other deposits. Although the secured party could claim a greater amount of the account as proceeds through use of common-law tracing methods, the UCC formula must be applied. First Nat'l Bank v. Martin, 48 Bankr. 317, 320 (ND Tex. 1985).

[332] UCC § 9-306(4).

[333] UCC §§ 9-104(g), 9-306(1).

Disposal of the collateral before settlement of an insurance claim prevented the secured party from claiming the insurance as proceeds. In this case, GMAC had a perfected security interest in a truck and its proceeds. The truck was damaged, and GMAC subsequently repossessed and sold it. After the sale, GMAC released its security interest. Shortly after the sale, the insurance company issued a check for $5,638 payable jointly to the debtor, GMAC, and the dealer who repaired the vehicle. Soon thereafter, the debtor became bankrupt and gave the check to the trustee. The court held that the trustee was entitled to the check. Although the insurance payment was proceeds of the truck and GMAC would have had an automatically perfected security interest in the insurance payment, once GMAC disposed of the vehicle without preserving its rights in the insurance claim, GMAC lost its security interest in the vehicle and its proceeds. In re Star Safety, Inc., 39 Bankr. 755, 756–757 (Bankr. DND 1984). Caution should be exercised in considering this ruling. Obviously, a seller may sell goods in a manner authorized by its inventory financer with the result that no security interest in the goods survives the sale, but the financer gets a security interest in the accounts, chattel paper, and other "proceeds" of the sale.

In Bradt v. Woodlawn Auto Workers F.C.U., 757 F2d 512 (2d Cir. 1985), the secured party and the debtor's trustee in bankruptcy disputed who had the prior right to insurance paid after the debtor's car was damaged. The district court said that the insurance could not constitute proceeds, because Section 9-306(1) requires a "disposition" of the collateral in order for proceeds to exist. Repair of damaged property is not a disposition. The appellate court reversed on other grounds. In its view, the insurance payment constituted proceeds belonging to the bankruptcy estate. The automatic stay prevented the secured

payable under the policy will constitute "proceeds" only to the extent that the policy is payable to one of the parties to the security agreement.[334]

The following example may illustrate the operation of the UCC's rule. Assume that the collateral is a motor vehicle. The vehicle is security for a loan made by Secured Party *A* in the amount of $1,000. It also is security for Secured Party *B*, who is junior in priority to *A*, for a debt of $1,200. There is a policy of insurance on the vehicle for $1,000, payable to Debtor, who owns the vehicle. If the vehicle is damaged and, under the policy, $1,000 becomes payable, the proceeds of the policy constitute "proceeds of the collateral." Secured Party *A* will be able to claim the entire $1,000, because *A*'s security interest has priority. On the other hand, if Secured Party *B* had taken the precaution of having an insurance policy on the vehicle specifically payable to *B*, the proceeds of that policy would not be considered as proceeds of the collateral, so far as the transaction between *A* and Debtor is concerned. That policy is payable to someone other than the parties to the security agreement between *A* and Debtor. Therefore, Secured Party *B* could claim all of the amount payable under that policy.

[9] Real Estate-Related Interests

Although interests in real estate are excluded from the scope of Article 9, *obligations* secured by interests in real estate usually are viewed as a separate form of property, which may be collateral in which a security interest can be created under Article 9. Such obligations are often classified as instruments.[335]

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party from obtaining possession of the payment or enforcing its security interest against it. 757 F2d at 516.

[334] UCC §§ 9-104(g), 9-306(1). The pre-1972 version of the UCC was silent on whether insurance could constitute proceeds in which a security interest would continue. The pre-1972 version of the UCC did provide that Article 9 did not apply "to a transfer of an interest or claim in or under any policy of insurance." UCC § 9-104(g). A number of courts held that insurance payments were not "proceeds" under the pre-1972 UCC. Sanchez v. United States, 696 F2d 213, 216 (2d Cir. 1982); First Nat'l Bank v. Merchants Mut. Ins. Co., 49 NY2d 725, 402 NE2d 1168, 426 NYS2d 267 (1980); Third Nat'l Bank v. Continental Ins. Co., 388 Mass. 240, 242, 446 NE2d 380, 382 (1983); In re Boyd, 658 P2d 470, 474 (Okla. 1983).

[335] See In re Maryvale Sav. & Loan Corp., 27 Bankr. 701 (Bankr. ED Tenn. 1983) (Article 9 applies to the creation of security interests in deeds of trust and accompanying notes). This decision was subsequently reversed in In re Maryvale Sav. & Loan Corp. 31 Bankr. 597 (ED Tenn. 1983). The court held that Section 47-9-401(J) of the Tennessee Commercial Code, which provided that Article 9 did not apply to "the creation or transfer of an interest in or lien on real estate including a lease or rents thereunder," precluded the application of Article 9 to the instruments involved in that case. 31 Bankr. at 598. The Sixth Circuit Court of Appeals ultimately held that Article 9 applied to the security interest in the promissory notes, but not to the deeds of trust. In re Maryville Sav. & Loan

A federal court applying Minnesota law concluded that the assignment of a seller's interest in a contract for the sale of real estate should be treated as the transfer of an interest in real estate, rather than as a transaction under Article 9. Thus, the court found that UCC § 9-104(j) excluded the assignment from the coverage of the UCC, and the creditor had to perfect the security interest by recording the assignment in the office where real estate instruments were recorded, rather than by filing a financing statement under Article 9.[336] Conversely, other courts have concluded that the assignment of a seller's interest in a real estate contract is not the transfer of an interest in real estate, but is a general intangible. Any security interest created in a general intangible falls under Article 9, and may be perfected only by the filing of a financing statement.[337] Following this approach, a court has concluded that a beneficiary under an Illinois land trust has an interest that can be classified as personal property and, thus, the provisions of Article 9 apply, permitting a creditor to obtain a security interest in such personal property.[338]

A federal court of appeals has said that it is necessary to separate the collateral into its real property and personal property components. The case involved a debtor who assigned to the bank various promissory notes that were secured by real estate deeds of trust. Subsequently, the debtor became bankrupt. The trustee claimed that the bank's security interest was not perfected because the bank failed to take possession of the notes. The court concluded that the collateral should be viewed as consisting of two parts: (1) the promissory notes,

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Corp., 743 F2d 413, 416–417 (6th Cir. 1984), opinion supplemented by 760 F2d 119 (6th Cir. 1985).

[336] Shuster v. Doane (In re Shuster), 784 F2d 883, 884 (8th Cir. 1986). See also In re Hoeppner, 49 Bankr. 124 (Bankr. ED Wis. 1985) (assignment of vendor's interest under a land sales contract as collateral not a transaction covered by Article 9); Garnett State Sav. Bank v. Tush, 232 Kan. 447, 657 P2d 508 (1983) (the buyer's equity acquired under a contract for the sale of real estate is an interest in the real property itself; a creditor who acquires an interest in the buyer's equity as security obtains an interest in real estate, not in personal property, and Article 9 does not apply).

[337] In re Simpson, 56 Bankr. 586, 588 (DNM 1986); Crichton v. Himlie Properties (In re Himlie Properties, Inc.), 105 Wash. 2d 191, 193, 713 P2d 108, 110 (1986). See In re D.J. Maltese, Inc., 42 Bankr. 589 (Bankr. ED Mich. 1984) (Article 9 governs the creation of security interests in the right to payment under a contract for the sale of real estate); In re Gemini at Dadeland, Ltd., 24 Bankr. 57 (Bankr. SD Fla. 1982) (creation of security interest in proceeds accounts from condominium sales is an Article 9 transaction); In re Southworth, 22 Bankr. 376 (Bankr. D. Kan. 1982) (assignment of real estate contracts is an Article 9 security transaction); Erickson v. Seattle Trust & Sav. Bank (In re Freeborn), 94 Wash. 2d 336, 617 P2d 424 (1980) (Assignment of a real estate contract is an Article 9 transaction); Krasnowiecki, Miller, and Ziff, "The Kennedy Mortgage Company Bankruptcy Case: New Light Shed on the Position of Mortgage Warehousing Banks," 56 Am. Bankr. LJ 325 (1982).

[338] Melrose Park Nat'l Bank v. Melrose Park Nat'l Bank, 123 Ill. App. 3d 282, 284, 462 NE2d 741, 743 (1984).

which should be classified as personal property and (2) the deeds of trust, which should be classified as a real estate transaction. The court then concluded that the bank's security interest in the notes was not perfected, but that Article 9, which treated the bank as having a properly perfected security interest, did not apply to the deeds of trust. The court did not explain further how the collateral would be allocated between the trustee and the bank, as a result of this conclusion.[339]

In a later case a conflict arose between the party holding promissory notes and the bank that held title to real estate under deeds of trust securing the promissory notes. The court held that Article 9 governed creation of a security interest in the notes and gave the holder of the notes the right to the payments made on the debt. The court suggested, without deciding, that the result might have been different had there been a foreclosure of the deeds of trust. The issue then would be to determine who had priority in the proceeds obtained as a result of the foreclosure.[340]

In summary, a security agreement may cover both real property and personal property as collateral. Real estate law governs the rights related to the security interest in the real property; Article 9 of the UCC governs the rights relating to the security interest in the personal property.[341] In some cases, the recordation of a mortgage or other real estate security instrument may be treated as equivalent to the filing of a financing statement on fixtures under Article 9.[342]

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[339] In re Maryville Sav. & Loan Ass'n, 743 F2d 413, 416–417 (6th Cir. 1984).

[340] In re Maryville Sav. & Loan Corp., 760 F2d 119, 121 (6th Cir. 1985).

[341] See United Va. Bank/Seaboard Nat'l v. B.F. Saul Real Estate Inv. Trust, 641 F2d 185 (4th Cir. 1981); Wiley v. Bank of Fountain Valley, 632 P2d 282 (Colo. Ct. App. 1981).

[342] UCC § 9-402(6). See generally Note, "An Article Nine Scope Problem: Mortgages, Leases, and Rents as Collateral," 47 U. Colo. L. Rev. 449 (1976).

23

Priorities: Rights of Competing Creditors, Purchasers, and Transferees

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¶ 23.01 PRIORITIES BETWEEN PARTIES WITH SECURITY INTERESTS IN THE SAME COLLATERAL

This section explains the rules that determine the priorities between secured parties when there is more than one secured party with a security interest in the same collateral. The rights of the holder of an unperfected security interest as against other claimants of all types, purchasers, lien creditors, and so forth, are discussed first. The situation in which there are two secured parties who both have a perfected security interest in the same collateral is discussed next. The rights of buyers of goods and other purchasers of property in which a secured party has a perfected security interest are discussed in a later section, as are the priority rules for proceeds, fixtures, processed goods and other special cases. It is important to keep in mind that secured party and security interest refer to terms defined in Article 9 of the UCC. A security interest is a consensual interest created in personal property or fixtures as discussed in Chapter 22. The discussion of priorities focuses on persons who hold such interests.

Resolution of priority disputes is important, as it determines the rights of competing creditors who may have to resort to the collateral to satisfy their claims in the event of debtor default. It also may have consequences for the determination of rights in the collateral when the debtor becomes bankrupt. Default is covered in Chapter 24 and bankruptcy in Chapter 25.

[1] Unperfected Security Interests

The secured party who fails to perfect a security interest in the collateral is vulnerable to other creditors, purchasers, or transferees who have claims to the same collateral. Although the general rule of the UCC is that a security agreement is effective between the parties "against purchasers of the collateral and against creditors" except as otherwise provided,[1] there are exceptions where a person with an unperfected security interest will lose to the claims of third parties. The unperfected security interest is inferior to the following claimants:

1. Another secured party who has a perfected security interest in the collateral.[2] It does not matter that the party with the perfected security interest had notice of the prior unperfected security interest.[3]
2. Lien creditors who obtain a lien on the collateral before the security interest is perfected.[4] A lien creditor is a creditor who obtains a lien on the property by attachment of the collateral, levy, or other judicial pro-

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[1] UCC § 9-201. All UCC references in this chapter are to the Uniform Commercial Code 1978 Official Text (West 1978).

[2] UCC §§ 9-301(1)(a), 9-312.

[3] See UCC § 9-312(5)(a).

[4] UCC § 9-301(1)(b).

ceeding. A trustee in bankruptcy is viewed as a lien creditor under the UCC.[5] Prior to the 1972 amendments to the UCC, the lien creditor had to be without knowledge of the security interest. The 1972 amendments deliberately eliminated the lack of knowledge requirement.[6]

3. A buyer of the collateral who gives value and receives delivery of the collateral without knowledge of the security interest[7] and before it is perfected, when the collateral is goods, instruments, documents, chattel paper, or farm products.[8] The buyer of farm products must be a buyer in the ordinary course of business to prevail. The buyer of the other types of goods may be a purchaser in bulk or not a buyer in the ordinary course of business.[9]

4. A buyer in the ordinary course of business of goods. Except for the buyer of farm products in the ordinary course of business, these buyers take free of any security interest, including perfected security interests,[10] created by the seller of the goods.

5. A buyer of consumer goods. When a consumer buys consumer goods, from a seller of consumer goods, that are subject to a security interest not perfected by a filed financing statement, the buyer takes free of the security interest in the goods if the buyer buys without knowledge of the security interest, for value, and for his or her own personal use.[11]

6. A good faith transferee of accounts and general intangibles. A person who is not a secured party but who acquires an interest in accounts and general intangibles for value, without knowledge of the security interest

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[5] UCC § 9-301(3).

[6] UCC § 9-301(1)(b).

[7] UCC § 9-301(1)(c) provides that a buyer not in the ordinary course of business who gives value without knowledge of the security interest takes priority over an unperfected security interest. In order for the secured party to defeat the rights of the buyer under this clause, the secured party must show that the buyer had "actual knowledge" of the security interest. It is not enough to show that the buyer had "reason to know." UCC § 1-201(25); Broadway Nat'l Bank v. G&L Athletic Supplies, Inc., 10 Kan. App. 2d 43, 47–48, 691 P2d 400, 403–404 (1984).

[8] UCC §§ 9-301(1)(c), 9-301(1)(d). It is not enough under this rule for the buyer or purchaser to give value before obtaining knowledge of the security interest. The buyer must take physical delivery of the property before knowing of the security interest when the property consists of goods or other property, such as instruments, documents or chattel paper, where there is a "representative piece of paper whose physical delivery is the only or the customary method of transfer." UCC § 9-301, comment 4.

[9] UCC § 9-301(1)(c).

[10] UCC § 9-307(1). There are special rules for buyers in the ordinary course of business of farm products under federal legislation. See infra ¶ 23.02[2].

[11] UCC § 9-307(2).

and before it is perfected, will take an interest in that collateral, which interest is superior to the unperfected security interest.[12]

The UCC provides a ten-day grace period for a secured party to perfect a purchase money security interest in the collateral. The secured party has ten days, after the debtor receives possession of the collateral, to perfect the security interest by filing a financing statement.[13] If the security interest is perfected within this period, the rights of the secured party are superior to the claims of any transferee in bulk or lien creditor that arose between the date of the attachment of the security interest and the time of the filing.[14] This provision permits a secured party to sell or to finance the sale of collateral to a debtor. It also allows the secured party to give the debtor immediate possession and to complete the steps required for perfecting the security interest in the collateral after delivery to the debtor. It should be noted that this grace period does not apply to rights that may be asserted by claimants other than transferees in bulk or lien creditors. A comparable grace period applies to claims of competing secured parties.

[2] Perfected Security Interests

When there is more than one perfected security interest in the collateral, the general rule of the UCC is that priority is determined by the date of filing or the date of perfection of the security interest. The first secured party to file or to perfect has priority. Thus, when *A* holds a security interest in equipment that was perfected by a filing on January 1, and *B* holds a perfected security interest in the same equipment, perfected by a filing on March 1 of the same year, *A* has priority because *A* filed first. Under the UCC, the date of filing of the financing statement establishes priority, even when the remaining steps for attachment of the security interest to the collateral have not yet taken place.

If, in the previous example, *A* had taken possession of the collateral on January 1, rather than filing a financing statement, the priority date for *A* would still be January 1, assuming that the other steps for perfection of the security interest were completed by January 1 of that year. If *A* then files a financing statement on April 1 and releases the equipment to the debtor after the filing, *A* will retain the priority previously established by possession. Priority is determined from the time *A* first perfected a security interest in the collateral, which was January 1, because *A* had a continuously perfected security interest in the equipment since that date.[15]

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[12] UCC § 9-301(1)(d).

[13] UCC § 9-301(2).

[14] Id.

[15] UCC § 9-312(5)(a).

[a] Purchase Money Security Interests. A secured party with a purchase money security interest has a favored position under the UCC.[16] When the collateral is anything other than inventory, a person with a perfected purchase money security interest takes priority over any other person with a conflicting security interest in the same collateral. The following example illustrates the operation of that rule. Assume that *X* has a blanket security interest in all of debtor's equipment, including any equipment that might be acquired at a later date, and that *X* filed a financing statement perfecting this security interest on January 1 of a given year. Assume further that *Y* finances the sale of a new piece of equipment to debtor and that *Y* acquires a purchase money security interest in the new equipment that is perfected by a filing on March 1 of that same year. Under the rules that give special priority to purchase money security interests, *Y* has priority so long as *Y* perfects the security interest by filing a financing statement within ten days of the time the debtor received the new piece of equipment.[17]

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[16] See generally Jackson & Kronman, "A Plea for the Financing Buyer," 85 Yale LJ 1 (1975).

[17] UCC § 9-312(4). When does the ten-day period provided for in UCC § 9-312(4) start to run? In Bank One v. Farmers Prod. Credit (In re Miller), 44 Bankr. 716 (Bankr. ND Ohio 1984), the debtor purchased a tractor but there was evidence that the seller had allowed the debtor use of the tractor for a week prior to the date on which the debtor became obligated to pay for it by signing the note. A financing statement was filed within ten days of the execution of the note, but the filing occurred more than ten days from the date that the debtor first obtained physical possession of the tractor. The court said that it must determine when the buyer was "possessed of this tractor as a debtor." The only evidence in the record that showed when the purchaser became a debtor was the time the debtor signed the promissory note and security agreement. Thus, the filing was within the ten-day period. See also Note, "Purchase Money Security Interest Priority Under the Uniform Commercial Code: When Does Section 9-312(4)'s Grace Period Begin to Run?" 48 Temp. LQ 1025 (1975).

In International Harvester Credit Corp. v. American Nat'l Bank, 296 So. 2d 32, 34–35 (Fla. 1974), noted 26 Case W. Res. L. Rev. 708 (1976), the Florida Supreme Court held that a party with a security interest that was perfected by filing and included after-acquired property takes priority over a subsequent creditor with a purchase money security interest who failed to perfect the purchase money interest within the ten-day period of UCC § 9-312(4), but that the priority of the first secured party extended only to the debtor's equity in the after-acquired property. This position is contrary to the UCC priority rules and was repudiated by legislation in Florida in 1978. Relying on this legislation, a Florida court concluded that the "debtor's equity" principle no longer applies. Regan v. ITT Indus. Credit Co., 469 So. 2d 1387, 1390–1391 (Fla. Dist. Ct. App. 1984). The court certified to the Florida Supreme Court the question of whether the debtor's equity concept of the *International Harvester* case survived the enactment of the new Florida legislation. The Florida Supreme Court ruled that the "debtor's equity" concept did not survive the enactment of Florida Statute 679.312 "thereby bringing our interpretation of Section 679.312, . . . , the Uniform Commercial Code provision relating to the priority of purchase money security interests, into conformity with other jurisdic-

This purchase money priority provision gives the debtor some freedom from the restrictions of the blanket prior encumbrance held by *X*. It promotes purchase money financing because it relieves *Y* from the task of checking what prior security interests may be claimed against debtor before financing the sale of the new equipment. The priority given to the holder of the purchase money security interest also extends to any proceeds of the collateral in which the purchase money security interest was held when the goods are not inventory.[18] Thus, in the example given, if debtor swaps the equipment in which *Y* holds the purchase money security interest for some other equipment, *Y*'s priority continues into this new equipment.[19]

When the collateral is inventory, a similar purchase money priority provision exists.[20] However, the secured party seeking to claim the benefit of the special priority must take additional steps. One of the most important of these is to give notice to the holder of any conflicting security interest in the inventory that is perfected by a filed financing statement.[21] In addition, a purchase money security interest must be perfected at the time the debtor receives possession of the inventory.[22] A similar purchase money priority rule exists for goods delivered on consignment, according to the 1972 amendments to the UCC.[23]

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tions and the express intent of the Florida Legislature." ITT Indus. Credit Co. v. Regan, 487 So. 2d 1047, 1048 (Fla. 1986).

When a debtor traded in old equipment in which the bank held a non-purchase money security interest for new equipment in which the seller took a perfected purchase money security interest, the bank did not have a priority interest in the new equipment. UCC § 9-306(2) is not a priority provision. UCC § 9-312(4) applies and gives priority to the seller's purchase money security interest. Deutz-Allis Credit Corp. v. Lynch Farms, Inc., 387 NW2d 593, 595-596 (Iowa 1986).

[18] UCC § 9-312(4). Proceeds are discussed infra ¶ 23.03[1].

[19] When a transaction involves a contract with a U.S. agency, federal rights may override UCC provisions. In one case, a manufacturer had a contract with the Department of the Army to supply cylinder heads. The Army contract contained a "title-vesting" clause that gave the Army title to all materials, inventories, special tooling, and so forth, that were chargeable to the contract. The manufacturer purchased a machine for use in performing the contract, and financed the machine with a bank who took a purchase money security interest in it. Even though UCC rules permit the purchase money security interest of the bank to have priority if the bank had complied with all of the Article 9 provisions, the question arises as to whether the "title-vesting" provisions of the U.S. contract created a federal interest superior to the bank's Article 9 security interest. A bankruptcy court, using archaic title-passing reasoning, concluded that the federal interest should prevail, but the opinion was vacated by the district court for lack of jurisdiction over the subject matter. In re Denalco Corp., 51 Bankr. 77, 78, 80–81 (Bankr. ND Ill. 1985), dismissed, 57 Bankr. 392 (ND Ill. 1986).

[20] UCC § 9-312(3).

[21] UCC § 9-312(3)(b).

[22] UCC § 9-312(3)(a).

[23] UCC § 9-114.

When a purchase money security interest has priority in inventory, that priority carries over into any "identifiable cash proceeds" received before delivery of the inventory item to a buyer.[24] Thus, if inventory is sold and an account is established representing the amount owed by the buyer to the seller, the secured party with the purchase money security interest may not claim the special purchase money priority in the account, even when the account is identifiable as proceeds, because it is not "cash proceeds."[25] On the other hand, if cash or a check is received on sale of the inventory, the holder of the purchase money security interest may claim priority in these proceeds, so long as they are "identifiable" and received by the debtor "on or before the delivery of the inventory" to the buyer.[26] Prior to the 1972 amendments to the UCC, the rules were unclear as to whether the purchase money priority extended into proceeds obtained upon the sale of the inventory.

Further, the UCC is not clear on how to determine relative priorities when the conflicting security interests are both purchase money security interests. In *United States v. Cahall Bros.*,[27] the court assumed, without directly addressing the issue, that the first party to file would have priority. However, it could also be argued that the parties should be equal in priority with a pro rata interest in the collateral. In *John Deere Co. v. Production Credit Ass'n*,[28] two secured parties had purchase money security interests in the same equipment. One obtained the purchase money security interest by advancing funds enabling the debtor to acquire the equipment; the other obtained a purchase money security interest because he sold the equipment and retained a security interest for the unpaid portion of the purchase price. The court determined that priority should be based on the principal of "first to file" and rejected a pro rata apportionment of the collateral between the two creditors.

[b] Security Interests In Crops. A special rule exists for a security interest perfected in crops that is similar in concept to the priority for purchase money security interests. This rule applies when the secured party has given the debtor new value to enable the debtor to produce the crops during the current production season, and when the value is given not more than three months before the crops are planted. The perfected security interest in the crops takes priority over an earlier perfected security interest to the extent that the earlier security interest secures older obligations of the debtor that were due more than six months prior to the planting of the crops.[29] The priority for the new crop financing holds even

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[24] UCC § 9-312(3).

[25] See UCC § 9-306(1).

[26] UCC § 9-312(3).

[27] 674 F2d 578, 581 (6th Cir. 1982).

[28] 686 SW2d 904, 908 (Tenn. Ct. App. 1984).

[29] UCC § 9-312(2).

when the secured party who gave the new value knew of the earlier security interest. For example, assume that Bank *A* has made a loan of $800,000 to a farmer debtor. That loan, which obligates the debtor to pay monthly amounts representing payments on the principal amount of the debt plus interest and taxes of $12,000 per month, is secured by a mortgage on the real estate, which mortgage also creates a security interest in all crops grown on the land. The special priority rule for new crop financing allows Bank *B* to loan funds to debtor to grow a new crop, as long as the loan is made and the value given within three months of the time "the crops become growing crops by planting or otherwise. . . ."[30] If the planting date is April 1, the value from the loan by Bank *B* must be made after January 1. Bank *B* will not have priority over the full amount of the obligation owed to Bank *A*, as occurs with the regular purchase money priority rule, because the priority extends only to the obligations to Bank *A*, which became due more than six months before the crops were planted or otherwise started growing. The six months' date under this example would be October 1. The obligations to Bank *A* that become due after October 1 are not subject to the special priority rule. As to this part of the debt owed to Bank *A*, the priority dispute with Bank *B* over whose security interest had priority would be governed by the normal first-to-file-or-perfect rule. Under this rule, Bank *A* takes priority to the extent of the obligations that became due after October 1. Further, this special priority rule applies only to security interests in crops that Bank *B* financed. The priority of security interests in other collateral will be determined by the general rules, such as the first-to-file rule discussed previously.

¶ 23.02 RIGHTS OF BUYERS AND PURCHASERS

[1] Buyers of Goods

[a] Buyers in the Ordinary Course of Business. Special protection is given the buyer in ordinary course of business for goods other than farm products.[31] Such a

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[30] UCC § 9-312(2).

[31] UCC § 9-307(1). The special farm products rules are discussed supra ¶ 23.02[2].

Bulk transfers receive special treatment under the UCC. See Hansell & Austin, "Bulk Transfers Under Article 6 of the Iowa Uniform Commercial Code Revisited," 31 Drake L. Rev. 383 (1981). The UCC defines a bulk transfer as "any transfer in bulk and not in the ordinary course of the transferor's business of a major part of the materials, supplies, merchandise or other inventory . . . of an enterprise subject to this Article." § 6-102(1). It also includes "a transfer of a substantial part of the equipment . . . of such an enterprise . . . if it is made in connection with a bulk transfer of inventory." § 6-102(2). The scope of the article was examined in Republic Steel Corp. v. Canyon Culvert Co., 104 NM 396, 398–400, 722 P2d 647, 649–650 (1986). Buyer purchased equipment from seller, who soon after went out of business by selling its inventory and remaining equipment to another firm. Seller's creditor claimed the sale of equipment was a bulk sale within UCC

buyer takes free of any security interest that the seller created in the goods, even though the security interest is perfected and even though the buyer knows that the security interest exists.[32] To be a buyer in the ordinary course of business, the

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§ 6-102(2), because it was "in connection with" a bulk transfer of inventory. The court took a narrow view of Section 6-102(2) to protect the interests of the buyer, who the court found had no reason to know of the seller's plans to make a bulk transfer at the time of the sale, even though the purchase contract promised that the seller would comply with any applicable bulk sales requirements. Id. at 400, 722 P2d at 650.

A buyer of goods on credit cannot qualify as a buyer in the ordinary course of business if the debt owed for the price of the goods is satisfied by canceling an offsetting debt owed to the buyer that was in existence at the time the goods were purchased. The court said that it did not have to decide if "all defenses to, or offsets of, a buyer's promise to pay will disqualify the buyer from status as one in ordinary course of business." It decided this case on the grounds that the buyer would not be in the "ordinary course of business" when the buyer offset the promise to pay with a debt that was in existence at the time the goods were bought. United States v. Handy & Harman, 750 F2d 777, 782 (9th Cir. 1984).

When a secured party seeks to enforce his or her interest in the collateral against someone who purchased the goods from the secured party's debtor, the buyer may seek to raise as a defense obligations owed to the buyer by the debtor that sold the goods. The buyer may have valid rights against the debtor. When can the buyer assert such a setoff against the secured party? When the buyer purchases the goods on credit, the promise to pay his or her seller (the debtor) becomes an account under the UCC. The secured party gets an interest in this account as proceeds of the original collateral. UCC § 9-318, which covers assignments of accounts, makes the assignee of the account (the secured party) subject to setoff rights held by the buyer. On the other hand, if the secured party's security interest continues in the collateral and is not cut off by the sale, the secured party may sue the buyer for conversion. In a suit for conversion, the secured party is entitled to recover, "since the basis for a conversion suit is the secured party's superior property interest in the inventory itself, not the assignment of the account held by the debtor." 750 F2d at 786. The result of this analysis is that if the security interest is not cut off, the secured party may sue and not be subject to the setoff. But if the security interest in the collateral is cut off, the secured party must sue on the account and is subject to the setoff rights. Id.

[32] UCC § 9-307(1). A secured party held a security interest in an airplane that was under construction by the seller. The seller had contracted with the buyer for the delivery of the plane being manufactured under the condition that the buyer pay in three installments: on signing the contract, on two-thirds completion, and on final delivery. The secured party was the seller's inventory financer, who held a security interest in all of the seller's work in progress. The secured party seized the plane to satisfy the seller's debt when the plane was substantially completed. As the buyer had made two of the progress payments on the plane, the buyer brought an action against the secured party to recover the aircraft and tendered the third installment payment directly to the secured party, after a deduction for work required to be completed. The court held that the buyer's remedies against the secured party were not limited to those the buyer might have had to recover the goods directly from the seller, because this was a situation where a third party had wrongfully interfered with the buyer's rights. Holding that the buyer was a buyer in the ordinary course of business, the court ruled that the buyer's interest in the plane was superior to the secured party's, notwithstanding that there had been no passage of title nor delivery of the goods. This interest entitled the buyer to possession of the aircraft or damages for conversion. Carey Aviation, Inc. v. Giles World Mktg., Inc., 46 Bankr. 458, 459–460, 462–463 (Bankr. D. Mass. 1985).

buyer must purchase from someone who is in the business of dealing in goods of that kind.[33] Thus, this provision applies primarily to buyers who purchase goods that, in the hands of the seller, constitute inventory.

A buyer in the ordinary course of business buys in good faith and without knowledge that the sale violates any ownership rights or security interest of a third party.[34] Under these limitations, the buyer takes free of any security interest "if he merely knows that there is a security interest which covers the goods." However, the buyer who knows, "in addition, that the sale is in violation of some term in the security agreement not waived by the words or conduct of the secured party" will take subject to the security interest.[35] This rule was applied in a case where officers of the debtor, an automobile dealer, arranged a sham sale to themselves of automobiles in the debtor's inventory in order to obtain double financing of the inventory in violation of the security agreement with the first secured party. The officers could not qualify as buyers in the ordinary course of business. The party who financed their purchases was subject to the original security interest of the first secured party because that security interest continued in the collateral, notwithstanding the sale, and was not cut off by the sale to the officers.[36]

One court has held that a purchaser may qualify as a buyer in the ordinary course of business even though title to the goods purchased had not yet passed to the buyer and delivery of the goods had not taken place. In this case, the buyer bought a drill from a dealer. The dealer had to obtain a drill to fill the order from a supplier. The supplier delivered a number of drills to the dealer retaining a security interest to secure their price. Upon receipt of the drills, dealer arranged for one to be delivered to the buyer, but before delivery could occur, the supplier seized the drill under its security agreement. The buyer then sued the supplier demanding the drill. The court held that the buyer was entitled to prevail as a buyer in the ordinary course of business even though title had not yet passed and the drill had not yet been identified to the contract.[37]

A buyer in the ordinary course of business does not include one to whom goods have been transferred "in total or partial satisfaction of a money debt."[38] Thus, although a secured party may be a "purchaser" under the UCC,[39] it will be

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[33] UCC § 1-201(9).

[34] Id. A purchaser of a car qualified as buying in good faith under UCC § 9-307(2), even though he did not receive a certificate of title with the sale. Dion v. Silver City Dodge, Inc., 398 Mass. 58, 495 NE2d 274 (1986).

[35] UCC § 9-307 comment 2.

[36] First Nat'l Bank & Trust Co. v. Ford Motor Credit Co., 231 Kan. 431, 434–435, 646 P2d 1057, 1061–1062 (1982).

[37] Wilson v. M & W Gear, 110 Ill. App. 3d 538, 539–541, 442 NE2d 670, 671–673 (1982).

[38] UCC § 1-201(9).

[39] See UCC § 1-201(32).

difficult for a secured party to qualify as a buyer in the ordinary course of business.[40] In one case, property was given by the owner to the bankrupt under a contract of bailment. A secured creditor of the bankrupt claimed the property under its security interest. Because the bankrupt was a bailee, the owner's interest was not a security interest and thus UCC § 9-307, relating to the rights of buyers in the ordinary course of business, did not apply. The case in fact arose under UCC § 2-403, dealing with bona fide purchasers. Under that section, only buyers in the ordinary course of business prevail over the rights of owners who have entered into bailment arrangements. The result is that the UCC provides greater protection for a bailor of goods than for a seller who reserves a security interest.[41] Although the bailment was attacked as being a contract for the sale of goods at a future time rather than a bona fide bailment, the court found that the transaction showed an intention to avoid any ownership rights in the bailee until the condition called for in the contract had occurred.[42] That condition was the destruction of the goods. The bailor, Kodak, had compelling business reasons for retaining control over the goods until their destruction. The goods were film of an inferior quality, film that Kodak did not want to get into the possession of others.[43]

In another case in which goods were purchased under circumstances where the buyer would otherwise have qualified as a buyer in the ordinary course of business, except that a portion of the purchase price was paid with new value and another portion paid by treating the transfer as in satisfaction of an antecedent debt, one court has held that the transaction may be fractionalized. That portion for which new consideration was given was treated as a transaction where the buyer had bought in the ordinary course of business. That portion of the goods purchased by releasing the antecedent debt did not qualify for buyer in the ordinary course of business treatment.[44]

[b] Buyers From Debtors Who Have Authority to Sell. When a secured party entrusts goods to a debtor who is in the business of selling such goods, the circumstances may justify the finding that the secured party has waived or is estopped from enforcing the security interest against a buyer of the goods. Under the UCC, buyers of goods take free of any security interest created by the seller

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[40] Eastman Kodak Co. v. Harrison (In re Sitkin Smelting & Ref. Inc.), 639 F2d 1213, 1215–1216 (5th Cir. 1981), reh'g denied.

[41] 639 F2d at 1216.

[42] Id. at 1217.

[43] Id. at 1214, 1217.

[44] Walter E. Heller Western, Inc. v. Bohemia, Inc., 61 Or. App. 57, 62–63, 655 P2d 1073, 1078–1079 (1982). But see General Elec. Credit Corp. v. R.A. Heintz Constr. Co., 302 F. Supp. 958, 964 (D. Or. 1969).

when the secured party has *authorized* the sale or disposition of the goods.[45] Authority to sell may be found in the security agreement or "otherwise,"[46] thus leaving open the possibility that a purchaser of goods could establish that under the circumstances, the secured party should be estopped from denying authority, in the debtor, to sell the collateral. Notwithstanding an express term in the security agreement forbidding the debtor to sell the collateral without the secured party's consent, the course of performance or course of dealing between the parties may be the basis for finding a modification or waiver of the need for consent. If such waiver can be shown, the sale by the debtor may be deemed to have been authorized by the secured party, with the result that any buyer, not just the buyer in ordinary course, may take the goods free from the security interest.[47]

A secured party who was financing debtor's cattle operations was held to have waived in its security agreement the term prohibiting the debtor from selling cattle without the consent of the secured party by allowing the debtor to follow a course of business of selling the cattle without the secured party's consent. At first, the debtor promptly accounted and remitted to the secured party for the sales. When the debtor encountered financial difficulties, the debtor diverted the proceeds to other creditors. The secured party then attempted to recover from the persons to whom the debtor had sold the cattle, claiming that the sales had been unauthorized and constituted conversion of its collateral. The court held that the secured party's acquiescence in this pattern of conduct constituted authorization for the sale of the collateral regardless of the express terms of the security agreement.[48] Numerous cases on this issue involve

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[45] UCC § 9-306(2). In Home Sav. Ass'n v. General Elec. Credit Corp., 101 Nev. 595, 597–598, 708 P.2d 280, 282–283 (1985), General Electric Credit Corporation (GECC) financed dealer's inventory of mobile homes. As the dealer sold mobile homes, the purchasers financed their acquisition through Home Savings. The dealer continued to hold one unit on its lot although it had been sold. The reasons for holding the unit were not clear; the court suggested it might have been for lack of a sufficient down payment to remove the unit or might have been because the purchasers had not yet located a lot on which to install the mobile home. In any event, when the dealer defaulted, GECC and Home Savings both claimed the unit. The court concluded that as GECC had authorized the sale to purchasers, those purchasers took free of the security interest of GECC and gave Home Savings a valid security interest in the unit. The court could have come to the same conclusion by finding that the purchasers were buyers in the ordinary course of business under UCC § 9-307, but they would then have had to decide if the special circumstances of the sale where the dealer retained possession were relevant to buyers' status as buyers in ordinary course of business. Id. at 602, 708 P2d at 287.

[46] UCC § 9-306(2).

[47] UCC §§ 2-208(2), 2-208(3). See Comment, "Federal Legislation Provides Protection For Buyers of Farm Products: Food Security Act Supersedes The Farm Products Exception of UCC Section 9-307(1)," 47 U . Pitt. L. Rev. 749 (1986).

[48] Anon, Inc. v. Farmers Prod. Credit Ass'n, 446 NE2d 656, 661-662 (Ind. Ct. App. 1983) (discussing cases on implied waiver by a secured party of limitations on the debtor's authority to sell the collateral). See Miami Valley Prod. Credit Ass'n v. Klipfer (In re Klipfer), 62 Bankr. 290, 295–296 (SD Ohio 1986). A secured party waived its security

farm products, since the "farm products" exception in UCC § 9-307(1) makes a security interest in such collateral effective even against a buyer in the ordinary course of business.[49] The problems with the farm products exception led to federal legislation, which is discussed later in this chapter.

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interest in farm products when it told the sales agent to make the check for the sales proceeds payable only to the debtor and to deliver it to him. UCC § 9-306(2).

[49] When a secured party allowed a farmer whose livestock he was financing to sell the livestock and account for the proceeds from the sale to the secured party, the farmer had authority under UCC § 9-306(2) to sell the livestock free of the secured party's security interest, notwithstanding that the security agreement did not authorize the farmer to sell or to use the proceeds for any purpose other than to repay the loan. Therefore, the secured party could not sue the purchaser of the livestock for conversion, because there was no security interest in the livestock in the hands of the purchaser. Ottumwa Prod. Credit Ass'n v. Heinhold Hog Market, Inc., 340 NW2d 801, 802-803 (Iowa Ct. App. 1983).

However, when the debtor sells livestock in violation of the security agreement in a manner that is different from their established course of dealing (as when the debtor transferred the livestock in partial satisfaction of a preexisting debt), the transaction is not otherwise authorized by the secured party as provided by UCC § 9-306(2), under the theory that a prior course of dealing could constitute authority in the debtor to dispose of the collateral. Thus, the secured party's perfected security interest would continue, notwithstanding the sale, and would have priority over the interest of the transferee. Larsen v. Warrington, 348 NW2d 637, 641–642 (Iowa Ct. App. 1984). See also Humboldt Trust & Sav. Bank v. Entler, 349 NW2d 778, 781–782 (Iowa Ct. App. 1984) (holding that the disposition of the collateral was within a prior course of dealing).

A course of dealing was established wherein the secured party never required the debtor to obtain the secured party's consent before selling cattle subject to the security interest, as required by the security agreement. The debtor's sale of the cattle was therefore free of the security interest. Parkersburg State Bank v. Swift Indep. Packing Co., 764 F2d 512, 514 (8th Cir. 1985). Although the security agreement may require the debtor to obtain the secured party's written consent before selling collateral (in this case, cattle), if the secured party authorizes the sale, the security interest in the collateral will not be effective against the purchaser, even though the secured party's authorization was not in writing. Colorado State Bank v. Hoffner, 701 P2d 151, 153 (Colo. Ct. App. 1985). Where the creditor has orally consented to the sale of cattle in which it held a security interest, the purchasers of the cattle take free of the security interest, despite the secured party's having expressly conditioned the sale upon the debtor's remitting the proceeds of the sale to the secured party. People's Nat'l Bank & Trust v. Excel Corp., 236 Kan. 687, 690–692, 695 P2d 444, 447–449 (1985).

When the debtor transfers collateral without authorization from the secured party and does so under circumstances where the transferees do not otherwise qualify for the rights of good faith purchasers who would take priority over the secured party, the security interest in the collateral continues and remains effective against the transferee. The secured party has a cause of action against the transferee for conversion. Ranier v. Gilford, 688 SW2d 753, 754 (Ky. Ct. App. 1985). In United States v. New Holland Sales Stable, Inc., 603 F. Supp. 1379, 1382, 1386 (ED Pa. 1984), a broker who sold cattle for the debtors was found liable for conversion of the cattle, because the cattle were subject to a security interest and were sold without the consent of the secured party. The case was decided under federal law because the United States, through the Farmers Home Administration (FHA), held a security interest in the cattle. Liability was found, even though the broker lacked knowledge of the defect in the debtor's title to the cattle. If the case had arisen under UCC § 7-404, it might have produced a different result. UCC § 7-404 provides that a bailee who acts in good faith and who observes reasonable commercial

In *Farmers State Bank v. Webel*,[50] the court had to determine whether goods were farm products purchased from a seller engaged in farming operations or inventory purchased from a person in the business of selling, to decide if the

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standards in dealing with goods that the bailee has received will not be liable for such actions.

A court concluded that a secured bank should be deemed to have consented to its debtor's sale of collateral, even though the security agreement prohibited sale without the bank's consent and the bank's consent was lacking. The court reasoned that if the debtor had given the secured party the proceeds from the sale, the secured party would not have objected to it. Moffat County State Bank v. Producer's Livestock Mktg. Ass'n, 598 F. Supp. 1562, 1570 (D. Colo. 1984), aff'd, 833 F2d 908 (10th Cir. 1987).

The Supreme Court of South Dakota held that a secured party did not waive its security interests by its course of conduct nor otherwise authorize the debtor to dispose of the goods in a case where the debtor had a history of cattle sales without obtaining written advance consent required by the security agreement. The suit was brought by Aberdeen Production Credit Association against the auction company that sold the livestock. The credit association held a perfected security interest in the livestock. The relevant security agreements required the debtor, Bellman Farms, to obtain advance written authorization of the credit association before selling the cattle. Although the credit association anticipated that the debtor would sell cattle to meet its obligation, this expectation did not amount to a waiver of the requirement for advance written consent, and there was no conduct "otherwise" authorizing sale of the collateral by the debtor. The court stated:

> The previous course of dealing amounted to nothing more than PCA's failure to impose some form of creditor discipline against Bellman Farms for selling cattle on prior occasions without written consent. Considering the fact that these particular sales were made without PCA's knowledge, sale barns' argument that PCA failed to protect itself ignores reality . . . . When Bellman Farms sold secured cattle and paid over the proceeds to PCA, PCA was presented with an accomplished fact. Since PCA was not prejudiced by such sales, to now argue that PCA's failure to nevertheless rebuke Bellman Farms or to call the loan constituted a waiver of the security agreement in the subsequent unreported sales is not persuasive.

Aberdeen Prod. Credit Ass'n v. Redfield Livestock Auction,Inc., 379 NW2d 829, 832 (SD 1985).

The FHA held a lien on farmer's cattle and sued commodity brokers who sold the cattle for conversion, because their debtor, the farmer, had not fully paid the proceeds received from the sale to the FHA. In an alternative holding, the court ruled the FHA had consented to the sale, thus terminating its security interest. The court reached this result by using UCC § 9-306 as the source for what the federal law should be, recognizing that United States v. Kimbell Foods, Inc., 440 US 715 (1979), made the question a matter of federal law. The FHA had adopted a regulation that it claimed preempted state law on this point. Alternatively, the court maintained that the regulation did not apply under the facts of the case, and, if it did, would not displace the UCC as the source of the federal law: "Kimbell's holding is in effect a finding that in the area of federal lending programs regulations such as [this], enacted under a general enabling provision, do not constitute the sort of explicit 'congressional directive' that will displace the application of state law as the federal rule of decision." United States v. Walter Dunlap & Sons, Inc. 800 F2d 1232, 1237, 1239 (3d Cir. 1986).

But see United States v. Missouri Farmers Ass'n, Inc., 800 F.2d 185, 187–188 (8th Cir. 1986), which held that the FHA regulation applied, rather than state law, but that conditions for release of the lien were met.

[50] 113 Ill. App. 3d 87, 90–92, 446 NE2d 525, 528–530 (1983).

purchaser was entitled to protection as a buyer in the ordinary course of business. If the goods were farm products, the farm products exception in UCC § 9-307(1) would allow the security interest to prevail, even as against a buyer in the ordinary course of business. The buyer bought pigs from a seller whose business was buying and selling feeder pigs and, sometimes, fattening them. The court concluded that the seller was a marketing agency that sold inventory and not farm products. Therefore, the purchaser could be a buyer in the ordinary course of business who took free of any security interest in the pigs granted by the seller.

[c] Scope of Protection for Buyers in the Ordinary Course of Business. A buyer in the ordinary course of business only takes free of security interest that the buyer's seller creates in the goods. If the seller has obtained goods already subject to a security interest, created by the person who transferred the goods to the seller, the buyer takes the goods subject to that security interest. This situation often arises with automobiles. In one case, First Tennessee Bank had a security interest in a car owned by the Brughs. The Brughs took the car to Tom Woods Used Cars to sell it. Woods sold the car to plaintiff, who paid Woods, but Woods did not pay off Tennessee Bank for its interest in the car or pay the Brughs. Woods then went bankrupt. Plaintiff sued First Tennessee Bank to establish her title to the car. The court said that plaintiff would not take free of the security interest as a buyer in the ordinary course of business from Woods, because the security interest in the car was not created by Woods.

The court avoided having to reach that result. It decided the case under the provisions of UCC § 2-403, which deals with the rights of good faith purchasers of goods against persons claiming an interest in the goods. Although that section does not expressly identify whether a secured party may fall within its provisions, it does state that Article 9 governs the rights "of other purchasers of goods and of lien creditors. . . ."[51] In any event, Section 2-403(2) provides that one who entrusts goods to a merchant who sells goods of that kind will have no claim to the goods from a buyer in the ordinary course of business from the merchant. When the Brughs gave the car to Woods, their action constituted an entrustment under UCC § 2-403(2). First Tennessee Bank acquiesced in the delivery of the car to Woods. Woods notified the bank that Woods was holding the car for sale and the bank did not object. Although it was argued that Section 2-403 should not be used, because Section 9-307(1) implicitly limits the scope of that section (Section 2-403), the court regarded the two sections as compatible. The entrustment provisions of Section 2-403(2), which recognize that a party may authorize the sale of goods by acquiescing in the conduct of the person entrusted with the goods, reflect a principle similar to that in Section 9-306(2), which cuts off a security interest when the secured party has authorized the sale of the collateral. Having had knowledge of the delivery of the goods to the seller, the secured party

[51] UCC § 2-403(4).

"cannot lie in wait until the merchant has misled some innocent buyer and then recover the collateral on the ground that it did not authorize the sale in writing."[52]

[2] Buyers of Farm Products—The Food Security Act of 1985

[a] Reasons for Enactment. The special protection given by UCC § 9-307 for buyers in the ordinary course of business does not apply to "a person buying farm products from a person engaged in farming operations."[53] Under the normal rule of UCC § 9-307(1), when a buyer purchases goods from a dealer under circumstances in which the buyer qualifies as a buyer in the ordinary course of business, the buyer takes free of any security interest that may exist in the purchased goods as security for the lender who is financing the seller. The buyer in the ordinary course of business obtains title to the goods free from the claims of the seller's financer, even though the buyer knew that the financer had a security interest in the goods. Because of the express exception to this rule for buyers of farm products, such buyers are exposed to significantly different risks. The farm products buyer acquires a title to the goods that is subject to the security interest of the seller's financer. This occurs regardless of the buyer's good faith or ignorance, at the time of purchase, of the existence of the security interest.

Application of the farm products exception to the buyer in ordinary course rule generated a spate of litigation. Most of this litigation focused on the question of whether the financer who claimed a security interest in the goods should be deemed to have consented to the farmer's sale of the goods. Under common lending arrangements, the secured party is aware of the debtor's practices in selling farm products subject to the secured party's security interest. The security agreement sometimes permits the sale if the debtor accounts to the secured party for the proceeds. If a court views these arrangements or practices as

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[52] In re Woods, 25 Bankr. 924, 926–929 (Bankr. ED Tenn. 1982). The Kansas Supreme Court followed the entrustment theory to protect the buyer of a tractor. Although the transaction qualified as the ordinary course of business, UCC § 9-307(1) did not apply, because the dealer that sold the tractor did not create the security interest. The dealer had obtained the tractor from a partnership that had acquired the tractor from the secured party under a financing lease arrangement. Thus, the partnership "created" the security interest in the deal with the secured party. The secured party argued that the provisions of Article 9 should be exclusive, but the court held that the actions of the secured party in allowing the dealer to retain possession and control of the tractor amounted to an entrustment under UCC § 2-403 to a merchant dealing in goods of that kind. Thus, the buyers took free of the security interests because they bought the tractor in the ordinary course of business. Executive Fin. Servs., Inc. v. Pagel, 238 Kan. 809, 813–815, 715 P2d 381, 385–387 (Kan. 1986).

[53] UCC § 9-307(1).

tantamount to the secured party's consent to the debtor's sale, the buyer acquires a title to the farm products free from the security interest of the secured party.[54]

Where there was a course of dealing or of performance between the debtor and the secured party over a period of time, which course indicated a pattern of acquiescence by the secured party in the sales, the course of performance or of dealing could be viewed as a modification of the security agreement or as a waiver by or estoppel of the secured party, which precluded the secured party from invoking clauses in the security agreement requiring debtors to get advance consent to the sale of the collateral. The law was further complicated as numerous states amended their versions of UCC § 9-307 to change the result for certain purchasers of farm products.

The controversy and confusion over the rights of purchasers of farm products led Congress to enact the Food Security Act of 1985, which provides legislative protection for buyers in the ordinary course of business of farm products. The act extends its protection not just to buyers but also to commission merchants and sales agents who deal in farm products. Commission merchants and sales agents are included because some UCC case law has made auctioneers and other agents subject to conversion liability when they sell farm products that were subject to security interests. The act, effective December 24, 1986, establishes a new federal rule for buyers of farm products. Congress explained the purpose for the legislation in the following way:

> This exception [in UCC § 9-307(1) for farm products] presents significant commercial problems for buyers and sellers of farm products. With the advent of 24-hour final payment rules for some commodities, there is insufficient time to check for liens and, thus, greater potential liability for buyers. In addition, with some lenders pursuing buyers several years following their purchases, many buyers limit who they do business with, thus restricting the markets of farmers and inhibiting the free-flow-of-commerce in the United States.
> Current State law forces innocent buyers of farm products to become unwilling loan guarantors, in essence assuming the credit supervision responsibilities that rightly belong with the lender who is making the profit off the loan to begin with. At the same time, farm product buyers have no control over the lender's practice, and receive no compensation in the form of interest to cover the risk exposure and jeopardy unknowingly and unwillingly assumed.
>
> Moreover, the current exception for farm products places an undue financial burden on markets to which producers sell their commodities, thus reducing the economic vitality of our nation's domestic agricultural markets. As the problem worsens, it adversely affects individual farmers, as well

[54] UCC § 9-306(2). These cases are discussed supra ¶ 23.02[1]. See generally B. Clark, The Law of Secured Transactions Under the Uniform Commercial Code, ¶ 8.4[3] (1980 & 1987 Cum. Supp.).

as their markets. Farmers buy products from other farmers, such as feeder cattle and pigs, breeding stock, grain and hay, and potentially may be forced to pay twice for these products as their suppliers default on secured debts. Risk exposure and actual losses from double payment are reflected in the prices paid to farmers and are passed on to other producers in terms of higher marketing fees and processing costs, and eventually are reflected in higher consumer prices for meat, milk, and eggs, etc.

Additionally, there is a question of equity—is it fair to require a purchaser of farm products to pay a second time for those commodities simply because of a financial dispute between the producer/borrower and his lender?

These considerations have led 20 states to "opt out" of the farm products exception and establish their own central filing or notice systems. Under such conditions, the Uniform Commercial Code is hardly "uniform" anymore in this particular field. And with the increasingly interstate nature of agricultural marketing, this patchwork of rules and regulations has become intolerable for buyers and sellers of farm products alike. Application of the current myriad of State laws has created a substantial burden on interstate commerce in agricultural products. A single Federal rule is needed to restore consistency to this area of the law, and remove that burden.[55]

[b] **Provisions of the Act.** The heart of the Food Security Act reads as follows:

Except as provided in subsection (e) of this section and notwithstanding any other provision of Federal, State, or local law, a buyer who in the ordinary course of business buys a farm product from a seller engaged in farming operations shall take free of a security interest created by the seller, even though the security interest is perfected; and the buyer knows of the existence of such interest.[56]

Commission merchants or selling agents receive similar protection when they sell, "in the ordinary course of business, a farm product for others."[57]

Section § 1631(b) sets forth an absolute rule protecting a buyer in the ordinary course of business of farm products from a seller engaged in farming, unless the person who claims a security interest in the farm products qualifies the security interest under the notification and filing procedures of the act. There are three circumstances under which the buyer of farm products will take the goods subject to a security interest that the buyer's seller created in the

[55] H.R. Rep. No. 271, 99th Cong., 1st Sess. 109, reprinted in 1985 U.S. Code Cong. & Admin. News 1213. See generally, Comment, "Farm Products Collateral: Still A Problem?" 1987 U. Ill. L. Rev. 241 (1987); Comment, "Federal Legislation Provides Protection for Buyers of Farm Products: Food Security Act Supersedes the Farm Products Exception of UCC Section 9-307(1)," 47 U. Pitt. L. Rev. 749 (1986).

[56] 7 USC § 1631(d) (Supp. IV 1986).

[57] 7 USC § 1631(g)(1) (Supp. IV 1986).

goods.[58] The first circumstance occurs when the buyer receives a formal written notice of the existence of the security interest prior to the sale of the farm products to that buyer. The other two circumstances arise when a state has established a central filing system that qualifies under the act. If a state has a central filing system, the security interest will be effective against a buyer who has received an official written notice of the security interest from the Secretary of State, pursuant to this central filing procedure. It also *may* be effective when the buyer fails to register with the Secretary of State prior to the purchase of the farm products. Each of these three alternatives is discussed in the text that follows.

[c] Presale Notice Procedures. If a farm products buyer gets written notification before the sale of the security interest in the farm products, the security interest will be effective against the buyer. Similarly, written notice preserves a security interest against commission merchants and selling agents. The act states the following:

> (e) Purchases subject to security interest
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> A buyer of farm products takes subject to a security interest created by the seller if—
>
> (1)(A) within 1 year before the sale of the farm products, the buyer has received from the secured party or the seller written notice of the security interest organized according to farm products that—
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> (i) is an original or reproduced copy thereof;
>
> (ii) contains,
>
> (I) the name and address of the secured party;
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> (II) the name and address of the person indebted to the secured party;
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> (III) the social security number of the debtor, or, in the case of a debtor doing business other than as an individual, the Internal Revenue Service taxpayer identification number of such debtor;
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> (IV) a description of the farm products subject to the security interest created by the debtor, including the amount of such products where applicable, crop year, county or parish, and a reasonable description of the property; and
>
> (iii) must be amended in writing, within 3 months, similarly signed and transmitted, to reflect material changes;
>
> (iv) will lapse on either the expiration period of the statement or the transmission of a notice signed by the secured party that the statement has lapsed, whichever occurs first; and

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[58] 7 USC § 1631(e) (Supp. IV 1986). Regulations of the Secretary of Agriculture offer additional detail on the operation of the Act. See 9 CFR pt. 205 (1987).

(v) any payment obligations imposed on the buyer by the secured party as conditions for waiver or release of the security interest; and
(B) the buyer has failed to perform the payment obligations, or . . ."[59]

For the secured party to prevail under this section, there must be a timely notice that is in writing and that contains the information required by the act. To be timely, the buyer must receive the notice "within 1 year before the sale of the farm products."[60] The act defers to the general law of the state for when notice is "received."[61]

The notice must be given in writing by either the secured party or the seller. Oral notification or knowledge by the buyer of the security interest from other sources will not suffice to protect the secured party. The buyer in ordinary course takes free of the security interest, as long as no written notice is received, "even though the security interest is perfected . . . and the buyer knows of the existence of such interest."[62] Further, in defining who is a "buyer in the ordinary course of business," the act does not require the buyer to be either in good faith or without knowledge that the transaction violates the rights of a party with a security interest in the goods.[63] Taken together, these provisions seem to point to the conclusion that formal notice must be given or the buyer prevails. This, of course, provides greater protection for buyers than that provided by UCC § 9-307(1). In a curious phrase, the act also states that the "written notice of the security interest . . . [must be] . . . an original or reproduced copy thereof."[64]

The contents of the notice are set forth in the act. The notice must be "organized according to farm products." What qualifies as an appropriate organization is not stated. Presumably the purpose of this requirement is to allow buyers easy identification of notices relating to the types of farm products

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[59] 7 USC § 1631(e) (Supp. IV 1986) (footnote omitted).

[60] Id.

[61] 7 USC § 1631(f) (Supp. IV 1986). There may be different definitions of receipt of notice under state law, depending on the particular circumstances or statutory scheme, but it would be appropriate to look to the UCC in light of the general application of Article 9 of the UCC to security transactions. The general provisions of the UCC in Article 1, which apply to all of the other articles unless specifically modified, state that a person has received notice or a notification when "(a) it comes to his attention; or (b) it is duly delivered at the place of business through which the contract was made or at any other place held out by him as the place for receipt of such communication." UCC §§ 1-201(26)(a), 1-201(26)(b). See also UCC § 1-201(27) on notification received by an organization. See discussion of notice at ¶ 16.01[2].

[62] 7 USC § 1631(f) (Supp. IV 1986).

[63] 7 USC § 1631(c)(1) (Supp. IV 1986).

[64] 7 USC § 1631(e)(1)(A)(i) (Supp. IV 1986). Since every notification would seem to be an original in its own right, and there is no one official "written notice," it is difficult to discern the purpose of the phrase.

they are purchasing. In addition, the notice must contain the following information:

> (I) the name and address of the secured party;
>
> (II) the name and address of the person indebted to the secured party;
>
> (III) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Internal Revenue Service taxpayer identification number of such debtor;
>
> (IV) a description of the farm products subject to the security interest created by the debtor, including the amount of such products, where applicable, crop year, county or parish, and a reasonable description of the property, etc. . . . .[65]

The act requires a statement in the written notice of what the buyer must do to obtain a release of the security interest, although it is grammatically difficult to read the language of the subsection as saying this expressly.[66] It is hoped that a simple notice of the person to contact for directions as to payment and release of the security interest, without elaborate detail on the amount of payment, would be sufficient. Giving proper notice of the *buyer's* payment obligations to obtain a release of the security interest is important since the security interest will be effective against the buyer only if "the *buyer* has failed to perform the payment obligations. . . ."[67]

The notice to the buyer is effective for only one year, because the buyer must receive it within one year of the sale of the farm product. When "material changes" occur, which changes are not spelled out in the act, the notice must be amended in writing and sent to the buyer within three months. For example, under some credit arrangements, the amount of the debtor's obligation will fluctuate as payments are made to the secured party and fresh advances are received. Yet the notice procedures, which do not require any disclosure of the amount of the debtor's unpaid debt, could become both cumbersome and uninformative if such changes were deemed to trigger the need for notice. Since the "material changes" term refers to the "written notice" given to the buyer, it would be appropriate to limit the concept to material changes in the information required in the notice, such as, perhaps, changes in the identity or legal organization of the debtor.

A question may arise as to when the sale has occurred, whether it be the time of contracting, the time of payment, the time of delivery of the products to the buyer, or some other point in time. The act offers no clarification. However, UCC § 2-106(1) may offer an analogy, as it distinguishes a "contract for sale" from a "sale," and then defines "sale" as "the passing of title from the seller to

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[65] 7 USC § 1631(e)(1)(A)(ii) (Supp. IV 1986).

[66] 7 USC § 1631(e)(1)(A)(v) (Supp. IV 1986).

[67] 7 USC § 1631(e)(1)(B) (Supp. IV 1986).

the buyer for a price." However, under this approach, a buyer in the ordinary course could enter into a contract with the farmer-seller and make a substantial payment in advance of taking delivery of the products, but receive no protection from security interests in the products, if written notice under the act is received after the time of payment but before title to the products has passed to the buyer.

The secured party or the seller may send the notice to the buyer. The act tries to help secured parties obtain information from their debtors about the buyers, commission agents, and selling agents with whom the buyer deals.

[d] Notification Through A Central Filing System. If a state chooses to establish a central filing system that the Secretary of Agriculture certifies meets the standards of the act, there are two additional ways in which a security interest in farm products may prevail over a buyer in the ordinary course of business. The first situation arises when the *buyer* fails to register with the central filing system prior to purchasing the farm products. The second arises when the central filing system has generated a written notice of the security interest that the buyer has received. Similar procedures exist for registration of and notification to commission merchants and selling agents. The subsection of the act applicable to buyers is set forth below:

> (e) Purchases subject to security interest
>
> A buyer of farm products takes subject to a security interest created by the seller if— . . . .
>
> (2) in the case of a farm product produced in a State that has established a central filing system—
>
> (A) the buyer has failed to register with the Secretary of State of such State prior to the purchase of farm products; and
>
> (B) the secured party has filed an effective financing statement or notice that covers the farm products being sold; or
>
> (3) In the case of a farm product produced in a State that has established a central filing system, the buyer—
>
> (A) receives from the Secretary of State written notice as provided in subparagraph (c)(2)(E) or (c)(2)(F) that specifies both the seller and the farm product being sold by such seller as being subject to an effective financing statement or notice; and
>
> (B) does not secure a waiver or release of the security interest specified in such effective financing statement or notice from the secured party by performing any payment obligation or otherwise; and . . .[68]

Before turning to a discussion of the methods by which a security interest may be made effective against buyers and others as a result of the central filing system, the nature of this filing system and the financing statements that are to

[68] 7 USC §§ 1631(e)(2), 1631(e)(3) (Supp. IV 1986) (footnotes omitted).

be filed must be reviewed. Although the terminology is familiar to persons conversant with the scheme in Article 9 of the UCC, the federal system is vastly different. Following are the parts of the act that define "central filing system" and "effective financing statement."

> (2) the term "central filing system" means a system for filing effective financing statements or notice of such financing statements on a statewide basis and which has been certified by the Secretary of the United States Department of Agriculture; the Secretary shall certify such system if the system complies with the requirements of this section; specifically under such system—
>
> (A) effective financing statements or notice of such financing statements are filed with the office of the Secretary of State of a State;
>
> (B) the Secretary of State records the date and hour of the filing of such statements;
>
> (C) the Secretary of State compiles all such statements into a master list—
>
> (i) organized according to farm products;
>
> (ii) arranged within each such product—
>
> (I) in alphabetical order according to the last name of the individual debtors, or, in the case of debtors doing business other than as individuals, the first word in the name of such debtors; and
>
> (II) in numerical order according to the social security number of the individual debtors or, in the case of debtors doing business other than as individuals, the Internal Revenue Service taxpayer identification number of such debtors; and
>
> (III) geographically by county or parish; and
>
> (IV) by crop year;
>
> (iii) containing the information referred to in paragraph (4)(D);
>
> (D) the Secretary of State maintains a list of all buyers of farm products, commission merchants, and selling agents who register with the Secretary of State, on a form indicating—
>
> (i) the name and address of each buyer, commission merchant and selling agent;
>
> (ii) the interest of each buyer, commission merchant and selling agent in receiving the lists described in subparagraph (E); and
>
> (iii) the farm products in which each buyer, commission merchant, and selling agent has an interest;
>
> (E) the Secretary of State distributes regularly as prescribed by the State to each buyer, commission merchant, and selling agent on the list described in subparagraph (D) a copy in written or printed form of those portions of the master list described in paragraph (C) that cover the farm products in which such buyer, commission merchant, or selling agent has registered an interest;

(F) the Secretary of State furnishes to those who are not registered pursuant to (2)(D) of this section oral confirmation within 24 hours of any effective financing statement on request followed by written confirmation to any buyer of farm products buying from a debtor, or commission merchant or selling agent selling for a seller covered by such statement.[69]

The financing statement under the act is not the same as that in Article 9 of the UCC.

(4) The term "effective financing statement" means a statement that—

(A) is an original or reproduced copy thereof;

(B) is signed and filed with the Secretary of State by the secured party;

(C) is signed by the debtor;

(D) contains,

(i) the name and address of the secured party;

(ii) the name and address of the person indebted to the secured party;

(iii) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Internal Revenue Service taxpayer identification number of such debtor;

(iv) a description of the farm products subject to the security interest created by the debtor, including the amount of such products where applicable; and a reasonable description of the property, including county or parish in which the property is located;

(E) must be amended in writing, within 3 months, similarly signed and filed, to reflect material changes;

(F) remains effective for a period of 5 years from the date of filing, subject to extensions for additional periods of 5 years each by refiling, or filing a continuation statement within 6 months before the expiration of the initial 5-year period;

(G) lapses on either the expiration of the effective period of the statement or the filing of a notice signed by the secured party that the statement has lapsed, whichever occurs first;

(H) is accompanied by the requisite filing fee set by the Secretary of State; and

(I) substantially complies with the requirements of this subparagraph even though it contains minor errors that are not seriously misleading.[70]

The central filing system in the Secretary of State's office under the act is not the same as the filing system provided for in Article 9 of the UCC. Firstly, the financing statement the act refers to is not the same as the financing statement

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[69] 7 USC § 1631(c)(2) (Supp. IV 1986) (footnotes omitted).

[70] 7 USC § 1631(c)(4) (Supp. IV 1986) (footnote omitted).

provided for in UCC § 9-402. The federal financing statement must meet additional descriptive requirements, including the social security number of the debtor or the debtor's Internal Revenue Service taxpayer identification number, when the debtor is doing business other than as an individual. The description of the farm products must include the amount of such products "where applicable." The act requires that it be amended within three months "to reflect material changes," although it is not clear what is intended by "material changes." In short, although a financing statement may be drafted that contains enough information to satisfy requirements of both the Act and the UCC, a financing statement that meets only the minimal requirements of UCC § 9-402 does not qualify under the act.

The federally prescribed central filing system also varies from the UCC filing system in Article 9, because it imposes considerably greater information burdens on the Secretary of State. The Secretary must organize information pertaining to the filed financing statements according to the type of farm product involved, with subcategories for each product that is comprised in the financing statements, according to:

1. The name of the debtor;
2. The social security number or taxpayer identification number of the debtor;
3. The geographic location by county; and
4. The crop year.

The Secretary of State also must maintain a registry for buyers of farm products, commission merchants, and selling agents.[71] Finally, the Secretary must distribute regularly to the persons on the registry for buyers, commission merchants, and selling agents a list of the financing statements "that covers the farm products in which such buyer, commission merchant, or selling agent has registered an interest."[72] The Secretary is bound to provide confirmation, initially on an oral basis within twenty-four hours of the request, to buyers who are not registered.[73]

The central filing system set forth in the act is not mandatory; states may elect not to establish such a system. If a state does not have a central filing system, a secured creditor may obtain a security interest in farm products that will prevail over a buyer in the ordinary course of business from the financer's debtor only by complying with the prenotification procedure. When a state adopts a central filing system, the U.S. Secretary of Agriculture must certify its compliance with the act.

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[71] 7 USC § 1631(c)(2)(D) (Supp. IV 1986).

[72] 7 USC § 1631(c)(2)(E) (Supp. IV 1986).

[73] 7 USC § 1631(c)(2)(F) (Supp. IV 1986).

When a state has a central filing system, the secured party must have an effective financing statement on file for the security interest to prevail over buyers in the ordinary course of business and the other protected parties. If the secured party has filed, the security interest is effective under two alternative circumstances. The first such circumstance is if the buyer failed to register with the Secretary of State "prior to the purchase of farm products."[74] The second circumstance arises when the buyer has received a notice from the Secretary of State of the existence of the security interest. The first circumstance is one that a secured party may determine from periodic checks with the Secretary of State. However, this is not a first-to-file rule. The buyer may register at any time prior to purchase. Once the buyer has registered, the security interest will be effective against the buyer only if he or she has received notification.

The second circumstance (namely, notification from the Secretary of State) is the critical issue in cases in which the buyer has registered. For what obligations does the Secretary have to give notice and what happens if the Secretary fails to give notice? The act states that the central filing system must be one where the Secretary "distributes regularly as prescribed by the State" a notice to the registered buyers of financing statements on file covering the farm products in which the buyers have indicated an interest. The act leaves it to state law to define "regular" distribution and for how long a notice, once given to a buyer, remains effective.[75] Because the act imposes a burden of *receipt* of notice by the buyer from the Secretary of State, a secured party cannot rely on the sending of notice at regular intervals to give complete protection. A buyer who registers with the central filing system between the intervals of the distribution of notices will not be subject to the security interest if the Secretary of State fails to give the buyer notice at the time of registration and if the purchase of the farm products occurs before the next regular distribution of notice. Thus, as a practical matter, the burden of notification may fall to the secured party even under the central filing system procedures.

[e] Debtor's Duty to Identify Buyers, Commission Merchants, and Sales Agents. The act contains a penalty provision to assist secured parties in obtaining information from their debtors about persons who have purchased farm products subject to their security interests. The penalty provisions become applicable when the secured party includes a requirement in the security agreement that the debtor furnish "a list of the buyers, commission merchants, and selling agents to or through whom the person engaged in farming operations may

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[74] See the earlier discussion of when a "sale" occurs. There is no reason to believe that the term "purchase" was used in Section 1631(e)(2)(A) with an intent to mean a different time than that in Section 1631(e)(1)(A) where the term "sale" is used.

[75] 7 USC § 1631(c)(2)(E) (Supp. IV 1986).

sell such farm product." When the security agreement contains this requirement, the debtor must give the secured party written notice of sales to buyers who have not been listed at least one week before the sale or who must account to the secured party for the proceeds received from the sale of the farm products within ten days of the sale.[76] The act does not say what the debtor must do to "account" for the proceeds of the sale. However, the House report explains the provision as follows:

> Under this provision, an off-list sale of farm products is not wrongful if the producer/seller promptly accounts to the lender for the proceeds of the sale. The term "accounted" is used in a broad sense to permit the seller to settle up with the secured lender through a cash payment, check, electronic transfer of funds, automatic account debit, or any other comparable payment or settlement technique that satisfies or replaces the security interest in the farm products that were sold. For example, after sale of farm products to an off-list buyer, the seller might endorse the buyer's check and transmit it to the secured party; or the seller might deposit the buyer's check in his account and then initiate an electronic transfer or debit of those funds to the secured party; or the seller might, with the secured party's assent, make arrangements for deferred payments, or even substitute other collateral for that sold, such as other farm products, farm equipment, instruments or documents.[77]

It appears that the security agreement may specify for which obligations the debtor has to account for proceeds of sales of farm products. In the absence of any requirement in the security agreement to make an accounting within ten days, the act might be read to impose a requirement on the debtor to account, which requirement had not been agreed to in the security agreement. It would be curious, however, for federal law to impose an obligation to account on the debtor that is more stringent than what the secured party had provided for in the security agreement itself. If the debtor fails to follow the procedures for giving notification of off-list sales or fails to account for the proceeds, the debtor is subject to a penalty. That penalty is a fine of $5,000 or 15 percent of the value received for the farm product, whichever is greater.[78] How practical a remedy this will be against debtors whose financial straits have impelled them to sell the collateral furtively is an open question.

[f] Scope of the Act and Federal Preemption. The act is limited to transactions in which farm products that are subject to a security interest created by their

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[76] 7 USC § 1631(h)(2) (Supp. IV 1986).

[77] H.R. Rep. No. 271, 99th Cong., 1st Sess. 110, reprinted in 1985 U.S. Code Cong. & Admin. News 1214 (hereinafter H.R. Rep. No. 271).

[78] 7 USC § 1631(h)(3) (Supp. IV 1986).

seller are sold to buyers in the ordinary course of business. The key terms that limit the scope of the act are farm products, security interests, and buyer in the ordinary course of business.

The term "farm product" is defined in the act with language that varies from that of the UCC; however, the differences do not appear to produce substantially different results. The act defines farm product as "an agricultural commodity . . . or a species of livestock . . . or poultry used or produced in farming operations, or a product of such crop or livestock in its unmanufactured state . . . that is in the possession of a person engaged in farming operations."[79] The UCC definition in Section 9-109(3) includes in the term "farm products" goods that are "supplies used or produced in farming operations," but there is no comparable language referring to "supplies" in the act. The definitions under both the act and the UCC do not extend to goods such as machinery or other equipment, although such goods may be used in farming operations.

In defining "buyer in the ordinary course of business," the act and the UCC are similar. The act defines such a buyer as "a person who, in the ordinary course of business, buys farm products from a person engaged in farming operations who is in the business of selling farm products."[80] The UCC definition in Section 1-201(9) requires that such a buyer act "in good faith" and also be without knowledge that the sale of the goods, although subject to a security interest, violates the rights of the person holding the security interest in the goods.[81] The omission in the act of the good faith requirement appears to be deliberate. The House conference report on the act noted that the original House bill defined "buyer in the ordinary course of business" differently than the Senate bill. The House definition required that a buyer who "buys the products in good faith without knowledge of [sic] the sale is in violation of the ownership rights of [sic] security interest of a third party." The Senate bill did not include this language, and the act follows the Senate version.[82] Unlike the UCC definition, the act is silent on whether a buyer in the ordinary course of business may include a purchaser on credit.

The term "security interest" in the act is comparable to the basic definition in the UCC. The UCC definition describes a security interest as "an interest in personal property or fixtures which secures payment or performance of an obligation."[83] The definition then provides details on circumstances involving leases, consignments, and title reservation transactions generally, to assist in determining when a security interest is created. The act simply states that a

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[79] 7 USC § 1631(c)(5) (Supp. IV 1986).

[80] 7 USC § 1631(c)(1) (Supp. IV 1986).

[81] See supra ¶ 23.02[1]; UCC § 9-307, comment 2.

[82] H.R. Conf. Rep. No. 447, 99th Cong., 1st Sess. 486, reprinted in 1985 U.S. Code Cong. & Admin. News 2412.

[83] UCC § 1-201(37).

security interest means "an interest in farm products that secures payment or performance of an obligation."[84] It does not provide the elaboration of the UCC on title reservation arrangements. Further, the broad reach of the language defining a security interest in the general definitions of UCC § 1-201(37) is limited by the scope provisions of Article 9, excluding certain transactions from coverage.[85] There is no express reference in the act that indicates an intention to confine the definition of security interest to consensual interests created under laws other than the UCC. For example, a mortgage lien that created an interest in farm products is not specifically addressed by the language of the act, but the definition is literally broad enough to apply to those interests, and the policies underlying the act support such inclusion, regardless of whether one views the interest in the farm products created by the mortgage as an interest arising under real estate law or UCC Article 9.[86]

The act affects the rights of four groups of persons:

1. Secured parties;
2. Buyers in the ordinary course of business;
3. Commission merchants; and
4. Selling agents.

It reduces the rights of secured parties from those that are granted to secured parties under Article 9 of the UCC and it expands the rights of buyers in the ordinary course of business, commission merchants, and selling agents from those that they otherwise would have under the UCC.

Failure to follow the requirements set forth in the act does not affect the enforceability of a security interest against parties other than those protected under the act. In other words, as long as the secured party is concerned only about claims from persons *other than* buyers in the ordinary course of business, commission merchants, and selling agents, compliance with the act is not necessary. The provisions of Article 9 of the UCC still determine when a security interest prevails over the claim of a lien creditor and purchasers who are not buyers in the ordinary course of business. Article 9 also controls if the issue is a dispute over priorities between two secured parties who have financed the debtor and who both claim a security interest in farm products of the debtor. Thus, one strategy for secured parties might be to forgo an attempt to obtain protection against buyers under the cumbersome procedures of the act and instead to rely on Article 9 perfection for protection against other creditors and to engage in a more thorough "policing" to guard against unauthorized sales.

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[84] 7 USC § 1631(c)(7) (Supp. IV 1986).

[85] UCC § 9-104.

[86] See ¶ 22.01[1] for a discussion of the scope of Article 9.

The preemptive effect of the act is explicit.[87] It gives protection to the buyer in ordinary course of business "notwithstanding any other provision of Federal, State, or local law."[88] The House report elaborates on the relationship of the Act to state law in this fashion:

> The bill is intended to preempt state law (specifically the so-called "farm products exception" of Uniform Commercial Code section 9-307) to the extent necessary to achieve the goals of this legislation. Thus, this Act would preempt state laws that set as conditions for buyer protection of the type provided by the bill requirements that the buyer check public records, obtain no-lien certificates from the farm products sellers, or otherwise seek out the lender and account to that lender for the sale proceeds. By contrast, the bill would not preempt basic state-law rules on the creation, perfection, or priority of security interests.[89]

From the standpoint of the buyer in the ordinary course of business (as well as that of the commission merchant and the selling agent), the act offers protection against the claims of persons who have financed their sellers and have taken a security interest in the farm products to secure their financing. As indicated previously, the scope of who is a secured party with a security interest is not wholly clear; the term "security interest" is defined broadly, without the limitations and exclusions imposed by Article 9. Nonetheless, there will be interests in the goods that the act does not cover. For example, interests based upon involuntary attachment by creditors would not be security interests from which a buyer in the ordinary course of business could take free. Also, the buyer in ordinary course of business only takes free from security interests "created by his seller."[90] For a security interest that was created by a debtor who then transferred the farm products to the seller in such a form that the security interest continues, the security interest would not be one that had been created by the buyer's seller and would be effective even under the act against a buyer in the ordinary course of business.

The act will probably have little effect on the line of cases that have found protection for buyers of farm products on the theory that the secured party's acquiescence in sales by the debtor amounted to consent to sell the farm products free from the security interest, and the secured party who complies with the act will probably remain subject to an argument from the buyer that there is no security interest to continue in the goods, because of the secured party's consent. The "consent to sale" doctrine is based on UCC § 9-306(2). Although Congress clearly expressed its intent to override the exception in UCC § 9-307(1) for farm

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[87] 7 USC § 1631(d) (Supp. IV 1986).

[88] See also 7 USC § 1631(g) (Supp. IV 1986).

[89] H.R. Rep. No. 271, supra note 77.

[90] 7 USC §§ 1631(d), 1631(e). UCC § 9-307(1) has a comparable provision that is discussed supra ¶ 23.02[1].

products, there is no mention of UCC § 9-306(2). Furthermore, congressional purpose is to protect *buyers*, not secured parties, and there is no expression of any intent to remove any other protections the law may afford buyers. Finally, as the act became effective on December 24, 1986, it applies to existing security interests in farm products that are sold after that date.

[3] Purchasers of Instruments, Chattel Paper, and Documents

As previously discussed in Chapter 22, instruments, chattel paper, and documents have elements of negotiability that make them freely transferable. Because of the transferable nature of this paper, purchasers to whom it is duly transferred may acquire rights that are superior to those of any party who claims a security interest that is perfected in these types of collateral by filing. A holder in due course of a negotiable instrument takes free of the claims of any other persons, including secured parties, to the instrument.[91] A holder of a negotiable document of title who has received it by due negotiation, which is a form of transfer comparable to that which creates rights of a holder in due course on instruments, takes title to the document free of the claims of secured parties.[92] The filing of a financing statement under the UCC does not constitute notice of the security interest to holders of instruments or to purchasers of negotiable documents of title.[93]

When the collateral consists of chattel paper or instruments, purchasers of this paper who give new value and who take possession in the ordinary course of business have priority over persons with any security interest, in the paper or instrument, created by filing. The purchaser, however, must act without knowledge that the paper or instrument is subject to a security interest.[94] When the claimed security interest in the chattel paper or instruments exists only because the paper or instrument constitutes the proceeds of inventory that were subject to a perfected security interest, the purchaser's rights are superior, even in cases where the purchaser knows that the paper or instrument was subject to the security interest.[95] The result of these rules is that a secured party who holds a perfected security interest in inventory, and who wants additional security from chattel paper generated when the inventory is sold, cannot be assured of priority either by filing to perfect a security interest in the chattel paper or by relying on having a proceeds interest perfected by filing. The only safe course of action is to

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[91] UCC §§ 3-302, 9-309.

[92] UCC §§ 7-501, 9-309. Due negotiation is explained at ¶ 14.05[1].

[93] Id.

[94] UCC § 9-308(a).

[95] UCC § 9-308(b). Knowledge of the existence of the security interest will be fatal, however, where it is not "merely" a proceeds interest as would be the case when the secured party's advances are based upon the value of both the inventory and the chattel paper.

take possession of the chattel paper, so that it may not come into the hands of a good faith purchaser.

When inventory is sold to a buyer in the ordinary course of business, the buyer takes free of the security interest held by the inventory financer. If the sale to the buyer is financed, the buyer has rights in the collateral that are superior to the former inventory secured party. The buyer may use these rights to transfer a security interest to a creditor willing to finance the buyer's purchase. A purchaser of chattel paper evidencing the buyer's obligation to pay the seller is treated by the UCC as a transaction that finances the buyer's purchase of the goods. Whether the buyer obtains the credit for the purchase by a direct loan from the creditor or through an indirect arrangement in which the creditor buys the chattel paper from the seller, the UCC permits the creditor who finances the buyer to prevail over the inventory financer who had a perfected security interest in the goods when they were inventory in the hands of the dealer.[96] The inventory financer has a proceeds interest in any chattel paper received by a dealer on the sale of the goods, but the purchaser of the chattel paper may acquire an interest that is superior to the proceeds interest of the inventory financer by following the rules discussed previously in this section.

Under the UCC, a purchaser includes someone who obtains a security interest in the collateral.[97] Thus, a second secured party may obtain priority over an earlier secured party when the second party takes possession of the paper or instrument and otherwise qualifies under these rules.[98] These rules make filing a hazardous method for perfecting security interests in chattel paper, negotiable documents, or instruments.

¶ 23.03 SPECIAL PRIORITY RULES

[1] Proceeds

"Proceeds" includes whatever is received when the collateral is sold, exchanged, or disposed of otherwise.[99] Proceeds may be cash proceeds (money,

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[96] See Aetna Fin. Corp. v. Massey-Ferguson, Inc., 626 F. Supp. 482, 485 (SD Ind. 1985). The priority afforded buyers in the ordinary course of business is discussed supra ¶ 23.02[1].

[97] UCC §§ 1-201(9), 1-201(33).

[98] UCC § 9-308.

[99] UCC § 9-306(1). Cash generated through the operation of video equipment is not "proceeds" of that equipment; therefore, a security interest in the video equipment will not extend to such cash. In re S & J Holding Corp., 42 Bankr. 249 (Bankr. SD Fla. 1984).

A federal agricultural program's payment-in-kind payments to a farmer for not producing a particular crop do not constitute proceeds that a secured party holding a security interest in crops may claim. In re Binning, 45 Bankr. 9, 12 (Bankr. SD Ohio 1984); Koch v. United States (In re Mattick), 45 Bankr. 615, 617 (Bankr. D. Minn. 1985).

checks, bank accounts, and the like) or noncash proceeds.[100] For example, if a debtor sells his or her car (in which the debtor's bank has a security interest) for a buyer's check in the amount of $800, a buyer's promissory note for $3,000, and a used motorcycle, the check, note, and motorcycle all constitute proceeds.

The general rule under the UCC is that a security interest will continue in any identifiable proceeds of collateral.[101] Thus, if the security interest in the

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On the other hand, in Osteroos v. Norwest Bank, Minot, 604 F. Supp. 848, 849 (DND 1984), the court held that a security agreement covering crops and the proceeds and products of crops was broad enough to create a security interest in payments made to the debtor under the Federal Agricultural Payment in Kind (PIK) Program. Two decisions by the Seventh Circuit considered when a secured party's security interests extend to rights of the debtor under a government payment-in-kind contract. In the first case, J. Catton Farms, Inc. v. First Nat'l Bank, 779 F2d 1242, 1244, 1247 (7th Cir. 1985), the court held that the secured party's interest did extent to the rights due the debtor under a payment-in-kind contract with the Department of Agriculture. (In this case, these were rights that arose out of a contract not to grow corn.) The security agreement covered the debtor's crops, receivables, and proceeds of receivables. The second case, In re Schmaling, 783 F2d 680, 683–684 (7th Cir. 1986), came to a different conclusion and held that there was no security interest in the payment-in-kind contract. This opinion said that the rights being claimed under the government contract were general intangibles. These general intangibles were not proceeds of crops because no crop had been grown to exchange for the payment-in-kind proceeds. Thus, a security agreement covering only "crops" and "proceeds of crops" was not sufficient to give a security interest in payments made under the payment-in-kind contract. The opinion distinguished *Catton* as a case where the security agreement had been drafted broadly enough to cover the payment-in-kind contract.

A security agreement covering livestock and farm products will give the secured party a security interest that continues to apply to the milk produced by the debtor's cows and to the payments owed to the debtor for the sale of the milk. In re Potter, 46 Bankr. 536, 538 (Bankr. ED Tenn. 1985); In re Johnson, 47 Bankr. 204, 206 (Bankr. WD Wis. 1985).

For an example of a case presenting a complex tracing issue involved in the determination of whether property qualified as proceeds in which a security interest continued, see In re Hugo, 50 Bankr. 963, 969–968 (Bankr. ED Mich. 1985). In this case, the questions were whether the original security interest in one crop continued into funds the debtor received for that crop, whether it then continued into the subsequent year's crop planted by the debtor, and finally whether it continued into checks received from the sale of that second crop.

The priority of a chattel paper financer over an inventory financer in returned goods continues into the new chattel paper created when the goods are sold the second time. Northwest Acceptance Corp. v. Lynnwood Equip., Inc. 1 UCC Rep. Serv. 2d (Callaghan) 1710, 1711–1712 (WD Wash. 1986).

[100] UCC § 9-306(1).

[101] UCC § 9-306(2). In Mattson v. Commercial Credit Business Loans, Inc., 301 Or. 407, 410–414, 723 P2d 996, 999–1003 (1986), the plaintiff owned lumber that the debtor cut and sold. The defendant finance company held a security interest in the debtor's inventory and accounts. The court held that because the debtor did not have title to the lumber, the defendant acquired no interest in the converted lumber or in the accounts created on the sale of the converted lumber. The security interest could not attach, because the debtor had no rights in the collateral claimed by defendant. The plaintiff could make a tracing claim to proceeds in the hands of the defendant but the defendant

collateral was perfected originally, the security interest in the proceeds will also be a perfected security interest for ten days following receipt by the debtor of the proceeds, and will continue beyond the ten days as a perfected security interest, when any one of the following occurs:

1. The financing statement on the original collateral is filed in the office where a security interest would be perfected by filing on the proceeds;
2. The financing statement covers the original collateral and the proceeds are identifiable cash proceeds; or
3. A security interest in the proceeds is perfected before the ten days expire.[102]

Special rules are provided when the debtor becomes insolvent. These rules allow the secured party to trace his or her security interest into the bank accounts of the debtor.[103]

As with security interests in other types of collateral, the mere fact that a secured party has a perfected security interest in proceeds does not automatically give the secured party priority. The other priority rules discussed in this chapter dealing with different types of collateral apply to proceeds as well. The general rule is that the date of filing or of perfection as to the original collateral is the date of filing or of perfection as to proceeds, for purposes of applying the "first to file or perfect" rule.[104] As discussed earlier in this chapter, purchase money priorities sometimes carry over into proceeds.

It is important to note that under the UCC, a security agreement gives the secured party an interest in proceeds regardless of whether the agreement expressly states it.[105] Also, since the 1972 amendments, there is no requirement that the financing statement filed on the original collateral mention proceeds.[106]

[2] Fixtures

Goods are fixtures when they become so related to the real estate that a person who has an interest in the real estate also obtains an interest in the goods.

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could raise a defense of bona fide purchase. Also, the plaintiff might be able to recover proceeds from the defendant on a theory of unjust enrichment.

[102] UCC § 9-306(3). These rules represent a substantial revision of the UCC prior to the 1972 amendments. Under the earlier version of the UCC, it was thought that security interests could exist in collateral where there was no adequate notice to third parties.

[103] UCC § 9-306(4). See ¶ 22.07[7] on security interests in bank accounts.

[104] UCC § 9-312(6).

[105] UCC § 9-203.

[106] UCC § 9-402. Prior to the 1972 amendments, the financing statement had to indicate that proceeds were claimed.

This may happen when the goods, such as an elevator or a central heating unit, become permanently attached to the land, depending upon local law.[107]

The UCC contains an elaborate set of rules designed to govern priorities between persons who claim security interests in goods and persons who claim interests in goods as a result of their interest in the real estate. These rules were extensively revised by the 1972 amendments to the UCC. In some instances, the revisions were clarifications of what was originally intended. In other instances, the 1972 provisions establish major new rules for priority. As a general rule, the priority goes to the party who is first in time. A security interest that is perfected by a fixture filing[108] has priority over the interest of any owner of the real estate or creditor with an interest in the real estate when (1) the security interest is perfected before the real estate claimants acquire an interest of record in the real estate and (2) the secured party has priority over the real estate claimants' predecessors in title as well.[109]

A secured party can obtain a purchase money security interest that has priority over any interest of a competing real estate claimant.[110] To obtain this priority, the security interest must be perfected by a fixture filing before the goods become fixtures.[111] (In certain cases, the secured party will have a ten-day grace period after the goods become fixtures within which to make a fixture filing.)

In addition to these general rules and comparable to the ordinary priority rules of the UCC, there are several special rules that apply to fixtures. When the collateral consists of "readily removable factory or office machines" or "readily removable replacements of domestic appliances which are consumer goods," the secured party will obtain priority if the security interest is perfected before the goods become fixtures.[112] In such a situation, the security interest may be perfected by any method allowed by the UCC, including an ordinary filing.[113] When the conflicting claimant is a creditor who holds a lien on the real estate as a result of a judgment or other legal proceeding, the secured party also has priority if the security interest was perfected by any method allowed by the UCC.[114] This latter rule was intended to give the secured party protection not only against lien creditors but also against trustees in bankruptcy who have the rights of lien creditors.

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[107] UCC § 9-313(1).

[108] See ¶ 22.06[5] for a discussion of security interests in fixtures.

[109] UCC § 9-313(4)(b).

[110] UCC § 9-313(4)(a).

[111] Id.

[112] UCC § 9-313(4)(c).

[113] Id.

[114] UCC § 9-313(4)(d).

Special rules protect construction mortgages. Security interests in fixtures are subordinate to the holder of a recorded construction mortgage when the goods become fixtures before the completion of construction.[115]

It is possible for the party with an interest in the real estate to consent in writing to the security interest in the fixture or otherwise to disclaim an interest in the goods as fixtures.[116]

When the secured party establishes priority, he or she has the right, on default, to sever the collateral from the real estate.[117] This requires, however, that the secured party reimburse any holder of an interest in the real estate who is not the debtor for the cost of repairing physical damage to the property.[118] The secured party is not obligated to make any payment for diminution in value of the real estate caused by the absence of the goods removed.[119] The secured party can be compelled to give security before being allowed to sever the collateral.[120]

Lastly, goods that are "ordinary building materials incorporated into an improvement on land" are not fixtures.[121] Such materials become part of the real estate, and the only way that one can obtain an interest in them is by following appropriate procedures under real estate security law.[122]

[3] Rights of Unpaid Sellers of Goods

Ordinarily, someone who sells goods on credit without securing an interest is simply a general creditor of the buyer. The seller retains no title to or interest in the goods. Any attempt by the seller to reserve title is treated as an effort to create a security interest and so must be in compliance with the provisions of Article 9 to be effective.[123]

When a seller contracts for a cash sale but the buyer fails to pay on delivery of the goods, the seller has a right to reclaim the goods from the buyer under Article 2 of the UCC, which generally covers sales of goods.[124] When the buyer

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[115] UCC § 9-313(6).

[116] UCC § 9-313(5).

[117] UCC § 9-313(8).

[118] Id.

[119] Id.

[120] Id.

[121] UCC § 9-313(2).

[122] See generally M. Schroeder, "Security Interests in Fixtures," 1975 Ariz. St. LJ 319.

[123] See UCC §§ 1-201(37), 9-102.

[124] See UCC §§ 2-507, 2-511. A good faith purchaser from the original buyer will cut off the rights of the cash seller, however. UCC § 2-403. When the purchaser has resold the goods to a person who qualifies as a good faith purchaser, the right of reclamation is lost. Although the good faith purchaser may have paid the original buyer who is still holding these proceeds, one court has held that the right of the seller to reclaim the goods does not extend to a right to reclaim the proceeds. Collingwood Grain, Inc. v. Coast Trading Co. (In re Coast Trading Co.), 744 F2d 686, 690–691 (9th Cir. 1984).

pays by a check that subsequently is dishonored, this rule also applies.[125] In some cases, the goods may be sold to a buyer who has given a security interest in them to some secured party. In such cases, the unpaid seller's right of reclamation conflicts with the security interest. The question of who has the best claim to the goods has attracted considerable attention. The case law has favored the claim of the financing bank over that of the unpaid sellers.[126]

Persons who sell goods to buyers who become insolvent immediately after receipt of the goods have a limited right to reclaim the goods under the UCC.[127] It is possible for similar conflicts to arise between a seller of the goods who is entitled to reclamation because of the buyer's insolvency and a secured party who claims a security interest in the goods. Under the reasoning of the Fifth Circuit, the secured party would prevail.[128]

The Bankruptcy Act of 1978 clarifies the rights of unpaid sellers to reclaim goods when the goods are delivered to a buyer who becomes insolvent. Section 546(c) of the Bankruptcy Code makes the trustee's rights to the goods subject to any "statutory right or common-law right" of the seller, such as the right contained in the UCC discussed previously, if the seller makes a demand in writing for the goods within ten days after the debtor receives them.

The UCC gives the seller a related right over goods that are in the possession of a carrier or other bailee for delivery to the buyer when the seller discovers that the buyer has become insolvent. The seller can stop delivery of such goods in transit.[129] In a case involving the delivery of 6,550 tons of raw sugar, the trustee in bankruptcy claimed that the seller could not stop delivery, because the provisions of the Bankruptcy Act gave the trustee power over the goods that was superior to the rights of the unsecured seller. The trustee argued that the seller's right to stop delivery in transit constituted a statutory lien that the trustee could avoid under Section 545 of the Bankruptcy Code, and that in any event, the trustee had obtained a perfected lien in the goods on the date of the filing of the petition in bankruptcy under Bankruptcy Code § 544(a)(1), and that perfected lien was superior to the interest of the seller. The federal district court rejected the trustee's arguments and upheld the right of the seller to stop delivery while the sugar was in transit. The court reasoned that Section 546(c) of the Bank-

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[125] UCC § 2-511(3).

[126] The leading case is In re Samuels & Co., 526 F2d 1238 (5th Cir. 1976), cert. denied, 429 US 834 (1976). Accord First Nat'l Bank v. Smoker, 153 Ind. App. 71, 286 NE2d 203 (1972). See generally B. Clark, The Law of Secured Transactions Under the Uniform Commercial Code ¶¶ 8.4[5], 10.6[5] (1980 & Cum. Supp.) (hereinafter B. Clark).

[127] UCC § 2-702(2).

[128] In re Samuel & Co., 526 F2d 1238 (5th Cir. 1976), cert. denied, 429 US 834 (1976). It should be noted that the Packers and Stockyard Act has been amended to reverse the result in the *Samuels* case. 7 USC § 196 (1982). But see In re American Food Purveyors, Inc., 17 UCC Rep. Serv. (Callaghan) 436, 441–443 (ND Ga. 1974). See generally J. White & R. Summers, Uniform Commercial Code § 24-9 (2d ed. 1980); Romans, "Seller's Right of Reclamation Under the Bankruptcy Code," 41 La. L. Rev. 1159 (1981).

[129] UCC § 2-705.

ruptcy Code gave the seller a limited right to reclaim, even after the goods came into the possession of the debtor, so the drafters of the Bankruptcy Code must have contemplated that the seller would retain the less drastic remedy of preventing delivery of the goods to the insolvent buyer in the first place. The court also held that the automatic stay provisions did not apply to the seller's action in exercising the right to stop in transit.[130]

[4] Conflicts With Liens Arising Under Other Laws

On occasion, collateral subject to a security interest may become subject to a lien arising under common law or other law apart from the UCC. Examples include liens given to persons such as garagemen, and other people who provide materials or perform services with respect to the collateral. The UCC makes these liens superior to the security interest in the collateral, so long as the lien claimant furnishes the services or the materials in the ordinary course of business.[131] The security interest prevails only when there is an express statutory direction to the contrary.[132]

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[130] In re National Sugar Ref. Co., 27 Bankr. 565, 567, 572–573 (Bankr. SDNY 1983).

Section 546(c) of the Bankruptcy Act permits the seller to reclaim goods from a buyer who received the goods while insolvent if the seller has such a right to reclaim under state law. The UCC provision that allows a seller to reclaim also requires the buyer to have received the goods while insolvent. The standard for insolvency under the Bankruptcy Act is more restrictive than the definition of insolvency in the UCC, which includes someone who has ceased to pay his or her debts in the ordinary course of business or who cannot pay debts as they become due. The federal bankruptcy definition of insolvency in Section 101(29) of the Bankruptcy Act requires that the debtor be insolvent in a balance-sheet test of showing more debts than assets. Two bankruptcy courts have held that the provision in the Bankruptcy Act should be interpreted as requiring the buyer to be "insolvent" as that term is defined in the Federal Act. In re Storage Technology Corp., 48 Bankr. 862, 863–864 (D. Colo. 1985); In re Furniture Distrib., Inc., 45 Bankr. 38, 42 (Bankr. D. Mass. 1984).

A seller who has made a timely demand under UCC § 2-702 and Bankruptcy Code § 546(c) for the return of unpaid goods delivered to a bankrupt does not lack a remedy when the bankrupt fails to return the goods under Oliver Rubber Co. v. Griffin Retreading Co., 56 Bankr. 239, 240–241 (D. Minn. 1985), aff'd, 795 F2d 676 (8th Cir. 1986). In that case, where the seller had made a timely demand but the bankrupt disposed of the goods before the seller could sue to enforce the claim to the goods, the court held that the seller was entitled to the priority of an administrative expense claim.

[131] UCC § 9-310. In United Parcel Serv. v. Weben Indus. Inc., 794 F2d 1005, 1009 (5th Cir. 1986), the interest of a subcontractor under a state law "trust" doctrine gave the subcontractor an interest in retained payments under a construction contract that was superior to the perfected security interest of a bank in the payments owed under the construction contract to its debtor, the contractor. This result was obtained although the state version of UCC § 9-310 provided that a perfected security interest was superior to a materialman's lien.

[132] UCC § 9-310. See generally Note, "Priority Between Security Interests and Liens Arising by Operation of Law in Oregon," 12 Willamette LJ 173 (1975). A state statute that

Another situation in which UCC security interests may conflict with other liens is that of the landlord's lien. The UCC does not apply to landlord's liens and there is no rule in the UCC to govern priority between these conflicting claimants. Another area of conflict that has proven troublesome is that involving rights of equitable subrogation, such as those rights claimed by sureties on construction performance bonds. These conflicts are not governed by the UCC either, and the local law of each state will control.[133]

[5] Commingled or Processed Goods

Security interests in goods that subsequently become manufactured into another product, or that become commingled with other goods to become part of another product, are not lost by the transformation of the goods—they continue into the product produced.[134] The security interest must originally have been perfected. Then, when the new product produced as a result of the manufacturing or the assembly is one in which the original goods have lost their identity, the security interest attaches to the completed manufactured or processed product.

The security interest will also continue into the product when the financing statement on the original goods covers the product into which they have been manufactured, processed, or assembled. In this case, it makes no difference that the original goods may remain identifiable; the security interest attaches to the final product and the security interest in the original goods used in the processing, manufacturing, or assembly is lost.[135] When there is more than one security interest that attaches to the product, all of the security interests rank equally in priority; their interest in the collateral is prorated according to the proportion of the claim to the total cost of the product. Under this rule, the time when the security interest in each separate component becomes perfected or filed is irrelevant—all security interests share on a pro rata basis.[136]

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created a lien in favor of persons who built or repaired ships created an interest in the property superior to a perfected security interest under the UCC. First Md. Leasecorp v. M/V Golden Egret, 764 F2d 749, 753–757 (11th Cir. 1985).

[133] See generally B. Clark, supra note 126, at ¶¶ 1.7, 1.8 (discussing surety's right of subrogation, landlord liens, and other excluded transactions).

[134] UCC § 9-315(1)(a). See generally Nickles, "Accessions and Accessories Under Pre-Code Law and U.C.C. Article 9," 35 Ark. L. Rev. 111 (1981).

When three secured parties, each having a perfected security interest in different cattle and the offspring of that cattle, have their collateral commingled and sold, the issue to be decided is one of allocation under UCC § 9-315 dealing with commingled goods, rather than under UCC § 9-312, dealing with priorities among conflicting security interest in the same collateral. Farmer's Bank v. First-Citizen's Nat'l Bank, 39 UCC Rep. Serv. (Callaghan) 355, 358–359 (Tenn. Ct. App. 1983).

[135] UCC § 9-315(1)(b).

[136] UCC § 9-315(2).

[6] Subordination Agreements

The UCC rules on priority may be varied by agreement between the parties.[137] Any secured party who is concerned about the priority of his or her security interest may enter into an agreement with the other persons who claim an interest in the collateral to clarify their respective rights. Although the UCC filing provisions permit filings to show the release of collateral on the assignment of a security interest, there is no procedure for filing a subordination agreement. This could be troublesome when lack of notice through filing leads other parties to draw faulty conclusions as to the state of priorities. Any party who becomes the assignee of a security interest would be well advised to check for possible subordination agreements and to obtain appropriate assurances.

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[137] UCC § 9-316. In Western Auto Supply Co. v. Bank of Imboden, 17 Ark. App. 4, 8, 701 SW2d 394, 395 (1986), the court enforced an oral subordination agreement holding that the statute of frauds did not require that the agreement be in writing.

24

Debtor Default and Enforcement of Security Agreements

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¶ 24.01 GENERAL RULES ON WHEN AN OBLIGATION IS DUE

[1] Obligations Based on Promissory Notes

The rules on when a promissory instrument is due, and what procedures must be followed to establish a cause of action based on the instrument against parties who are liable to pay it, have been discussed in Part 2 of this book. That section also covers the related issues of when a cause of action on the instrument arises and when the statute of limitations begins to run.[1]

The time at which an obligation is due under a negotiable note will depend on whether the note is payable on demand or payable at a stated time. When the note is payable at a particular time, the existence of an acceleration clause in the note may make the obligation due in advance of the stated time for payment. The text that immediately follows discusses the use of demand notes and of notes that are not payable on demand but that contain acceleration clauses.

[a] Notes Payable on Demand. When a promissory note is payable on demand, the holder may require the maker to pay it at any time. Although the holder has the power to compel payment; the obligor on the note may contend that the holder has a duty not to exercise this power in bad faith. The Uniform Commercial Code § 1-203 imposes a general obligation of good faith, but this provision has not been applied to demand for payment of instruments that are payable on demand.[2] This approach is supported by a comment to UCC § 1-208, which imposes a good faith requirement when the holder of an obligation exercises a power to accelerate the due date of the obligation under a provision giving the right to accelerate "at will" or in the event of "insecurity." The comment to the section states:

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[1] See ¶¶ 14.04[2][f], 14.04[2][g], 21.02[1].

[2] Centerre Bank v. Distributors, Inc., 705 SW2d 42 (Mo. Ct. App. 1985). See also Delta Diversified, Inc. v. Citizens & S. Nat'l Bank, 171 Ga. App. 625; 320 SE2d 767 (1984); Fulton Nat'l Bank v. Willis Denney Ford, Inc., 154 Ga. App. 846, 269 SE2d 916 (1980); Allied Sheet Metal Fabricators, Inc. v. People's Nat'l Bank, 10 Wash. App. 530, 518 P2d 734 (1974), cert. denied, 419 US 967 (1974).

> Obviously this section has no application to demand instruments or obligations whose very nature permits call at any time with or without reason. This section only applies to an agreement or to paper which in the first instance is payable at a future date.[3]

Further, any evaluation of a creditor's rights to demand payment immediately, without advance notice, must consider the possibility of collateral agreements between the creditor and the debtor. UCC § 3-119 permits agreements between the immediate parties to a transaction to limit or condition the terms of a negotiable note. In one case, *K.M.C. Co. v. Irving Trust Co.*, which did not indicate if the debtor had signed a promissory note and so did not discuss what the creditor's rights would have been under a demand note, the court held that a financer had an obligation of good faith when the financer agreed to provide the debtor with a specific line of credit to carry on the debtor's business. Although the financing agreement stated that the amount loaned was repayable on demand, when the financer refused to make further advances within the credit line without any period of notice that would have allowed the debtor time to seek alternative financing, the financer breached its implied obligation of good faith and became liable for damages of $7.5 million, based on the loss of the value of the business. In this case, the termination of financing put the debtor out of business because all of the debtor's receivables were locked up by the lender in a controlled account. Although this case is distinguishable from the "payable on demand" issue, as it involves a refusal to extend additional credit that had been committed to under an ongoing line-of-credit arrangement, it is nevertheless relevant because demand notes often are used in contexts in which an ongoing financing relationship is intended.[4]

A court in Florida declined to follow the *K.M.C. Co.* decision in *Flagship National Bank v. Gray Distribution Systems, Inc.*[5] The bank had workout arrangements with its debtor whereby the bank agreed to loan up to $400,000 under a loan agreement that the bank could make payable on demand. Pursuant to the agreement, the bank took control of the debtor's inventory and accounts and imposed certain practices on the debtor, including the liquidation of some of debtor's assets, in order to reduce the debt. After the credit amount grew to $600,000, the bank gave notice of default, demanded payment in full, and liquidated the collateral. The debtor counterclaimed and raised defenses to the bank's action for a deficiency judgment, asserting malicious interference with a

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[3] UCC § 1-208 comment.

[4] K.M.C. Co. v. Irving Trust Co., 757 F2d 752 (6th Cir. 1985). The role of good faith in exercising acceleration rights is discussed infra ¶ 24.01[1][b]. There is a growing use of the implied covenant of good faith to regulate creditor agreements. Perdue v. Crocker Nat'l Bank, 38 Cal. 3d 913, 702 P2d 503, 216 Cal. Rptr. 345 (1985), appeal dismissed, 475 US 1001 (1986). See the discussion of a bank's duty of good faith infra ¶ 24.02[2].

[5] 485 So. 2d 1336 (Fla. Dist. Ct. App.), review denied, 497 So. 2d 1217 (Fla. 1986).

business relationship, failure to sell the collateral in a commercially reasonable manner, usury, indemnification, and other claims.

The trial court gave an award of $700,000 in compensatory damages and $2.5 million in punitive damages to the debtor, but this was reversed in part on appeal. The conduct of the bank in continuing to extend credit above the amount of the loan did not constitute a course of dealing that modified the initial loan agreement. The specific terms of the note controlled in the event of a conflict between a course of dealing and the writings. When it was not reasonable to construe the written agreement and course of action as consistent with one another, the express terms of the agreement must control. Further, the court held that the good faith provisions of UCC § 1-203 had no application to demand instruments in which the holder may call the loan obligation at any time with or without reason. Accordingly, the court ruled that there was no breach of contract by the bank for refusing to continue lending beyond its loan limit.[6]

[b] Acceleration Clauses. The UCC recognizes the use of acceleration clauses in negotiable instruments and in other types of contracts.[7] As discussed previously, the presence of an acceleration clause does not make an instrument nonnegotiable.[8] Although a note may be subject to an acceleration term, a holder in due course of the note who is not aware of any acceleration may be excused if the holder is late in presenting the note for payment.[9] Although one cannot be a holder in due course if one takes an instrument with notice that it is overdue, a holder who is not aware of the exercise of an acceleration term does not have notice that the instrument is overdue.[10] The acceleration clause may be contained in a separate agreement apart from the note itself. In such a case, as with other writings that purport to modify the terms of an instrument, the acceleration clause does not bind a holder in due course who does not have notice of it. The clause may be effective, however, as to the immediate parties or persons who are not holders in due course.[11]

[i] Good faith requirement. The existence of an acceleration clause in a contract or a note is not the same as making the obligation due on demand. Even when the acceleration clause provides that the holder may require payment of the obligation "at will" or when the holder "deems himself insecure" or any

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[6] Id. at 1340. For support, the court relied upon the following cases: Midlantic Nat'l Bank v. Commonwealth Gen., Ltd., 386 So. 2d 31 (Fla. Dist. Ct. App. 1980) Grandin Indus., Inc. v. Florida Nat'l Bank, 267 So. 2d 26 (Fla. Dist. Ct. App. 1972).

[7] UCC § 3-109. See also UCC § 1-208.

[8] UCC § 3-109.

[9] UCC §§ 3-109, comment 4, 3-511(1).

[10] UCC §§ 3-302(1)(c), 3-304(4)(f).

[11] UCC § 3-119 & comment 3.

similar language, the holder may exercise the power to accelerate "only if he in good faith believes that the prospect of payment or performance is impaired."[12] As the comments to the UCC indicate, the acceleration clause is not to be construed as converting what on its face appears to be an instrument payable at a stated time into one that is payable on demand "at the whim and caprice of one party." Such a construction of an acceleration clause, the comments indicate, could be challenged as one making the "agreement void as against public policy or to make the contract illusory or too indefinite for enforcement. . . ."[13] Thus, the architects of the UCC drew a distinction between instruments payable on demand and obligations payable at a definite time subject to an acceleration. In the latter case, the holder must act in good faith. In the former case, where the instrument is payable on demand, the drafters stated that the instrument could be called for payment "at any time with or without reason."[14] The relevant comment states in full, "Obviously this section has no application to demand instruments or obligations whose very nature permits call at any time with or without reason. This section applies only to an agreement as to paper which in the first instance is payable at a future date."

Although the drafters indicated in the comment quoted earlier that the good faith requirement for exercising acceleration powers should not apply to demand instruments, these comments are directed at UCC § 1-208. The comments do not consider what effect, if any, the general obligation of good faith contained in UCC § 1-203 has on the holder of a demand note who calls for its payment.[15] Thus, while it is clear that the holder of an instrument who chooses to exercise an acceleration power must do so in good faith, it is not clear that these same standards are applicable to the exercise of the right to demand payment under a demand note. In view of the expanded growth of the banker's duty of good faith, as discussed further in this chapter, even the holder of a demand note is advised to proceed cautiously.

[ii] Types of acceleration provisions. While there are different types of acceleration provisions, they all concern obligations that, apart from the operation of the clause, would not be due in full until some future date. The application of the clause makes the entire obligation due at an earlier time, which usually is immediately or on demand. Some such clauses are drafted in terms that make it operate *automatically*, so that when the stated event occurs the entire obligation represented by the instrument becomes due and payable. More often, however, the provision is worded to give the holder of the instrument the *option* to declare a default and require payment of the obligation immediately

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[12] UCC § 1-208.

[13] UCC § 1-208 comment.

[14] Id.

[15] The obligation of good faith in UCC § 1-203 provides that "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."

when the stipulated event occurs. The events in the agreement that give rise to the right to accelerate may include specific acts of default, such as failing to make an installment payment when due or removing collateral from the jurisdiction, and other conditions that may even be beyond the control of the parties, such as destruction of collateral or actions taken by other creditors against the debtor. An acceleration clause may give rights not only to require payment but also to demand other performance by the obligor such as supplying additional collateral. Defining the events of default and rights of acceleration, obviously, should be done with care and with a view to the needs of the particular type of transaction.

[iii] Scope of UCC § 1-208. UCC § 1-208 refers to and limits rights of acceleration founded on language in clauses that give such rights "at will" or when a party "deems himself insecure," or "words of similar import."[16] By way of contrast, terms in clauses that give a party rights to accelerate when specific events of default occur appear to be outside the scope of this section, which is directed at language that on its face is susceptible to interpretation so as to give an unreasonably broad discretion in a party to accelerate. However, UCC § 1-203 imposes an obligation of good faith in the performance or enforcement of any contract or duty under the UCC, regardless of the scope of Section 1-208. A federal court has interpreted the scope of Section 1-208 broadly and has ruled that a party must act in good faith in exercising acceleration rights even under a clause that identifies specific acts of default.[17] The clause in question gave a creditor the right to accelerate "at its option" when the debtor leased the collateral without the consent of the creditor. Recognizing that a default clause, where the occurrence of the event of default was within the debtor's control, differed from an insecurity clause, where the creditor might act capriciously, the court believed that even the default clause could be the occasion for abuse. The power to accelerate the debt "could be used as a sword for commercial gain rather than as a shield against security impairment."[18] Both UCC § 1-208 and general equitable principles require more than "a good faith belief that a technical breach occurred. . . ." There should be a showing of a good faith belief that performance of the contract or the security for the obligation has been impaired, as Section 1-208 requires. The court reasoned that it was proper to apply Section 1-208 to such a clause, because the UCC drafters indicated that the good faith standard of Section 1-208 was the safeguard against abuse from acceleration clauses of all types,[19] and because a right to accelerate at the "option" of the creditor when default occurs is within Section 1-208, which applies when a party may accelerate "at will" or when there are "words of similar import."

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[16] UCC § 1-208.

[17] Brown v. Avemco Inv. Corp., 603 F2d 1367 (9th Cir. 1979).

[18] Id. at 1379.

[19] See UCC § 3-109, comment 4.

Other courts have taken a different view than *Brown*. In *Bowen v. Danna*,[20] the court held that the good faith standard in UCC § 1-208 did not apply to a term in a note that provided that acceleration of the debt would occur in the event of any "default" of the debtor. The court reasoned that the good faith requirement applied only to circumstances in which acceleration was at the will of the holder, and did not apply to circumstances in which the acceleration was within the control of the debtor, which was the case with the occurrence of "default" in the agreement. Also, in *Hersch v. Citizens Savings & Loan Association*,[21] a court concluded that a creditor's use of an acceleration clause when a debtor breached an obligation to maintain collateral did not violate a duty of good faith, although the creditor may have been motivated to accelerate and foreclose on the debtor's collateral in order to profit from an opportunity to reinvest the proceeds of the collateral in more lucrative alternatives. The court said:

> None of defendants' evidence was offered to prove that plaintiffs' conduct was dishonest or corrupt. Even if it could be established that plaintiffs profited economically by foreclosure, and that the collateral when sold and the proceeds invested at the rates then current was worth far more than performance by defendants upon the note would have been, the plaintiffs were entitled to exercise their rights under the security agreement. They were not required to choose the least profitable manner of doing so. Likewise, even if it were proved that the plaintiffs were motivated not to forebear further by economic factors outside this transaction, or even by outright greed, no dishonesty is shown where only legal rights are being enforced. Reasons or lack of reasons are thus irrelevant and the court properly refused evidence thereof.[22]

When the holder's good faith in demanding payment pursuant to a power of acceleration is placed in issue, the burden of showing lack of good faith is on the party who is being charged with the obligation to pay.[23] The UCC definition of "good faith" is relevant. Although the general definition is the narrow one of "honesty in fact,"[24] there is a higher standard of good faith on persons who are professionals for purposes of some types of transactions. Thus, under Article 2, which deals with the law relating to the sales of goods, a merchant must not only act with "honesty in fact" but must also observe "reasonable commercial stan-

[20] 276 Ark. 528, 637 SW2d 560 (1982).

[21] 146 Cal. App. 3d 1002, 194 Cal. Rptr. 628 (1983).

[22] Id at 1011, 194 Cal. Rptr. at 637.

[23] UCC § 1-208. The UCC defines "burden of establishing" in UCC § 1-201(8) as meaning that "the burden of persuading the triers of fact that the existence of the fact is more probable than its non-existence."

[24] UCC § 1-201(19).

dards of fair dealing in the trade."[25] As discussed previously, for purposes of determining when a person takes an instrument in good faith in order to qualify as a holder in due course, the UCC in Article 3 has specifically adopted the narrow definition of good faith of "honesty in fact."[26] When a party, even a holder, is enforcing an acceleration clause under a contract or a promissory note, the standard of good faith required to invoke the acceleration term will not necessarily be the narrow standard of "honesty in fact." The question at the time that the holder enforces the instrument will not be whether the holder was acting in good faith when the holder acquired the instrument (which is the holder in due course test), but rather whether the holder is acting in good faith in demanding payment under the power granted by the acceleration clause. The former good faith test is intended to promote the free circulation and marketability of commercial paper. Those policies have no application to conduct by the holder after the instrument has been acquired.[27]

The case law reflects the willingness of courts to use the good faith requirement to restrict the power of a creditor to exercise rights of acceleration. In *Clayton v. Crossroads Equipment Co.*,[28] the promissory note provided that the holder could accelerate the note when he regarded the debt insecure. After taking this note, and in the course of seeking financing for a second transaction with the same debtor, the holder learned that the debtor was a bad credit risk. The court held that the holder's acceleration of the debt was not in good faith as required by UCC § 1-208. Relying on principles established before adoption of the UCC, the court said that insecurity clauses are "meant to apply to possible changes in conditions or circumstances, or new developments affecting the mortgagee's security" and that no such showing had been made in this case, namely, that the debtor had suffered any deterioration in credit from the date of the signing of the first note or that the debtor had failed to meet any required payments under the contract.

In another case, a vice-president of the bank promised the plaintiff, a maker of a promissory note to the bank, that he would renegotiate its terms to convert it from an obligation that would come due on August 16, 1979 to an installment loan. About two weeks before the original note became due, the plaintiff telephoned another officer of the bank to complete the arrangements for changing the note to an installment obligation. The second bank officer said that he knew nothing about the arrangements that had been negotiated with the other vice-president, who was not in town. During the conversation, the plaintiff told the bank officer he would not be able to pay the note when it came due. The bank,

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[25] UCC § 2-103(1)(b).

[26] UCC § 3-302; see discussion at ¶ 16.01[3].

[27] For a good discussion of the factors that are considered in determining good faith, see Best v. U.S. Nat'l Bank, 303 Or. 557, 739 P2d 554 (1987); Restatement (Second) of Contracts § 205, comments a, d (1979).

[28] 655 P2d 1125 (Utah 1982).

anticipating that the note would not be paid, then accelerated the obligation and set off the amount of the note from funds that were on deposit in the plaintiff's checking account with the bank. The plaintiff received first notice of the setoff when he attempted to cash a check the following day. Approximately $850 in checks were dishonored as a result of the setoff. The court held that the bank had breached the obligation of good faith in UCC § 1-203. The court further held that because the obligation of good faith had been imposed by law, rather than as a matter of contract, the breach was tortious and thus punitive damages could be recovered.[29]

In *Finley, Inc. v. Longview Bank & Trust Co.*,[30] the court ruled that a bank acted in good faith in exercising its rights under an acceleration clause when the debtor threatened bankruptcy. Although the debt to the bank was secured by a certificate of deposit (CD) in the same amount as the debt, the interest payable was 11 percent on the note but only 9 percent on the CD. Thus, the collateral did not cover the entire indebtedness, and the bank's acceleration for "insecurity" was in good faith, given "the nature and value of the collateral."[31]

It has been held that a lender cannot accelerate payment on a loan and then make the borrower pay a prepayment penalty.[32]

[c] Due-on-Sale Clauses

[i] Enforceability in real estate transactions. A special form of acceleration clause is the due-on-sale or due-on-transfer clause. These terms are used frequently in real estate financing. They have been extensively litigated when creditors have sought to enforce them against consumer purchasers of residential real estate, and there is an extensive body of state law on the enforceability of such clauses. As discussed later in this section, this dispute became a federal issue when consumers challenged the use of such clauses by federally insured banking institutions. The U.S. Supreme Court's decision giving supremacy to the regulations of the federal banking agencies led to enactment of a broad federal law applying to use of due-on-sale provisions.

Due-on-sale clauses have been attacked as invalid when they are used in connection with real estate security devices, on the theory that they constitute an

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[29] First Nat'l Bank v. Twombly, 689 P2d 1226 (Mont. 1984).

[30] 705 SW2d 206 (Tex. Ct. App. 1985).

[31] Id. at 209. See Karner v. Willis, 238 Kan. 246, 710 P2d 21 (1985).

[32] Slevin Container Corp. v. Provident Fed. Sav. & Loan Ass'n, 98 Ill. App. 3d 646, 424 NE2d 939 (1981). The California Court of Appeals also has held that a lender may not charge a prepayment penalty when the lender exercises its rights to accelerate the debt under a due-on-sale clause. In the court's view, the prepayment penalty was linked to a privilege granted the borrower to voluntarily prepay the note, and should not apply when the prepayment is not the voluntary choice of the borrower. Tan v. California Fed. Sav. & Loan. Ass'n, 140 Cal. App. 3d 800, 189 Cal. Rptr. 775 (1983).

unreasonable restraint on the alienation of property. Most courts do not view such clauses as unenforceable on their face, but engage in a scrutiny of the particular circumstances to determine if the enforcement of the clause is reasonable.[33] The Colorado Supreme Court, for example, has held that the use of a due-on-sale clause in an installment real estate contract cannot be attacked on such grounds, absent a showing of unconscionability. The court said that such a clause is per se reasonable, and it rejected requiring the lender to prove on a case-by-case basis the reasonableness of his interest in including the clause in the contract. Although the debtor may challenge the lender's exercise of the clause on the ground that enforcement is unconscionable, the debtor must bear the burden of showing why the lender should not be permitted to enforce a provision that the debtor voluntarily entered into.[34] But other jurisdictions have taken a more restrictive view toward lender enforcement of such clauses.[35]

The U.S. Supreme Court upheld the authority of the Federal Home Loan Bank Board to promulgate regulations for federally chartered savings and loan associations that allow federal associations to use due-on-sale acceleration clauses in lending instruments, in disregard of any state law limiting their use or enforcement.[36] The decision that the federal regulation preempts state law was based upon the Court's conclusion that Congress had committed to the FHLBB a broad discretion to regulate federal savings and loan associations in accordance with what the Board considers the "best practices" of the industry. Following this decision, the enforceability of due-on-sale clauses became bewilderingly complicated, depending on the identity of the lender and on local law. Thus, Congress was prompted to address the use of such clauses.

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[33] One of the leading early cases is Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P2d 970, 148 Cal. Rptr. 379 (1978). For a thorough discussion, see G. Nelson & D. Whitman, Real Estate Finance Law §§ 5.21–5.26, 7.6–7.8 (2d ed. 1985).

[34] Income Realty & Mortgage, Inc. v. Columbia Sav. & Loan Ass'n, 661 P2d 257 (Colo. 1983).

[35] See generally id.; G. Nelson & D. Whitman, Real Estate Finance Law §§ 15.24–15.26 (2d ed. 1985).

[36] Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 US 141 (1982). For a collection of earlier state and federal cases, see generally Annotation, "Validity, Construction and Application of Provisions Entitling Mortgagee to Increase Interest Rate on Transfer of Mortgaged Property," 92 ALR3d 822 (1979); Annotation, "Validity, Construction and Application of Clause Entitling Mortgagee to Acceleration of Balance Due in Case of Conveyance or Transfer of Mortgaged Property," 69 ALR3d 713 (1976). Acceleration clauses making obligations due on sale are also used in transactions where personal property is the collateral. Although UCC § 9-311 provides that the debtor's rights in collateral may be transferred voluntarily or involuntarily, this section does not prevent the parties from entering into a security agreement that makes a transfer by the debtor a default. Brummund v. First Nat'l Bank, 99 NM 221, 656 P2d 884 (1983). Accord Layne v. Fort Carson Nat'l Bank, 655 P2d 856 (Colo. Ct. App. 1982).

[ii] Garn-St Germain Act. The Garn-St Germain Depository Institutions Act of 1982[37] contains far-ranging provisions that deal with use of due-on-sale clauses in residential real estate transactions.[38] Except for a three-year "window period," discussed subsequently, the act broadly authorizes use of due-on-sale clauses. At the heart of the act is the following provision: "Notwithstanding any provision of the Constitution or laws (including the judicial decisions) of any state to the contrary, a lender may. . .[subject to the window period provisions] enter into or enforce a contract containing a due-on-sale clause with respect to a real property loan."[39] The act further provides that a lender's exercise of rights pursuant to a due-on-sale clause "shall be exclusively governed by the term of the loan contract, and all rights and remedies of the lender and the borrower shall be fixed and governed by the contract."[40] The act encourages lenders to permit assumptions of real property loans at market rates, but it does nothing to compel a lender to do so.[41]

The act applies to lenders of all kinds, both institutional and individual, and it includes government agencies who make real property loans.[42] The act does not require that a lender be chartered, insured, or otherwise regulated by a federal agency in order for the act to apply. The coverage of the act literally extends to purely private transactions between two individuals.

The loan must be a "real property loan" in order for the federal due-on-sale rules to apply. Real property loans are transactions involving the extension of credit that is secured by a lien on real property or an interest in a cooperative housing unit, a mobile home, or other residential manufactured home.[43] All real property loans containing a due-on-sale clause,[44] except those that come within the window period, are governed by the act. With respect to these loans, the federal law preempts all state provisions limiting the right to enforce due-on-sale clauses, whether those limitations are based on state constitutions, statutes, or

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[37] Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified in scattered sections of titles 12, 15 and 18 USC). For an excellent review of the act, see G. Nelson & D. Whitman, Real Estate Finance Law § 15.24–15.26 (2d ed. 1985).

[38] Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, tit. III, § 341, 96 Stat. 1505 (codified at 12 USC § 1701j-3 (1982 & Supp. IV 1986)) (hereinafter Act).

[39] Act § 341(b)(1) (codified at 12 USC § 1701j-3(b)(1) (1982)).

[40] Act § 341(b)(2) (codified at 12 USC § 1701j-3(b)(2) (1982)).

[41] Act § 341(b)(3) (codified at 12 USC § 1701j-3(b)(3) (1982)).

[42] Act § 341(a)(2) (codified at 12 USC § 1701j-3(a)(2) (1982)). See 12 CFR § 591.2(g) (1987).

[43] Act § 341(a)(3) (codified at 12 USC § 1701j-3(a)(3) (1982)).

[44] The act defines a due-on-sale clause as "a contract provision which authorizes a lender, at its option, to declare due and payable sums secured by the lender's security instrument if all or any part of the property, or an interest therein, securing the real property loan is sold or transferred without the lender's prior and written consent." Act § 341(a)(1) (codified at 12 USC § 1701j-3(a)(1) (1982)).

judicial decisions; further, the law creates a federal right to enforce due-on-sale clauses in accordance with the terms of the loan agreement.[45]

The act recognizes nine situations in which there may be a technical transfer of an interest in property, but which may not be used by a lender as the basis for enforcement of a due-on-sale clause.[46] These situations are as follows:

1. The creation of a lien on the property that is subordinate to the lender's interest in the property, and that does not relate to a transfer of rights of occupancy in the property.[47]
2. The creation of a purchase money security interest for household appliances.
3. A transfer of an interest in the property "by devise, descent, or operation of law" on the death of a joint tenant.
4. The granting of a leasehold interest in the property of three years or less that does not contain an option to purchase. (This exception applies even when there has been a change of possession of the property pursuant to the lease.)[48]
5. A transfer of an interest in the property to a relative, as a result of the death of the borrower.
6. A transfer of ownership to the spouse or children of the borrower.
7. A transfer of ownership of the property as a result of a divorce decree, separation agreement, or property settlement.
8. A transfer of the property to an inter vivos trust in which the borrower remains a beneficiary of the trust and which does not relate to a transfer of rights of occupancy in the property.
9. Other transfers or dispositions as provided in regulations by the FHLBB.[49]

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[45] The act also provides that the Federal Home Loan Bank Board regulations restricting the use of balloon payments do not apply to loans covered by the act. Act § 341(g) (codified at 12 USC § 1701j-3(g) (1982)).

[46] Act § 341(d) (codified at 12 USC § 1701j-3(d) (1982 & Supp. IV 1986)).

[47] Some states have allowed lenders to enforce due-on-sale clauses when their debtors further encumber the property, on the theory that in some of these situations the debtor's lack of financial stake in the property can increase the risks to the lender that the debtor will impair the security in the property or will fail to pay. The federal act broadly prohibits exercise of the due-on-sale clause even in these cases. Moreover, since the statute applies to "the creation of a lien or other encumbrance," it can be read as preventing resort to a "due-on-encumbrancing" clause when judgment or judicial liens attach to the property. See Act § 341(d)(1) (codified at 12 USC § 1701j-3(d)(1) (1982 & Supp. IV 1986)).

[48] See Act § 341(d)(4) (codified at 12 USC § 1701j-3(d)(4) (1982 & Supp. IV 1986).

[49] the FHLBB has general authority to interpret the act and to issue regulations to implement it. Act § 341(e)(1) (codified at 12 USC § 1701j-3(e)(1) (1982)).

When any of these nine exceptions exist, the rights given a lender under the act to enter into or enforce a due-on-sale clause do not apply. Moreover, given the broad manner in which this part of the act is drafted, it appears that the act affirmatively prohibits a lender from exercising due-on-sale rights when any of these situations are present and preempts any state law to the contrary. As originally enacted, the exceptions listed were unlimited, and applied to any real property transfer otherwise within the act. In 1983, Congress narrowed the scope of these exceptions by providing that they apply only when the property consisted of "less than five dwelling units."[50]

The act establishes a "window period" during which state law provisions that limit enforcement of due-on-sale clauses may continue to apply. The purpose of the window is to afford some protection to owners of property who own property subject to mortgage loans that they might have regarded as "assumable" on transfer of the property under the relevant state law at the time their ownership arose. The window period expired on October 15, 1985, three years after the date of enactment of the act. The window period varies for each state that can qualify as a window state. The window begins on the date when the state took legal action to limit the exercise of due-on-sale clauses. Specifically, the statute states that the period begins "on the date a state adopted a constitutional provision or statute prohibiting the exercise of due-on-sale clauses, or the date on which the highest court in such state has rendered a decision (or if the highest court has not so decided, the date on which the next highest appellate court has rendered a decision in a final judgment if such decision applies statewide) prohibiting such exercise . . . ."[51]

During this window period, for any real property loan that is made or assumed or otherwise transferred, the state limitations on the enforcement of due-on-sale clauses continue to be effective.[52] However, also during this window period, a state may enact a law allowing enforcement of due-on-sale clauses with respect to loans originated in the state by lenders other than federally chartered depository institutions.[53] Additionally, the Comptroller of the Currency, as to

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[50] 12 USC § 1701j-3(d) (Supp. IV 1986).

[51] Act § 341(c)(1) (codified at 12 USC § 1701j-3(c)(1) (1982)). The window period rules have led to litigation to determine if a state is a window state. For example, the Arizona Supreme Court has held that Arizona is a window state under the Garn-St Germain Act. Scappaticci v. Southwest Sav. & Loan Ass'n, 135 Ariz. 456, 662 P2d 131 (Ariz. 1983). (The court relied upon its prior decision in Baltimore Life Ins. Co. v. Harn, 15 Ariz. App. 78, 486 P2d 190 (1971), petition denied, 108 Ariz. 192, 494 P2d 1322 (1972) and Ariz. Rev. Stat. Ann. § 33-801 (1988).) A New York court has ruled that New York is not a window state. However, the court prevented enforcement of a due-on-sale clause in the case before it, which involved a transaction that occurred prior to the effective date of the act, because the Garn-St Germain Act does not apply retroactively. Home Sav. Bank v. Baer Properties Ltd., 92 AD2d 98, 460 NYS2d 833 (1983).

[52] Act § 341(c)(1) (codified at 12 USC § 1701j-3(c)(1) (1982)).

[53] Act § 341(c)(1)(A) (codified at 12 USC § 1701j-3(c)(1)(A) (1982)).

national banks, and the National Credit Union Administration Board, as to federal credit unions, may permit those institutions to adopt regulations enforcing due-on-sale clauses in loans originated by those institutions.[54] Action by these bodies to authorize enforcement of due-on-sale clauses for window period loans may not apply to any transfer that occurred prior to the date the act was adopted, October 15, 1982. The exemption of window period loans is not complete. Lenders may enforce due-on-sale clauses even for window period loans when it is done to enforce customary credit standards followed by the lender in making loans on similar property.[55]

The window period exception to enforcement of due-on-sale clauses does not apply in the case of transfers of loans originated by federal savings and loan associations or federal savings banks.[56] These loans are covered by the Supreme Court decision in *Fidelity Federal Savings & Loan Associations v. de la Cuesta*,[57] discussed previously, which held that FHLBB regulations authorizing due-on-sale clauses for such loans preempted state limitations.[58]

[2] Notes With Special Contract Provisions

Promissory notes frequently contain conditions, such as the acceleration term discussed previously, that deal with debtor duties to maintain collateral and other duties relating to the financing arrangement. The UCC recognizes this practice, and it specifically provides that the inclusion of certain terms of this nature does not destroy the negotiability of the instrument. Thus, the note may contain statements to the effect that collateral secures the obligation, the holder may have recourse against the collateral when default occurs, the debtor promises to protect the collateral or to give additional collateral, the holder may enter a confession of judgment when the instrument is not paid at the time it is due, and other such terms in which the obligor purports to waive the benefit of laws intended to protect the obligor.[59] Although the UCC stipulates that the

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[54] Act § 341(c)(1)(B) (codified at 12 USC § 1701j-3(c)(1)(B) (1982)).

[55] Act § 341(c)(2)(A) (codified at 12 USC § 1701j-3(c)(2)(A) (1982)).

[56] Act § 341(c)(2)(C) (codified at 12 USC § 1701j-3(c)(2)(C) (1982)).

[57] 458 US 141 (1982).

[58] The *de la Cuesta* decision does not resolve whether state limitations on due-on-sale clauses would be preempted as to mortgages originated by state institutions and subsequently acquired by a federally chartered savings and loan association. This question was presented in a 1982 case. The court said that it did not have to reach the question of whether the FHLBB has the authority to preempt state law in such a case, because it concluded that the Board did not intend to preempt state law in such cases under its current regulations. The court came to this conclusion because the Board represented to the court that "the Board has never reached the question of, nor taken a formal position on, federal preemption in the specific factual situation before this court." Bleecker Assocs. v. Astoria Fed. Sav. & Loan Ass'n, 544 F. Supp. 794 (SDNY 1982).

[59] UCC § 3-112.

inclusion of such terms in a note does not affect the note's negotiability, it is important to bear in mind that the UCC stipulation does not authorize or validate any such term that might otherwise be illegal. Thus, use of confessions of judgment and waivers of rights of obligors may be invalid and may subject the creditor who uses such terms to other legal consequences. In consumer transactions in particular, the use of confession of judgment clauses will be invalid under the FTC Credit Practices Rule discussed later in this chapter. Other waivers also may be invalid.[60]

Additionally, a promissory note ordinarily will be part of a larger transaction. The terms of the broader transaction may modify or affect the terms of the note.[61]

[3] Waiver or Cancellation of Debts

The obligation on a negotiable instrument may be discharged by any "act or agreement with [the obligor on the instrument] which would discharge his simple contract for the payment of money."[62] The simplest form of discharge is waiver or cancellation of a debt. Although the general rule in contract law is that some type of consideration is necessary to support a binding agreement to discharge a debt, there are exceptions to this rule. One exception involves the cancellation of negotiable papers such as notes, checks, or other instruments. Liability on these instruments may be discharged, without giving any value, simply by the creditor's canceling the instrument or surrendering it to the debtor.[63] No consideration is necessary when the creditor cancels the obligation in this way.[64]

The UCC also carves out another broad exception where a debt may be discharged without consideration in its rules on waiver. It is a general rule under the UCC, not limited to the law of negotiable instruments, that "any claim or right arising out of an alleged breach can be discharged in whole or in part without consideration by a written waiver or renunciation signed and delivered by the aggrieved party."[65] A waiver made in accordance with this provision will

[60] UCC § 3-112(2) provides that the section does not "validate any term which is otherwise illegal." The comments indicate an express intent to allow local rules on these matters to govern, so long as the negotiability of the instrument is not affected. UCC § 3-112 comment 2. The FTC Holder in Due Course Rule, of course, also affects the use of waivers of consumers' rights to assert claims and defenses. See discussion at ¶ 16.06.

[61] These matters are discussed in ¶ 16.05

[62] UCC § 3-601(2).

[63] UCC § 3-605. See discussion at ¶ 15.07.

[64] UCC § 3-605.

[65] UCC § 1-107. This is similar to the provision expressly incorporated in UCC § 3-605 on the cancellation of negotiable instruments, which recognizes a written renunciation signed and delivered to the obligor.

be effective regardless of whether any consideration was given for the waiver. The person seeking to enforce the waiver, of course, must comply with the UCC provisions on good faith.[66] Oral waivers may be effective when there is consideration or, in some circumstances, as a waiver even when no consideration exists.[67] Additionally, there are circumstances in which a course of dealing or course of performance between the parties may give rise to a modification or waiver under the provisions of Article 2 on sales of goods.[68] The rules on modification of contracts generally, in UCC Article 2 on sales, permit modifications without consideration, although the effectiveness of a modification may depend on whether a signed writing containing the modification will be necessary. The UCC provides a basis for enforcing even oral modifications when a person makes a material change of position in reliance on the circumstances.[69]

While the issue of contract formation and modification is too broad to be discussed fully in this text,[70] emphasis is placed on the special rules applicable to debts represented by a negotiable instrument. The general circumstances concerning discharge from the obligation on such an instrument have been discussed in Chapter 15. The present chapter discusses several special situations.

[a] Problems With Renewal Notes. When a note is canceled and a renewal note executed, some cases regard the renewal note as not discharging the original note. These cases view the new note as extending the time for paying the original indebtedness. This rule has been applied to preserve security given for the first note as security for the renewal note.[71] In *Peterson v. Crown Financial Corp.*,[72] a bank extended the debt of its customer by having the customer execute a renewal note. As part of the transaction, the bank canceled the original note. The bank neglected to collect all of the interest due under the original note and did not add it to the face amount of the renewal note. When the bank sued to enforce the

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[66] UCC § 1-107 comment.

[67] See UCC §§ 1-109 comment, § 2-208, § 2-209.

[68] UCC §§ 2-208, 2-209.

[69] UCC § 2-209(5).

[70] For good general sources on this subject, see Restatement of the Law (Second) of Contracts Ch. 4 (1981); J. White & R. Summers, Uniform Commercial Code Ch. 1 (2d ed. 1980) (hereinafter White & Summers).

[71] See cases collected in Peterson v. Crown Fin. Corp., 661 F2d 287 (3d Cir. 1981). In Chadron Energy Corp. v. First Nat'l Bank, 221 Neb. 590, 379 NW2d 742 (1986), the court held that cancellation of an old note and execution of a new note resulted in the release of security given for the old note.

When a note is canceled by mistake, the cancellation is not effective to discharge the parties to the note from their obligations. Guaranty Bank & Trust Co. v. Dowling, 4 Conn. App. 376, 494 A2d 1216, cert. denied, 197 Conn. 808, 499 A2d 58 (1985). See UCC § 3-605(1)(a), which refers to "intentionally cancelling" an instrument.

[72] 661 F2d 287 (3d Cir. 1981).

renewal note, the debtor argued that the cancellation of the original note resulted in a discharge of liability for the uncollected interest on the old note. The court held that this case did not involve either an unintentional cancellation or a mistake, (If the cancellation had been unintentional or a mistake, it would not discharge liability.) Additionally, the court did not regard the case as being similar to those where the security given for the original note or guarantees of the original note were continued for the renewal note. This case, the court said, involved the existence of the debt itself. In such a case, the documents must reflect the obligations of the parties. Accordingly, the court held that the subjective intent of the parties was irrelevant, and that cancellation of the old note constituted a discharge to the extent that the debt was not carried forward in the face amount of the renewal note.

The need for care in handling renewal note transactions also is apparent in *American Bank of Commerce v. Boger-Hare Manufacturing Co.*[73] In this case, two notes were executed by individuals who subsequently formed a corporation. A third note was executed in the corporate name for an amount equal to the two prior notes. The individuals claimed that the corporate note was a renewal note intended to discharge the previous two notes on which the individuals were obligated. The court held that since the original two notes had not been canceled, there was not sufficient evidence to establish that the third note was intended to discharge the two individual notes. Rather, it should be interpreted as an assumption of the debt by the corporation without release of the two individual obligors.

In *Hubbard Realty Co. v. First National Bank*,[74] the court held that the intent of the parties determined whether the issuance of a renewal note and the cancellation of the former note accomplished a discharge of those liable on the former note that was canceled. The court rejected an argument that UCC § 3-605(1)(b) makes intent irrelevant. By the court's finding that the former parties to the note were not discharged, the holder of the note was able to collect from the corporate maker of the note, although the renewal note had been executed without authority under circumstances in which the bank had notice of the lack of authority.

[b] Full Payment Checks. When the amount of an obligation is disputed in good faith, an agreement may be made that settles the dispute. Such agreement

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[73] 633 P2d 1270 (Okla. Ct. App. 1981). See Gullette v. FDIC, 231 Va. 486, 344 SE2d 920 (1986). Gullette executed a note with another party. Subsequently, the bank, who was payee, stamped the note, "Paid by Renewal," and a new note was executed to which Gullette was not a party. The new note also differed from the old note in that it allowed for additional collateral, a longer term, and additional credit. The court held that Gullette remained liable on the old note because he failed to establish that a novation was intended. Although its terms were different, the new note was only conditional payment of the old one. UCC § 3-605(1) did not apply, because the note was not marked "canceled."

[74] 704 F2d 733 (4th Cir. 1983).

will be binding without any further consideration.[75] Acceptance of a check stating that it is in full payment, when the amount to be paid is in dispute, will be regarded as within this rule, and will amount to an agreement to the settlement proposed.[76] This general rule does not apply when the claim is for a fixed amount that is not in dispute. In such cases, although the debtor may attempt to treat the payment, if the payment is accepted, as indicating an agreement by the creditor that the debt is discharged, the law has permitted the creditor to accept payment and to continue to enforce the original obligation. Although the general rule requires a good faith dispute as to the amount that is owed before there can be an "accord and satisfaction" that discharges the obligation, a creditor obviously cannot safely accept payment in partial satisfaction of an obligation for which the amount is in dispute and for which the payment is tendered as a full settlement.

The UCC muddies these general principles. Under the UCC, there is a provision that permits a party to preserve that party's rights by making clear that any tendered performance has been accepted "without prejudice" or "under protest."[77] This suggests that a creditor could, in circumstances in which the UCC applied, accept payment with the statement that such payment was being accepted "without prejudice," and, by doing so, the creditor would not be bound to the offered settlement. The exact scope of this section in the UCC is not clear, however, because it runs contrary to the general contract principles, which would not regard such a reservation of rights as effective.[78]

Debtors frequently seek to accomplish an "accord and satisfaction" under these rules by tendering to a creditor a check that contains language stating that acceptance of the check or indorsement of the check or obtaining collection of the check constitutes "full payment" of the debtor's obligation. The applicability of the common-law accord and satisfaction doctrine, and the extent to which the UCC varies that doctrine, if at all, in its provision in Section 1-207 allowing a party to "reserve all rights," has been a matter of considerable commentary and litigation. Although there are some who suggest that such a "full payment" notation on a check perhaps should have no effect,[79] the case law recognizes circumstances in which such language may be given effect as a common-law "accord and satisfaction." Making clear in a separate writing accompanying the

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[75] See Restatement of the Law (Second) of Contracts § 73 (1981).

[76] See H. Bailey, Brady on Bank Checks ¶ 4.12 (6th ed. 1987).

[77] UCC § 1-207.

[78] See Restatement of the Law (Second) of Contracts §§ 58, 59 (1981). See also Caraballo, "The Tender Trap: U.C.C. § 1-207 and Its Applicability to an Attempted Accord and Satisfaction by Tendering a Check in a Dispute Arising From a Sale of Goods," 11 Seton Hall L. Rev. 445 (1981).

[79] See H. Bailey, Brady on Bank Checks ¶ 4.12 (6th ed. 1987); Shanker, "The Folly of Full Settlement Checks—And a Declaration of Their Independence," 90 Com. LJ 7 (1985).

check that the check is tendered as an accord and satisfaction in full payment, as long as the writing and the check are delivered to the creditor under circumstances in which there is evidence of their receipt by parties authorized to accept such offers, is probably a more effective manner of accomplishing the accord and satisfaction than by language noted on the check itself.[80]

A number of courts have decided that UCC § 1-207 does not permit the payee to accept a check tendered as "full payment" by noting that it is accepted under protest. One of the leading opinions on this matter is by Justice Peters for the Connecticut Supreme Court.[81] In the Connecticut case, the defendant ten-

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[80] See H. Bailey, Brady on Bank Checks ¶ 4.12 (6th ed. 1987). Checks issued to large companies, where payments are routinely collected by persons who have no authority to contract for the company, obviously present questions whether an accord and satisfaction has been entered into by the action of such a limited agent in collecting payment of the check for the company.

[81] County Fire Door Corp. v. C.F. Wooding Co., 202 Conn. 277, 520 A2d 1028 (1987). See also Milgram Food Stores, Inc. v. Gelco Corp., 550 F. Supp. 992 (WD Mo. 1982). In *Milgram Food Stores*, the payee crossed out the language on the check referring to full settlement and negotiated it to obtain payment. The court held that striking out the *full settlement language had no effect*, and obtaining payment constituted an accord and satisfaction. Accord In re Zerodec Mega Corp., 47 Bankr. 304 (Bankr. ED Pa.), aff'd in part & rev'd in part, 60 Bankr. 884 (Bankr. ED Pa. 1985). See also Stultz Electric Works v. Marine Hydraulic Engineering Co., 484 A2d 1008 (Me. 1984), indorsement "under protest without prejudice and with a reservation of our rights to the balance of"; Hixson v. Cox, 633 SW2d 330 (Tex. Ct. App. 1982), indorsement "without prejudice" would not prevent an accord and satisfaction.

On the other hand, in Charleston Urban Renewal Authority v. Stanley, 346 SE2d 740 (W. Va. 1985), an accord and satisfaction was found in a landlord/tenant dispute over the amount of rent owed where the tenant paid the landlord with a check that on its face contained the notation, "January rent in full." Although the landlord crossed out the "in full" prior to depositing the check, the notation was proof that the landlord knew the check had been tendered on the condition that acceptance and use of the money constituted a full satisfaction of the debt. But the court declined to find an accord and satisfaction for a series of monthly rent checks that stated only, "February rent," "March rent," and so forth, because strict application of the rule requires that the debtor make clear the conditional nature of the tendered payment. The court noted that other jurisdictions had applied UCC § 1-207 to defeat the full payment check rule, and the court reserved its judgment as to what decision it would make when faced with a transaction to which that section applied. As the case involved a lease of land, the court found UCC § 1-207 inapplicable. Also, in United States v. Consolidated Edison Co., 590 F. Supp. 266 (SDNY 1984), the court gave effect to the payee's statement that was added to the check, noting that the check was accepted under protest. The facts of the case did not make clear whether the check itself bore the statement that it was offered in full payment. In Niebler & Muren, S.C. v. Brock-White Co., 122 Wis. 2d 445, 361 NW2d 732 (Wis. Ct. App. 1984), the court held that the payee's obtaining the bank certification of a check constituted an acceptance of an offer of accord and satisfaction. In this case, after the payee received a check tendered in full payment of a disputed amount, the payee had the bank certify the check and then pursued collection of the full amount of its debt. The Wisconsin Supreme Court reversed a jury verdict for the payee. The court held that obtaining the certification

dered a check that provided that the payee, by indorsing, accepted the check in full satisfaction of all claims against the defendant. The plaintiff took the check but wrote above his indorsement, "This check is accepted under protest and with full reservation of rights to collect the unpaid balance for which this check is offered in settlement." The court ruled that this language did not prevent an accord and satisfaction by taking the check as payment. Harmonizing Section 1-207 with Articles 2 and 3 of the UCC, the court pointed to the conclusion that Section 1-207 did not change the common-law rule of accord and satisfaction. In the view of the court, Article 3 was not intended to incorporate the Section 1-207 result. The section in UCC § 3-407 on alteration proclaimed a policy against unauthorized alterations and allowed enforcement of an instrument only in accordance "with its original tenor." Article 2, on the other hand, could be consistent with Section 1-207, because many of the Article 2 provisions were intended to encourage the parties to a contract that was not fully performed but to which a dispute had arisen, to engage in negotiations to resolve the disagreement rather than terminate the contract. This policy of Article 2 is different from Article 3, where "the contracts encapsulated in various forms of negotiable instruments instead envisage conduct of negotiation or transfer, indorsement or guarantee, payment or acceptance, and honor or dishonor." Thus, in a case where "performance of a sales contract has come to an end, [UCC § 1-207] was not intended to empower a seller, as payee of a negotiable instrument, to alter that instrument by adding words of protest to a check tendered by a buyer on condition that it be accepted in full satisfaction of an unliquidated debt.[82]

The Connecticut case also found an accord and satisfaction, although the amount of the check submitted did not represent a compromise of the parties' dispute as to the amount owing. As discussed previously, under the common-law rule, if a claim is unliquidated, there will be an accord and satisfaction when the debtor offers and the creditor accepts a check in payment of the dispute. The Connecticut court said that the claim in that case was unliquidated, because there were two different amounts in dispute, only one of which could be correct.

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of the bank was the equivalent of obtaining payment because the certification substituted the bank's obligation for that of the drawer of the check. See generally Annotation, "Application of UCC § 1-207 to Avoid Discharge of Disputed Claim Upon Qualified Acceptance of Check Tendered as Payment in Full," 37 ALR4th 358 (1985); Annotation, "Creditor's Certification of Check Purporting to Be Final Settlement of Disputed Amount as Constituting Accord and Satisfaction," 42 ALR4th 95 (1985); Annotation, "Creditor's Retention Without Negotiation of Check Purporting to be Final Settlement of Disputed Amount as Constituting Accord and Satisfaction," 42 ALR4th 117 (1985); Annotation, "Modern Status of Rule That Acceptance of Check Purporting to Be Final Settlement of Disputed Amount Constitutes Accord and Satisfaction," 42 ALR4th 12 (1985).

[82] County Fire Door Corp. v. C.F. Wooding Co., 202 Conn. 277, 520 A2d 1028 (1987), citing cases from other jurisdictions indicating that the majority rule was the one adopted by the court.

Although the defendant did not pay any more than the amount he calculated as due and owing, such a payment is sufficient consideration when tendered in settlement of the dispute.

¶ 24.02 SPECIAL DUTIES OF GOOD FAITH AND FIDUCIARY RESPONSIBILITY OF BANK TO CUSTOMER

When default occurs, banks seeking to enforce obligations against debtors may encounter claims and defenses asserted by the debtor that the bank itself has breached a duty of good faith or other obligation owed to the debtor in the transaction. There is an extensive body of trust law establishing the duties of a fiduciary to the principal, which have governed some of the obligations bankers have undertaken for many years. Additionally, there is an emerging case law imposing similar types of obligations to act in good faith based on contract and tort law doctrines. Similar duties have been found under other general principles of liability. This handbook cannot canvass fully the extensive and rapidly developing case law on all of these fronts. This section is intended to introduce some understanding of the general body of law applicable to fiduciaries and to give illustrations of some of the new developments on the banker's duty of good faith to customers.

[1] The Bank as a Fiduciary

[a] Fiduciary Relationships Generally. When one person conducts business for another in a representative capacity, whether gratuitously or for profit, the one who acts for the other is said to act in a fiduciary capacity. The person for whom the party acts is usually called the principal or beneficiary. The relationship between the parties is termed a fiduciary relationship. Thus, the term "fiduciary" includes any sort of trustee, executor, administrator, guardian, receiver, assignee for the benefit of creditors, agent, partner when acting for other partners, attorney, officers and directors of public and private corporations, public officials, and any other person who acts as an agent or deals with property on behalf of another.[83] Corporations, partnerships, and other business units may act as fiduciaries.[84] In such cases, the agents and officers of such organizations have the duties of fiduciaries, first, to the corporation that employs them[85] and, second, to the person for whom the corporation or business unit acts.[86]

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[83] Uniform Fiduciaries Act § 1, 7A ULA 395 (1985).

[84] Id.

[85] See First Nat'l Bank v. Hall, 143 Ga. App. 300, 238 SE2d 284 (1977) (lending officer who knew of improper loans liable to bank).

[86] See Tettenborn, "Fiduciary Duties of Banks," 1980 J. Bus. L. 10.

The general responsibilities of fiduciaries under the common law of trusts and agency are supplemented by additional requirements under the specific laws of each state dealing with the obligations of corporate officers, partners, and other agents, as well as by the federal securities laws. Directors and other "insiders," for example, are prohibited from taking advantage of nonpublic information in the purchase and sale of securities of corporations with which they are connected.[87]

The details of the duties of fiduciaries vary, depending on the closeness of the relationship between the parties and the extent to which the principal or beneficiary is dependent on and confides in the fiduciary. In general, however, under the common law and rules of equity, it can be said of all cases that the fiduciary owes the principal the strictest loyalty, and that the fiduciary must exercise the utmost good faith and must do nothing to prejudice the interest of the principal or beneficiary.[88] There are many applications of this duty of loyalty. Contracts made by a fiduciary in a representative capacity must be for the benefit of the principal or beneficiary, and all profits arising out of the relationship belong to the principal.[89] The fiduciary may not use his or her position as a fiduciary to make a personal profit when the transaction is for the beneficiary, and a fiduciary who does so must turn the profit over to the principal or beneficiary.[90] A fiduciary may not compete with the principal in business concerning the subject matter of their relationship.[91] A fiduciary may not make contracts in the capacity as a fiduciary with himself or herself in an individual capacity and may not sell property that the principal has entrusted to the fiduciary unless the principal or beneficiary gives permission and the fiduciary conducts the transaction at arm's length and under conditions of full disclosure.[92]

Unless specifically agreed upon, a fiduciary may not represent interests that conflict with those of the principal or beneficiary in the matters in which the fiduciary is employed.[93] For example, a fiduciary may not without permission of the principal accept commissions from third parties who deal with the principal through the fiduciary, and, if the fiduciary does accept such commissions, the

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[87] See discussion of the securities laws in Chapter 7.

[88] Restatement of the Law (Second) of Trusts § 170 (1959) (hereinafter Restatement Trusts); Restatement of the Law (Second) of Agency § 387 (1958) (hereinafter Restatement Agency); Loring, Trustees Handbook 67 (6th ed. 1962) (hereinafter Trustees Handbook).

[89] Restatement Trusts, supra note 88, at §§ 172, 181, 182.

[90] Id. at § 203; Restatement Agency, supra note 88, at §§ 388, 404.

[91] Restatement Agency, supra note 88, at § 393.

[92] Restatement Trusts, supra note 88, at § 170(2); Restatement Agency, supra note 88, at § 389; Trustees Handbook, supra note 88, at 68.

[93] Restatement Agency, supra note 88, at § 391.

fiduciary must surrender them to the principal.[94] In fact, any profit the fiduciary might make of any nature arising from violation of the duty or loyalty to the principal belongs to the principal, and the fiduciary must account for it or its value to the principal or beneficiary.[95]

Any property of the principal or beneficiary that comes into the hands of the fiduciary as a result of the relationship must be kept separate and treated with special care to protect the interests of the principal in the same manner and skill that the fiduciary would use in administering his or her own property.[96] However, if the fiduciary treats property entrusted to the fiduciary as the fiduciary's own personal property or mingles it with the fiduciary's own property, the fiduciary is guilty of conversion.[97]

Although these duties may be varied by contract between the parties, and although the principal may relieve the fiduciary of many of these strict duties, no contract of this nature is effective to relieve the fiduciary of liability for breach of duty in bad faith, done intentionally or with reckless indifference to the interests of the principal. Similarly, a contract term where a principal waives his or her right to claim any profit that the fiduciary has derived from a breach of fiduciary duty is not enforceable.[98]

[b] Transactions Where a Bank Is a Fiduciary. Determining whether a bank is acting in a fiduciary capacity may be a difficult matter.[99] The relationship between bank and depositor ordinarily is that of a creditor and a debtor, not of a fiduciary and a principal.[100] Circumstances exist, however, in which a fiduciary relationship will be implied as a matter of law, because the relationship between the parties involves a special confidence placed by one person in the other.[101] In

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[94] Id. at §§ 392, 394, 403.

[95] Restatement Trusts, supra note 88, at § 205(b); Restatement Agency, supra note 88, at §§ 403, 404.

[96] Restatement Trusts, supra note 88, at §§ 174, 179; Restatement Agency, supra note 88, at §§ 402(f), 404.

[97] Restatement Agency, supra note 88, at §§ 398, 402.

[98] Restatement Trusts, supra note 88, at § 222; cf. id. § 216.

[99] See generally Annot., "Existence of Fiduciary Relationship Between Bank and Depositor so as to Impose Special Duty Upon Bank," 70 ALR3d 1344 (1976); Hagedorn, "The Impact of Fiduciary Principles on the Bank-Customer Relationship in Washington," 16 Williamette L. Rev. 803 (1980).

[100] See Denison State Bank v. Madeira, 230 Kan. 684, 640 P2d 1235 (1982).

[101] An example is an escrow deposit. An escrow depository owes a fiduciary duty to the parties to the escrow transaction. The escrow depository does not have a duty to others, although, under proper circumstances, notice of the interests of a third party may justify imposing a constructive trust upon property held by the depository. DeMello v. Home Escrow, Inc., 4 Haw. App. 41, 659 P2d 759 (1983). An escrow agent has two fiduciary duties to the principals to the transaction. There is a duty of strict compliance with the terms of the escrow agreement, and there is a duty to disclose known fraud;

Denison State Bank v. Madeira,[102] a person who borrowed funds from a bank to acquire a business claimed that the bank breached a fiduciary duty to him by not disclosing information relevant to the financial standing of the business he was acquiring. The borrower argued that the bank had a fiduciary relationship to him because the bank had superior knowledge in the transaction. The court declined to hold the bank to the standard of a fiduciary. The borrower was a knowledgeable and experienced businessman who had full access to the relevant financial records of the business he was acquiring. In the view of the court, the borrower could not avoid responsibility for his own lack of diligence in investigating the financial status of the business. This was an ordinary business transaction with the bank, and not a fiduciary relationship.

In *Dolton v. Capitol Federal Savings & Loan Association*,[103] the court reversed entry of summary judgment for the plaintiff savings and loan association in a case in which a customer of the savings and loan claimed that the association improperly deprived him of a business opportunity by purchasing land the customer was negotiating to obtain. The customer sued on theories of tortious interference with prospective business advantage and breach of fiduciary duty. The court held that questions of facts were presented on both issues requiring a trial.

Although there is no per se fiduciary relationship between a borrower and lender, the court said, "a fiduciary duty may arise from a business or confidential relationship which impels or induces one party 'to relax the care and vigilance it would and should have ordinarily exercised in dealing with a stranger.'"[104] The jury was entitled to determine if the borrower had trusted the association to deal with him on a fiduciary basis and if the association had invited or accepted such a trust. In referring these questions to the jury, the court

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Maganas v. Northroup, 135 Ariz. 573, 663 P2d 565 (1983). "A correspondent bank relationship, standing alone, does not create an agency relationship. . . ." Accordingly, no fiduciary relationship existed. Aaron Ferer & Sons., Ltd. v. Chase Manhattan Bank, 731 F2d 112, 122 (2d Cir. 1984).

The deposit of a check with an escrow depository without the indorsement of the payee prevents an escrow relationship from being established because the payee retains control over the instrument. To create an escrow, it must be possible for the check to be delivered to the party entitled to it upon the performance of all the terms of the escrow agreement without any further conditions. Patel v. Gannaway, 726 F2d 382 (8th Cir. 1984).

[102] 230 Kan. 684, 640 P2d 1235 (1982).

[103] 642 P2d 21 (Colo. Ct. App. 1981). See also Zions First Nat'l Bank v. United Health Club, Inc., 704 F2d 120 (3d Cir. 1983). In Collins v. Union Fed. Sav. & Loan Ass'n, 99 Nev. 284, 662 P2d 610 (1983), the court rejected a claim for interference with prospective economic advantage brought against a bank. The plaintiff claimed that the bank discouraged buyers from dealing with him about the sale of plaintiff's property in order to depress the price that would be bid for the property at a mortgage foreclosure sale.

[104] 642 P2d at 23.

noted that the nature of banking involved a "constant invitation" to prospective borrowers to place trust in the bank. If there was a fiduciary relationship, then the savings and loan association had a duty to refrain from engaging in transactions "antagonistic to its customer." In this case, the transaction involved a purchase of real estate. Although the savings and loan knew of the property previously and had a prior interest in obtaining it, there would be a breach of fiduciary duty if the circumstances justified finding that there was a fiduciary relationship. With respect to the claim of tortious interference with a prospective business advantage, the court also ruled that a trial should be held. The court recognized that competitors do not act improperly by obtaining a business advantage over other competitors, but it concluded that the savings and loan association should not be viewed as a competitor in the field of real estate development.

A bank that made a real estate loan to a purchaser of a condominium unit did not breach a fiduciary duty to its debtor by misrepresenting the extent to which the units in the condominium complex had been sold, because the bank did not owe a fiduciary duty to its borrower even when the bank had special knowledge of the circumstances of the condominium development.[105] Here, the bank participated in the construction financing, and the developer referred purchasers of condominium units to the bank for financing.

In *Aaron Ferer & Sons' Ltd. v. Chase Manhattan Bank*,[106] the court discussed the issue of when a bank engaged in business negotiations has a duty to disclose information to participants in the transaction. Under circumstances in which there is a duty to disclose, omissions of material fact can constitute fraud. But there is a disclosure duty only in two situations: "first, where the parties enjoy a fiduciary relationship . . . and second, where one party possesses superior knowledge, not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge."[107] In determining whether there is a fraudulent concealment because of superior knowledge, it is necessary to consider the extent to which the information may be public, the extent of disclosure made, and the extent that the party claiming injury pursued obtaining the information under procedures available for discovering it. Accordingly, when there was a failure to inquire, a failure to follow up on information disclosed, and a failure to utilize existing litigation to obtain the information, as well as when the bank had reasonable grounds for not volunteering information so as to protect the confidentiality of its customers' affairs, the court declined to find the bank had a duty of disclosure.[108]

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[105] Indermill v. United Sav., 5 Ohio App. 3d 243, 451 NE2d 538 (1982).

[106] 731 F2d 112 (2d Cir. 1984).

[107] Id. at 123. Access to the financial records of a business corporation does not create a fiduciary relationship. Under New York law, "the usual relationship of bank and customer is that of debtor and creditor" absent an intent to make the relationship something more. Id. at 122.

[108] Id. at 123-124.

In a California case, a court found that a bank had a special duty to its customer to act in good faith because the nature of the relationship between bank and customer was a special one, like that of a fiduciary, because of the trust and confidence placed in the bank and because the business of banking is a "highly regulated" one that involves "performing vital public services substantially affecting the public welfare." Depositors are dependent on their banks to act honestly and competently to protect the funds entrusted to the banks. Thus, the court viewed the bank-depositor relationship as at least a "quasi-fiduciary" one, characterized by elements of public interest, adhesion, and fiduciary responsibility. Because of this relationship, a bank impliedly covenants to act in good faith and to deal fairly, and so may be held liable in tort for breach of its covenant when it raises spurious defenses and engages in stonewalling tactics to prevent its depositor from recovering funds lost through the bank's negligence.[109]

A decision by the Ninth Circuit, although not involving common-law fiduciary principles, presented a similar issue. In the case, a bank honored its customer's overdrafts to enable the customer to pay wages, on which withholding and FICA taxes were due the Internal Revenue Service, to its employees. The court held that a trial was necessary to determine if the bank was liable for the failure of the borrower to pay the taxes. Under the Internal Revenue Code, a person who supplies funds for wages with notice that the employer will not pay the required withholding and FICA taxes is liable for payment of the taxes.[110] The district court had held that the bank did not violate this statute by honoring the overdrafts. The court of appeals reversed and remanded the case for trial.[111]

[2] A Bank's Duty of Good Faith and Related Obligations

A series of cases, often loosely referred to as lender liability cases, has sharpened awareness of a bank's obligation to treat its customers fairly and in good faith. Although many of these cases have involved situations in which a bank has moved to collect a loan or to exercise what the bank thought were its remedies under various financing arrangements, the principles involved in the cases are broader than the specific circumstances of the particular financing arrangement. In some of these cases, large jury awards were obtained against banks by parties who claimed that the bank's conduct in handling the financing relationship was wrongful and injurious. In one of the earliest in this series of cases, *State National Bank v. Farah Manufacturing Co.*,[112] the court upheld a

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[109] Commercial Cotton Co. v. United Cal. Bank, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985). The covenant of good faith and fair dealing is discussed supra ¶ 24.02[2].

[110] 26 USC § 3505(b) (1982).

[111] United States v. First Nat'l Bank, 652 F2d 882 (9th Cir. 1981).

[112] 678 SW2d 661 (Tex. Ct. App. 1984).

jury award of $18 million against a bank that had loaned funds to the plaintiff company, because the bank's actions in threatening to invoke a management change clause in its loan agreement with the plaintiff was held to constitute fraud, duress, and interference with the business relationships and governance of the company.

[a] Theories Underlying Lender Liability Cases. The cases that fall in the lender liability category are based upon a number of different legal theories. Some of these are new, and some of them are familiar common-law concepts. While this section cannot give a detailed analysis of the various theories,[113] the discussion that follows illustrates the major developments.

There is a general duty of good faith in the UCC, which attaches to every contract and to every duty under it. The relevant section simply states, "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."[114] This is intended to be an overarching principle of the UCC.[115] What constitutes the obligation of good faith is refined and developed to some extent in the particular provisions of the UCC that deal with specific transactional matters. In general, as discussed here previously,[116] the UCC defines "good faith" as "honesty in fact in the conduct or transaction concerned."[117] In some circumstances, there may be a higher duty. A merchant who engages in transactions subject to Article 2 on the sales of goods is required to observe "reasonable commercial standards of fair dealing in the trade."[118] The standards of the trade that are relevant, according to the UCC, are those "currently observed by the great majority of decent dealers, even though dissidents ready to cut corners do not agree."[119] The concept of good faith is necessarily an open-ended and general idea, which permits courts to exercise some leeway in seeing that justice is done under the particular circumstances, and there is no hard, bright line rule to distinguish good faith conduct from that which is not.

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[113] There is a growing literature on the issue of lender liability. See generally Granoff, "Emerging Theories of Lender Liability: Flawed Applications of Old Concepts," 104 Banking LJ 492 (1987).

[114] UCC § 1-203.

[115] UCC § 1-203 comment.

[116] See discussion at ¶ 16.01 of good faith with respect to the qualifications to be a holder in due course.

[117] UCC § 1-201(19).

[118] UCC § 2-103(1)(b).

[119] UCC § 1-205, comment 5. In Van Bibber v. Norris, 419 NE2d 115 (Ind. 1981), the court indicated that a lender is not held to the merchant duty of following reasonable commercial standards. See the discussion of the development of the concept of good faith in the UCC in Wiseman, "The Limits of Vision: Karl Llewellyn and the Merchant Rules," 100 Harv. L. Rev. 465 (1987).

Under the UCC, any right or obligation recognized by the UCC "is enforceable by action" unless there is a specific declaration in the UCC that limits the availability of enforcement.[120] The type of relief that might be available, whether in the nature of specific performance or equitable relief, the comments say should be determined by the specific provisions of the UCC and supplementary principles of law that the UCC incorporates.[121] This invites actions by aggrieved parties to enforce the duty of good faith. Further, it leaves open the question of what relief might be appropriate under the circumstances.

There are provisions in the UCC that limit the award of damages, particularly in the sections on bank collections, which provide that the measure of damages for not exercising ordinary care in "handling an item" is limited to "the amount of the item reduced by an amount which could not have been realized by the use of ordinary care . . . ."[122] This limitation on damages is not applicable when there is bad faith. In cases of bad faith, the measure of damages "includes other damages, if any, suffered by the party as a proximate consequence."[123] Although the UCC adopts as a general principle that the remedies provided in the UCC are to be liberally administered to put the injured party "in as good a position as if the other party had fully performed" the obligation, the UCC also takes a stance that "neither consequential or special nor penal damages may be had except as specifically provided in this Act or by other rule of law."[124] There are few circumstances in the UCC itself in which punitive damages are addressed, but the reference to "other rule of law" indicates an intent to incorporate general rules of law on measuring damages from outside the UCC.

There is a line of cases, discussed earlier in this chapter, that deal with the bank's duty of good faith when a bank decides to demand payment of a note under an acceleration clause or by making demand on a demand note.[125] As these cases reveal, there are divergent views on the extent to which the duty of good faith may limit a bank from exercising rights that otherwise are specifically provided for in the lending agreement.[126]

A growing body of cases holds that a bank may be liable in tort for breach of an implied covenant of good faith and fair dealing.[127] The covenant of good faith

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[120] UCC § 1-106(2).

[121] UCC § 1-106, comment 2.

[122] UCC § 4-103(5).

[123] Id.

[124] UCC § 1-106(1).

[125] See discussion supra ¶ 24.01[1].

[126] See Brown v. Avemco Inv. Corp., 603 F2d 1367 (9th Cir. 1979), where the duty of good faith limited the ability of the bank to exercise a default provision entitling the lender to accelerate the debt.

[127] See Commercial Cotton Co. v. United Cal. Bank, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985).

and fair dealing is not based on the UCC obligation of good faith, but rather is a tort duty whose origin is founded upon the existence of a special relationship between the parties, such as that in which a fiduciary relationship exists.[128] A 1985 California case found that there was a special relationship between a bank and a customer who had a checking account with the bank, because of the importance of the public service provided by the bank and the regulated nature of the banking industry.[129]

Breach of the duty of good faith is but one of the many theories on which recovery from banks for wrongful conduct in dealing with customers has been sought. Some of the additional theories are fraud, both for deliberate misrepresentation as well as for fraudulent nondisclosure where there is a duty to disclose.[130] Interference with business relationships and theories based on lender control of the debtor also have been the basis for recovery.[131]

When a debtor becomes bankrupt, claims asserted against the bankrupt may be challenged under principles of equitable subordination.[132] Under this doctrine, a bankruptcy court may subordinate the claims of creditors whose conduct is inequitable to the claims of other creditors.[133] Liability issues also arise when a secured lender acts to repossess collateral or to exercise other Article 9 rights on default. These problems are discussed in the sections of this chapter that deal with the enforcement of security interests. The remainder of this section provides examples of some of the cases involving various theories of liability, such as those referred to previously.

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[128] See Seaman's Direct Buying Serv., Inc. v. Standard Oil Co., 36 Cal. 3d 752, 686 P2d 1158, 206 Cal. Rptr. 354 (1984). This principle has been applied in wrongful discharge from employment cases and in cases involving insurers' dealings with their policyholders.

[129] See also Best v. United States Nat. Bank, 78 Or. App. 1, 714 P2d 1049 (1986), aff'd, 303 Or. 557, 739 P2d 554 (1987). In this case, plaintiffs brought a class action to recover $30 million for bank charges for return of insufficient funds checks on the grounds, among others, of breach of the covenant of good faith and unconscionability. Although the court held that unconscionability could not be an affirmative basis for relief, the court ruled that recovery could be obtained for breach of an implied covenant of good faith. See generally Annot., "Bank's Liability for Breach of Implied Contract of Good Faith and Fair Dealing," 55 ALR4th 1026 (1987).

[130] State Nat'l Bank v. Farah Mfg. Co., 678 SW2d 661 (Tex. Ct. App. 1984). See also Central States Stamping Co. v. Terminal Equip. Co., 727 F2d 1405 (6th Cir. 1984), which found a bank officer improperly failed to disclose material information.

[131] State Nat'l Bank v. Farah Mfg. Co., 678 SW2d 661 (Tex. Ct. App. 1984).

[132] See 11 USC §§ 510(c) (1982), which recognizes the principle of equitable subordination in making distributions to bankruptcy claimants.

[133] See generally Taylor v. Standard Gas & Electric Co., 306 US 307 (1939); Pepper v. Litton, 308 US 295 (1939); In re Westgate-Cal. Corp., 642 F2d 1174 (9th Cir. 1981); In re Mobile Steel Co., 563 F2d 692 (5th Cir. 1977).

[b] Liability Cases. In *State National Bank v. Farah Manufacturing Co.*,[134] the court upheld a jury award of $18 million against a bank that had loaned funds to the plaintiff company, because the bank's actions in threatening to invoke a management change clause in its loan agreement with the plaintiff in order to influence the management of the company amounted to fraud, duress, and interference with the business relationships and governance of the company.

The secured party should carefully investigate the possibility of other creditors with priority rights in the collateral to avoid interfering with their property interests in the collateral. In *Barr v. White Oak State Bank*,[135] a secured party repossessed collateral and disposed of it only to discover that there was another secured party with a superior interest. The foreclosing secured party, a bank, knew that other creditors needed to be informed before disposing of the collateral, and that the interests of other secured parties could be found by a search of the records held by the Secretary of State, but it failed to conduct such a search. The court found that these circumstances were "sufficient to raise the issue that the bank acted with reckless disregard for the rights of the other secured creditor . . .," entitling the other secured creditor to exemplary damages.

In the *K.M.C. Co.* case, the bank entered into an agreement to provide a line of credit stipulating that advances under the line of credit were within the discretion of the bank and, further, that the bank could require all funds advanced to be repaid on demand. When the bank terminated the credit, the court found that the bank had a duty of good faith that required giving advance notice to its borrower for a period that would allow the borrower to arrange alternative financing.[136] A different court declined to follow K.M.C. Co. and ruled that past advances made by the bank beyond the credit limits of the loan agreement did not constitute a course of dealing that modified the bank's power under the loan agreement to make the loan due on demand.[137] In *Finley, Inc. v. Longview Bank & Trust Co.*,[138] the court ruled that a bank acted in good faith in exercising its rights under an acceleration clause when the debtor threatened bankruptcy. Although the debt to the bank was secured by a CD in the same amount as the debt, the interest payable was 11 percent on the note but only 9 percent on the CD. Thus, the collateral did not cover the entire indebtedness, and the bank's acceleration for "insecurity" was in good faith given "the nature and value of the collateral."[139]

A federal appellate court affirmed a $100,000 award for breach of the duty of good faith when a bank called due a loan of $25,000 and took steps to collect it

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[134] 678 SW2d 661 (Tex. Ct. App. 1984).

[135] 677 SW2d 707 (Tex. Ct. App. 1984).

[136] K.M.C. Co. v. Irving Trust Co., 757 F2d 752 (6th Cir. 1985).

[137] Flagship Nat'l Bank v. Gray Distribution Sys., Inc., 485 So. 2d 1336 (Fla. Dist. Ct. App.), reviewed denied, 497 So. 2d 1217 (Fla. 1986).

[138] 705 SW2d 206 (Tex. Ct. App. 1985).

[139] See Karner v. Willis, 238 Kan. 246, 710 P2d 21 (1985).

by setoff of other bank credits and seizure of the borrower's personal automobile. Although the loan involved a demand note, the court ruled that the bank still had a duty to act in good faith and pointed to other loan documents indicating that the bank's right to demand payment had been qualified.[140]

A Texas state court jury awarded over $59 million to a couple who borrowed $1.5 million from the Texas Commerce Bank-McAllen to build a furniture store. The award was the result of the bank's failure to release its lien on property that secured a second loan to the couple of $185,000 when that loan was repaid. The suit was based on fraud by misrepresentation and breach of the bank's duty of good faith and fair dealing.[141] In *Conlon v. Wells Fargo Bank*,[142] a jury awarded $10 million in compensatory damages and $50 million in punitive damages to borrowers who claimed that the Wells Fargo bank engaged in fraudulent conduct, breach of contract, and infliction of emotional distress by its actions in terminating an $8 million crop loan financing program previously established for the borrowers.

¶ 24.03 ENFORCEMENT OF SECURITY INTERESTS UNDER UCC ARTICLE 9

[1] Default

Default occurs when the conditions constituting default, as stipulated in the security agreement, arise.[143] Subject to the UCC's good faith rules, the security agreement may stipulate those actions of the debtor or those other circumstances that constitute a default.[144] The agreement may contain an "acceleration" clause establishing that the debtor's obligation will become due at the "will of the secured party" or when the secured party "deems himself insecure," but these clauses may be exercised only when the secured party "in good faith believes that the prospect of payment or performance is impaired," as discussed earlier in this chapter.[145]

When default occurs, the secured party has the following options. It may sue and obtain a judgment against the debtor for the obligation and then utilize the normal procedures available to creditors for enforcement of judgments; it may use the provisions provided in the UCC, which permit the secured party to take

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[140] Reid v. Key Bank, 821 F2d 9 (1st Cir. 1987).

[141] Robinson v. McAllen State Bank, 48 Banking Rep. (BNA) 1004 (No. C-1948-84-D, Tex. 206th Dist. Ct. May 12, 1987).

[142] 48 Banking Rep. (BNA) 1041 (No. 82852, Cal. App. Dep't Super. Ct. June 10, 1987).

[143] UCC § 9-501(1).

[144] Id.

[145] UCC § 1-208. See supra ¶ 24.01[1][b].

possession of the collateral;[146] or it may have further rights provided by the security agreement.[147] The rights and remedies of the secured party are cumulative and nonexclusive.[148]

Although the UCC ordinarily allows the parties to modify the way its rules apply by agreements made in good faith, there are some rules on the rights and duties of the parties on default that cannot be changed by agreement. Those rules requiring the secured party to account for any surplus money received from the sale of collateral, those dealing with the method of disposing of collateral, those governing the rights of the secured party to keep the collateral in satisfaction of the obligation, those giving the debtor the right to redeem the collateral, and those that establish the secured party's liability for failure to comply with the UCC procedures cannot be varied by agreement.[149]

[2] Repossession of the Collateral

One of the more important rights of a secured party, which distinguishes secured from unsecured creditors, is the right to use the collateral as a source of payment for the obligation when default occurs.[150] Although the UCC gives the secured party all the rights and remedies that may be available generally to unsecured creditors,[151] the secured party may also take steps to obtain possession of the collateral (assuming that the secured party does not already have possession) when default occurs.[152] Upon obtaining possession, the secured party may in some cases retain the collateral in satisfaction of the obligation, as discussed later, or it may resell it and apply the proceeds of the sale to the obligation.

The right to take possession of the collateral arises when default occurs.[153] In determining whether a default exists, not only must the terms of the security agreement be considered, but also attention must be given to the possibility that the course of dealing between the parties or other conduct may have created a waiver, estoppel, modification, or other ground for asserting that default has not

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[146] UCC § 9-501(1).

[147] Id.

[148] Id.

[149] UCC § 9-501(3).

[150] See generally Skilton & Dunham, "Security Interests in Returned and Repossessed Goods Under Article 9 of the Uniform Commercial Code," 15 Willamette L. Rev. 779–858 (1978); White, "Consumer Repossessions and Deficiencies: New Perspectives From New Data," 23 BCL Rev. 385–418 (1982); Annotation, "Validity, Under State Law, of Self-Help Repossession of Goods Pursuant to UCC § 9-503," 75 ALR3d 1061 (1977); Annotation, "Punitive Damages for Wrongful Seizure of Chattel by One Claiming Security Interest," 35 ALR3d 1016 (1971).

[151] UCC § 9-501(1).

[152] UCC § 9-503.

[153] Id.

occurred. The secured party also must act in good faith in deciding whether to declare a default.[154]

The UCC permits the secured party to repossess the collateral by self-help when that may be done without "breach of the peace."[155] Numerous cases, both under the UCC and prior to the UCC, have dealt with the question of what constitutes a breach of the peace.[156] A secured party's unconsented entry into the debtor's home to retake collateral, or the secured party's forcible seizure of the collateral from the debtor's possession, will be a breach of the peace under the usual rules, but there will be no breach of the peace when the debtor voluntarily consents to the removal.[157] It is important to consult the law of each jurisdiction carefully on this question, as the issue of what constitutes a breach of peace is one for decision on a case-by-case basis, and definitions vary among the states. Even when the retaking may in fact be accomplished peacefully, the potential of the circumstances for a violent confrontation has led to decisions in other areas of the law that the remedy cannot be used.[158] Alternatively, the secured party may utilize judicial process to take possession of the collateral.[159] Typically, this will be by an action in the nature of replevin. Such remedies have been challenged on constitutional grounds. These issues are discussed later in this section.

Of course, when the secured party is already in possession of the collateral, no further action is necessary to obtain possession of it, although there are procedures that the secured party must follow in order to dispose of the collateral or to apply it toward satisfaction of the debt. The secured party is subject to the obligations, discussed subsequently, to preserve and maintain the collateral.[160]

The security agreement may provide that the debtor, upon default, assemble the collateral and make it available to the secured party at a place designated by the secured party as reasonably convenient.[161] When the collateral consists of

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[154] See UCC § 1-203; discussion supra ¶ 24.01.

[155] UCC § 9-503.

[156] See B. Clark, The law of Secured Transactions Under the Uniform Commercial Code ¶ 4.5 (1980 & Supp.) (hereinafter Clark), White & Summers § 26-6 (2d ed. 1980).

[157] Id.

[158] See Berg v. Wiley, 264 NW2d 145 (Minn. 1978) (landlord repossession). For a discussion of breach of the peace under UCC Article 9, see generally T. Crandall, R. Hagedorn & F. Smith, Jr., Debtor-Creditor Law Manual ¶ 7.05[6] (1985). Some factors that have been considered in determining whether there has been a breach of the peace are the following: using actual force by the creditor, using threats and intimidation, having a police officer accompany the creditor, continuing repossession action after a debtor threatens violence or is in a position of bodily harm, and entering a residence without the debtor's consent. Id.

[159] UCC § 9-503.

[160] UCC §§ 9-501(1), 9-207.

[161] UCC § 9-503. See Clark Equip. Co. v. Armstrong Equip. Co., 431 F2d 54 (5th Cir. 1970), cert. denied, 402 US 909 (1971) (allowing the secured party to obtain an injunction requiring assembly of the collateral.)

an account, chattel paper, general intangibles, or an instrument, the secured party may give notice to the account debtor or obligor to make payments directly to the secured party.[162] The secured party is permitted to take possession of the collateral by rendering equipment unusable.[163] The secured party also may dispose of collateral on the debtor's premises by following the procedures provided for disposition of the collateral.[164]

[3] Constitutional Limitations on Secured Party Remedies

[a] Supreme Court Due Process Decisions. Since the U.S. Supreme Court decided the case of *Sniadach v. Family Finance Corp.*,[165] serious constitutional issues have surrounded use of creditors' remedies involving seizure of property of the debtor without prior notice or judicial proceeding. *Sniadach* involved the garnishment of wages of the debtor before a judicial judgment was obtained. The court held that, absent "extraordinary situations," due process requires giving notice to the debtor and allowing the debtor an opportunity to be heard prior to seizure of the property. Because the state garnishment statute did not afford these safeguards, the court held it unconstitutional.

Three years later, the Supreme Court decided *Fuentes v. Shevin*.[166] This case involved the validity of the replevin remedy. The creditor obtained from the clerk of the court a writ of replevin, ex parte, directing the sheriff to seize the property in which the creditor claimed an interest. Under the statute, it was not necessary to give prior notice to the debtor or to hold a hearing. The court held that this procedure also violated due process. As in *Sniadach*, there had to be notice and a hearing before seizure.

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[162] UCC § 9-502(1). See UCC § 9-318(3). This right may be exercised by the secured party, when there is an agreement with the debtor permitting such action, and may be exercised even without agreement on default. UCC § 9-502(1). Presumably, the obligor on a negotiable instrument would still be entitled to have the instrument canceled on payment to avoid the risk of double liability from the instrument's transfer to a holder in due course. UCC §§ 3-505, 9-318(3). With this type of collateral, the secured party may act more freely to liquidate the debt. See § 9-502(2) and comments.

[163] UCC § 9-503.

[164] Id.

[165] 395 US 337 (1969). See generally Annot., "Post-*Sniadach* Status of Banker's Right to Set Off Bank's Claim Against Depositor's Funds," 65 ALR3d 1284 (1975); Annot., "Modern Views as to Validity, Under Federal Constitution, of State Prejudgment Attachment, Garnishment, and Replevin Procedures, Distraint Procedures Under Landlord's Lien Statutes, and Like Procedures Authorizing Summary Seizure of Property," 18 ALR Fed. 223 (1974); Annot., "Replevin or Claim and Delivery: Modern View as to Validity of Statute or Contractual Provision Authorizing Summary Repossession of Consumer Goods Sold Under Retail Installment Sales Contract" 45 ALR3d 1233 (1972).

[166] 407 US 67 (1972).

Subsequently, in 1974, in *Mitchell v. W.T. Grant Co.*, the Court upheld a Louisiana statute that contained a procedure similar to replevin.[167] Under the Louisiana statute, however, there were safeguards for the protection of the debtor that were absent in *Fuentes*. Among the differences referred to by the Court was the fact that the Louisiana statute required the creditor to set forth specific facts justifying the creditor's claim—not just to provide conclusory allegations. It was required that the application for the remedy be made to a judge, not to a clerk of the court. The Louisiana statute gave further protection to the debtor by requiring a prompt hearing after the seizure.

Although some observers of the Court thought that *Mitchell* might have marked a retreat from the broad principles indicated in *Sniadach* and *Fuentes*, this conclusion was proved wrong in *North Georgia Finishing, Inc. v. Di-Chem Inc.*[168] In that case, the Supreme Court held as unconstitutional a Georgia garnishment statute that permitted a creditor to garnish funds in a bank account before judgment and without notice to the debtor. As the debtor in *Di-Chem* was a corporate business debtor, the case put to rest any notion that the constitutional due process protections of *Sniadach* and *Fuentes* apply only to consumer debtors. *Di-Chem* followed *Sniadach* in finding the garnishment procedures lacking in due process, but it also distinguished *Mitchell* on the grounds that the safeguards existing in the Louisiana statute were not present in the Georgia garnishment statute in *Di-Chem*. Thus, although *Di-Chem* makes clear that the due process limitations on creditor's remedies are to be taken seriously, it perpetuates the ambiguity in the law as to what may be needed to have a remedy that will pass constitutional muster.

In light of these discussions by the Supreme Court, it seems clear that a creditor should move cautiously prior to exercising any remedy to seize goods of the debtor before the creditor has obtained a judgment against the debtor. In most instances, it will be necessary to give notice and to provide an opportunity for a hearing before property can be seized prior to judgement. Indeed, this is reflected in the revisions made by most states in their replevin procedures, which require some kind of preseizure hearing.

[b] Self-Help Repossession and the Issue of State Action. The application of the constitutional principles announced by the Supreme Court in these cases to the remedies given secured parties by the UCC has attracted considerable attention. Under the UCC, upon default the secured party is entitled to repossess the collateral either by self-help, when that can be done without breach of the peace, or by appropriate judicial action.[169] The customary procedure by which creditors may obtain possession of collateral in the hands of the debtor is the

[167] Mitchell v. W.T. Grant Co., 416 US 600 (1974).

[168] 419 US 601 (1974).

[169] UCC § 9-503.

replevin remedy. As indicated previously, it is clear that in most cases, before this remedy can be safely used prior to judgment against the debtor, the secured party must give notice to the debtor and some sort of preseizure hearing must be held. To a creditor, the consequences of using an unconstitutional procedure are serious. The creditor could be liable under federal statutes for violating the civil rights of the debtor.[170]

The UCC's self-help repossession provision has generated considerable litigation. If statutory replevin procedures are unconstitutional when no notice or hearing is afforded, one may ask why the even more unsupervised and potentially abusive remedy of self-help repossession should not be unconstitutional. The courts that have considered this question generally have rejected the attacks on the self-help repossession remedy.[171]

The reason given by the courts for rejection of the constitutional attack is that a creditor's use of the repossession remedy does not involve any "state action." The due process clause applies only to "state action." It does not limit purely private conduct.[172] Because the UCC is a state statute and contains a provision indorsing the self-help remedy, there is at least the gloss of state action when this remedy is employed. The decided cases reject this line of reasoning, but the Supreme Court has not decided the question. In *Flagg Brothers, Inc. v. Brooks*,[173] the court rejected an attack on the constitutionality of a warehouseman's lien provided under Section 7-210 of the UCC for unpaid storage bills. The court, notwithstanding the statutory provision creating the lien, held that no state action was involved. The court reasoned that the UCC provision only

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[170] 42 USC § 1983 (1982). Lugar v. Edmundson Oil Co., 457 US 922 (1982). Although one court has held that there was no civil rights act violation when the creditor used the Pennsylvania replevin statute later invalidated by the Supreme Court in *Fuentes* (Kacher v. Pittsburgh Nat'l Bank, 545 F2d 842 (3d Cir. 1976)), liability has been imposed upon a creditor for using a defective replevin statute, after the Court had decided *Fuentes*, similar to the one used in that case. Guzman v. Western State Bank, 540 F2d 948 (8th Cir. 1976).

[171] Gibson v. Dixon, 579 F2d 1071 (7th Cir. 1978); Calderon v. United Furniture Co., 505 F2d 950 (5th Cir. 1974); Gary v. Darnell, 505 F2d 741 (6th Cir. 1974); Turner v. Impala Motors, 503 F2d 607 (6th Cir. 1974); Gibbs v. Titleman, 502 F2d 1107 (3d Cir. 1974), cert. denied sub nom Gibbs v. Garver, 419 US 1039 (1974); Grantley v. Union Bank & Trust Co., 498 F2d 365 (5th Cir. 1974), cert. denied, 419 US 1034 (1974); Nichols v. Tower Grove Bank, 497 F2d 404 (8th Cir. 1974); Nowlin v. Professional Auto Sales, Inc., 496 F2d 16 (8th Cir. 1973), cert. denied, 419 US 1006 (1974); James v. Pinnix, 495 F2d 206 (5th Cir. 1974); Shirley v. State Nat'l Bank, 493 F2d 739 (2d Cir. 1974), cert. denied, 419 US 1006 (1974); Adams v. Southern Cal. First Nat'l Bank, 492 F2d 324 (9th Cir. 1974), cert. denied, 419 US 1006 (1974); Bichel Optical Laboratories, Inc. v. Marquette Nat'l Bank, 487 F2d 906 (8th Cir. 1973).

[172] The cases are collected in Annot., "Validity, Under Federal Constitution and Laws, of Self-Help Repossession Provisions of § 9-503 of Uniform Commercial Code," 29 ALR Fed. 481 (1976). See generally, J. Nowak, R. Rotunda & J. Young, Constitutional Law § 13.5, at 476 (3d ed. 1986).

[173] 436 US 149 (1978).

codified a remedy that existed apart from the statute at common law. But the court was careful to add, "This is not to say that dispute resolution between creditors and debtors involves a category of human affairs that is never subject to constitutional constraints."[174] Similarly, in *Jackson v. Metropolitan Edison Co.*,[175] the Supreme Court found that the due process clause did not apply to an action by a public utility to cut off electric service of its customer unilaterally following a dispute over the amount owed the utility. Although the utility was a regulated monopoly and the utilization of the service cutoff had been approved by the state utility commission in a rate tariff hearing, the court said that no state action was involved.[176]

Where the creditor's actions involve the participation of state officials in a procedure that leads to seizure of the debtor's property, there will be state action as a result of the involvement of the state in the process. Such was the ruling in *Lugar v. Edmundson Oil Co.*,[177] a case that involved a prejudgment writ of attachment against a debtor's property. Under the state procedure, the county sheriff and the court system were involved in the issuance and execution of the writ of attachment. This created state action. The test articulated by the court for determining whether state action was implicated in the attachment of debtor's property was as follows: "First, the deprivation must be caused by the exercise of some right or privilege created by the state, or by a rule of conduct imposed by the state, or by a person for whom the state is responsible .... Second, the party charged with the deprivation must be a person who may fairly be said to be a state actor because he is a state official, or because he has acted together with or has obtained significant aid from state officials, or because his conduct is otherwise chargeable to the state."[178] Notwithstanding this statement, substantial difficulties remain in determining how to apply this test to particular situations. Further development of the state action doctrine by the U.S. Supreme Court is likely to occur.

What constitutes state action was at issue in *Harris v. City of Roseburg*.[179] The facts in this case illustrate the difficulties in making that determination on a

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[174] Id. at 149, 162 n. 12 (1978).

[175] 419 US 345 (1974).

[176] A number of state court decisions also have upheld the constitutionality of the UCC self-help repossession provision. Melara v. Kennedy, 541 F2d 802 (9th Cir. 1976); McDuffy v. Worthmore Furniture, Inc., 380 F. Supp. 257 (ED Va. 1974); Kipp v. Cozens, 40 Cal. App. 3d 709, 115 Cal. Rptr. 423 (1974); John Deere Co. v. Catalano, 186 Colo. 101, 525 P2d 1153 (1974); A&S Excavating, Inc. v. International Harvester Credit Corp., 31 Conn. Supp. 152, 325 A2d 535 (1974); King v. South Jersey Nat'l Bank, 66 NJ 161, 330 A2d 1 (1974); Helfinstine v. Martin, 561 P2d 951 (Okla. 1977); Cook v. Lily, 208 SE2d 784 (W. Va. 1974).

[177] 457 US 922 (1982).

[178] Id. at 922, 938–939 (1982).

[179] 664 F2d 1121 (9th Cir. 1981).

practical level. A seller acted to repossess a truck from the debtor by self-help measures and arranged for a police officer to accompany him during the repossession. The officer, Bergman, informed the seller that the police could not participate in the repossession, but the officer accompanied the seller to be available to stop a fight if one should occur during the effort to repossess the vehicle. When the seller found the truck parked on the street near the debtor's residence, he began to take it. The debtor discovered him, and a verbal confrontation followed. The police officer was present during the controversy. Eventually the debtor returned to his house, to avoid becoming violent, and the seller took the vehicle while the debtor was inside. The debtor subsequently was successful in state court action against the seller claiming that the repossession was unlawful. He then brought suit against the city under the federal Civil Rights Act contending that his constitutional rights had been denied. Under the law of the state, the debtor had a right to resist the repossession by the seller, whose only remedy then would be to resort to legal process. The debtor claimed that the presence of the police officer constituted a participation in the repossession in denial of the debtor's rights. The court concluded that the debtor was entitled to a trial of his claim:

> We conclude that there may be a deprivation within the meaning of § 1983 not only when there has been an actual "taking" of property by a police officer, but also when the officer assists in effectuating a repossession over the objection of a debtor or so intimidates a debtor as to cause him to refrain from exercising his legal right to resist a repossession. While mere acquiescence by the police to "stand by in case of trouble" is insufficient to convert a repossession into state action, police intervention and aid in the repossession does constitute state action.[180]

The court further held, however, that the police officer could claim a good faith immunity defense based on his sincere and honest belief that his actions were lawful and necessary to prevent violence from occurring.

The remedy of setoff often used by banks has also been challenged as violating due process because it is used without notice or hearing prior to its exercise. Nonetheless, this procedure has been upheld based on the same reasoning as that used in cases upholding the self-help repossession remedy.[181]

As this discussion indicates, there remain some substantial uncertainties in the law pertaining to creditor's remedies. The safe course, and the one that may

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[180] Id. at 1127.

[181] Fletcher v. Rhode Island Hosp. Trust Nat'l Bank, 496 F2d 927 (1st Cir.) cert. denied, 419 US 1001 (1974); Kruger v. Wells Fargo Bank, 11 Cal. 3d 352, 521 P2d 441, 113 Cal. Rptr. 449 (1974); Nietzel v. Farmers and Merchants State Bank, 307 Minn. 147, 238 NW2d 437 (1976). There is a comprehensive discussion of the constitutional problems involved with these creditor's remedies in Clark, supra note 156 at ¶¶ 4.5(1), 12.5(4). See generally Chiaw, "The Banker's Duty of Care with Respect to Security Documents," 1986 J. Bus. L. 113 (1986).

engender the most good will, is to use judicial process and to conform to the notice and hearing requirements established for these procedures. Any deviation should be undertaken only after seeking advice of counsel as to the risks involved under the law applicable in the particular jurisdiction.

[4] Disposition of Collateral After Default

[a] Requirements for Disposal of Collateral. After obtaining possession of the collateral upon default, the secured party may sell, lease, or otherwise dispose of it and use the proceeds of the disposition to satisfy the obligation.[182] The sale may be of the property in its then present condition, or after any "commercially reasonable preparation or processing."[183] Proceeds from the disposition go firstly, toward satisfying expenses of the secured party in taking possession and disposing of the collateral, including reasonable attorney fees and legal expenses;[184] secondly, to satisfy the indebtedness secured by the security interest concerned;[185] and thirdly, to satisfy any indebtedness that is subordinate to the security interest being enforced, when the secured party receives a written notice of the junior interest before completing distribution of the proceeds.[186] When a surplus exists, the secured party must account to the debtor for such surplus, unless the transaction was a sale of accounts or chattel paper. If the security transaction was such a sale, the debtor is entitled to the surplus only when the security agreement so provides; otherwise, it is presumed that the sale was absolute.[187]

When disposition of the collateral does not produce enough proceeds to satisfy the expenses of disposition and the indebtedness secured, the debtor remains liable for the deficiency unless the security agreement provides otherwise.[188] If, however, the secured transaction was an absolute assignment or sale of accounts or chattel paper, the debtor will be liable for a deficiency only when the security agreement so stipulates.[189]

The procedures established by the UCC for disposing of the collateral are critical, and close consultation with counsel is essential. There is a general requirement that "every aspect of the disposition including the method, man-

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[182] UCC § 9-504(1).

[183] Id.

[184] UCC § 9-504(1)(a).

[185] UCC § 9-504(1)(b).

[186] UCC § 9-504(1)(c).

[187] UCC § 9-504(2).

[188] Id. See generally Page, "A Secured Party's Right to a Deficiency Judgment After Noncompliance with the Resale Provisions of Article 9," 60 NDL Rev. 531 (1984).

[189] UCC § 9-504(2).

ner, time, place and terms must be commercially reasonable."[190] The secured party must give notice to the debtor of the time and place of any public sale or notice of the time after which a private sale or disposition will be made. In the case of collateral other than consumer goods, notice must be given to any other secured party from whom the first secured party has received written notice of a claim of an interest in the collateral.[191] When the collateral is perishable, or is such that it will quickly decline in value as a result of any delay, notification need not be given.[192] This also holds true when the collateral is of a "type customarily sold in a recognized market." (This last provision presumably applies to collateral for which there is a standard price established by a public market, such as a stock exchange or commodities exchange.)[193]

The secured party is permitted to buy the collateral at any public sale.[194] The secured party also may purchase the collateral at a private sale when the collateral is of the type customarily sold in a recognized market or is the subject of widely distributed standard price quotations.[195]

Apart from the requirement of commercial reasonableness, there is little specificity regarding the type of notice, the manner in which it should be sent, and the procedures for conducting any sale. This is an area in which problems may arise, and the law may vary between jurisdictions. In any case, local counsel should be consulted.[196]

A properly conducted sale will transfer all of the debtor's rights to the purchaser and will discharge the security interest that is being enforced, as well

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[190] UCC § 9-504(3). See infra ¶ 24.03[6] on liability for failure to follow correct procedures. In some states, the secured party may be unable to obtain a deficiency judgment if these are incorrect procedures. Note, "Secured Transactions: Commercial Reasonability of Secured Party's Sale of Collateral After Default Under UCC § 9-504(3)," 29 Okla. L. Rev. 486-505 (1976); see generally Annot., "What Is 'Commercially Reasonable' Disposition of Collateral Required by UCC § 9-504(3)," 7 ALR4th 308 (1981); Annot., "Uniform Commercial Code: Burden of Proof as to Commercially Reasonable Disposition of Collateral," 59 ALR3d 369 (1974).

[191] UCC § 9-504(3). See generally Annot., "Sufficiency of Secured Party's Notification of Sale or Other Intended Disposition of Collateral Under § 9-504(3)," 11 ALR4th 241 (1982); Annot., "Loss or Modification of Right to Notification of Sale of Repossessed Collateral Under Uniform Commercial Code § 9-504," 9 ALR4th 552 (1981); Annot., "Construction of Term 'Debtor' as Used in UCC § 9-504(3), Requiring Secured Part to Give Notice to Debtor of Sale of Collateral Securing Obligation," 5 ALR4th 1291 (1981).

[192] UCC § 9-504(3). See generally Annot., "Nature of Collateral Which Secured Party May Sell or Otherwise Dispose of Without Giving Notice to Defaulting Debtor Under UCC § 9-504(3)," 11 ALR4th 1060 (1982).

[193] See Clark, supra note 156, at ¶ 4.8(7).

[194] UCC § 9-504(3).

[195] Id.

[196] See generally Clark, supra note 156, at ¶ 4.8.

as any subordinate security interest or lien.[197] The purchaser takes free of all of these interests, even though there may be a defect in the procedures required for disposing of the collateral, as long as the purchaser buys in good faith in the case of any private disposition, or has no knowledge of the defects and is not in collusion with the secured party in the case of a public sale.[198]

The debtor has a right to redeem the collateral at any time before the collateral has been disposed of or before the secured party has entered into a contract for its disposition.[199] The debtor must tender to the secured party satisfaction of all obligations secured by the collateral, as well as all expenses incurred by the secured party including reasonable attorney's fees and legal expenses.[200] Secured parties who hold security interests junior to the enforcing secured party may also exercise a right to redeem the collateral by following the same procedures.[201] Numerous cases illustrate the application of these requirements. Some of the cases that demonstrate important aspects of the enforcement procedures are described subsequently.

[b] Cases Illustrating Requirements. In a case decided under the pre-1972 version of Article 9, a court concluded that a guarantor should be classified as a "debtor" under UCC § 9-105(1)(d) after default occurs, because the guarantor then "owes payment or other performance of the obligation secured" as set forth in the definition. Thus, the guarantor is entitled to the same protection of notice that the provisions of Article 9 extend to a debtor, and the secured party may not dispose of the collateral without giving reasonable notice to the guarantor. The court also discussed the circumstances under which a guarantor could waive notice of disposition of collateral. It drew a distinction between waivers that occurred prior to default under the security agreement, before the guarantor became primarily liable on the obligation, and postdefault waivers made after the guarantor became primarily liable on the obligation. In the latter situation, the court held that the guarantor could not waive his right to notice; the contract as guarantor cannot alter the mandate that notice be given under UCC § 9-501(3), which states that the rules relating to compulsory disposition of collateral may not be waived other than as provided in those provisions. It should be noted that the 1972 version of UCC § 9-504 does permit the debtor to waive

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[197] UCC § 9-504(4). A secured party has no duty under UCC § 9-504(3) to search the record to identify the interests of other secured parties before disposing of the collateral. The court further stated that although the interest of a senior lienholder in the collateral remained effective, the foreclosing secured party had no duty to give the lienholder the name of the buyer of the collateral. Utility Trailers of Wichita, Inc. v. Citizens Nat'l Bank & Trust Co., 11 Kan. App. 2d 421, 726 P2d 282 (1986).

[198] UCC § 9-504(4).

[199] UCC § 9-506.

[200] Id.

[201] Id.

notice when the waiver is made after default has occurred. (The waiver in the case at hand was contained in the original contract of guaranty that the guarantor signed.)[202]

The cosigner of a note is a debtor under Article 9 who must receive notice of the sale of collateral, even when the signer is not the owner of the collateral.[203] Notice requirements are strictly enforced. It is not sufficient to show that the secured party acted in good faith and sold the collateral in a commercially reasonable manner and in substantial compliance with the objectives of the statute, if the notice requirements are not strictly followed. In *Ford Motor Credit Co. v. Price*,[204] a secured party was denied recovery of a deficiency judgment because the notice of sale of collateral was published in the wrong county. In *First National Bank of Maryland v. DiDomenico*,[205] the secured party, who had voluntarily obtained possession of the collateral, sent the debtor a notice stating that the secured party would conduct a private sale in fifteen days and that the debtor had fifteen days within which to redeem the goods. The court held that the notice was not reasonable because it stated incorrectly that the debtor's redemption rights were limited to fifteen days, when UCC § 9-506 provides that the debtor may redeem the collateral at any time prior to its disposition. A guarantor of an obligation is entitled to notice under UCC § 9-504(3) as a "debtor," because a guarantor has potential liability for any deficiency arising on the disposition of the collateral.[206]

In *Midwest Bank & Trust Co. v. Roderick*[207] a codebtor complained that he had not received notice of the disposition of the collateral. The court held that UCC § 9-504 does not require that notice be given, because that section applies to disposition of collateral by the secured party, not to disposition by the debtor. In another case, a letter stating the bank's intent to sell the collateral within ten days in a commercially reasonable manner was not adequate notice of disposition, because it failed to disclose the time or place of the public sale. The letter was also defective when the sale was not held within ten days. A follow-up letter, which gave notice that some of the items of the collateral (in this case, cattle) would be sold at a particular date and place, was not adequate notice as to the remaining collateral (other cattle) not sold at the original date and place. The

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[202] McEntire v. Indiana Nat'l Bank, 471 NE2d 1216 (Ind. Ct. App. 1984). Prescott v. Thompson Tractor Co., 495 So. 2d 513 (Ala. 1986), held that UCC § 9-501(3) precludes a guarantor from agreeing in a guaranty agreement entered into prior to default to waive rights to notification of disposal of the collateral and conduct of the disposition by the secured party in a commercially reasonable manner. (The opinion collects the cases on this point.)

[203] Stockdale, Inc. v. Baker, 364 NW2d 240 (Iowa 1985).

[204] 163 Cal. App. 3d 745, 210 Cal. Rptr. 17 (1985).

[205] 302 Md. 290, 487 A2d 646 (1985).

[206] Reeves v. Habersham Bank, 254 Ga. 615, 331 SE2d 589 (1985).

[207] 132 Ill. App. 3d 463, 476 NE2d 1326 (1985).

court said there was a further obligation on the part of the bank to advise the debtor of when the balance of the collateral would be sold.[208]

A secured party's notice of disposition of the collateral should reach the debtor in time to allow the debtor a reasonable amount of time, usually several business days, in which to arrange alternative financing. Furthermore, the court found that an issue of good faith existed when the price of $1,000 paid by the secured party at the sale was grossly disproportionate to the purchase price of $306,000 for the goods six years earlier.[209]

In another case, the notice of disposition was not held to be commercially reasonable when it failed to state the manner in which, and the date on which, the collateral would be sold. The posting of a notice with the correct information in the lobby of the bank that was the secured party was not adequate to provide the notice required.[210]

Other difficulties arose when a secured party took separate action against different items of the collateral, and distinguished between new and used equipment that it was financing for its debtor. The debtor was an agricultural implement dealer with both new and used equipment. The secured party foreclosed against all the equipment. Because it had sold the equipment to the debtor, the secured party, when it took back the new equipment, gave the debtor credit in the amount of the invoice price for which the equipment had been sold. The used equipment was then sold at a private sale. A deficiency judgment resulted, and the secured party pursued recovery against the defendant guarantors. The court held that when the new equipment was taken for credit, at the invoice price against the debt, there was an "other disposition" of the collateral under UCC § 9-504, for which disposition the secured party was required to give statutory notice.[211]

In another case, the assignor of chattel paper became responsible for the duties of the secured party when it reacquired the paper.[212] A mobile home dealer assigned chattel paper on a mobile home unit to a financer, but, when the purchaser of the mobile home defaulted on the installment contact, the dealer took back the unit under a repurchase agreement with the financer. The dealer had the duties of a secured party to give proper notice of the sale of the mobile home because of the repurchase arrangement.[213]

Where a secured creditor did not make a serious effort to interest potential buyers, but ran only one inconspicuous ad in a trade publication and no one

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[208] Havelock Bank v. McArthur, 220 Neb. 364, 370 NW2d 116 (1985). See generally Annot., "What Constitutes Secured Parties' Authorization to Transfer Collateral Free of Lien Under 9-306(2)." 37 ALR4th 787 (1985).

[209] Paco Corp. v. Vigliarola, 611 F. Supp. 923 (EDNY 1985).

[210] Bank of Sheridan v. Devers, 702 P2d 1388 (Mont. 1985).

[211] Allis-Chalmers Corp. v. Haumont, 220 Neb. 509, 371 NW2d 97 (1985).

[212] Joyce v. Cloverbrook Homes, Inc., 81 NC App. 270, 344 SE2d 58 (1986).

[213] Id. at 272, 344 SE2d at 600. See UCC § 9-504(5).

showed up for the sale except the secured party, the sale was held to be not commercially reasonable because the notice was not adequate. However, the court said that the fair market value of the collateral at the time of the sale was adversely affected by a lis pendens that the debtor had filed against it. The value of the collateral (in this case an airplane) must be evaluated with the lis pendens against it, because the debtor must accept the consequences of having filed the lis pendens.[214]

Where a secured party has a blanket security interest in various assets of the debtor securing multiple advances of credit, the secured party must exercise care in taking steps to foreclose its security interest. The action taken to dispose of the collateral should be appropriate to the interests of all parties who are debtors and of all guarantors who might be affected by the disposition. In *Reeves v. Habersham Bank*,[215] the guarantors on a $35,000 note that represented a subsequent advance under an earlier security agreement were relieved from responsibility for a deficiency judgment, because the secured party had failed to give notice and had proceeded in an unreasonable manner in disposing of the original assets that secured the original debt. The future advance clause and cross-collateral provisions in the security agreement gave the guarantors of the later obligation an interest in the disposition of the original collateral.

A secured party who cannot recover a deficiency from its debtor because of the party's having proceeded in a commercially unreasonable manner in disposing of the collateral may make a claim against the debtor in bankruptcy. However, the secured party's claim extends only to the value of the collateral to which the secured party is entitled, because of the bar against recovery of a deficiency judgment. Thus, the secured party's claim will be disallowed to the extent it exceeds the value of remaining collateral.[216]

In *Associates Commercial Corp. v. Hammond*,[217] the court upheld the secured party's sale of collateral on an item-by-item basis, rather than as a single group, finding that the sale was commercially reasonable regardless of whether a higher price could have been obtained by selling the collateral as a group.

[5] Retention of Collateral in Discharge of the Obligation

In certain cases, a secured party may elect to retain the collateral in full discharge of the obligation.[218] The rules for consumer goods in this respect are

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[214] Contrail Leasing Partners, Ltd. v. Consolidated Airways, Inc., 742 F2d 1095 (7th Cir. 1984).

[215] 254 Ga. 615, 331 SE2d 589 (1985).

[216] In re Gerber, 51 Bankr. 526 (Bankr. D. Neb. 1985).

[217] 285 SC 277, 330 SE2d 82 (Ct. App. 1985).

[218] UCC § 9-505(1). See generally Annot., "Construction and Operation of UCC § 9-505(2) Authorizing Secured Party in Possession of Collateral to Retain It in Satisfaction of Obligation," 55 ALR3d 651 (1974).

different from those for other collateral. When consumer goods are involved, and the consumer-debtor has paid either 60 percent of the cash price of a purchase money security interest or 60 percent of the loan in the case of other security interests, the UCC compels the secured party to dispose of the collateral within ninety days after taking possession of it.[219] In this case, the provisions on disposition of collateral (discussed previously) must be followed. Failure to dispose of the collateral subjects the secured party to liability to the debtor for conversion or other injury.[220] The consumer-debtor may waive or modify these rights in writing *after default occurs*. It is not possible to waive this provision in the security agreement or prior to default.[221]

In cases where the collateral is not consumer goods, or in cases involving consumer goods where the 60 percent payment has not been satisfied, the secured party may retain the collateral in satisfaction of the obligation by sending a written notice to the debtor proposing to retain the collateral. In cases involving collateral other than consumer goods, notice also must be sent to other secured parties who have notified the secured party of their interest in the collateral.[222] If any person who is entitled to receive notification objects to the secured party's retention of the collateral, the secured party must dispose of it under the procedures discussed earlier in this section.[223] The debtor may waive receipt of this notice after, but not prior to, default.[224]

[6] Creditor Liability for Failure to Comply With UCC Procedures

Failure to comply with the UCC provisions on repossession and disposition of the collateral will result in liability of the secured party to the debtor and to

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A secured party may not take advantage of its own failure to give notice to the debtor of an intent to retain collateral in satisfaction of the debt where the secured party later disposes of the collateral and proceeds against the debtor for a deficiency. When the secured party retained the collateral and used it for a period of almost three years, the court found that the secured party had elected to retain the collateral as satisfaction of the obligation. Schmode's, Inc. v. Wilkinson, 219 Neb. 209, 361 NW2d 557 (1985).

Although in some cases it is appropriate to view the use of collateral as evidence of intent to accept collateral in satisfaction of the debt, use of collateral was not viewed as acceptance where the secured party had made clear his intention not to accept the collateral by timely and continued notification to the debtor. Johnson Equip., Inc. v. Nielson, 108 Idaho 867, 702 P2d 905 (Ct. App. 1985).

[219] UCC § 9-505(1).

[220] UCC §§ 9-505(1), 9-507(1).

[221] UCC §§ 9-501(3), 9-505(1).

[222] UCC § 9-505(2).

[223] Id. See ¶ 24.03[4].

[224] Id.

other secured parties who suffer loss as a result of such failure to comply.[225] The general rule adopted by the UCC recognizes that a person who may be harmed by a secured party's failure to follow the UCC procedures for enforcing the security interest may have a right to injunctive relief to restrain the manner in which the secured party is proceeding, as well as a right to recover damages for losses caused by the secured party's noncompliance.[226] The applicable section states that when the secured party is not following the provisions of the UCC dealing with default, "disposition may be ordered or restrained on appropriate terms and conditions."[227] This language, as well as the comments, makes clear that such relief may be obtained "prospectively before the unreasonable disposition has been concluded."[228] The provision recognizes that a court may impose appropriate conditions and suggests that the power of a court to control the manner of disposition to assure its commercial reasonableness may require that the collateral be liquidated, in conjunction with other property of the debtor not subject to the security interest, when the combined liquidation would enhance the value of the debtor's estate for the benefit of all creditors.[229]

The UCC rule clearly recognizes a right to damages, which extends to any person entitled to notification of the disposition of the collateral or to any person whose security interest in the property has been made known to the secured party before the disposition occurs. Such persons have "a right to recover from the secured party any loss caused by a failure to comply with the provisions of [the UCC on default in Article 9] . . . ."[230] The language of this section does not indicate whether the recovery should be based upon contract damages principles or on the measure of damages appropriate in tort actions. The general principles in the UCC on the recovery of damages, discussed previously, should apply, and would permit the incorporation of supplemental principles of law from outside the UCC.[231]

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[225] UCC § 9-507(1). When the secured party disposes of the collateral in a commercially unreasonable manner, even though the sale may have produced a surplus over the outstanding debt, the debtor has a right to bring an action for recovery of the lost surplus value of the collateral if a sale in a reasonable manner would have produced a larger surplus than the actual sale. Chadron Energy Corp. v. First Nat'l Bank, 221 Neb. 590, 379 NW2d 742 (1986).

[226] UCC § 9-507(1). See generally Schecter, "The Principal Principle: Controlling Creditors Should Be Held Liable for Their Debtor's Obligations." 19 UC Davis L. Rev. 875 (1986).

[227] UCC § 9-507(1).

[228] UCC § 9-507, comment 1.

[229] Id.

[230] UCC § 9-507(1).

[231] See discussion supra ¶ 24.02. For a discussion of the availability of damages and the different measures possible, see, Clark, supra note 156, at ¶ 4.12. Under this provision, punitive damages may be appropriate. See id., citing Davidson v. First Bank & Trust Co., 559 P2d 1228 (Okla. 1976); Klingbiel v. Commercial Credit Corp., 439 F2d 1303 (10th

When consumer goods are involved, there is a statutory penalty under which the debtor has a right to recover an amount not less than the sum of any credit service charge, plus 10 percent of the principal amount of the debt.[232] In addition to these provisions, courts have held that failure to comply with the UCC procedures may result in the loss of the secured party's right to a deficiency judgment.[233] There is a division of views here, with some courts finding an absolute bar to a deficiency, while others treat the circumstances as a presumption in favor of the debtor, with the secured party having the burden of proving the value of the collateral and the reasonableness of the sale in order to recover the deficiency. The cases in the latter category emphasize that the UCC gives the debtor a remedy in Section 9-507(1) to recover from the secured party for any loss caused by the secured party's failure to follow proper procedures. In appropriate cases, the secured party's conduct may give rise to liability in tort, based on conversion or other wrong committed. Certain creditor conduct may even be punishable as a crime.[234] When a consumer is involved, the standards for debt collection practices under federal and state statutes must also be followed.

The UCC does provide that failure to obtain the best price does not in itself make a disposition of the collateral "commercially unreasonable."[235] Further, following the customary procedures used by dealers of the type of property

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Cir. 1971); Franklin Inv. Co. v. Homburg, 252 A2d 95 (DC 1969). But in Texas Nat'l Bank v. Karnes, 717 SW2d 901 (Texas 1986), the court held that punitive damages were not appropriate for creditor noncompliance with the Article 9 default procedures.

[232] UCC § 9-507(1); Clark, supra note 156 at ¶ 4.12. See generally Whitford, "The Appropriate Role of Security Interests in Consumer Transactions," 7 Cardozo L. Rev. 959 (1986).

[233] See generally Clark, supra note 156, at ¶ 4.12; White & Summers, supra note 156, at ¶ 26-15; Annot., "Failure of Secured Party to Make 'Commercially Reasonable' Disposition of Collateral Under UCC § 9-504(3) as Bar to Deficiency Judgment," 10 ALR4th 413 (1981); Annot., "Uniform Commercial Code; Failure of Secured Creditor to Give Required Notice of Disposition of Collateral as Bar to Deficiency Judgment," 59 ALR3d 401 (1974).

See generally Warkentine, "Consumer Liability for Deficiencies in Washington," 4 U. Puget Sound L. Rev. 99–122 (1980); Note, "Adequacy of Sale Price: A Secured Party's Burden of Proof in Seeking a Deficiency Judgment After Resale of Collateral," 33 Mercer L. Rev. 397–405 (1981).

For examples of cases in jurisdictions holding that when a secured party fails to give proper notice of the sale of collateral, the secured party is not barred from obtaining a deficiency judgment against the debtor, and there is a presumption that the value of the collateral at the time of sale equals the amount of the debt, see First Galesburg Nat'l Bank & Trust Co. v. Joannides, 103 Ill. 2d 294, 469 NE2d 180 (1984); Weiner v. American Petrofina Mktg., Inc. 482 So. 2d 1362 (Fla. 1986). See generally Annot., "Sufficiency of Secured Party's Notification of Sale or Other Intended Dispositions of Collateral Under § 9-504(3)." ALR4th 241 (1982).

[234] For example, the Consumer Credit Protection Act establishes criminal penalties for extortionate collection practices. 18 USC §§ 891–896 (1982).

[235] UCC § 9-507(2).

involved, or obtaining the price current in any recognized market for the collateral constitutes a disposition that is commercially reasonable.[236]

¶ 24.04 SPECIAL CONSUMER CREDIT RULES

Often there are special rules that apply to credit practices when the debtor is a consumer. The scope of creditor and debtor rights and duties in consumer transactions is a subject too large for comprehensive coverage in this handbook. Some of the major laws that affect consumer transactions are described in Chapter 26.[237]

The Federal Trade Commission has a set of rules governing consumer credit practices. Under these rules it is an unfair act or practice under the Federal Trade Commission Act for a lender or a retail installment seller to use instruments or contracts in consumer transactions that contain a confession of judgment or other waivers of the consumer's right to notice the opportunity to be heard.[238] The rules also prohibit such lenders or sellers from requiring the consumer to waive exemptions that might be available to the consumer under state law from attachment or execution on the property of the consumer, both real estate and personal property, except as to the specific property subject to the security interest that was "executed in connection with the obligation."[239] Finally, and most importantly, the rules make it an unfair trade practice for such a lender or seller to use an instrument or contract that has an obligation containing "a non-possessory security interest in household goods other than a purchase money security interest."[240] Household goods are defined to include "clothing, furniture, appliances, one radio and one television, linens, china, crockery, kitchenware, personal effects (including wedding rings, clothes (of the consumer and his or her dependents)) . . ." with certain exceptions for works of art, electronic entertainment equipment, antiques, and jewelry.[241]

The FTC credit rules also regulate cosigner practices,[242] the collecting of late charges that arise as a result of the assessment of prior assessments of late fees or delinquency charges,[243] and assignments of wages or other earnings.[244]

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[236] Id.

[237] For general coverage of debtor-creditor relationships, see T. Crandall, R. Hagedorn & F. Smith, Jr., Debtor-Creditor Law Manual (1985 & Cum. Supp.).

[238] 16 CFR § 444.2(a)(1) (1987).

[239] 16 CFR § 444.2(a)(2) (1987).

[240] 16 CFR § 444.2(a)(4) (1987).

[241] 16 CFR § 444.1(i) (1987).

[242] See discussion at ¶ 15.06[4].

[243] 16 CFR § 444.4 (1987).

[244] 16 CFR § 444.2(a)(3) (1987).

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Bankruptcy

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¶ 25.01 SOURCE OF LAW, JURISDICTION, AND PROCEDURE

Bankruptcy is a complex and technical system of federal law that attempts to give relief to financially strapped debtors while ensuring fair treatment of the creditors.[1] This chapter provides a brief outline of the general concepts and provisions of bankruptcy law. Other sources are available for more thorough treatment of these topics, and should be consulted for further information.[2]

To begin with, in any discussion of bankruptcy proceedings, the parties generally involved should be identified, and the various terms used in the Bankruptcy Code should be defined, to establish a common point of reference. The bankrupt is known as the debtor. Creditors of the debtor generally are

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[1] The primary author for this chapter is Catherine R. Hardwick, J.D. 1988, Arizona State University, College of Law, Tempe, Arizona.

[2] The following references contain more detailed information about bankruptcy: Collier on Bankruptcy (15th ed. 1979) (updated through looseleaf service); Norton Bankruptcy Law & Practice (Callaghan 1982) (updated through looseleaf service); R. Aaron, Bankruptcy Law Fundamentals (1984); see especially R. Aaron, *Bankruptcy Law Handbooks*, published annually, for issues of current debate and interest in bankruptcy law, B. Weintraub & A. Resnick, Bankruptcy Law Manual, (rev. ed. 1986 and Cum. Supps.).

divided into two categories: secured and unsecured. Secured creditors are those that have a lien on property in which the debtor has an interest, generally under a security agreement. Unsecured creditors include all creditors that do not have secured claims.

The trustee is the person appointed by the court to liquidate or operate the business (depending on the purpose of the bankruptcy petition) during the bankruptcy proceedings. The trustee's duties and powers are explained later in this chapter. A "debtor in possession" is a debtor who is authorized to continue to operate the business during the pendency of the bankruptcy case in a Chapter 11 proceeding. A creditor's committee is also created in Chapter 11 proceedings, and is made up of the debtor's creditors to watch over the operation of the business during the pendency of the proceedings. The general definition section of the Bankruptcy Code is Section 101.

A petition in bankruptcy must be filed to begin a bankruptcy proceeding.[3] The Bankruptcy Code does not require that the debtor allege it is insolvent or unable to pay its debts. No minimum debt is required, but maximum debt limits do apply to certain types of bankruptcy proceedings. A filing fee generally must accompany the petition, along with documents containing financial information, such as a list of assets and liabilities, and a list of creditors.[4]

The Bankruptcy Code, enacted as part of the Bankruptcy Reform Act of 1978,[5] provides the substance of bankruptcy law today. Substantial amendments were made in 1984 in the Bankruptcy Amendments and Federal Judgeship Act of 1984,[6] particularly to the jurisdiction provisions. The Code was again amended in 1986, by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986.[7] The substantive law is supplemented by the Bankruptcy Rules of Procedure, which govern the procedural matters under the Code.[8]

Under the Bankruptcy Code, as amended, jurisdiction over proceedings arising in, arising under, or related to a bankruptcy case, and all property of the

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[3] Venue provisions in 28 USC § 1408 (1982 & Supp. III 1985) outline where a bankruptcy petition should be filed. The petition may be filed in the district court for the district in which the domicile, residence, principal place of business, or principal assets of the person or entity that is the subject of the petition have been located for the 180 days immediately preceding the filing. If the person or entity had more than one location in the preceding 180 days, it should file in the district in which the person or entity was located for the longer portion of the 180-day period.

[4] See Bankr. R. 1002, 1006 and 1007. For a discussion of the maximum debt limits applicable to certain types of bankruptcy proceedings see infra ¶ 25.02.

[5] Pub. L. No. 95-598, 92 Stat. 2549 (1978).

[6] Pub. L. No. 98-353, 98 Stat. 333 (1984).

[7] Pub. L. No. 99-554, 100 Stat. 3088 (1986).

[8] The Bankruptcy Rules were promulgated by the United States Supreme Court and took effect August 1, 1983. They were substantially amended in 1987, effective August 1, 1987.

debtor, is originally vested in the United States district court.[9] Bankruptcy courts have been established and operate under the supervision of the district courts.[10] All proceedings are initially begun in the bankruptcy courts, although later proceedings may have to be withdrawn and decided in the district court.[11]

The Bankruptcy Amendments divide bankruptcy proceedings into two categories: "core" proceedings and "related" proceedings.[12] Bankruptcy courts have jurisdiction to enter final orders for all core proceedings.[13] A bankruptcy court does not, however, have power to enter a final order for a related proceeding without consent of the parties.[14] In related proceedings the bankruptcy court is limited to submitting proposed findings of fact and conclusions of law to the district court. The district court may adopt those findings, or may disregard them and make its own decision.[15]

Core proceedings generally are those that arise under the bankruptcy law itself including objections to claims, orders turning over property of the debtor, motions to avoid preferences or to terminate the automatic stay, and objections

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[9] 28 USC § 1334 (Supp. III 1985).

[10] 28 USC § 157(a) (Supp. III 1985).

[11] See 28 USC § 157 (Supp. III 1985). A proceeding must be withdrawn if its resolution requires consideration of both bankruptcy and other laws of the United States regulating organizations or activities affecting interstate commerce (for example, antitrust, civil rights laws, etc.). Similarly, personal injury and wrongful death tort claims are to be tried in the district court.

[12] See 28 USC § 157(b) (Supp. III 1985).

[13] 28 USC § 157(b)(1) (Supp. III 1985).

[14] 28 USC § 157(c)(2) (Supp. III 1985). Consent may be implied, however, by conduct of the parties. If a party fails to object to the bankruptcy court's jurisdiction, the party may be deemed to have consented to it. See In re Men's Sportswear, Inc., 834 F2d 1134 (2d Cir. 1987); In re Daniels-Head & Assoc., 819 F2d 914 (9th Cir. 1987); In re Alloy Metal Works, Inc., 52 Bankr. 39 (Bankr. ED Pa. 1985); In re Baldwin-United Corp., 48 Bankr. 49, 54 (Bankr. SD Ohio 1985) (consent may be implied from failure to object or from any act indicating a willingness to have the bankruptcy court determine a claim). But see 1 Collier on Bankruptcy ¶ 3.01[2][d][ii] (15th ed. 1987) ("[S]ection 157(c)(2) may contemplate the informed and actual consent of the parties, as opposed to consent implied from the failure to object to jurisdiction").

In In re Hudson Shipbuilders, Inc., 794 F2d 1051 (5th Cir. 1986), the filing of a proof of claim was deemed consent to the bankruptcy court's jurisdiction. Accord In re Axton, 641 F2d 1262 (9th Cir. 1981).

See also In re I.A. Durbin, Inc. 62 Bankr. 139 (SD Fla. 1986) (promissory note maker, who was comaker of note with debtor, and who voluntarily joined debtor's counterclaim against promissory note payee without indication that she objected to bankruptcy court jurisdiction, had implicitly consented to the bankruptcy court's jurisdiction). But see In re Interconnect Tel. Serv., Inc., 59 Bankr. 397 (SDNY 1986) (party did not impliedly consent to jurisdiction by conducting discovery and moving to dismiss plaintiff's complaint while the action was pending in the bankruptcy court).

[15] 28 USC § 157(c)(1) (Supp. III. 1985).

to discharges.[16] Related proceedings are proceedings other than core proceedings that are related in some way to the bankruptcy case. Examples include claims of the debtor against third parties,[17] or actions brought by secured creditors against guarantors of the debtor.[18]

Appeals from bankruptcy court decisions may be taken to the district court or to a bankruptcy appellate panel, if one is available in that district.[19] Subsequent appeals to the federal Circuit Courts of Appeal are available as of right.[20]

¶ 25.02 DIFFERENT TYPES OF BANKRUPTCY PROCEEDINGS

[1] Chapter 7: - Liquidation

In a Chapter 7[21] liquidation proceeding, the debtor seeks a discharge from

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[16] 28 USC § 157(b)(2) (Supp. III 1985). The statute lists several core proceedings, but the list is not exclusive. Core proceedings listed include matters concerning the administration of the estate, counterclaims by the estate against persons filing claims, orders pertaining to obtaining credit, proceedings to determine, avoid, or recover fraudulent conveyances, determinations as to the dischargeability of particular debts, determinations of the validity, extent, or priority of liens, confirmations of plans, and orders approving the use, lease, or sale of property. Id.

[17] Adversary proceedings that rest solely on state law, such as collection suits by a debtor in bankruptcy against noncreditor defendants, are not "core proceedings," but rather, are "related or non-core matters." M & E Contractors, Inc. v. Kugler-Morris Gen. Contractors, Inc., 67 Bankr. 260 (ND Tex. 1986). See also UNR Indus., Inc. v. Continental Ins. Co., 623 F. Supp. 1319 (ND Ill. 1985) (proceeding by debtor against insurers and insurance broker seeking recovery for their conduct with respect to company's insurance fell under bankruptcy court's "related to" jurisdiction).

There is disagreement as to whether a debtor's suit on account receivables is a "core" or "related" proceeding. See In re Nell, 71 Bankr. 305 (D. Utah 1987) (related); In re George Woloch Co., 49 Bankr. 68 (ED Pa. 1985) (related); In re Century Brass Prods. Inc., 58 Bankr. 838 (Bankr. D. Conn. 1986), (related); 1 Collier on Bankruptcy ¶ 3.01 (15th ed. 1986) (describing as "egregious" error In re All American of Ashburn, Inc., 49 Bankr. 926 (Bankr. ND Ga. 1985), which held that a suit to collect prepetition accounts receivable was a core proceeding). But see In re Windsor Communications Group, Inc., 67 Bankr. 692 (Bankr. ED Pa. 1986) (core), In re National Equip. & Mold Corp., 60 BR 133 (Bankr. ND Ohio 1986) (core); In re Baldwin-United Corp., 48 Bankr. 49 (Bankr. SD Ohio 1985) (core).

[18] See Howard Brown Co. v. Reliance Ins. Co., 66 Bankr. 480 (ED Pa. 1986) (supplier's adversary proceeding against debtor's surety to recover on contract bond is a "related" proceeding); In re Showcase Natural Casing Co., 54 Bankr. 142 (Bankr. SD Ohio 1985) (secured creditor's suit against debtor's guarantors is a "related" proceeding).

[19] 28 USC §§ 158(a), 158(b) (Supp. III 1985). Currently only the Ninth Circuit has a system of Bankruptcy Appellate Panels (BAPs) (made up of three bankruptcy court judges) to review bankruptcy court decisions.

[20] 28 USC § 158(d) (Supp. III 1985).

[21] "Chapter 7" refers to Title 11, Ch. 7 of the United States Code. See generally 11 USC §§ 701-766 (1982 & Supp. IV 1986).

personal liability of his or her debts through a liquidation of the debtor's assets and distribution of them to creditors. One of the stated purposes of the Chapter 7 discharge is to relieve the debtor of prior debts and to give the debtor a "fresh start."[22]

Any individual, partnership or corporation may file a petition under Chapter 7, except for railroads, government entities, insurance companies, and financial institutions.[23] Partnerships and corporations, however, cannot receive a discharge from debts; only individuals can.[24] One of these entities may still wish to file under Chapter 7, however, to liquidate its business and distribute all its assets to creditors.

[2] Chapter 13: - Debt Adjustment

Under a Chapter 13 individual debt adjustment proceeding, the debtor obtains a discharge from personal liability of his or her debts after payment to creditors to the extent possible from the debtor's future income, according to a court-approved payment plan. This type of proceeding is only available to an individual. Further, the debtor must have regular income. Regular income is defined as income that is sufficiently stable and regular so that payments under a Chapter 13 plan may be made.[25] The definition is broad, and includes both wage earners and individuals who are self-employed. It also includes individuals whose primary source of income is from pensions, disability benefits, investments, or similar sources.[26] It is questionable, however, as to whether Social Security benefits may be considered "regular income" because the 1983 amendments to the Social Security Act preclude the assignment of benefits.[27] There is a

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[22] HR Rep. No. 595, 95th Cong., 1st Sess. 384, reprinted in 1978 U.S. Code Cong. & Admin. News 5963, 6340. See also Jackson, "The Fresh Start Policy in Bankruptcy Law," 98 Harv. L. Rev. 1393 (1985).

[23] 11 USC §§ 101(35), 109(b) (1982 & Supp. IV 1986). For proceedings related to insolvent financial institutions, see Chapter 10.

[24] 11 USC § 727(a)(1) (1982). See generally infra ¶ 25.08 on discharge.

[25] 11 USC § 101(29) (Supp. IV 1986). This definition expressly precludes stockbrokers and commodity brokers.

[26] In re Cole, 3 Bankr. 346 (Bankr. SDWV 1980) ("This test is no longer the nature of the income but rather its stability and regularity"); HR Rep. No. 595, 95th Cong., 1st Sess. 311-312, reprinted in 1978 US Code Cong. & Admin. News 5963, 6268-6269 ("Thus, individuals on welfare, Social Security, fixed pension incomes, or who live on investment incomes, will be able to work out repayment plans with their creditors rather than being forced into straight bankruptcy"). See In re Hammonds, 729 F2d 1391 (11th Cir. 1984) (income from Aid to Families with Dependent Children program); In re Iacovoni, 2 Bankr. 256 (Bankr. D. Utah 1980) (welfare); In re Overstreet, 23 Bankr. 712 (Bankr. WD La. 1982) (unemployment benefits); In re Wood, 23 Bankr. 552 (Bankr. ED Tenn. 1982) (pension benefits); In re Taylor, 15 Bankr. 596 (Bankr. D. Ariz. 1981) (child support payments); In re Dawson, 13 Bankr. 107 (Bankr. MD Ala. 1981) (disability benefits).

[27] Under 11 USC § 1325(b) the bankruptcy court has the power to "order any entity

limitation in Chapter 13 proceedings on the amount of debt a debtor may have. The debtor must have noncontingent liquidated unsecured debts of less than $100,000 and noncontingent liquidated secured debts of less than $350,000 measured as of the date of the filing of the petition.[28]

Under Chapter 13, the debtor files a plan, which must provide for repayment of his or her debts within a three-year period.[29] Under this plan, tax liabilities must be paid in full; secured creditors must receive the value of their security; and unsecured creditors must receive more than they would have received from a Chapter 7 liquidation.[30] A trustee is appointed to collect the funds and to distribute the payments to the creditors under the plan.[31]

To encourage debtors to adjust their debts under Chapter 13, the 1984 Bankruptcy Amendments require the clerk of the court to give written notice to individuals with primarily consumer debts about both Chapter 7 and Chapter 13 proceedings.[32] The amendments also require an individual consumer debtor filing a Chapter 7 petition to state in the petition that he or she (1) is aware that he or she may proceed under 7 or 13; (2) understands the relief available in both; and (3) chooses Chapter 7.[33]

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from whom the debtor receives income to pay all or any part of such income to the trustee." Courts had generally held that Social Security benefits could be assigned to a Chapter 13 trustee, despite the nonassignability provision of the Social Security Act. See United States v. Devall, 704 F2d 1513 (11th Cir. 1983), Toson v. United States, 18 Bankr. 371 (ND Ga. 1982); In re Moore, 17 Bankr. 551 (Bankr. MD Fla. 1982). In 1983, Congress amended the antiassignment clause of the Social Security Act specifically to overrule these decisions. See H.R. Rep. No. 25, 98th Cong., 1st Sess., 83 reprinted in 1983 U.S. Code Cong. & Admin. News 143. It now appears the Social Security Administration cannot be compelled to pay benefits due to individuals to the trustee of a Chapter 13 proceeding. In re Buren, 725 F2d 1080 (6th Cir.), cert. denied 469 US 818 (1984). But see In re Baxter, 34 Bankr. 911 (Bankr. ED Tenn. 1983) (antiassignment provision of the Social Security Act, which has the effect of preventing social security payments from becoming part of a bankruptcy estate and thus prevents a recipient with no other income from becoming eligible for Chapter 13 relief, denies such recipients equal protection of the laws, and is thus unconstitutional).

[28] 11 USC § 109(e) (1982). The same debt limits apply if an individual files a joint petition with his or her spouse. Id. A debtor can file a bankruptcy petition under Chapter 13 in good faith that the extent of the debts do not exceed the limit for Chapter 13 petitions, despite a subsequent determination that the debts exceed that amount, if, at the time of the filing of the petition, the debt was not liquidated and the value of the property securing it was uncertain. In re Pearson, 773 F2d 751 (6th Cir. 1985). See also In re King, 9 Bankr. 376 (Bankr. D. Or. 1981).

[29] 11 USC § 1325(c) (Supp. IV 1986). The court may approve a longer payment period for cause, but not longer than five years.

[30] 11 USC § 1325(a) (1982 & Supp. IV 1986).

[31] 11 USC §§ 1302, 1326 (1982 & Supp. IV 1986).

[32] 11 USC § 342(b) (Supp. IV 1986).

[33] Bankr. Rule 9009; Official Bankr. Form No. 1. The debtor's attorney must sign an exhibit to the petition declaring he has informed the debtor of availability of both Chapter

[3] Chapter 11: - Reorganization

A Chapter 11 bankruptcy proceeding is generally called a reorganization. The objective of Chapter 11 proceedings is to rehabilitate a viable business entity that has run into financial trouble so that it may continue in business. In Chapter 11, the debtor's assets are not entirely liquidated, but rather, under the guidance of the court, the obligations of the debtor are readjusted. The House report explains the purpose of these proceedings:

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designated are more valuable than those same assets sold for scrap.... It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.[34]

Chapter 11 proceedings are available to all types of entities: individuals, partnerships, trusts, and corporations.[35] There is disagreement, however, on whether a consumer who does not run a business, or who does not have business debts, may file under Chapter 11.[36] Entities specifically excluded from Chapter

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7 and 13, and has explained the relief available under both chapters. Official Bankr. Form No. 1, Exhibit B.

[34] H.R. Rep. No. 595, 95th Cong., 1st Sess. 220, reprinted in 1978 U.S. Code Cong. and Admin. News 5963, 6179.

[35] 11 USC § 109(d) (Supp. IV 1986).

[36] See In re Moog, 774 F2d 1073, 1075 (11th Cir. 1985) (court held that housewife with no regular income (and thus ineligible for Chapter 13) and only consumer debts could file under Chapter 11. "We see nothing in the current Bankruptcy Code or its legislative history or the prior Bankruptcy Act that would suggest that a consumer debtor may not seek relief under Chapter 11.") Accord In re Warner, 30 Bankr. 528 (Bankr. 9th Cir. 1983); In re Greene, 57 Bankr. 272 (Bankr. SDNY 1986); In re Gregory, 39 Bankr. 405 (Bankr. MD Tenn. 1984). See also In re Bock, 58 Bankr. 374 (Bankr. MD Fla. 1986) ("[T]he fact that an individual debtor is not engaged in business is certainly a relevant factor to be considered when his or her right to maintain a Chapter 11 is challenged. Thus, when an individual debtor who is not engaged in business in an orthodox sense seeks relief under this chapter but filed a petition in order to achieve a legitimate readjustment of his debts and to salvage valuable property interests, there is no reason why such individual debtors should be left without remedy and should not be given reasonable opportunity to seek and achieve rehabilitation").

But see In re Wamsganz, 54 Bankr. 759, 763 (ED Mo. 1985), aff'd, 804 F2d 503 (8th Cir. 1986) ("To qualify for relief under chapter 11, a person must be a business enterprise or operate a business. A salaried person who displays the characteristics of a wage earner, does not operate a business, and whose debts and assets are primarily consumer debts and assets is not eligible to proceed under Chapter 11."). Accord In re Ponn Realty Trust, 4 Bankr. 226, (Bankr. D. Mass. 1980).

11 reorganization include financial institutions,[37] governmental units,[38] insurance companies,[39] railroads,[40] and stock and commodity brokers.[41]

After a bankruptcy petition is filed in a Chapter 11 proceeding, the debtor usually remains in possession of the business and continues to operate it. The debtor remaining in control is called the "debtor in possession."[42] If an interested party so requests, the bankruptcy court may appoint a trustee to operate the business.[43] The court may appoint a trustee "for cause," including fraud, dishonesty, incompetence or gross mismanagement by the current management of the debtor, either before or after the bankruptcy petition is filed, or where it is in the interests of the creditors, any equity security holders, and other interests of the estate.[44]

Because the purpose of a reorganization is to keep the debtor business operating, provisions in the Bankruptcy Code ensure protection of the assets and allow the business to keep operating without interference from creditors or other interested parties. These provisions protect the debtor from actions by creditors by automatically staying actions against the debtor and by giving the trustee special powers to enforce obligations to the debtor and to avoid certain transfers of property of the debtor. If a trustee is not appointed, the debtor in possession has the same rights and duties as a trustee. These provisions are discussed later in this chapter. In addition, the trustee, or debtor in possession, is required to file reports on the operation of the business, including disbursements and receipts, and any other information the court may require.[45]

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[37] 11 USC §§ 109(b), 109(d) (1982 & Supp. IV 1986). See also Chapter 10.

[38] Government bodies and municipalities must seek relief under Chapter 9, 11 USC §§ 901–946 (1982 & Supp. IV 1986), Adjustment of Debts of a Municipality.

[39] See 11 USC §§ 109(b), 109(d) (1982 & Supp. IV 1986).

[40] Railroads may proceed under specific provisions of Chapter 11, 11 USC §§ 1161–1174 (1982 & Supp. IV 1986), which differ in some respects from the principles of general reorganization under Chapter 11.

[41] Stock and commodity brokers are treated separately under §§ 741–752 and 761–766 of Chapter 7, but are not eligible for reorganization. 11 USC § 109(d) (1982 & Supp. IV 1986). The special rules relating to stockbroker and commodity broker liquidations are designed to give preferential protection to customers. Congress recognized that an application of these customer protection features to the reorganization principles in Chapter 11 would be unworkable. Liquidation is the only option available to stockbrokers and commodity brokers under the Bankruptcy Code. See B. Weintraub & A. Resnick, Bankruptcy Law Manual ¶ 8.05 (Rev. ed. 1986 & Cum. Supp. 1987).

[42] See 11 USC § 1101(1) (Supp. IV 1986).

[43] 11 USC § 1104(a) (1982 & Supp. IV 1986).

[44] Id. The House report defines the duty of the court as follows: "The court may order appointment only if the protection afforded by a trustee is needed and the costs and expenses of a trustee would not be disproportionately higher than the value of the protection afforded." H.R. Rep. No. 595, 95th Cong., 1st Sess. 402, reprinted in 1978 U.S. Code Cong. & Admin. News 5963, 6358.

[45] 11 USC § 1106(a)(1) (1982 & Supp. IV 1986) (referring to 11 USC § 704(8)).

Because the debtor continues operating, the debtor's business needs the use of assets, and may otherwise need to lease or sell property. The Bankruptcy Code provides authorization for the business to conduct such transactions, without notice, as long as it is within the ordinary course of business.[46] If unusual transactions are required, the trustee or debtor in possession may request authorization to conduct such transactions after notice and a hearing.[47] A trustee or debtor in possession, however, may not use cash collateral, which, in addition to cash, consists of negotiable instruments, documents of title, securities, deposit accounts or other cash equivalents,[48] unless the secured creditor consents, without authorization from the court.[49]

Shortly after the case is filed, the court schedules a meeting of the creditors. The debtor must attend this meeting, and must submit to questions by the creditors.[50] A creditors committee must subsequently be appointed by the court.[51] This committee has fiduciary obligations and must act for the benefit of all creditors. In addition to watching over the operation of the debtor's business, it may investigate possible wrongdoing and generally has an active role in the formulation and approval of the reorganization plan.[52]

To reorganize the debts of the business, the debtor has the exclusive right, if a trustee has not been appointed, to propose a plan of reorganization during the first 120 days after filing a petition.[53] After the 120-day period, any party in interest may submit a plan of reorganization. A reorganization plan is basically a repayment plan, under which the debtor will operate. The plan must provide for full payment of taxes within six years, for payment to secured creditors of the value of their security, and unsecured creditors must receive more than they would have in a Chapter 7 liquidation.[54] The plan also must provide for adequate means by which the debtor may implement the plan, and such means may include selling certain assets, merging with another entity, restructuring internally, or issuing securities.

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[46] 11 USC § 363(c) (1982 & Supp. IV 1986). See infra ¶ 25.05[4] for a discussion of the *adequate protection necessary to allow the business to use collateral.*

[47] 11 USC § 363(b) (Supp. IV 1986).

[48] 11 USC § 363(a) (Supp. IV 1986).

[49] 11 USC § 363(c)(2) (1982 & Supp. IV 1986).

[50] 11 USC § 341(c) (Supp. IV 1986).

[51] 11 USC § 1102(a)(1) (Supp. IV 1986). The court has authority to appoint several committees, including a committee of shareholders, or limited partners, or various types of creditors: suppliers of goods, institutional lenders, etc.

[52] 11 USC § 1103(c) (1982 & Supp. IV 1986).

[53] 11 USC § 1121 (1982 & Supp. IV 1986).

[54] 11 USC § 1129 (1982 & Supp. IV 1986). Creditors may agree to receive less than statutorily required, and once the plan is approved, the debtor and all creditors are bound by it. See 11 USC §§ 1129(7), 1141(a) (1982 & Supp. IV 1986).

Once a plan has been proposed, there are basically two methods of confirming the plan, both of which require that the court hold a hearing expressly for that purpose.[55] In the first method, the proponent of the plan seeks acceptance of it by all the creditors. Any holder of a claim may accept or reject a plan.[56] A plan must be confirmed by each class of claim holders. For creditors, the plan is accepted by a class if the members who hold at least two-thirds in amount and more than one-half in number of the total allowed claims of the class who vote accept it.[57] Classes of stockholders or other interested holders accept a plan if it is accepted by class members holding at least two-thirds the amount of the total allowed interests held by the members of the class who vote.[58]

If any class that is impaired under the plan fails to accept it by the minimum required votes, as outlined earlier, the proponent of the plan may still request confirmation under the "cram down" method, which is the second method of confirmation. Under this method, at least one class must have accepted the plan with the required number of votes, the plan must not "discriminate unfairly" with respect to a class that does not accept the plan,[59] and the plan must be "fair and equitable" with respect to each class that did not accept the plan.[60] If these requirements are met, the court may confirm the plan. If more than one plan is proposed that meets the requirements for confirmation, the Bankruptcy Code provides that the court may confirm only one plan after considering the preferences of creditors and equity security holders.[61]

[4] Chapter 12: - Family Farmer

In 1986, Congress passed legislation aimed specifically at the plight of the family farmer. Farmers are seldom able to file for relief under Chapter 13 because their debts have usually exceeded the statutory maximum and their income was not regular. Additionally, family farmers often operate as partnerships or corporations, which are ineligible for Chapter 13 relief. Further, Chapter 11 is not a practical solution because of the specific problems and needs of

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[55] 11 USC § 1128(a) (1082 & Supp. IV 1986). There are certain requirements that must be met before the court may confirm a plan. They are outlined in 11 USC § 1129(a), and include that the plan must have been proposed in good faith.

[56] 11 USC § 1126(a) (1982 & Supp. IV 1986).

[57] 11 USC § 1126(c) (1982 & Supp. IV 1986).

[58] 11 USC § 1126(d) (Supp. IV 1986).

[59] 11 USC § 1129(b)(1) (1982 & Supp. IV 1986). See generally Booth, "The Cramdown on Secured Creditors: An Impetus Toward Settlement," 60 Am. Bankr. LJ 69 (1986).

[60] Id. The "fair and equitable" standard has come to mean an absolute priority rule among the classes; that is, the plan is fair and equitable to a class if that class receives full compensation for its allowed claims before any junior class receives anything.

[61] 11 USC § 1129(c) (1982 & Supp. IV 1986).

family farmers.[62] Thus farmers facing serious financial difficulties were left without any form of rehabilitative relief until Congress created the Chapter 12 alternative.

Chapter 12 was "designed to give family farmers facing bankruptcy a fighting chance to reorganize their debts and keep their land. It offers family farmers the important protection from creditors that bankruptcy provides while, at the same time, preventing abuse of the system and ensuring that farm lenders receive a fair repayment."[63]

Chapter 12, titled "Adjustment of Debts of a Family Farmer with Regular Annual Income," is modeled after Chapter 13, but contains provisions tailored to meet the family farmer's needs. To qualify under Chapter 12, the petitioner must be a "family farmer with regular annual income."[64] An individual, or an individual and spouse, engaged in farming operations[65] is a family farmer if (1) aggregate debts do not exceed $1,500,000; (2) 80 percent of aggregate noncontingent liquidated debts arise out of a farming operation; and (3) income received from the farming operation accounts for at least 50 percent of the individual's, or individual and spouse's, gross income for the prior tax year.[66]

A corporation or partnership may be a family farmer if the following conditions are met: (1) more than 50 percent of the stock or equity is held by one family, or by one family and the relatives of the members of such family, and the family or relatives conduct the farming operation; (2) more than 80 percent of the value of its assets consists of assets related to the farming operation; (3) its aggregate debts do not exceed $1,500,000; (4) 80 percent or more of its aggregate noncontingent, liquidated debts arise out of the farming operation; and (5) if the corporation issues stock, it is stock that is not publicly traded.[67]

Once an entity qualifies as a family farmer it must be determined that the farmer has "regular annual income."[68] This requirement is not as strict as the

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[62] Congress found that Chapter 11 proceedings for family farmers were needlessly complicated, unduly time-consuming, inordinately expensive and, in many cases, unworkable. H.R. Conf. Rep. No. 958, 99th Cong., 2d Sess. 48, reprinted in 1986 U.S. Code Cong. & Admin. News 5246, 5249.

[63] H.R. Conf. Rep. No. 958, 99th Cong., 2d Sess. 48, reprinted in 1986 U.S. Code Cong. & Admin. News 5246, 5249. See generally Armstrong, "The Friendly Farmer Bankruptcy Act of 1986: An Analysis for Farm Lenders," 104 Banking LJ 189 (1987).

[64] 11 USC § 109(f) Supp. IV 1986).

[65] "Farming operations" is defined in the Bankruptcy Code to include farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and production of poultry or livestock products in an unmanufactured state. 11 USC § 101(20) (Supp. IV 1986).

[66] 11 USC § 101(17)(A) (Supp. IV 1986). Debt for the principal residence of the individual or individual and spouse is excluded in calculating the 80 percent requirement, unless the debt arises out of farming operations. Id.

[67] 11 USC § 101(17)(B) (Supp. IV 1986).

[68] 11 USC § 101(18) (Supp. IV 1986).

"regular income" requirement under Chapter 13, because Congress recognized that agriculture's business cycle has long intervals between harvests that result in irregular cash flow. A family farmer will meet the income requirement if the farmer's *annual* income is sufficiently stable and regular to make payments under a Chapter 12 plan.[69]

Under Chapter 12, the debtor must file a plan within 90 days of filing the bankruptcy petition case.[70] Creditors have no right to file a plan under Chapter 12; however, if the debtor does not file a plan in a timely fashion, the case may be dismissed.[71] The plan must provide that all or a portion of the debtor's future income be submitted to the trustee for repayment of creditors.[72] The plan must provide for full payment of creditors with priority claims (generally, taxes) unless a claim holder agrees to different treatment.[73] Similarly, if the plan classifies claims and interests (for example, secured versus unsecured claims), it must provide the same treatment for each claim within a particular class, unless the claim holder agrees to less favorable treatment.[74] Repayment under the plan must be made within three years, but the court can approve a longer repayment period, not to exceed five years, for cause.[75] As in Chapter 13, a discharge is usually granted after the debtor completes all payments provided for under the plan.[76]

Lastly, it is important to note that Chapter 12 relief is an experiment, a solution to what hopefully is a temporary crisis.[77] The amendments of 1986 include a sunset provision, which provides that unless Congress takes further action, Chapter 12 will be repealed automatically on October 1, 1993.[78]

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[69] Id.

[70] 11 USC § 1221 (Supp. IV 1986).

[71] 11 USC § 1208(c)(3) (Supp. IV 1986).

[72] 11 USC § 1222(a)(1) (Supp. IV 1986).

[73] 11 USC § 1222(a)(2) (Supp. IV 1986). Creditors with priority claims are those whose claims meet the requirements of Section 507.

[74] 11 USC § 1222(a)(3) (Supp. IV 1986).

[75] 11 USC § 1222(c) (Supp. IV 1986). This three or five year deadline does not apply, however, to certain secured claims, where the debtor may modify payments and make them for a longer period of time. For example, the family farmer's mortgage on his principal residence may be modified under the plan to decrease monthly payments, but pay over a longer period of time. See Section 1222(b)(9).

[76] 11 USC § 1228(a) (Supp. IV 1986). Under this section, the court must grant a discharge as soon as practicable after completion of all payments under the plan, other than payments to holders of allowed long-term obligations.

[77] "Because this is a new chapter aimed at a specific class of debtors, Congress will want to evaluate both whether the chapter is serving its purpose and whether there is a continuing need for a special chapter for the family farmer." H.R. Conf. Rep. No. 958, 99th Cong. 2d Sess. 48, reprinted in 1986 U.S. Code Cong. & Admin. News 5246, 5249.

[78] Bankruptcy Act of 1986, Pub. L. No. 99-554, title III, § 302(f), 100 Stat. 3124.

¶ 25.03 VOLUNTARY VERSUS INVOLUNTARY PROCEEDINGS

Bankruptcy takes two general forms. A debtor who desires to be relieved of financial obligations may unilaterally file a petition in bankruptcy.[79] In this instance, the court takes over the debtor's assets, calls in the creditors, and carries out the bankruptcy procedures. This process is known as voluntary bankruptcy, and its counterparts also apply in corporate reorganization.

In cases where the debtor does not desire to go into bankruptcy, creditors on their own motion may file an involuntary petition in bankruptcy.[80] The number of creditors required to file an involuntary petition varies from one to three, depending on the amount of the debtor's obligations and the size of the creditor's claims.[81] The debtor may, however, oppose the involuntary petition and force a trial of the facts before the bankruptcy judge.[82] The creditors must prove, at this trial, that the debtor generally is not paying his or her debts as they become due, or that, within 120 days before the involuntary petition was filed, a custodian was appointed or took possession of debtor's property.[83]

Involuntary petitions may be filed only against debtors who are able to file voluntary petitions under Chapters 7 or 11.[84] A further exception is that while farmers, family farmers and corporations that are not moneyed, business, or commercial corporations may file voluntary petitions, they are not subject to involuntary petitions.[85] Farmers include any persons that received more than 80 percent of their gross income, during the taxable year preceding the date of bankruptcy, from a farming operation owned or operated by such persons.[86] A

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[79] 11 USC § 301 (1982).

[80] 11 USC § 303 (1982 & Supp. IV 1986).

[81] 11 USC § 303(b) (1982 & Supp. IV 1986). Generally, if the debtor has twelve or more creditors, three entities are required to file an involuntary petition. If the debtor has less than twelve creditors, one creditor may file the petition if its claim is over $5,000. Id.

[82] See 11 USC § 303(h) (1982 & Supp. IV 1986).

[83] Id. Debts that are subject to a bona fide dispute are not considered as past due for the purpose of determining whether debtor is paying debts as they become due. Id. The creditor's burden of proof requires evidence that debts are past due, that debts are not being paid in the "regular course of business," and of when creditors actually expected payment, regardless of when the obligation arose. In re Trans-High Corp., 3 Bankr. 1 (Bankr. SDNY 1980). See generally Annot., "Involuntary Bankruptcy: When is Debtor 'Generally Not Paying Such Debtor's Debts as Such Debts Become Due' so as to Warrant Relief Against Debtor in Involuntary Bankruptcy," 73 ALR Fed. 763 (1985).

As to who is a custodian, Section 101(1) of the Code defines a custodian as a receiver or trustee of the property of the debtor appointed in a case or proceeding (but not including a trustee in bankruptcy) or an assignee under a general assignment for the benefit of the debtor's creditors. See also In re Williams, 6 Bankr. 789 (Bankr. ED Mich. 1980) (repossessing secured creditor was held to be a custodian).

[84] 11 USC § 303(a) (Supp. IV 1986).

[85] Id.

[86] 11 USC § 101(19) (Supp. IV 1986).

family farmer is a farmer that meets the standards required to file under Chapter 12.[87] Non-profit institutions such as churches, schools, charitable organizations, and foundations are exempt from involuntary bankruptcy as they are nonmoneyed corporations.[88] Involuntary proceedings are not available under Chapters 12 or 13.

Because creditors can force a debtor into liquidation or reorganization, involuntary bankruptcy is a special weapon available to creditors who do not want to join in a general composition or assignment for the benefit of creditors, who want to prevent the debtor from transferring his or her assets, or who want to force a reorganization of the debtor.

¶ 25.04 PROPERTY OF THE BANKRUPTCY ESTATE

[1] Determining What Constitutes Property

An estate is created as soon as a voluntary or involuntary petition is filed under the Bankruptcy Code.[89] Generally, only property of the estate is administered in the bankruptcy case, so that the determination of what constitutes such property is a very important one, particularly in liquidation cases. The Code provides that the estate includes all the property in which the debtor has an interest on the date the petition is filed, wherever located and by whomever held.[90] Property of the debtor includes, but is not limited to, cash and bank accounts, the debtor's interests in copyrights, patents, trademarks, accounts receivable, causes of action, licenses, books and records, insurance policies, leaseholds, security interests or liens held by the debtor, vested rights in pension plans, and general tangible property such as machinery, equipment, and furniture.[91] A letter of credit generally is not part of the bankruptcy estate, when it was procured by the debtor.[92]

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[87] 11 USC § 101(17) (Supp. IV 1986). See also supra ¶ 25.02[4] on who may file under Chapter 12.

[88] See In re United Kitchen Assoc., 33 Bankr. 214 (Bankr. WD La. 1983).

[89] 11 USC § 541(a) (1982 & Supp. IV 1986).

[90] Id.

[91] See B. Weintraub & A. Resnick, Bankruptcy Law Manual ¶ 4.03 (rev. ed. 1986 & Cum. Supp. 1987), and cases cited within.

[92] Courts have generally held that letters of credit represent irrevocable obligations of the issuing bank to pay third parties from the bank's own assets. See In re Elegant Merchandising, Inc., 41 Bankr. 398 (Bankr. SDNY 1984); In re L.B.G. Properties, Inc. 33 Bankr. 196 (Bankr. SD Fla. 1983); In re Page, 18 Bankr. 713 (DDC 1982). If the debtor has pledged property to secure the letter of credit, however, that is property of the estate. In re Val Decker Packing Co., 61 Bankr. 831 (Bankr. SD Ohio 1986); In re W.L. Mead, Inc., 42 Bankr. 57 (Bankr. ND Ohio 1984). See infra ¶ 25.09[2] for a discussion of paying letters of credit procured by the debtor.

Property acquired by the debtor after the filing of the case generally does not become part of the bankruptcy estate.[93] However, out of concern for the possible abuse of this principle by debtors filing bankruptcy just prior to receiving a planned or fortuitous sum, Congress made three exceptions to this rule. These exceptions include any property a debtor acquires or becomes entitled to acquire, within 180 days of filing a petition in bankruptcy, (1) by bequest, devise, or inheritance; (2) as a result of a property settlement agreement with the debtor's spouse or a divorce decree; or (3) as a beneficiary of a life insurance policy or death benefit plan. Such property becomes part of the bankruptcy estate.[94]

[2] Exemptions

The Bankruptcy Code provides that certain property shall be exempt from inclusion in the bankruptcy estate of individual debtors. When property is exempt, it will not be distributed to creditors but will remain the property of the debt or free from the claims of creditors. Under the Code, debtors have a choice of exemptions; they may use those exemptions provided in Section 522(d) of the Code or those provided for by the laws of the state of domicile and federal nonbankruptcy laws.[95] Any state, however, may pass legislation allowing the debtor only the exemptions provided by its state law (and federal nonbankruptcy law.)[96] Most states have done so, and constitutional challenges to such legislation have been struck down.[97]

Exemptions generally include the basic necessities: homes, household furniture, clothes, and food, although limits on the value of each exemption may be imposed. For example, the Bankruptcy Code exempts a home, but only up to a value of $7,500.[98] Vehicles frequently are included but, again, their value may not exceed a certain amount. Other typical exemptions include tools or machin-

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[93] 11 USC § 541(a) (1982 & Supp. IV 1986). Conversion of a case from one chapter to another does not affect the commencement date for these purposes. Property acquired postpetition but preconversion is ordinarily not property of the estate. See Koch v. Myrvold, 784 F2d 862 (8th Cir. 1986); 11 USC § 348(a) (1982). But in a Chapter 12 or 13 proceeding, property acquired postpetition and earnings from services performed postpetition also become part of the bankruptcy estate, because of the nature of the relief granted. See 11 USC §§ 1207(a), 1306(a).

[94] 11 USC § 541(a)(5) (1982 & Supp. IV 1986).

[95] 11 USC § 522(b) (1982 & Supp. IV 1986). Federal nonbankruptcy laws that contain exemption provisions include the Social Security Act, the Foreign Service Retirement and Disability System, benefits from the Veterans Administration, Railroad Unemployment Insurance, and retirement pensions for United States civil service employees.

[96] 11 USC § 522(b) (1982 & Supp. IV 1986).

[97] See In re Sullivan, 680 F2d 1131 (7th Cir.) cert. denied, 459 US 992 (1982); In re Stinson, 36 Bankr. 946 (Bankr. 9th Cir. 1984).

[98] 11 USC § 522(d)(1) (1982).

ery of trade, books used in business, and farming implements. Professionally prescribed health aids and insurance policies also are frequently exempt.[99]

[3] Lien Avoidance for Exempt Property

Judicial liens on, and nonpossessory nonpurchase money security interests in, most types of exempt property may be set aside by the debtor, but only to the extent that they impair the exemption.[100] For example, under the Bankruptcy Code exemptions, if the debtor owns a residence worth $30,000, which is not subject to a mortgage, but is subject to a judicial lien for $30,000, the debtor may reduce the lien to $22,500 to preserve the $7,500 exemption on a residence. The creditor is thus secured for $22,500, but is unsecured for the remaining $7,500.

A judicial lien is defined as a lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding.[101] By definition, this does not include statutory liens, which are liens arising by operation of law,[102] or consensual security interests. Nonpossessory, nonpurchase money security interests avoidable under this section generally include security interests arising under Article 9 of the UCC, in collateral that is exempt property, that does not include mortgages on real estate.[103] By definition, the liens avoidable under this section may not be purchase money security interests, and the debtor must retain possession of the goods.

Most courts hold that the debtor may avoid judicial liens even if he has no equity in the property.[104] The rationale is that interests in the property, other than an equity interest, such as a possessory interest or a right to redeem, are also protected by this section.[105] *In re Brown*[106] held that the debtor is permitted, even

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[99] See 11 USC §§ 522(d)(7), 522d(9) (1982).

[100] 11 USC § 522(f) (1982). Liens in effect prior to November 6, 1978, the date the Bankruptcy Code was enacted, may not be avoided by the debtor. United States v. Security Indus. Bank, 459 US 70 (1982). See generally Annot., "Avoidance of Nonpossessory Nonpurchase Money Security Interest in Debtor's Exempt Personal Property," 55 ALR Fed. 353 (1981).

[101] 11 USC § 101(32) (Supp. IV 1986).

[102] 11 USC § 101(47) (Supp. IV 1986) defines statutory lien as liens arising solely by force of a statute on specified circumstances or conditions, or a lien of distress for rent, whether or not statutory, but it does not include a security interest or a judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute. Examples of statutory liens include mechanics liens and artisans liens. See infra ¶ 25.07[3] on the power of the trustee to avoid statutory liens.

[103] See 11 USC § 522(f)(2) (1982 & Supp. IV 1986).

[104] See In re Brown, 734 F2d 119 (2d Cir. 1984); In re Bland, 793 F2d 1172 (11th Cir. 1986); Alu v. New York ex rel. Dep't of Taxation & Finance, 41 Bankr. 955 (EDNY 1984).

[105] See In re Chesarow, 25 Bankr. 228 (Bankr. D. Conn. 1982).

[106] 734 F2d 119, 125 (2d Cir. 1984).

if he lacks an equity interest in the property, to avoid the fixing of a judicial lien on the property if that avoidance would allow the debtor to enjoy an exemption provided by Section 522(b). In *Brown*, a creditor had a judgment against Brown, which became a judicial lien against Brown's real estate. A local bank held a mortgage on the property, and foreclosed. The bank was fully paid from the proceeds of the sale. By operation of law, the creditor's lien was transferred automatically to the surplus funds from the foreclosure sale. Brown claimed the surplus funds as a state homestead exemption. They were paid into state court until distribution rights were resolved. Brown and her husband then filed a petition in bankruptcy, and claimed the surplus funds as an exemption. The Second Circuit Court of Appeals held that the surplus funds were exempted, and the lien by the creditor on those funds was avoided. In this case the full amount of the lien was avoided because the amount of the allowable exemption exceeded the lien amount.

Another circuit, however, recently held that a debtor could not avoid a judicial lien on exempt real property when mortgages, which were not subject to avoidance by the debtor, exceeded the stipulated sale price.[107] In *In re Simonson,*[108] the debtors had a first mortgage on the real estate for $25,000, two judicial liens were next in priority, totalling $14,000, and a second mortgage on the property had a balance of $41,000. The parties stipulated that the property should be sold for $58,000. The debtors argued that the first $25,000 belonged to the first mortgagee, but that the next $14,000 belonged to them as an exemption, because they could avoid the judicial liens to enjoy their exemption. The Third Circuit Court of Appeals disagreed, and held that Section 522(f)(1) of the Code did not apply because the debtors had no equity in the property in that the first and second mortgages exceeded its value. The fact that the judicial liens preceded and had priority over the second mortgage was held irrelevant.

[4] Turnover of Property Belonging to the Estate

To assure that all property of the estate is placed in the custody of the trustee or debtor in possession, any entity that holds property of the estate on the date of the filing of the bankruptcy petition must turn over such property to the debtor.[109] This includes debts that are owed the debtor.[110] This turnover provision is very broad, and includes property of the debtor repossessed by a secured creditor.[111] Prior to turning over the property, however, the creditor is entitled to

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[107] In re Simonson, 758 F2d 103 (3d Cir. 1985).

[108] Id.

[109] 11 USC § 542 (1982 & Supp. IV 1986).

[110] 11 USC § 542(b) (1982 & Supp. IV 1986).

[111] United States v. Whiting Pools, Inc., 462 US 198, 205-206 (1983).

adequate protection of his or her interest.[112] The U.S. Supreme Court explained this provision as follows: "In effect, § 542(a) grants to the [bankruptcy] estate a possessory interest in certain property of the debtor that was not held by the debtor at the commencement of reorganization proceedings. The Bankruptcy Code provides secured creditors various rights, including the right to adequate protection, and these rights replace the protection afforded by possession."[113]

The Supreme Court held that this turnover provision could be asserted by the trustee against the Internal Revenue Service (IRS) to require the IRS to return to the trustee tangible personal property seized by the IRS, pursuant to its power to levy a tax lien for unpaid federal taxes withheld from employees. The Court indicated that the result might be different had the IRS obtained ownership of the property seized, but this was not the case as the interest of the IRS was only a lien on the property to secure the unpaid taxes. The trustee's turnover power does not destroy the IRS's interest in the property. The IRS was entitled to adequate protection of its interest, but had to seek this protection in accordance with the procedures established in the Bankruptcy Code, "rather than by withholding the seized property from the debtor's efforts to reorganize."[114]

The only exceptions to this turnover provision include property of inconsequential value or benefit to the estate,[115] or property that the holder of the property has transferred in good faith, without knowledge of the bankruptcy petition.[116]

¶ 25.05 THE AUTOMATIC STAY

[1] General Rule

The automatic stay provisions of the Bankruptcy Code prevent interference with the property of the estate by staying all lawsuits, foreclosure proceedings, collection efforts, and creation or enforcement of security interests.[117] The stay is very broad; basically any proceeding that could potentially interfere with the administration of the bankruptcy estate will be stayed.[118] The stay applies to all

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[112] See 11 USC § 363(e) (Supp. IV 1986). See also infra ¶ 25.05[4] (discussing adequate protection of a creditor's interest).

[113] *Whiting Pools*, 462 US at 207.

[114] Id. at 198.

[115] 11 USC § 542(a) (1982). The value or benefit to the bankruptcy estate does not have to be monetary in nature. See H.R. Rep. No. 595, 95th Cong. 1st Sess. 369, reprinted in 1978 U.S. Code Cong. & Admin. News 5963, 6325.

[116] 11 USC § 542(c) (1982). The trustee may, however, be able to recover the property transferred in good faith under Section 550. See infra ¶ 25.07[6] on the rights of transferees of avoided transfers.

[117] 11 USC § 362 (1982 & Supp. IV 1986).

[118] Section 362(a) specifically outlines eight types of actions that are prohibited by the stay. They include:

creditors; secured creditors have no greater right to enforce repayment than do general creditors.

The stay begins automatically with the filing of the bankruptcy petition, whether voluntary or involuntary.[119] It continues until the property in question is no longer part of the bankruptcy estate, the case is closed or dismissed, the debtor is discharged, or the stay is modified or terminated by court order.[120]

Any action taken by a creditor in violation of the stay may be void.[121] A common reaction by the courts is to deprive the violator of the stay of any fruits of the violation, or to prevent any injury to the debtor or the debtor's estate. This could include refusing to give effect to a garnishment,[122] declaring a foreclosure proceeding of no effect,[123] or declaring a judgment obtained void.[124] If a violation of the stay consists of a transfer of debtor's property, in good faith and without actual knowledge of the bankruptcy petition, Section 542(c) will protect the transferor from liability.[125]

If the requirements of Section 542(c) do not apply, a violator of the automatic stay may be held in contempt.[126] If a creditor is found to have willfully violated the stay, it may be liable for actual damages, costs, attorney's fees and

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1. Any commencement or continuation of a judicial, administrative, or other action against the debtor that was or could have been commenced before the bankruptcy petition was filed, or to recover a claim against the debtor that arose before the petition was filed;
2. The enforcement of a judgment obtained before the bankruptcy petition was filed, either against the debtor or against property of the bankruptcy estate;
3. Any act to obtain possession or exercise control of property of the bankruptcy estate;
4. Any act to create, perfect, or enforce any lien against property of the estate;
5. Any act to create, perfect, or enforce any lien against property of the debtor to the extent the lien secures a claim that arose before the commencement of the bankruptcy case;
6. Any act to collect, assess, or recover a claim against the debtor that arose before the bankruptcy petition was filed;
7. The setoff of any debt owing to the debtor that arose before the commencement of the case against any claim against the debtor;
8. The commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

[119] 11 USC § 362(a) (1982 & Supp. IV 1986).

[120] 11 USC §§ 362(c), 362(d) (1982 & Supp. IV 1986).

[121] Kalb v. Feuerstein, 308 US 433 (1940); Borg-Warner Acceptance v. Hall, 685 F2d 1306 (11th Cir. 1982).

[122] In re Baum, 15 Bankr. 538 (Bankr. D. Va. 1981).

[123] In re Wheeler, 5 Bankr. 600 (Bankr. ND Ga. 1980).

[124] In re Seafare Fiber Glass Yachts, Inc., 1 Bankr. 358 (Bankr. EDNY 1979).

[125] 11 USC § 542(c) (1982).

[126] See In re Computer Communications, Inc., 824 F2d 725 (9th Cir. 1987); In re Ellis, 66 Bankr. 821 (ND Ill. 1986); In re DeLay, 48 Bankr. 282 (WD Mo. 1984).

punitive damages.[127] The purpose of the automatic stay is best described in the House Report on the 1978 Bankruptcy Act:

> The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.
>
> The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally.[128]

Because the automatic stay suspends the ability of a creditor to pursue remedies to collect the debt owed to the creditor, the circumstances that entitle a creditor to be freed from the stay are of great importance. These are discussed in the following sections.

[2] Exceptions

There are several exceptions to the automatic stay provisions.[129] These include criminal proceedings against the debtor (either pending or commencing an action),[130] collection of alimony, maintenance or support from property that

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[127] 11 USC § 362(h) (1982 & Supp. IV 1986). Generally a creditor must act intentionally and with knowledge of the bankruptcy to be held liable under this subsection. See In re Santa Rosa Truck Stop, Inc., 74 Bankr. 641 (Bankr. ND Fla. 1987) (a violation of the stay is willful when the party acts with knowledge of the filing of bankruptcy); In re Rinehart, 76 Bankr. 746 (Bankr. DSD 1987) (where there is actual notice of the filing of bankruptcy, it is presumed that the creditor's setoff in violation of the stay was deliberate or intentional); In re Stucka, 77 Bankr. 777, 783 (Bankr. CD Cal. 1987) (A party "willfully" violates a stay, for purposes of Section 362(h), where he "acts in violation of the stay with knowledge or notice of sufficient facts to cause a reasonably prudent person to make additional inquiry to determine whether a bankruptcy petition has been filed"). But see Budget Serv. Co. v. Better Homes, Inc. 804 F2d 299 (4th Cir. 1986) (a finding of civil contempt is not a necessary predicate to impose Section 362(h) sanctions).

[128] H.R. Rep. No. 595, 95th Cong., 1st Sess. 340, reprinted in 1978 U.S. Code Cong. & Admin. News 5963, 6296–6297.

[129] 11 USC § 362(b) (1982 & Supp. IV 1986).

[130] 11 USC § 362(b)(1) (1982). A creditor, however, cannot initiate or encourage the commencement of criminal proceedings against the debtor for the purpose of trying to collect on its debt. In In re Ohio Waste Serv., Inc., 23 Bankr. 59 (SD Ohio 1982) the bankruptcy court found that the creditor had violated the automatic stay provisions by writing a letter to the county attorney requesting investigation into an insufficient funds check written by the debtor. But see In re DeLay, 48 Bankr. 282 (WD Mo. 1984), where a

is not part of the bankruptcy estate,[131] actions brought by the government to enforce its police or regulatory powers,[132] a notice of a tax deficiency,[133] presentation of negotiable instruments and giving notice of dishonor or making a protest,[134] and evictions of commercial tenants.[135]

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creditor filed a criminal complaint for conversion against the debtor. The creditor was not held in contempt as the court found his actions were not for the purpose of collecting the debt. The creditor had already written off the debt before he filed the complaint. Because the creditor was seeking to "get even" only in an emotional sense, not in a monetary sense, the district court reversed the contempt citation.

[131] Collection of alimony, maintenance, and support is excepted from the automatic stay only to the extent that it is against property that is not part of the bankruptcy estate. Under Chapter 7 and Chapter 11 proceedings, for example, postpetition assets and income are not property of the bankruptcy estate, so efforts to collect alimony, maintenance or support from those assets will not be affected by the automatic stay. Under Chapters 12 and 13, however, postpetition assets and income earned from services performed after the petition is filed are part of the bankruptcy estate, so enforcement proceedings, including garnishments, will be stayed upon the filing of a bankruptcy petition. Exempt property of the debtor is not property of the bankruptcy estate, so will always be subject to collection of alimony, maintenance, and support.

See In re Summerlin, 26 Bankr. 875 (Bankr. EDNC 1983) (former wife entitled to pursue collection of alimony from ex-husband debtor's postpetition assets and future income in a Chapter 11 case); In re Renzulli, 28 Bankr. 41 (Bankr. ND Ill. 1982) (postpetition assets and income of a Chapter 7 debtor were not property of the bankruptcy estate, so collection effort by a former spouse against that property was not stayed). But see In re Mack, 46 Bankr. 652 (Bankr. ED Pa. 1985) (The Department of Public Welfare of Pennsylvania, the assignee of a claim for alimony and child support from the debtor's former wife, was held in contempt for violating the automatic stay by continuing a wage garnishment after the Department had knowledge that the debtor filed a Chapter 13 petition in bankruptcy). See also Annot., "Exception From Bankruptcy Estate of Earnings From Services Performed by an Individual Debtor After Commencement of the Case," 76 ALR Fed. 853 (1986).

[132] 11 USC § 362(b)(4) (1982 & Supp. IV 1986). Examples of this type of proceeding include actions by the National Labor Relations Board (NLRB) for unfair labor practices; NLRB v. Edward Cooper Painting, Inc., 804 F2d 934 (6th Cir. 1986), Ahrens Aircraft, Inc. v. NLRB, 703 F2d 23 (1st Cir. 1983); NLRB v. Evans Plumbing Co., 639 F2d 291 (5th Cir. 1981); employment discrimination actions; EEOC v. Rath Packing Co., 787 F2d 318 (8th cir.) cert. denied 107 S. Ct. 307 (1986); EEOC v. Guerdon Indus., 76 Bankr. 102 (WD Ky. 1987); some types of environmental regulations, both federal and state; In re Commonwealth Oil Refining Co., 805 F2d 1175 (5th Cir. 1986), cert. denied, 107 S. Ct. 3228 (1987) (see also infra ¶ 25.09[6][a] for further discussion of environmental regulation proceedings and the automatic stay); and state professional licensing actions; In re Thomassen, 15 Bankr. 907 (Bankr. 9th Cir. 1981) (physician's license revocation proceeding); In re Hanson, 71 Bankr. 193 (ED Wis. 1987) (attorney disciplinary hearing). See generally Tabb, "Competing Policies in Bankruptcy: The Governmental Exception to the Automatic Stay," 21 Tulsa LJ 183 (1985).

[133] 11 USC § 362(b)(9) (1982 & Supp. IV 1986).

[134] This exception was added in the 1984 amendments. Holders of checks drawn by the debtor may deposit them for the purpose of preserving their rights, despite the filing of

[3] Procedure for Obtaining Relief From the Stay

Any party in interest may request relief from the stay, such as modifying or terminating it, for cause.[136] "Cause" specifically includes the lack of adequate protection of the party's interest,[137] but is otherwise not defined in the Bankruptcy Code. In addition, if the debtor has no equity in the property and the property is not necessary to an effective reorganization, the stay may be modified or terminated.[138]

Congress anticipated that "for cause" be determined by the facts in each case.[139] Similarly, the House Report gave the examples of allowing an action to be completed in another tribunal, and the lack of connection with or interference with the pending bankruptcy case, as other possible reasons to modify a stay.[140] Courts have defined "for cause" to include the bad faith of the debtor.[141]

The party requesting relief must file a motion with the bankruptcy court.[142] The stay automatically terminates thirty days after the motion is filed, if the court does not order a continuance of the stay.[143] In any hearing, the party requesting relief has the burden of proof on the issue of debtor's equity in the property, but the party opposing the motion has the burden on all other issues.[144] Section 362(f) of the Bankruptcy Code provides relief from the stay without a

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a bankruptcy petition. 11 USC § 362(b)(11) (1982 & Supp. IV 1986). See also Chapter 21 on presentment and notice of dishonor. The payment of a check where the bankruptcy debtor is the drawer is, however, subject to the automatic stay. See infra ¶ 25.09[1] on the bank's rights and defenses for checks in the process of collection.

[135] 11 USC § 362(b)(10) (1982 & Supp. IV 1986).

[136] 11 USC § 362(d) (1982 & Supp. IV 1986).

[137] See infra ¶ 25.05[4].

[138] 11 USC § 362(d)(2) (1982 & Supp. IV 1986). In determining whether a debtor has equity in the property, courts generally look to all encumbrances on the property, and not merely the lien of the creditor requesting relief from the stay. In re Louden, 69 Bankr. 723 (Bankr. ED Mo. 1987); In re Dunes Casino Hotel, 69 Bankr. 784 (Bankr. DNJ 1986).

[139] H.R. Rep. No. 595, 95th Cong., 1st Sess. 343, reprinted in 1978 U.S. Code Cong. & Admin. News 5963, 6300.

[140] Id. See In re Baker, 75 Bankr. 120 (Bankr. D. Del. 1987) (debtor's former wife was entitled to proceed with a family court action to determine her rights in the marital property, since it was family court, and not the bankruptcy court, that had expertise in these matters). See also In re Elliott, 66 Bankr. 466 (Bankr. SD Fla. 1986) (automatic stay was modified to permit parties to conclude litigation in state court to settle the amount of the claim).

[141] See In re Thirtieth Place, Inc. 30 BR 503 (Bankr. 9th Cir. 1983); In re Corporation Deja Vu, 34 BR 845 (Bankr. D. Md. 1983).

[142] 11 USC § 362(d) (1982 & Supp. IV 1986).

[143] 11 USC § 362(e) (1982 & Supp. IV 1986).

[144] 11 USC § 362(g) (1982 & Supp. IV 1986).

hearing, only if it is necessary to prevent irreparable damage to the interests of an entity in property that will occur before there is an opportunity for notice and a hearing.[145]

[4] The Secured Creditor, the Collateral, and Adequate Protection

As discussed earlier, a secured creditor may not begin or continue a judicial proceeding to collect on debts owed, may not enforce a previous judgment, and cannot foreclose on the collateral securing the debt once a debtor has filed its petition in bankruptcy.[146] Secured creditors may, however, request protection of their property interests pending the stay, through requesting a modification or termination of the stay.[147] For example, while the automatic stay is pending, the collateral is depreciating in value. As a result, the secured party is deprived of the value of the collateral to the extent of the depreciation. If the court orders the debtor to provide adequate protection, the trustee may do so in a variety of ways.[148] The trustee may (1) make periodic cash payments to the secured creditor equal to the loss in value;[149] (2) provide an additional or replacement lien to the extent of the loss in value;[150] or (3) provide other relief that is equal to the "indubitable equivalent" of the secured creditor's interest in the property.[151]

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[145] 11 USC § 362(f) (1982 & Supp. IV 1986).

[146] 11 USC § 362(a) (1982 & Supp. IV 1986).

[147] 11 USC § 362(d) (1982 & Supp. IV 1986).

[148] A Family Farmer Chapter 12 proceeding has its own rules on what constitutes adequate protection. See 11 USC § 1205 (Supp. IV 1986). For a discussion of these provisions, see B. Weintraub & A. Resnick, Bankruptcy Law Manual ¶ 9A.06 (Cum. Supp. 1987).

[149] 11 USC § 361(1) (1982 & Supp. IV 1986). See In re Byker, 64 Bankr. 540 (Bankr. ND Iowa 1986) (debtor's offer of cash payment to be made after harvest of crops on the property that was the subject of the real estate contract between the debtor and the creditor was adequate protection, and the stay would not be lifted); In re Shriver, 33 Bankr. 176 (Bankr. D. Ohio 1983). But see In re Walton, 77 Bankr. 617 (Bankr. ND Ohio 1987) (if the source of adequate protection payments is uncertain or overly speculative, debtor's offer of cash payments is not "indubitable equivalent" of creditor's bargained for rights).

[150] 11 USC § 361(2) (1982). See In re Island Helicopter Corp., 63 Bankr. 515 (Bankr. EDNY 1986) (creditor holding security interest in debtor's fleet of helicopters was adequately protected where debtor had taken significant steps to maintain and upgrade the value of the helicopters, had offered replacement liens on all new components purchased for and installed in the collateral, had offered to provide insurance policies on collateral with the creditor as the loss payee, and had proposed to grant the creditor replacement liens in helicopters to be purchased with recently received insurance proceeds).

[151] 11 USC § 361(3) (1982 & Supp. IV 1986). See In re Ahlers, 794 F2d 388 (8th Cir. 1986) (a debtor's offer of adequate protection should, as nearly as possible under the circumstances, provide the creditor with its bargained for rights), rev'd on other grounds, Norwest Bank Worthington v. Ahlers, 56 USLW 4225 (US March 7, 1988).

One method is to require debtors to provide insurance against destruction of the collateral.[152]

If, however, the secured party has a sufficient "equity cushion" in the collateral, it is usually deemed adequately protected. When the debtor has a significant amount of equity, the secured creditor is oversecured and the loss in value during the stay generally will not harm the creditor.[153]

Courts have sometimes required debtors to compensate secured creditors for their lost opportunity cost in that they were unable to repossess and sell the collateral and reinvest the proceeds.[154] This type of protection essentially amounts to interest, but there is controversy as to whether it applies to both oversecured and undersecured creditors.[155]

The trustee or the debtor in possession may use the collateral during the pendency of the bankruptcy.[156] This use may, however, be conditioned on the creditor receiving adequate protection, as discussed above.[157] In addition, use of the collateral entitles the secured creditor to an administrative priority,[158] and, if the provisions for adequate protection prove to be insufficient (for example, if

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[152] See In re Marchand, 61 Bankr. 81 (Bankr. ED Ark. 1986) (debtor ordered to purchase insurance on farm equipment).

[153] See In re Liona Corp., 68 Bankr. 761 (Bankr. ED Pa. 1987) (in calculating the equity cushion the court compares the value of the collateral to the sum of the claims of the secured party seeking relief from stay and secured claims senior to that of the party seeking relief). The costs of foreclosure and sale are generally included also; In re Pitts, 2 Bankr. 476 (CD Cal. 1979).

[154] In re American Mariner Indus. Inc., 734 F2d 426 (9th Cir. 1984). The Fourth Circuit has followed *American Mariner*. Grundy Nat'l Bank v. Tandem Mining Corp., 754 F2d 1436 (4th Cir. 1985).

[155] See In re American Mariner Industries, Inc., 734 F2d 426 (9th Cir. 1984) (analysis implies it applies to both over and under secured creditors). But see In re Timbers of Inwood Forest Assoc. Ltd., 808 F2d 363 (5th Cir. 1987) (en banc) (Adequate protection does not require postpetition payments for interest or lost opportunity costs to an undersecured creditor as compensation for delay in Chapter 11 cases); In re Briggs Transportation Co., 780 F2d 1339 (8th Cir. 1985) (undersecured creditors are not entitled to interest as matter of law, disagreeing with *American Mariner*, but interest payments may be required on a case-by-case basis, within the sound discretion of the court). This split in circuits will probably have to be resolved by Congress or the Supreme Court. See generally Eisenberg, "The Undersecured Creditor in Reorganizations and the Nature of Security," 38 Vand. L. Rev. 931 (1985); Note, "Adequate Protection and the Availability of Post-Petition Interest to Undersecured Creditors in Bankruptcy," 100 Harv. L. Rev. 1106 (1987).

[156] 11 USC §§ 363(b), 363(c) (1982 & Supp. IV 1986). Cash collateral, which includes cash, negotiable instruments, documents of title, securities, deposit accounts or other cash equivalents may not be used without consent or court approval. Id. at § 363(c)(2).

[157] 11 USC § 363(e) (1982 & Supp. IV 1986).

[158] See 11 USC § 503(b)(1), 507(a)(1) (1982 & Supp. IV 1986). See infra ¶ 25.06 on priority of claims.

the collateral is destroyed and debtor had no insurance), the claim may be entitled to priority over all other administrative expense claims.[159]

¶ 25.06 CREDITORS' CLAIMS: PROCEDURES AND PRIORITY OF DISTRIBUTION

Anyone who has a claim against the debtor may share in the distribution of the estate.[160] A "claim" is defined broadly as a right to payment.[161] It may or may not be reduced to judgment, liquidated, fixed, contingent, matured, disputed, legal, equitable, or secured.[162]

Anyone with a claim may file a proof of claim with the bankruptcy court.[163] There are deadlines for filing proofs of claim. In a Chapter 7, 12, or 13 proceeding, it must be filed within ninety days after the first date set for the meeting of creditors.[164] In a Chapter 11 proceeding, the court fixes the deadline for filing claims.[165] An untimely filing, or no filing, may result in subordination of the claim to timely claims, or in possible discharge of the debt without the creditor receiving any benefits or pro rata share of the estate. In Chapter 11 proceedings, however, a creditor will be deemed to have filed a proof of claim if it is named on the schedule of creditors that the debtor files.[166]

Once a proof of claim is filed, it must go through an allowance process. A claim is considered allowed unless a party in interest objects to it on one of the statutory grounds.[167] The trustee has a duty to review the claims filed and to object to any improper ones.[168] Such grounds include the following: (1) the claim is unenforceable against the debtor; (2) the claim is for unmatured interest; (3) if it is a claim for property tax, the tax assessment exceeds the value of the debtor's interest in the property; (4) if it is a claim for services of an insider or an attorney of the debtor, the claim exceeds the reasonable value of the services; (5) unmatured claims for alimony, maintenance or support; (6) landlord's claims over a

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[159] 11 USC § 507(b) (1982 & Supp. IV 1986).

[160] See 11 USC § 501 (1982 & Supp. IV 1986). Section 101(9) defines creditor as "an entity that has a claim against the debtor. . . ."

[161] See 11 USC § 101(4) (1982).

[162] 11 USC § 101(4) (1982).

[163] 11 USC § 501(a) (1982 & Supp. IV 1986). Filing a proof of claim also assures the creditor of notice of the proceedings.

[164] See Bankr. R. 3002 & 3003.

[165] See Bankr. R. 3003(c)(3).

[166] 11 USC § 1111(a) (1982). If the claim is disputed, contingent or unliquidated, however, the creditor must file a proof of claim. Id.

[167] 11 USC § 502(a) (1982 & Supp. IV 1986).

[168] See 11 USC §§ 704(5), 1106(a)(1), 1202(b)(1), 1302(b)(1) (1982 & Supp. IV 1986).

certain amount; (7) claims by employees for breach of employment contracts exceeding a certain amount; and (8) employment tax claims.[169]

Once a claim is allowed, it must be determined whether the claim is secured or unsecured, and to what extent. If the creditor has collateral of greater value than the amount of the claim, it is fully secured.[170] If the amount owed by the debtor is greater than the value of the collateral, the creditor is secured as to the value of the collateral, but unsecured for the deficiency.[171] A secured creditor who looks only to the value of the collateral for recovery does not need to file a proof of claim.[172] State law generally determines whether a lien is valid, although it still may be subject to avoidance by the trustee.[173] If a claim is subject to a subordination agreement between the debtor and creditors, the bankruptcy court is authorized to enforce it on equitable grounds.[174]

Distributions to creditors under Chapters 11, 12, and 13 are made according to the approved plan. In a liquidation proceeding, the Code provides as follows, for the specific order of distribution of the estate:[175]

1. Secured claims are to be paid in full out of the proceeds of the collateral before any of the proceeds may be used to pay the remainder of the claims.[176]

2. The priority claims, as outlined in Section 507(a), are paid in order of their priority.[177] They include (in order) administrative expenses,[178] involuntary gap claims,[179] wages, salaries and commissions,[180] claims for contributions to an employee benefit plan,[181] grain producer and fisher-

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[169] 11 USC § 502(b) (1982 & Supp. IV 1986).

[170] 11 USC § 506(a) (1982 & Supp. IV 1986).

[171] Id. See generally Butler, "The Insecurity of Secured Creditors Under the Bankruptcy Code," 59 Am. Bankr. LJ 277 (1985).

[172] See 11 USC § 506(d)(2) (1982 & Supp. IV 1986).

[173] See infra ¶ 25.07.

[174] 11 USC § 510 (1982 & Supp. IV 1986).

[175] 11 USC § 726 (1982 & Supp. IV 1986). See generally Buckley, "The Bankruptcy Priority Puzzle," 72 Va. L. Rev. 1393 (1986).

[176] See 11 USC § 725 (Supp. IV 1986).

[177] 11 USC § 726(a)(1) (1982 & Supp. IV 1986).

[178] See 11 USC § 503(b) (1982 & Supp. IV 1986).

[179] See 11 USC § 502(f) (1982 & Supp. IV 1986).

[180] 11 USC § 507(a)(3) (1982 & Supp. IV 1986). These claims are for wages earned by an individual within ninety days before the date the bankruptcy petition was filed, or the date the debtor's business stopped, whichever is first, but not exceeding $2,000.

[181] 11 USC § 507(a)(4) (1982 & Supp. IV 1986). This priority is also limited in amount. The benefits must have accrued to employees during the last 180 days of the business, or by the filing of the petition, whichever was first. In addition, the total amount given priority is equal to the number of employees under the plan, multiplied by $2,000,

men claims against storage facility debtors,[182] consumer deposits,[183] and tax claims.[184]

3. Allowed unsecured claims are paid, as long as they were filed before the deadline.[185]
4. Allowed unsecured claims that were filed after the deadline.[186]
5. Claims for fines, punitive damages, and penalties.[187]
6. If any property of the estate remains, postpetition interest is paid on all unsecured claims at the legal rate. It is prorated among all unsecured claims, without regard to priority.[188]
7. If any surplus remains, it goes to the debtor.[189]

If at any of the distribution levels there are insufficient funds to pay the full amounts due, the proceeds are prorated.[190]

¶ 25.07 POWERS AND DUTIES OF THE BANKRUPTCY TRUSTEE

The trustee is the officer who represents the estate in a bankruptcy proceeding.[191] Generally trustees are appointed by the bankruptcy judge,[192] and must file

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minus the total amount paid to other benefit plans or to employees under the wage priority.

[182] 11 USC § 507(a)(5) (1982 & Supp. IV 1986). In the 1984 amendments Congress gave this priority status to those who delivered grain or fish to a storage facility that subsequently went bankrupt. The limit is $2,000.

[183] 11 USC § 507(a)(6) (1982 & Supp. IV 1986). Consumers that have made deposits to retail institutions that subsequently filed bankruptcy are entitled to a priority of up to $900. The deposit must have been made in connection with the purchase, lease or rental or property or services of a consumer nature (not commercial).

[184] 11 USC § 507(a)(7) (1982 & Supp. IV 1986). This tax priority includes various types of income tax, property tax, social security and employment tax, excise tax, customs duties, and penalties relating to any of the listed taxes.

[185] 11 USC § 726(a)(2) (1982 & Supp. IV 1986).

[186] 11 USC § 726(a)(3) (1982 & Supp. IV 1986).

[187] 11 USC § 726(a)(4) (1982 & Supp. IV 1986).

[188] See 11 USC § 726(a)(5) (1982 & Supp. IV 1986).

[189] 11 USC § 726(a)(6) (1982 & Supp. IV 1986).

[190] 11 USC § 726(b) (1982 & Supp. IV 1986).

[191] 11 USC § 323(a) (1982).

[192] In liquidation cases under Chapter 7, the unsecured creditors have the right to elect a trustee by a majority vote if creditors holding at least 20 percent of the amount of the outstanding unsecured claims request an election. 11 USC § 702(b), (c) (1982 & Supp. IV 1986).

a bond.[193] The role of the trustee is to act in the best interests of the creditors in collecting and preserving the bankruptcy estate. To accomplish this goal, the trustee is given special powers to avoid several different kinds of liens, transfers, and executory contracts.

[1] Trustee as Lien Creditor

Under Section 544(a) of the Code, known as the "strong-arm" clause, the trustee has, as of the date the petition in bankruptcy is filed, all the rights and powers that a lien creditor might have, if that lien creditor had obtained a lien on the property at the time the bankruptcy case commenced, to set aside or avoid any transfer of property by the debtor.[194] A lien creditor is a creditor who obtains an interest in the property by attachment or legal process, and does not include a creditor with a security interest in the property. These rights are the rights of a hypothetical lien creditor; one does not in fact have to exist.[195] The hypothetical lien creditor is one who is deemed to have obtained a lien on the property in question, as of the date of bankruptcy.

This power involves a mixture of federal and state law. While the federal Bankruptcy Code gives the trustee the rights of a lien creditor, state law defines what rights such a lien creditor has. In cases involving personal property, the controlling state law is the UCC, and the UCC gives a lien creditor priority over a security interest in collateral that is unperfected.[196] As a result, this provision gives the trustee power to set aside all security interests created by the debtor that are unperfected as of the commencement of the bankruptcy proceeding.[197]

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[193] 11 USC § 322(a) (1982 & Supp. IV 1986).

[194] 11 USC § 544(a) (1982 & Supp. IV 1986).

[195] Section 544(a)(1) of the Bankruptcy Reform Act of 1978 specifically overruled a Ninth Circuit case, Pacific Fin. Corp. v. Edwards, 304 F2d 224 (9th Cir. 1962), which held that despite the trustee having the power of a hypothetical lien creditor, the trustee did not have those powers if there was no creditor that could have obtained a lien. Under the Code, there is no requirement that an actual creditor exist who could have obtained the lien. See 124 Cong. Rec. H32400 (1978).

[196] UCC § 9-301(1)(b).

[197] 11 USC § 544(a) (1982 & Supp. IV 1986). See also UCC. 9-301. Perfection of a security interest is discussed at ¶ 22.03. A purchase money security interest is superior to the claim of a lien creditor whose lien attaches while the security interest was unperfected, if the purchase money security interest is perfected within ten days of delivery of the goods, because the perfection relates back to the date the security interest attached to the goods. UCC. 9-301(2). Thus, a lien creditor's rights under the relevant state law are not superior to the secured party whose purchase money security interest became so perfected, and a trustee in bankruptcy, who only has the rights of such a lien creditor under this section of the Bankruptcy Code, will not be able to avoid the security interest.

For example, assume debtor buys goods from a seller on credit on day 1, seller takes a purchase money security interest in the goods which attaches on day 1, debtor takes possession of the goods on day 2, and debtor's bankruptcy filing occurs on day 4. Seller's

[2] Trustee as Successor to the Rights of Actual Unsecured Creditors

The trustee may also assert the same rights that any unsecured creditor who has a claim against the debtor might exercise.[198] Under this provision, if there is an *actual* unsecured creditor who has the power under any applicable state law to avoid a security interest, lien, or any other transfer of an interest in the debtor's property, the trustee in bankruptcy will have a similar power to set aside such transfers for the benefit of all creditors. This gives the trustee the powers of any type of unsecured creditor, not just those of a lien creditor. It permits the trustee to void a debtor's transfer of an interest in the debtor's property that could have been avoided by any particular unsecured creditor of the debtor, as long as there is an actual unsecured creditor with such power under the relevant state law.[199] The theory underlying this power is that the trustee, as the representative of all creditors, should be able to recover for the estate what any actual creditor might recover.

The potential liability under this section can be great, because the transfer avoided is not limited by the amount of the unsecured claim on which it is based. Under the *Moore v. Bay*[200] rule, the entire transfer is avoided. For example, suppose a bankrupt debtor made a bulk sale under Article 6 of the UCC, selling $500,000 in inventory. The buyer, however, failed to give proper notice to all debtor's creditors, as required by the UCC. The debtor received the proceeds from the sale and paid all its creditors, but inadvertently missed one general

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security interest is unperfected on the date of bankruptcy, so ordinarily the trustee's power as a hypothetical lien creditor would enable the trustee to set aside the security interest. But if the seller files to perfect the security interest by day 12 (within 10 days after the debtor received possession of the collateral), the perfection will relate back to the date the security interest attached (day 1), and the seller's perfected security interest will be effective against the trustee. Section 546(b) of the Bankruptcy Code specifically recognizes the validity in bankruptcy of this relation-back of perfection for purchase money security interests. Section 362(b)(3) of the Bankruptcy Code allows a secured party to file to perfect such a security interest as an exception to the automatic stay. For further discussion of priority rights relating to security interests, see ¶ 23.01.

[198] 11 USC § 544(b) (1982 & Supp. IV 1986).

[199] Actions under state-enacted uniform codes such as the Uniform Fraudulent Conveyance Act (UFCA), the newer Uniform Fraudulent Transfer Act (UFTA) and bulk transfers under the Uniform Commercial Code (Article 6) are common under Section 544(b). See In re Steele, 79 Bankr. 503 (Bankr. MD Fla. 1987) (trustee avoided transfer of real property from debtor to grandmother under Florida state fraudulent conveyance statute); In re Zarling, 70 Bankr. 402 (Bankr. ED Wis. 1987) (UFCA voided a transfer of real property to an alleged religious society); In re Kenval Marketing Corp., 69 Bankr. 922 (Bankr. ED Pa. 1987) (bulk sale avoided under Pennsylvania law); In re Express Liquors, Inc. 65 Bankr. 952 (Bankr. D. Md. 1986) (trustee avoided transfer under Maryland UCC on bulk transfers).

[200] In Moore v. Bay, 284 US 4 (1931), the U.S. Supreme Court held that the bankruptcy trustee can succeed to the rights of a creditor without being limited by the amount of the creditor's claim.

trade creditor who held a $1,000 claim. The debtor subsequently *filed* bankruptcy. The actual creditor with the $1,000 unsecured claim has a cause of action against the buyer in the bulk sale because of the defective notice. The trustee, under Section 544(b), succeeds to the rights of the unsecured creditor and may avoid the entire bulk transfer; that is, the trustee may require the return of the entire $500,000 of inventory, or its value, from the buyer in the bulk sale transaction. Thus even though the trustee's claim was based on a $1,000 debt, the entire $500,000 transfer is set aside.

The trustee's recovery under this section is for the benefit of the bankruptcy estate.[201] The actual creditor, on whose claim the recover is based, is in no better a position than any other actual unsecured creditor with regard to the proceeds recovered.

The UCC however, decreases the number of opportunities for this potential liability to result. Under the UCC, an unperfected security interest is vulnerable only to a perfected security interest or to a lien creditor.[202] Under the Bankruptcy Code, Section 544(b), the trustee succeeds only to the rights of an *unsecured* creditor; those creditors having perfected security interests, or liens, are *secured* creditors.[203]

[3] Power to Set Aside Statutory Liens

Statutory liens, such as mechanics' liens, artisans' liens, and landlord liens, are interests in the debtor's property that arise by force of statute.[204] Statutory liens are generally valid against a bankruptcy trustee. A statutory lien is different from a UCC Article 9 security interest because a security interest is created by the voluntary action of the parties in agreeing to create the security interest, while the statutory lien arises without the need for any particular agreement, simply from the operation of the statute on the circumstances. Nevertheless, the Bankruptcy Code classifies holders of statutory liens as secured creditors.[205] The trustee may avoid statutory liens in only the following three circumstances:[206]

1. A statutory lien that becomes effective only upon the bankruptcy or insolvency of the debtor. The Bankruptcy Code gives the trustee this power, so that states may not create lien statutes whose sole purpose is to alter the order of distribution in bankruptcy cases dictated by the

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[201] See id.

[202] See UCC §§ 9-201, 9-301.

[203] For a more detailed analysis, see J. White & R. Summers, Uniform Commercial Code § 24-7 (2d ed. 1980).

[204] 11 USC § 101(47) (Supp. IV 1986).

[205] 11 USC § 506 (1982 & Supp. IV 1986).

[206] See 11 USC § 545 (1982 & Supp. IV 1986).

national policies established in the Code.[207] To prevent this, the trustee may avoid statutory liens that, by their own terms, become effective upon certain events indicating insolvency.[208]

2. A statutory lien if it is not perfected or enforceable as of the date the bankruptcy petition is filed against a hypothetical bona fide purchaser.[209] The most common liens under this category are tax liens. Notices of tax liens generally must be filed in the county recorder's office before they are effective against a bona fide purchaser. If not filed prior to the date the bankruptcy petition is filed, they may be avoided by the trustee.[210]
3. A landlord's statutory lien.[211] A landlord is treated as a general creditor, with respect to prebankruptcy rent claims, unless the landlord's claim is secured by a security interest in the property of the debtor created by agreement of the parties prior to bankruptcy.[212]

[4] Power to Set Aside Preferences

[a] Elements of a Preference. When a debtor who is insolvent transfers property shortly before bankruptcy to satisfy a prior debt, this transfer is called a "preference." The trustee has the authority to set aside the transfer and to recover the property for the benefit of the estate.[213] Five elements must be

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[207] See B. Weintraub & A. Resnick, Bankruptcy Law Manual ¶ 7.04[1] (rev. ed. 1986 & Cum. Supp. 1987).

[208] These events include: (1) debtor files a petition in bankruptcy; (2) when any other insolvency proceeding is commenced; (3) when a custodian is appointed or authorized to take, or does take, possession; (4) when the debtor becomes insolvent; (5) when the debtor's financial condition fails to meet a specified standard; or (6) at the time of an execution against property of the debtor levied by an entity other than the holder of the statutory lien. 11 USC § 545(1) (1982 & Supp. IV 1986).

[209] 11 USC § 545(2) (1982 & Supp. IV 1986).

[210] For a thorough discussion of the trustee's avoiding powers under Section 545(2), as applied to federal tax liens, see In re Coan, 72 Bankr. 483 (Bankr. MD Fla. 1987). See also In re Barnett, 62 Bankr. 638 (Bankr. D. Md. 1986) (trustee can avoid tax lien where the United States had filed a notice of it in the wrong county, despite its subsequent correction of the error). This subsection applies to other types of statutory liens as well. See In re Nicholson, 57 Bankr. 672 (Bankr. D. Nev. 1986) (attorney's lien, which was unperfected due to lack of notice to debtor at the time of commencement of debtor's bankruptcy case, was statutory lien avoidable by the trustee under Section 545(2)).

[211] 11 USC § 545(3) (1982 & Supp. IV 1986).

[212] See In re Brittain, 81 Bankr. 7 (Bankr. WD La. 1987); In re Zaison, Inc., 80 Bankr. 832 (Bankr. SD Tex. 1987); In re John Deskins Pic Pac, Inc., 59 Bankr. 809 (Bankr. WD Va. 1986).

[213] 11 USC § 547(b) (1982 & Supp. IV 1986). On preferences, see generally Countryman, "The Concept of a Voidable Preference in Bankruptcy," 38 Vand. L. Rev. 713 (1985); Duncan, "Loan Payments to Secured Creditors as Preferences Under the 1984 Bankruptcy Amendments," 64 Neb. L. Rev. 83 (1985).

present before a trustee can treat a transfer as a preference and recover the property that was transferred.[214] A preference is any transfer of the debtor's interest in property that is (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before the transfer was made; (3) made while the debtor is insolvent;[215] (4) made within ninety days before the filing of the bankruptcy petition;[216] and (5) one that gives the creditor more than it would receive in a liquidation case, if the transfer had not been made.[217]

More specifically, there must be a "transfer"[218] within the relevant period of time of an "interest of the debtor in property," to or for the benefit of a creditor.[219] The transfer must be made while the debtor was insolvent,[220] and it must enable the creditor to receive more than the creditor would have been entitled to receive under liquidation.[221] To illustrate, assume debtor has an outstanding debt of $1,000 to *C*, which debtor incurred for the purchase of some goods. Within the ninety-day period before bankruptcy, and at a time while the debtor was insolvent, the debtor pays *C*. (There is a presumption the debtor is

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[214] Transfer is defined very broadly in the Code: it means "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property. . . ." It includes retention of a security interest, and foreclosure of the debtor's equity of redemption. 11 USC § 101(50) (Supp. IV 1986).

[215] The debtor is assumed to have been insolvent during the ninety-day period preceding the date a bankruptcy petition was filed. 11 USC § 547(f) (1982 & Supp. IV 1986).

[216] If the creditor is an insider, a transfer made within one year before the bankruptcy petition is filed is vulnerable as a preference. 11 USC § 547(b)(4)(B) (1982 & Supp. IV 1986).

Because the transfer must be made within 90 days of the filing date, *when* the transfer is made is crucial. A transfer is made at the time such transfer takes effect between the transferor and the transferee, if the transfer is perfected at or within ten days after such time. If it is perfected later than ten days after, it is made at the time the transfer is perfected. If the transfer is not perfected by the time the bankruptcy petition was filed it is deemed to have been made immediately before the filing date. See 11 USC § 547(e)(2) (1982 & Supp. IV 1986). A transfer is not made, however, until the debtor has acquired rights in the property transferred. Id. at § 547(e)(3).

[217] 11 USC § 547(b) (1982 & Supp. IV 1986).

[218] The term "transfer" is defined in the Code as meaning "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption . . . ." 11 USC § 101(50) (Supp. IV 1986).

[219] 11 USC § 547(b) (1982 & Supp. IV 1986).

[220] The Code defines "insolvent." The test is whether the debtor's debts exceed the value of its property computed as prescribed in the Code to exclude certain property that has been fraudulently transferred or may be exempt from the property of the estate. 11 USC § 101(31) (Supp. IV 1986). There is a special definition for when a partnership is insolvent. Id.

[221] 11 USC § 547(b) (1982 & Supp. IV 1986).

insolvent throughout the ninety-day period before the filing of the petition.)[222] The payment is a transfer of property of the debtor to the creditor, *C*, for an antecedent obligation. The transfer has the effect of preferring *C* over other creditors, because *C* would not likely receive full payment of the debt had there been a bankruptcy liquidation proceeding in which *C*, for example, might be given 40 percent of the claim. The transfer to the creditor does not have to be a payment of money; any interest in property of the debtor will do. Thus, if *C* held an unsecured obligation, and shortly before bankruptcy the debtor gave *C* a security interest in property owned by the debtor, the creation of the security interest in favor of *C* also will qualify as a preference.

There must be an "antecedent debt" for a preference to exist. The contemporaneous substitution of property of equal value does not create a preference, because there is no transfer of property for an antecedent debt but only an exchange of property of equivalent value. The creditor is not preferred over other creditors because the value of the bankrupt's estate remains unchanged by the exchange. Thus, when a debtor purchases goods on credit but gives the seller or other secured party a security interest in the goods, there is no transfer on account of an antecedent debt if the security interest is granted by the debtor at the same time that the debtor receives the goods. It is a simultaneous exchange. If the debtor subsequently pays the obligation to the secured party, the payment is not necessarily a transfer for an antecedent debt, because the release by the secured party of the security interest in the goods, in exchange for payment, is a similar exchange of property of equivalent value. Moreover, as long as the collateral fully secures the debt, the payment to the secured party does not give the secured party any more than the secured party would get on liquidation, because the claim is fully secured.

What happens when the security interest is unperfected or does not become perfected until sometime subsequent to the creation of the debt within the ninety-day period prior to the filing of the petition? In such cases, the Bankruptcy Code contains rules that define when the transfer of property to the creditor shall be deemed to have occurred. If the security interest is never perfected, the transfer of the security interest to the secured party is viewed as having occurred immediately before the date of the filing of the petition in bankruptcy.[223] This makes the security interest a transfer for an antecedent debt because the transfer is deemed to occur immediately before bankruptcy while the debt arose at an earlier time. Thus, according to this rule, a debtor is prevented from concealing from other creditors security interests in the debtor's property by not following the rules for perfecting the security interest. Perfection is defined, as far as personal property or fixtures are concerned, as the moment "when a creditor on a simple contract cannot acquire a judicial lien that is

[222] 11 USC § 547(f) (1982).

[223] 11 USC § 547(e)(2) (1982 & Supp. IV 1986).

superior to the interests of the transferee."[224] This definition of perfection makes Article 9 of the UCC applicable. Under Section 9-301(1)(b) of the UCC, a judicial lien creditor will not prevail over a *perfected* security interest. Thus, perfection for these purposes of the Bankruptcy Code, will occur when the secured party has perfected a security interest under Article 9 of the UCC.

When there is a delay in perfecting the security interest, the Bankruptcy Code establishes a grace period of ten days. If the security interest is perfected at or within ten days after the security interest is created in the goods, the transfer is regarded as having taken effect at the time the security interest "takes effect," which would be the time at which the security interest attached under Article 9 of the UCC.[225] The consequence of this rule is that the transfer of the security interest to the secured party occurs simultaneously with the acquisition of rights by the debtor in the goods, if the secured party has taken the proper steps to make sure the security interest attaches at that moment. The transfer will not be for an antecedent debt and thus will be secure against the trustee in bankruptcy. The ten-day grace period corresponds neatly with the ten-day period in the UCC for perfecting a purchase money security interest in goods.[226] The bankruptcy provision is broader than the UCC, however, because the ten-day grace period is applicable for purposes of the preference rules, regardless of whether the security interest is a purchase money interest.

If there is a delay in perfection of the security interest of more than ten days, the transfer will be deemed to occur at the time the security interest is perfected. Using the example above of a purchase of goods on credit, secured by a security interest in the goods, the delay of more than ten days in perfecting the security interest makes the transfer one that is subsequent in time to the creation of the obligation to pay for the goods, and thus constitutes a transfer on account of an antecedent debt.[227]

When the transfer is one that is made to an "insider," the relevant period in which the transfer may be subject to attack as a preference is extended to reach transfers that occur before the ninety-day period, but which are within one year prior to the date of filing the bankruptcy petition, so long as the creditor who gets the benefit of the transfer was an "insider" at the time of the transfer.[228] As

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[224] 11 USC § 547(e)(1)(B) (1982 & Supp. IV 1986). There is a bona fide purchaser test for transfers of real property other than fixtures. The interest in real property of a seller or purchaser is perfected "when a bona fide purchaser of such property from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest that is superior to the interest of the transferee. . . ."

[225] 11 USC § 547(e)(2)(A) (1982 & Supp. IV 1986).

[226] See discussion of the purchase money security interest perfection procedures in ¶¶ 22.02[2], 22.03[1].

[227] 11 USC § 547(e)(2)(A) (1982 & Supp. IV 1986).

[228] 11 USC § 547(b)(4)(B) (1982 & Supp. IV 1986).

defined in the Bankruptcy Code,[229] when the debtor is an individual, an insider includes relatives of the debtor, a general partner, or a partnership in which the debtor is a general partner, and a corporation of which the debtor is a director, officer, or person in control.[230] When the debtor is a corporation, an insider includes a director, an officer, or a person in control of the corporation, as well as a partnership in which the debtor is a general partner or a general partner of the debtor or relatives of a general partner, director, officer, or control person.[231] There are similar definitions of "insider" for debtors that are partnerships and debtors that are municipalities.[232] The rules on what constitutes a preference are otherwise similar to those stated earlier, but the trustee must establish that the creditor was an insider, and further the trustee does not have the benefit of the presumption of insolvency during the ninety days immediately preceding the filing of the bankruptcy petition.

A case involving an escrow transaction posed the question of how to determine the time at which a "transfer" took place. The Eighth Circuit Court of Appeals held that payments arising out of an escrow agreement created prior to the ninety-day period preceding bankruptcy, even though they occurred during the ninety-day period, could not be avoided as preferences or postpetition transfers.[233] The debtor had set up the escrow to provide for payment to the creditor, in the event that a judgment against the debtor was upheld on appeal. The judgment was upheld, and the court said that the creditor became entitled to the escrowed funds, although the debtor had since become bankrupt. The court reasoned that "to be avoidable [under the Bankruptcy Act] a transfer must deprive the debtor's estate of something of value that could otherwise be used to satisfy creditors. Once the escrow was created, the only interest in the escrow funds remaining in the debtor was a contingent right to the funds if the judgment was reversed. This interest is worthless in light of the affirmance [of the judgment.] Therefore, the 'transfer' of this interest did not deprive the estate of anything of value."[234]

[b] Statutory Exceptions. The Code contains a number of statutory exceptions that are recognized as transfers, which the trustee may not set aside.[235] These exceptions in party codify doctrines recognized in case law prior to the Code. Thus, the Code provides that the trustee may not avoid a transfer which was

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[229] 11 USC § 101(30) (1982 & Supp. IV 1986).

[230] 11 USC § 101(30)(A) (1982 & Supp. IV 1986).

[231] 11 USC § 101(30)(B) (1982 & Supp. IV 1986).

[232] 11 USC § 101(30)(C), (D) (1982 & Supp. IV 1986).

[233] In re Newcomb, 744 F2d 621 (8th Cir. 1984).

[234] Id.

[235] See 11 USC § 547(c)(1) (1982 & Supp. IV 1986).

intended to be "a contemporaneous exchange for new value[236] given to the debtor" and was in fact "a substantially contemporaneous exchange. . . ."[237] For example, if a debtor buys new equipment and pays the creditor with a check, it is contemporaneous payment, because the check is generally deemed to be payment when it is delivered, rather than when it is honored.[238] If the check is dishonored, however, it will not have been contemporaneous payment in fact, as required by Section 547(c)(1)(B), and may, if the other requirements are met, be voided as a preference. A similar exception exists for certain ordinary course of business transactions.[239] The trustee may not avoid a transfer by the debtor to

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[236] New value is defined and includes "money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee . . ." in certain transactions "but does not include an obligation substituted for an existing obligation." 11 USC § 547(a)(2) (1982 & Supp. IV 1986).

[237] 11 USC § 547(c)(1) (1982 & Supp. IV 1986). To come within this exception, the parties must intend the exchange to be a contemporaneous exchange for value. In re Prescott, 805 F2d 719 (7th Cir. 1986) (trustee could avoid transfer of a CD to a bank where the parties intended it to be additional security for a loan, rather than a contemporaneous exchange for debtor's overdrafts). Release of a security interest may constitute new value, but forbearance from foreclosure on collateral, or exercising a right to cancel a contract, may not constitute new value. If it did, unsecured and undersecured creditors could extract payments out of debtors at the expense of general creditors. Drabkin v. A.I. Credit Corp., 800 F2d 1153 (DC Cir. 1986). Accord In re Air Conditioning Inc., 72 Bankr. 657 (Bankr. SD Fla. 1987). See generally Annot., "What Falls Within 'Contemporaneous Exchange' Exception to Bankruptcy Trustee's Power to Avoid Transfer of Property by Debtor," 77 ALR Fed. 14 (1986).

[238] 11 USC § 547(c)(1) (1982 & Supp. IV 1986). See S. Rep. No. 989, 95th Cong., 2d Sess. 88, reprinted in 1978 US Code Cong. & Admin. News 5787, 5874. The report states that payment by check is contemporaneous payment if the check is presented for payment in the normal course of affairs (within thirty days, under UCC 3-503(2)(a)). See In re White River Corp., 799 F2d 631 (10th Cir. 1986); In re Standard Food Serv., Inc., 723 F2d 820 (11th Cir., 1984); In re Fasano/Harriss Pie Co., 71 Bankr. 287 (WD Mich. 1987); In re Almarc Mfg., Inc., 61 Bankr. 684 (Bankr. ND Ill. 1986) (and cases cited therein). But see *In re* Bob Grissett Golf Shoppes, Inc., 78 Bankr. 787 (Bankr. ED Va. 1987), holding that transfer occurs when a check is delivered and subsequently honored only if parties intended to rely on the check as a cash transaction, and only if such reliance was reasonable under the circumstances. Otherwise, transfer occurs when the check is honored. In this case the court found that the parties did not intend a cash transaction because the checks were postdated and were for an antecedent debt (earlier checks had been dishonored). As a result, only goods delivered after the checks were honored could be deemed as "new value."

Where the date of delivery of the check was not known, a district court held that the date the check was signed would be adopted as a proxy for the date of delivery. In re Fuel Oil Supply & Terminaling, Inc., 72 Bankr. 752 (SD Tex. 1987).

A Ninth Circuit bankruptcy appellate panel recently held that, because a sight draft is the practical and legal equivalent of a check, payment was made when the sight draft was delivered. In re Gaildeen Indus. Inc., 71 Bankr. 759 (Bankr. 9th Cir. 1987).

[239] To be considered normal course of business, three requirements must be met: (1) the debt must have been incurred in the ordinary course of business; (2) the payment

pay "a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor..." as long as the payment was made in the ordinary course of business and was made "according to ordinary business terms. . . ."[240]

Additionally, there is also a statutory exception to deal with certain transactions involving after acquired property. For example, assume debtor enters into a security agreement with a lender on day 1 to borrow money to purchase a particular piece of equipment in which the security interest will attach. Twenty-one days later the debtor takes delivery of the equipment, and the security interest attaches at that time. In answer to the question as to whether there is a transfer on account of an antecedent debt, because the security interest attached on day 21 to secure a debt created 20 days earlier, the current version of the Bankruptcy Code contains a provision specifying that a transfer may not occur "until the debtor has acquired rights in the property transferred."[241] Under this rule, the transfer would occur on day 21. The statutory exception says that the trustee may not set aside this transfer as a preference if (1) the transfer creates a security interest in property acquired by the debtor; (2) the security interest secures "new value" given to enable the debtor to acquire the property; (3) the debtor did use the new value to acquire the property; and (4) the security interest is perfected "on or before ten days after the debtor receives possession of such property. . . ."[242] In the preceding example, the secured party's loan to buy the equipment constitutes "new value," and as long as the loan was given to enable the debtor to buy the equipment, as long as the debtor in fact used the proceeds of the loan to buy such equipment, and as long as the security interest is timely perfected, the transaction cannot be attacked as a preference.

The statutory exceptions in the current Bankruptcy Code also apply to circumstances in which a creditor gives new value to the debtor after the transfer has occurred. This exception would assist creditors who make a subsequent advance to a debtor that is secured by a security interest already created in property of the debtor.[243] It also covers the case in which the debtor makes a payment on a debt that otherwise could be attached as a preference, but for

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must have been made in the ordinary course of business; and (3) the payment must have been made according to ordinary business terms. 11 USC § 547(c)(2) (1982 & Supp. IV 1986).

The purpose of this exception is to leave debtor's normal financial relations undisturbed, while prohibiting any unusual conduct that allows some creditors to gain an advantage over others. See In re Day Telecommunications, Inc., 70 Bankr. 904 (Bankr. EDNC 1987). See generally De Simone, "Section 547(c)(2) of The Bankruptcy Code: The Ordinary Course of Business Exception Without the 45 Day Rule," 20 Akron L. Rev. 95 (1986).

[240] 11 USC § 547(c)(2) (1982 & Supp. IV 1986).

[241] 11 USC § 547(e)(3) (1982 & Supp. IV 1986).

[242] 11 USC § 547(3) (1982 & Supp. IV 1986).

[243] 11 USC § 547(c)(4) (1982 & Supp. IV 1986).

which the creditor subsequently makes an offsetting advance, as in a revolving credit plan.

Treatment of the UCC security interest that floats in inventory and receivables, and proceeds of such property, has been the object of considerable debate.[244] When there is a constantly shifting mass of inventory or accounts or proceeds, whose value may fluctuate over time, one may ask whether the creation of security interests in new property coming into the mass that serves as collateral is to be regarded as a preference. In answer to this question, it is possible for the secured party to obtain an improved position when there is a buildup of such collateral in the ninety-day period. The Bankruptcy Code contains a series of rules to determine whether the change in value of the collateral in relationship to the debt should be regarded as a preference.[245]

The Code also contains exceptions for statutory liens that are not avoidable under other provisions of the Code, and for transfers by individual debtors whose debts primarily are consumer debts, when the total value of the property that is involved in the transfer is less than $600.[246]

[5] Power to Set Aside Fraudulent Conveyances

The Bankruptcy Code authorizes the trustee to avoid fraudulent conveyances of debtor's property.[247] Such transfers of a debtor's interest in property, or any obligation incurred by the debtor, must have been made within one year before the date the bankruptcy petition was filed.[248] The trustee's power to avoid the transfer exists whether the debtor made the transfer voluntarily or involuntarily.

There are two general categories of fraudulent conveyances: (1) transfers of a debtor's property made deliberately, with intent to harm creditors and (2) transfers of a debtor's property that are financially damaging to the debtor and deprive creditors of assets, but which are not necessarily made with any actual intent to prevent payment to creditors. Any transfer made with actual intent to hinder, delay, or defraud a creditor may be avoided as a fraudulent conveyance.[249] The actual intent required distinguishes a fraudulent transfer from a preferential transfer. Proof of actual intent is difficult, but where assets are transferred to relatives, or obligations are incurred to relatives, corporations are

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[244] For an excellent discussion of the legal issues in applying the preference provisions of the Bankruptcy Code to floating liens, after acquired property, and proceeds under the UCC, see J. White & R. Summers, Uniform Commercial Code §§ 24-5, 24-6 (2d ed. 1980); 2 G. Gilmore, Security Interests in Personal Property § 45 (1965).

[245] 11 USC § 547(c)(5) (1982 & Supp. IV 1986).

[246] 11 USC § 547(c)(7) (1982 & Supp. IV 1986).

[247] 11 USC § 548(a) (1982 & Supp. IV 1986).

[248] Id.

[249] 11 USC § 548(a)(1) (1982 & Supp. IV 1986).

used to manipulate assets, or the transfer is conducted in secrecy, such "badges of fraud" may give rise to a presumption of actual intent.[250] For example, transfers of nonexempt property to family members shortly before the filing of a petition in bankruptcy generally constitute fraudulent conveyances and so may be avoided by the trustee.[251]

Under the second category, the transfer of debtor's property for less than its "reasonably equivalent value" is suspect as a fraudulent conveyance. If, in addition to receiving less than the reasonably equivalent value, the debtor (1) was insolvent when the transfer was made, or became insolvent as a result of the transfer; (2) was engaged in business or a transaction with unreasonably small capital; or (3) intended to incur debts that would be beyond its ability to pay as the debts matured, the transfer may be avoided as a fraudulent conveyance.[252] Neither an intent to defraud nor a demonstration of bad faith is necessary for this type of fraudulent transfer.[253]

Whether a foreclosure of real property may be avoided as a fraudulent conveyance, if the price paid at the sale is significantly below the fair market price, is an unresolved issue. In *Durrett v. Washington National Insurance Co.*[254] the Fifth Circuit held that a nonjudicial foreclosure of a deed of trust, within one year before debtor filed bankruptcy, was a fraudulent conveyance because the property sold for 57.7 percent of its fair market value. The court found that this price was not the "reasonably equivalent value" of the property, so that the sale could be avoided. The court stated that it had found no decisions approving a transfer for less than 70 percent of fair market value, which encouraged subsequent courts to use a 70 percent rule for determining fraudulent conveyances.[255] In *In re Madrid*,[256] however, a Ninth Circuit bankruptcy appellate panel held that if the sale is a noncollusive and regularly conducted mortgage foreclosure, the price received is, as a matter of law, the "reasonably equivalent value" of the

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[250] See In re Kaiser, 32 Bankr. 701 (DNY), aff'd, 722 F2d 1574 (2d Cir. 1983).

[251] See In re Duque Rodriguez, 77 Bankr. 936 (Bankr. SD Fla. 1987) (Debtor's transfer of $2.15 million to his wife, two days before filing bankruptcy, for no consideration and while under pressure from creditors was avoidable under Section 548(a)(1)); In re Jones, 68 Bankr. 483 (Bankr. WD Mo. 1984) (debtor's transfer of real estate to his brother, while retaining use and enjoyment of it, and acknowledging the intent of the transfer was to keep it out of creditors' hands, was avoidable by the trustee as a fraudulent conveyance).

[252] 11 USC § 548(a)(2) (1982 & Supp. IV 1986).

[253] Id.

[254] 621 F2d 201 (5th Cir. 1980).

[255] See In re Willis, 48 Bankr. 295 (SD Tex. 1985); In re Fargo Biltmore Motor Hotel Corp., 49 Bankr. 782 (Bankr. DND 1985); In re Wheeler, 34 Bankr. 818 (Bankr. ND Ala. 1983).

[256] 21 Bankr. 424 (Bankr. 9th Cir. 1982). aff'd on other grounds, 725 F2d 1197 (9th Cir.) cert. denied, 469 US 833 (1984).

property, so that it cannot be the grounds for a fraudulent conveyance.[257] The court reasoned that "a regularly conducted sale, open to all bidders and all creditors, is itself a safeguard against the evils of private transfers to relatives and favorites."[258]

A third view now exists, holding that what constitutes the "reasonable equivalent value" should be determined by the facts, on a case-by-case basis. In a thoughtful opinion that reviews the precedent of the various circuits, a bankruptcy court, in *In re Pruitt*,[259] held that the issue of whether a foreclosure sale price is reasonably equivalent to the value of the foreclosed upon property should be determined on a case-by-case basis, rather than by a standard 70 percent rule (*Durett*) or by a conclusive presumption that the price at the sale is fair (*Madrid*). The issue appears to be as yet unresolved, despite changes in wording of the text of the Bankruptcy Code in the 1984 Amendments.[260]

[6] Rights of Transferees in Avoided Transfers

A further complication in collecting the assets of the estate is the protection given by the code when the property that the debtor has transferred is transferred by the transferee to a subsequent party, and when such party has acted in good faith in the transaction, has paid value, and is without knowledge that the first trans-

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[257] See also In re Bundles, 61 Bankr. 929 (Bankr. SD Ind. 1986) aff'd, 78 Bankr. 203 (SD Ind. 1987); In re Verna, 58 Bankr. 246 (Bankr. CD Cal. 1986); In re Ristich, 57 Bankr. 568 (Bankr. ND Ill. 1986); In re Upham, 48 Bankr. 695 (Bankr. WDNY 1985).

[258] *Madrid*, 21 Bankr. at 424–425.

[259] 72 Bankr. 436 (Bankr. EDNY 1987). In *Pruitt*, the court found that the purchase price at the foreclosure sale, $22,500, was not the reasonably equivalent value of the property where the fair market value was estimated at $110,000–$115,000, and the purchaser took the property subject to a first mortgage of $27,000 and liens of $3,600. See In re Hulm, 738 F2d 323 (8th Cir.), cert. denied 469 US 990 (1984) (remanded for an evidentiary hearing on the issue of reasonably equivalent value; declined to follow *Madrid*). See also In re Adwar, 55 Bankr. 111 (Bankr. EDNY 1985); In re Ruebeck, 55 Bankr. 163 (Bankr. D. Mass. 1985).

[260] In the 1984 Amendments Congress added the language "voluntary or involuntary" to the text of Section 548(a). Also, it added language in the definition of transfer that included "foreclosure of the debtor's equity of redemption." These changes may imply that Congress wanted to overrule *Madrid*, and agreed with *Durrett*.

See also David & Standiford, "Foreclosure Sale as Fraudulent Transfer Under the Bankruptcy Code: A Reasonable Approach to Reasonably Equivalent Value," 13 Real Est. LJ 203 (1985); Henning, "An Analysis of *Durrett* and Its Impact on Real and Personal Property Foreclosures: Some Proposed Modifications," 63 NCL Rev. 257 (1985).

fer was avoidable by the trustee. The trustee may not recover the property, or the value of the property, from a *subsequent* bona fide purchaser for value. The trustee may only recover such property or its value from the first transferee.[261] Moreover, in situations where the trustee is able to recover the property transferred, but the first transferee acquired the property in good faith, the Code gives such a good faith transferee a lien on the recovered property to secure any improvements he or she made to the property.[262]

[7] Other Specific Powers of the Trustee

[a] Executory Contracts. The trustee has the power either to assume or to reject executory contracts and unexpired leases, subject to court approval.[263] The purpose of this provision is to allow the trustee to take advantage of a contract that will benefit the estate, or to relieve the estate of a burdensome contract by rejecting it. Before allowing the trustee to accept or reject the contract, the court must first find that it is "executory." The Bankruptcy Code does not define "executory contract," but the majority of courts now accept as the definition a contract that has not been fully performed by either party at the time the bankruptcy petition was filed.[264]

Various types of contracts have been held to be executory, and thus the trustee may reject them. For example, contracts to sell goods to be delivered in the future may be executory contracts,[265] but if either party has accepted delivery, the contract generally will no longer be executory.[266] Other examples of

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[261] 11 USC § 550(a) (1982 & Supp. IV 1986). See generally B. Weintraub & A. Resnick, Bankruptcy Law Manual, ¶ 7.07 (rev. ed. 1986 & Cum. Supp. 1987).

[262] 11 USC § 550(d) (1982 & Supp. IV 1986). The lien for improvements given to good faith transferees from whom the trustee recovers property also is given to subsequent good faith transferees. Id.

[263] 11 USC § 365(a) (1982 & Supp. IV 1986). See generally Note, "Executory Contracts & Unexpired Leases: Section 365," 3 Bankr. Dev. J. 217 (1986).

[264] A commonly used definition was proposed by Professor Countryman: "an executory contract is one under which the obligation of the bankrupt and the other party to the contract is so far unperformed that the failure of either to complete its performance would constitute a material breach excusing the performance of the other." See Countryman, "Executory Contracts in Bankruptcy: Part I, "57 Minn. L. Rev. 439, 460 (1973). See also Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F2d 1043 (4th Cir. 1985); cert. denied, 475 US 1057 (1986); In re Placid Oil Co., 72 Bankr. 135 (Bankr. ND Tex. 1987).

[265] DiLauro v. Electronic Wholesales, Inc., 239 A2d 162 (DDC 1968).

[266] See In re Pester Refining Co., 66 Bankr. 801 (Bankr., SD Iowa 1986) (a contract for the sale and purchase of natural gas was not an executory contract where the supplier had completed its performance by executing product transfer order forms, and could not stop the product in transit); In re Air Vermont, Inc., 47 Bankr. 540 (Bankr. D. Vt. 1985) (contract for sale of aircraft was not executory because the aircraft had been delivered to and accepted by the debtor-airline, and thus performance was complete by the seller).

executory contracts include options and rights of first refusal for real estate purchases,[267] and collective bargaining agreements.[268]

The right of the trustee to assume or reject executory contracts and unexpired leases is limited in some respects. If the trustee assumes an executory contract, the debtor must cure or compensate the creditor for any default, and provide assurance of future performance.[269] Another limitation is that the trustee may not assume a contract that requires a third party to extend credit to the debtor.[270] A trustee also may not assume a contract that requires the personal services and skills of the debtor.[271]

The trustee must choose whether to assume or reject a contract or lease within certain deadlines.[272] If a contract is rejected, it constitutes a breach that relates back to the date immediately prior to the bankruptcy filing.[273] The other party to the rejected contract or lease will have a claim against the bankruptcy estate for damages from the debtor's breach, and will be treated as a general unsecured creditor.[274]

[b] Waiving the Attorney-Client Privilege. In certain situations, the trustee may have the power to waive the debtor's attorney-client privilege, requiring testimony that normally would fall under that privilege. In *Commodity Futures Trading Commission v. Weintraub*,[275] the Supreme Court held that the trustee of a corporate debtor in a Chapter 7 proceeding could waive the attorney-client privilege and require the debtor's counsel to testify in an investigation into the debtor's alleged misappropriation of customer funds and fraud (debtor was a

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[267] See In re Jackson Brewing Co., 567 F2d 618 (5th Cir. 1978); In re Coordinated Fin. Planning Corp., 65 Bankr. 711 (Bankr., 9th Cir. 1986).

[268] See NLRB v. Bildisco, 465 US 513 (1984). After the *Bildisco* decision, holding that collective bargaining agreements could be rejected by the trustee in bankruptcy, Congress amended the Code to establish strict procedural requirements for rejecting collective bargaining agreements in Chapter 11 proceedings. See 11 USC § 541 (1982 & Supp. IV 1986).

[269] 11 USC § 365(b) (1982 & Supp. IV 1986).

[270] 11 USC § 365(c)(2) (1982 & Supp. IV 1986).

[271] 11 USC § 365(c) (1982 & Supp. IV 1986).

[272] See 11 USC § 365(d) (1982 & Supp. IV 1986). In a Chapter 7, there is a presumption of rejection unless the trustee assumes it within sixty days after the order for relief, or within additional time ordered by the court, for cause. In a case under Chapters 9, 11, 12 or 13, the trustee may assume or reject such a contract any time before the confirmation of a plan, but the court may require the trustee to decide within a specified period of time if requested to so order by any party to a contract or lease affected.

[273] 11 USC § 365(g)(1) (1982 & Supp. IV 1986).

[274] See 11 USC § 365(g) (1982 & Supp. IV 1986). See also In re Jartran, 71 Bankr. 938 (Bankr. ND Ill. 1987); In re McFarlin's, Inc. 46 Bankr. 88 (Bankr. WDNY 1985).

[275] 471 US 343 (1985).

commodity broker).[276] The Court found that the successor management of a corporation, whether by shareholder vote, takeover, merger, or statutory succession, had the power to waive the privilege of the corporation. Because the trustee has broad authority to operate the debtor business or to wind up its affairs, it is the only meaningful holder of management power, and thus has the authority to waive the attorney-client privilege. This power, however, must be exercised in a fiduciary capacity, as the trustee must act in the best interests of the general creditors. The Supreme Court refused to comment on the trustee's powers to waive the attorney-client privilege when the debtor is an individual.[277] Lower federal courts generally have allowed waiver of the attorney-client privilege in the corporate context, but not when the debtor is an individual.[278]

[c] Abandoning Property of the Estate. The trustee may abandon property of the estate if it is in the best interests of the creditors to do so.[279] This generally occurs when the property is encumbered to such an extent that the costs of collecting and disposing of the property may outweigh any benefit received from

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[276] Id.

[277] Id. at 356.

[278] See In re O.P.M. Leasing Serv. Inc., 670 F2d 383 (2d Cir. 1982) (trustee could waive debtor corporation's attorney client privilege where all officers and directors had resigned); Citibank v. Andros, 666 F2d 1192 (8th Cir. 1981) (trustee can waive debtor corporation's attorney client privilege over the objections of the officers); In re Vantage Petroleum Corp., 40 Bankr. 34 (Bankr. EDNY 1984) (trustee cannot waive attorney client privilege of debtor corporation if the corporation has officers and directors who could make that decision); In re Silvio de Lindegg Ocean Dev., Inc., 27 Bankr. 28 (Bankr. SD Fla. 1982) (in a jointly administered liquidation involving a corporation and the individual who owned all the corporate stock, the trustee could waive the corporation's attorney client privilege, but not the individual's). But see In re Smith, 24 Bankr. 3 (Bankr. SD Fla. 1982), where the bankruptcy court held that the trustee of an individual debtor bankruptcy could waive the attorney client privilege for the individual. Debtor had suffered a $4 million wrongful death judgment precipitating the bankruptcy. The judgment creditor sought information in an examination under Bankruptcy Rule 2004 that might support a malpractice claim against the insurance company attorneys who represented the debtor and/or the insurer for a bad faith failure to settle within policy limits. Debtor's trustee was willing to waive the attorney client privilege because a subsequent recovery might provide income to the estate and some dividend to the bankruptcy creditors. The debtor asserted the attorney client privilege, upon the advice of his attorney, who was recommended and paid by the insurance company. At oral argument debtor's position was argued primarily by the insurance company lawyers who had defended the debtor in the wrongful death action. These unusual facts may have been the reason for the holding that the trustee can waive an individual debtor's attorney client privilege. See also Annot., "Power of Trustee in Bankruptcy to Waive Privilege of Communications Available to Bankrupt," 31 ALR3d 557 (1970 & Supp. 1987).

[279] 11 USC § 554 (Supp. IV 1986).

it. The trustee must give notice to all creditors of its intent to abandon certain property, and anyone with an interest in the property may file an objection.[280]

One limitation on this power was outlined by the Supreme Court in *Midlantic National Bank v. New Jersey Department of Environmental Protection.*[281] In *Midlantic*, the trustee had abandoned deteriorating drums of hazardous chemicals at two different sites. The Court held that a bankruptcy trustee may not abandon property in contravention of a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards. Before authorizing abandonment of the property, the court must formulate conditions that will adequately protect the public's health and safety.[282]

¶ 25.08 DISCHARGE OF THE DEBTOR

The ultimate goal of the debtor is to obtain a discharge from debts. A discharge voids any judgment for a debt discharged, and acts as an injunction to prevent any further attempts to collect on any discharged debt.[283] Only individuals may be discharged in Chapter 7, 12, or 13 proceedings. Individuals, corporations, and partnerships may be discharged under Chapter 11 reorganizations.

[1] Nondischargeable Debts

A discharge serves the purpose of giving the debtor "a fresh start." Weighed against this interest, however, are policy considerations that may justify continuation of some financial obligations even after a discharge. As a result, Congress provided for ten categories of nondischargeable debts, also called "exceptions to discharge." Nondischargeable debts are not extinguished by a discharge, and the debtor subsequently remains liable on these even after all bankruptcy proceedings are finished. Exceptions to discharge are to be strictly construed, and the burden is on the creditor to prove the exception.[284]

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[280] 11 USC §§ 554(a), 554(b) (Supp. IV 1986).

[281] 474 US 494 (1986).

[282] For further discussion of the abandonment of hazardous waste sites, and potential lender liability for clean-up costs, see infra ¶ 25.09[6][c].

[283] 11 USC § 524 (1982 & Supp. IV 1986). On discharge, see generally Sleeper, "Discharge: Sections 727, 524 & 523," 2 Bankr. Dev. J. 115 (1985).

[284] See Gleason v. Thaw, 236 US 558 (1915) (because of the very nature and philosophy of the bankruptcy law, the exceptions to dischargeability are to be construed strictly). See also In re Hunter, 780 F2d 1577 (11th Cir. 1986).

Nondischargeable debts include most taxes,[285] liabilities incurred through fraud,[286] debts that were not listed by the debtor,[287] debts arising out of debtor's

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[285] 11 USC § 523(a)(1) (1982 & Supp. IV 1986).

[286] 11 USC § 523(a)(2) (Supp. IV 1986). The premise of this exception is that bankruptcy is designed to benefit only the honest debtor. Two types of fraudulent conduct are included in this exception. The first type is when the debtor obtains money, property, services, or an extension, renewal or refinance of credit by "false pretense, false representation, or actual fraud, other than a statement regarding debtor's financial condition." 11 USC § 523(a)(2)(A).

Courts are split on whether silence or nondisclosure constitutes false pretense. See In re Hunter, 780 F2d 1577, 1580 (11th Cir. 1986) ("[N]ot making full disclosure is not within the exception"); In re Reder, 60 Bankr. 529, 535 (Bankr. D. Minn. 1986) ("[T]here must be actual overt false pretense or representation to come within the exception to dischargeability."). But see In re Schmidt, 70 Bankr. 634 (fraud for nondischargeability may consist of silence, concealment or intentional nondisclosure of material fact); In re Frye, 48 Bankr. 422 Bankr. MD Ala. 1985) (failure to disclose fact that debtor was in Chapter 13 at time she entered a contract to buy property inferred intent that she never intended to go through with purchase, together with willful and malicious injury to vendors in abandoning property without protection or insurance precluded a discharge of judgement of $40,000 for the property); In re Milbank, 1 Bankr. 150 (Bankr. SDNY 1979) (concealment of extramarital affair was false pretense in obtaining loan from father-in-law).

There has been much litigation regarding the nondischargeability of credit card balances under this subsection. See infra ¶ 25.09[4] for a discussion of this issue. The second category of fraudulent conduct is the use of a materially false financial statement in writing regarding the debtor's financial condition, that was made or published with intent to deceive and on which the creditor reasonably relied. 11 USC § 523(a)(2)(B) (Supp. IV 1986). See In re Wolf, 67 Bankr. 844 (Bankr. D. Colo. 1986) (financial statement that failed to disclose that debtors had concluded a loan with one bank two days before completing a loan application with the second bank that did not list the first loan or the fact that the equipment and inventory of the debtor were used as security for the first loan was grounds for nondischargeability. Without the value in inventory and equipment, the second bank would not have made the $20,000 loan to the debtor).

The reasonableness of the creditor's reliance is an important issue in these cases. See In re Bogstad, 779 F2d 370 (7th Cir. 1985) (debtor's financial statement was not materially false because lender would have made the loan even had it known the debtor's true financial condition); In re Breen, 13 Bankr. 965 (SD Ohio 1981) (reliance on financial statement held to be unreasonable, because creditor could have discovered an undisclosed mortgage by conducting a title examination or by telephoning the mortgagee that was listed as the holder of another mortgage). But see In re Allen, 65 Bankr. 752 (ED Va. 1986), appeal dismissed, 823 F2d 548 (4th Cir. 1987) (there is no per se requirement that the creditor verify the correctness of the statement before it can assert reasonable reliance; inquiry into the business practices and industry custom in extending credit is appropriate (refusing to follow *Breen*)).

[287] 11 USC § 523(a)(3) (1982). Under Section 521(1), the debtor has the duty to file a list of creditors along with a schedule of assets and liabilities and other documents. The court can then identify and notify all creditors. If a debtor neglects to include a creditor on such list, the creditor may never be notified and thus should not be subject to the discharge of the debtor.

embezzlement, larceny, or certain misconduct when acting as a fiduciary,[288] alimony, maintenance and child support,[289] willful and malicious injury,[290] fines and penalties payable to any governmental unit,[291] government-insured student

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[288] 11 USC § 523(a)(4) (1982).

[289] 11 USC § 523(a)(5) (1982 & Supp. IV 1986).

[290] 11 USC § 523(a)(6) (1982). A variety of acts have been held nondischargeable as being "willful and malicious injury." See Ford Motor Credit Co. v. Owens, 807 F2d 1556 (11th Cir. 1987) (conversion of creditor's collateral is willful and malicious injury); Chrysler Credit Corp. v. Perry Chrysler Plymouth, 783 F2d 480 (5th Cir. 1986) (taking trust funds and going to Las Vegas with hopes of winning enough to save the car dealership was willful and malicious injury to the property of another); Perkins v. Scharffe, 817 F2d 392 (6th Cir.), cert. denied, 108 S. Ct. 156 (1987) (malpractice judgment was willful and malicious injury when acts were done intentionally, without just cause and necessarily produced the patient's harm); In re Massier, 51 Bankr. 229 (Bankr. D. Colo. 1985) (copyright infringement constituted willful and malicious injury). See also In re Allen, 75 Bankr. 742 (Bankr. CD Cal. 1987) (garden variety breaches of contract are not included in "willful and malicious injury" category); but the tort of intentional interference with another's contract may be. In re Dubian, 77 Bankr. 332 (Bankr. D. Mass. 1987) (state court judgment that debtor intentionally interfered with contractual relations estopped him from asserting that the debt did not arise out of his "willful and malicious" conduct).

Whether driving while intoxicated constitutes "willful and malicious" injury has been heavily litigated, see infra note 293 for a discussion of this issue. Other traffic violations or accidents are generally held not to meet the standard of "willful and malicious." See In re Frazee, 60 Bankr. 109 (Bankr. WD Mo. 1986) (speeding); In re Leifheit, 53 Bankr. 271 (Bankr. SD Ohio 1985) (speeding); In re Hoppa, 31 Bankr. 753 (Bankr. ED Wis. 1983) (defective brakes causing fatal accident; driver had no license); In re Donnelly, 6 Bankr. 19 (Bankr. D. Or. 1980) (guilty plea to reckless driving). See also Annot., "Debtor's Traffic-Related Liability as 'Willful and Malicious Injury' Excepted by 11 U.S.C.A. § 523(a)(6) From Bankruptcy Discharge," 85 ALR Fed. 643 (1987).

It is not clear what standard of conduct is required to constitute "willful and malicious" injury. Under the old Bankruptcy Act "reckless disregard" was generally the standard. Tinker v. Colwell, 193 US 473 (1904). The legislative history of the 1978 Bankruptcy Code indicates a stricter standard was intended. H.R. Rep. No. 595, 95th Cong., 1st Sess. 365, reprinted in 1978 U.S. Code Cong. & Admin. News 5963, 6320–6321. Several courts have since applied a "deliberate and intentional" standard. See In re Wrenn, 791 F2d 1542 (11th Cir. 1986) (reckless disregard of employer's rights in bringing a frivolous discrimination claim was not willful and malicious injury); Wheeler v. Laudani, 783 F2d 610 (6th Cir. 1986) (libel judgment is nondischargeable if author knew statements were false, but reckless disregard for the truth or falsity of the statements is not willful and malicious injury). Generally the acts must be intentional, but no malice, ill will, or intent to injure is required. See In re Condict, 71 Bankr. 485 (ND Ill. 1987) (finding of "malice," does not require finding of ill will, but rather, requires only lack of just cause or excuse); In re Cecchini, 780 F2d 1440, 1443 (9th Cir. 1986) ("When a wrongful act . . . done intentionally, necessarily produces harm and is without just cause or excuse, it is 'willful and malicious' even absent proof of a specific intent to injure").

[291] 11 USC § 523(a)(7) (1982). The Supreme Court recently held that a state court restitution order constituted a nondischargeable fine or penalty under Section 523(a)(7). Kelly v. Robinson, 107 S. Ct. 353 (1986). Costs assessed by a state criminal court, intended as a condition of probation, were nondischargeable debts notwithstanding a

loans,[292] judgments and consent decrees resulting from driving while intoxicated,[293] and debts from a previous bankruptcy in which discharge was waived or defined.[294]

Family farmers proceeding under Chapter 12 are subject to the same nondischargeable debts.[295] If the debtor proceeding under Chapter 13 makes all payments according to the plan, he or she is discharged from all debts, even "nondischargeable" debts, except for alimony, maintenance, and support.[296] If the Chapter 13 debtor receives a "hardship" discharge under Section 1328(b), the debtor is still subject to all the nondischargeable debts of Section 523(a), listed previously.[297]

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state statute that said costs shall not be deemed part of the penalty in a criminal case. In re Hollis, 810 F2d 106 (6th Cir. 1987). Accord In re Zarzynski, 771 F2d 304 (7th Cir. 1985). Fines from traffic violations are another example of nondischargeable debts falling under this subsection.

[292] 11 USC § 523(a)(8) (Supp. IV 1986). Student loans included under this subsection are those that are insured or guaranteed by a governmental unit, or made under any program funded in whole or part by a governmental unit or a nonprofit institution, unless the loan became due more than five years prior to the filing of bankruptcy, or if requiring the debtor to pay such loan would impose an undue hardship on the debtor and the debtor's dependents. Id. See generally Annot., "Bankruptcy Discharge of Student Loan on Ground of Undue Hardship," 63 ALR Fed. 670 (1983).

[293] 11 USC § 523(a)(9) (Supp. IV 1986). In 1984, Congress added this new subsection to penalize drunk drivers. If a debt arises from a judgment or consent decree entered in a court of record against the debtor, and the liability was incurred as a result of the debtor's operation of a motor vehicle while legally intoxicated, the debt is nondischargeable. If there is no judgment or decree, it may still be nondischargeable as a willful and malicious injury to persons or property under § 523(a)(6) (see supra note 290). See In re Fielder, 799 F2d 656 (11th Cir. 1986) (consuming quantities of alcohol and immediately driving a vehicle on the public highways is a malicious and wanton act and one in which the result can be predicted. A debt directly resulting from driving while so intoxicated is not dischargeable); but see In re Compos, 768 F2d 1155 (10th Cir. 1985) (Section 523(6) requires an intent to injure before a debt is nondischargeable; facts of driving while intoxicated cannot meet that standard); accord Cassidy v. Minihan, 794 F2d 340 (8th Cir. 1986). Since Congress added Subsection (9), some courts view the addition as a clarification that driving while intoxicated meets the standard of a willful and malicious injury, and if Subsection (9) does not apply, the debt will be nondischargeable under Subsection (6). In re Adams, 761 F2d 1422 (9th Cir. 1985); In re Moore, 53 Bankr. 259 (Bankr. SD Ohio 1985).

[294] 11 USC § 523(a)(10) (Supp. IV. 1986).

[295] 11 USC § 1228 (Supp. IV 1986).

[296] See 11 USC § 1328(a)(2) (1982).

[297] 11 USC § 1328(c)(2) (1982). See also id. at § 523(a). Under a "hardship" discharge, the debtor may be discharged any time after confirmation of the plan, and thus has not made all the payments required under the plan. This type of discharge is available only if modification of the plan is not practical. See id. at § 1328(b).

In a Chapter 11 reorganization case, if the debtor is an individual, the debtor will still be subject to the nondischargeable debts outlined earlier.[298] If the debtor is a corporation or partnership, however, it will be discharged from all debts, even those nondischargeable as to an individual.[299] The policy behind this is that many of the nondischargeable debts relate to honesty or undesirable conduct on the part of the debtor. When the debtor is a corporation or partnership, dishonest management will most likely be replaced, and if the debts are held to be nondischargeable, the statute would be punishing new management and the stockholders and creditors for the conduct of former employees.[300]

[2] Objections to Discharge

Objections to a debtor's discharge must be distinguished from nondischargeable debts. Nondischargeable debts are those that, for policy reasons, will not be discharged and thus survive the bankruptcy, even though the debtor receives a general discharge of his or her other debts. Objections to discharge, however, bar the debtor from receiving any discharge at all; if a successful objection is made, the debtor will not be relieved of any debts. The debtor generally receives an automatic discharge unless someone objects. The only parties with authority to object are the creditors and the trustee.[301] A creditor who wants to block the debtor's discharge must file a timely objection. A deadline for objections generally is set in the initial notice to creditors. In Chapter 7 proceedings, the deadline is within sixty days of the first date set for the meeting of creditors. In Chapter 11 proceedings, the deadline for objections to discharge is the first date set for the hearing on confirmation of the plan.

An objection to the debtor's discharge is an adversary proceeding, and is instituted by the filing of a complaint before the deadline.[302] The complaint must state a ground for objection to discharge, and if the debtor contests the complaint by filing an answer, a trial will be held. At trial the objector has the burden to prove all facts essential to the objection.[303]

The basic grounds for denial of a discharge under Chapter 7 include fraudulent transferring or concealing of property,[304] failure to keep books and

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[298] See 11 USC § 1141(d)(2) (1982).

[299] 11 USC § 1141(d)(1) (1982).

[300] See B. Weintraub and A. Resnick, Bankruptcy Law Manual, ¶ 8.24 (rev. ed. 1986 & Cum. Supp. 1987).

[301] 11 USC § 727(c) (Supp. IV 1986).

[302] See Bankr. R. 4004(d), 7001(4), 7003, 5005.

[303] See Bankr. Rule 4005.

[304] 11 USC § 727(a)(2) (1982).

records,[305] commission of a "bankruptcy crime,"[306] failure to explain loss of assets,[307] refusal to obey a court order,[308] commission of these acts in connection with an insider's bankruptcy,[309] a prior discharge in bankruptcy of the debtor within six years,[310] or the debtor waives a discharge.[311]

Chapter 7 grounds also apply to Chapter 11 cases.[312] In proceedings under Chapter 12 and 13, however, the traditional grounds for objecting to a discharge, listed previously, do not apply.[313] A debtor who received a discharge within the previous six years is thus not barred from receiving a discharge under Chapter 12 or 13. Similarly, if the debtor was discharged under Chapter 12 or 13 in the previous six years, it may not prevent a subsequent discharge under Chapter 7. For example, if the debtor made payments totalling 100 percent of the allowed unsecured claims, the Chapter 12 or 13 discharge does not prevent a Chapter 7 discharge within the next six years.[314]

[3] Reaffirmation of Debt by the Debtor

A debtor may reaffirm a particular debt, prior to discharge, if it so desires. The effect of such agreement is that the debt is revived, and is enforceable against the debtor. To be effective, a reaffirmation agreement must meet certain conditions outlined in the Bankruptcy Code.[315] These provisions apply whenever a creditor and the debtor enter into an agreement, the consideration for which is in whole or in part based on a dischargeable debt.[316] The Code requires a written agreement, and such agreement must contain a clear and conspicuous statement that the agreement may be rescinded at any time prior to discharge or within sixty days after the agreement is filed with the court, whichever occurs later, by giving notice of rescission to the creditor.[317] The agreement must be made before the discharge.

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[305] 11 USC § 727(a)(3) (1982).

[306] 11 USC § 727(a)(4) (1982). These crimes include making a false oath, presenting or using a false claim, giving or receiving a bribe, or withholding records.

[307] 11 USC § 727(a)(5) (1982).

[308] 11 USC § 727(a)(6) (1982 & Supp. IV 1986).

[309] 11 USC § 727(a)(7) (Supp. IV 1986).

[310] 11 USC § 727(a)(8) (Supp. IV 1986).

[311] 11 USC § 727(a)(10) (1986).

[312] 11 USC § 1141(d)(3)(C) (1982).

[313] See 11 USC § 727(a) (1982 & Supp. IV 1986). There are no similar provisions in the discharge subsections of Chapter 12 (Section 1228) or Chapter 13 (Section 1328).

[314] See 11 USC § 727(a)(9) (Supp. IV 1986).

[315] See 11 USC § 542(c) (1982).

[316] Id.

[317] 11 USC § 542(c)(2) (1982).

If the debtor is represented by an attorney, the agreement must be accompanied by an affidavit or declaration of the attorney that states that the reaffirmation agreement is a fully informed and voluntary agreement by the debtor, and does not impose an undue hardship on the debtor or a dependent of the debtor.[318] If the debtor is not represented by an attorney, the court must approve the reaffirmation agreement and may do so only if it finds that the agreement does not impose an undue hardship on the debtor or a dependent of the debtor, and that it is in the best interests of the debtor.[319]

If the case involves an individual debtor, the court must, at the discharge hearing, inform the debtor that reaffirmation is not required by law or by agreement not made in accordance with the stated requirements, and of the legal effect and consequences of reaffirmation and default.[320] Reaffirmation of a debt will not categorize the debt as nondischargeable in a subsequent bankruptcy.[321] The sanction for failing to comply with the statutory requirements is unenforceability of the reaffirmation agreement.[322]

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[318] 11 USC § 542(c)(3) (1982).

[319] 11 USC § 542(c)(6)(A) (1982). These findings do not have to be made if the debt reaffirmed is a consumer debt secured by real property. Id. at § 542(c)(6)(B).

The courts are generally reluctant to find that reaffirmation is in the best interests of the debtor. See In re Griffin, 13 Bankr. 591 (Bankr. SD Ohio 1981) (reaffirming a debt to prevent a creditor from filing a criminal complaint concerning the debtor's bad check was not in the best interests of the debtor); In re Jones, 6 Bankr. 336 (Bankr. SD Ohio 1980) (a moral obligation to repay is insufficient to justify reaffirming a debt); In re Sampson, 51 Bankr. 13 (Bankr. DDC 1984) (reaffirming a debt arising out of the purchase of household furnishings was not in debtor's best interest and would in fact impose undue hardship where she could make the payments only with outside financial assistance, and the marginal value of the collateral made repossession by the creditor unlikely); In re Bryant, 43 Bankr. 189 (Bankr. ED Mich. 1984) (unemployed debtor whose unemployment benefits would soon run out was not entitled to reaffirm a debt owed on an expensive luxury automobile because there was no adequate showing that her extremely high car payments would not impose an undue hardship on her family, or that reaffirmation, which could expose her to a deficiency judgment in the future, was in her best interests).

[320] 11 USC § 542(d)(1) (1982). Several bankruptcy courts have held that the requirement of the bankruptcy court to admonish the debtor of the consequences of the reaffirmation agreement cannot be waived, thus the failure of the court to do so renders the reaffirmation agreement unenforceable. See In re Roth, 43 Bankr. 484 (ND Ill. 1984); In re Jackson, 49 Bankr. 298 (Bankr. D. Kan. 1985).

[321] In re Lones, 50 Bankr. 801 (Bankr. WD Ky. 1985).

[322] In re Jackson, 49 Bankr. 298 (Bankr. D. Kan. 1985). The rationale is generally that reaffirmation agreements must be strictly construed to protect the debtor's interest, and not the creditor's, because of the danger that creditors may coerce debtors into undesirable reaffirmation agreements. See In re Eccleston, 70 Bankr. 210 (Bankr. NDNY 1986); In re Gardner, 57 Bankr. 609 (Bankr. D. Me. 1986).

¶ 25.09 ISSUES INVOLVING THE RIGHTS AND DUTIES OF A BANK

[1] Checks in the Process of Collection

A bank has a duty to dishonor checks or other items payable from a customer's account once it receives actual notice that its customer has filed bankruptcy. Under Section 549, postpetition transfers are prohibited; if a bank honors checks written on debtor's bank account after a petition in bankruptcy has been filed, it is transferring assets that belong to the bankruptcy estate.[323]

A bank will be protected, however, if it honors a check of a bankrupt debtor without actual notice or knowledge, and acts in good faith. In *Bank of Marin v. England*,[324] the U.S. Supreme Court held that a bank was not liable for honoring a bankrupt debtor's check where it had no knowledge of the bankruptcy. The check was drawn before the petition was filed, but honored subsequent to the filing. The Court based its holding on equitable principles. This rule was subsequently codified as part of the Bankruptcy Code in 1978.[325] Under Section 542(c), a bank is not liable for honoring a check written on its customer's account, after the customer has filed a petition in bankruptcy, provided that the bank did not have actual notice or actual knowledge of the bankruptcy filing, and acted in good faith.[326] Once a bank has actual notice or knowledge of a customer's bankruptcy, however, it must refuse to honor any checks written on the customer's accounts. Although the bank will not be liable for transferring debtor's property when the bank acts in good faith and without knowledge, the transferee may be liable to the trustee for the property or its value as a postpetition transfer.[327]

The interplay of federal and state law in the context of paying checks is not clear. Under the UCC, a bank has a ten-day grace period in which it is authorized to accept, pay, or collect an item after it receives notice of the incompetence of its customer.[328] This provision cannot be used as an analogy to the bankruptcy of a customer, however, because the Bankruptcy Code does not provide a specific grace period, once the bank receives actual notice or knowledge of the bankruptcy petition.

Two additional issues arise on the interplay of state law and bankruptcy law. Firstly, UCC § 4-303 outlines certain events that amount to a "payment" from

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[323] See 11 USC § 549 (Supp. IV 1986); and In re Hoffman, 51 Bankr. 42, 46 (Bankr. WD Ark. 1985).

[324] 385 US 99 (1966).

[325] 11 USC § 542(c) (1982). See H.R. Rep. No. 595, 95th Cong., 1st Sess. 369 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 83 (1978) "[t]his subsection codifies the result of *Bank of Marin v. England*, 385 U.S. 99 (1966)."

[326] 11 USC § 542(c) (1982).

[327] See 11 USC §§ 549(a)(2)(A), 550(a) (1982 & Supp. IV 1986).

[328] See UCC 4-405.

the account of a bank's customer. Although there is no equivalent provision in the Bankruptcy Code, the events listed in UCC § 4-303 should be effective as to defining the timing of when payment occurs for bankruptcy purposes. Secondly, UCC § 4-303 defines the time at which notice of a garnishment, a stop payment order, or other legal notice, such as notice of a customer's bankruptcy, is effective as against a bank. The bank generally has a "reasonable time" to act upon notice it receives before it will be effective.[329] If any of the outlined events has already occurred, the notice was too late to be effective as against those items. The Bankruptcy Code makes no provision as to when actual notice or knowledge of, for example, the debtor's bankruptcy will be effective in the context of a bank paying or collecting items.

[2] Letters of Credit as Preferences

The general rules regarding creation and enforcement of letters of credit are discussed in Chapter 17, but there are special issues that arise when the customer of the issuing bank becomes bankrupt. One such issue concerns whether a letter of credit can be attacked as a preference under Section 547 of the Bankruptcy Code. This issue arises when a debtor (the customer) files bankruptcy after procuring a letter of credit, and one of the parties involved in the transaction seeks a court injunction to prevent the issuing bank from paying the letter of credit.

In re Twist Cap, Inc.[330] started the controversy. In that case, a bankruptcy court in Florida issued a temporary restraining order against payment under a standby letter of credit for the benefit of several of the debtor-customer's creditors.[331] On March 28, 1978, Twist Cap entered into a security agreement with the Southeast Bank of Tampa under which Twist Cap transferred collateral to the bank. Between December 5, 1977 and March 19, 1979, the bank issued three letters of credit for the account of Twist Cap. On August 22, 1979, Twist Cap filed a petition for relief under Chapter 11. Six days later, Twist Cap filed suit to restrain the bank from honoring the letters of credit.

The bankruptcy court found that allowing the bank to honor the letters of credit would diminish the assets of the debtor available for distribution to the general unsecured creditors, because the bank held collateral to secure its obligation. The court reasoned that by paying the beneficiary, the bank would substitute itself as a secured creditor for the unsecured holder of a letter of credit. This would then be a preference, in violation of the Bankruptcy Act.

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[329] UCC § 4-303(1).

[330] 1 Bankr. 284 (Bankr. D. Fla. 1979).

[331] Id.

In re Twist Cap, Inc. was heartily criticized.[332] There are generally three major criticisms of the court's analysis of the letter of credit as a preference. Firstly, the requirements for a preference include a transfer. When the issuer honors a letter of credit, there is no transfer of debtor's property. The issuer uses its own funds to satisfy an independent obligation, not the funds or property of the debtor. Secondly, the transfer of debtor's property as collateral for the issuer's obligation occurs when the property is pledged, not when the issuer honors the letter of credit, so that in the majority of cases the transfer will have occurred before the preferential period. Thirdly, even if there is collateral securing the bank's obligation, the transfer of debtor's property is not in payment of an antecedent debt, as long as the debtor pledged the collateral before, or contemporaneous with, the issuer's extension of credit.

Several courts subsequent to the *In re Twist Cap, Inc.* decision declined to follow it.[333] *In re Page*[334] represents the more accepted view today, i.e., that letters of credit are independent obligations of the issuer, and neither the letter of credit nor its proceeds are property of the estate. In addition, in *In re Page*, the creation and perfection of the issuer's security interest in debtor's collateral occurred prior to the filing of bankruptcy, and therefore the honoring of the letter of credit would not be an act to "create, perfect or enforce" a lien, in violation of the automatic stay provisions. The court did find, however, that the bank would be stayed from executing against the debtor's collateral under the automatic stay provisions.[335] It thus appears that *Twist Cap* is probably not the law today.

In re Air Conditioning, Inc.,[336] however, indicates that there is still a potential for enjoining payment of letters of credit when the collateral is transferred during the ninety days preceding bankruptcy, and is in contemplation of antecedent debt. The debtor in *In re Air Conditioning* leased computer equipment and granted the creditor a blanket security interest on personal property as security for creditor's claims under the lease. When debtor defaulted, the creditor sued for both damages and repossession of the computer equipment. Subsequently, the creditor obtained two writs: one for the computer equipment and the other for the personal property of the debtor. The creditor executed the first writ and

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[332] Baird, "Standby Letters of Credit in Bankruptcy," 49 U. Chi. L. Rev. 130 (1982); Chaitman & Sovern, "Enjoining Payment on a Letter of Credit in Bankruptcy: A Tempest in a Twist Cap," 38 Bus. Law. 21 (1982); McLaughlin, "Letters of Credit as Preferential Transfers in Bankruptcy," 50 Fordham L. Rev. 1033 (1982).

[333] See In re Planes, Inc., 29 Bankr. 370 (Bankr., ND Ga. 1983); In re North Shore & Cent. Ill. Freight Co., 30 Bankr. 377 (Bankr. ND Ill. 1982); In re M.J. Sales & Distributing Co., 25 Bankr. 608 (Bankr. SDNY 1982).

[334] 18 Bankr. 713 (DDC 1982).

[335] Id. at 716.

[336] 55 Bankr. 157 (Bankr. SD Fla. 1985); aff'd in part and rev'd in part, 72 Bankr. 657 (SD Fla. 1987).

repossessed the computer equipment. The debtor agreed to provide a letter of credit to the creditor, so that the creditor would not execute on its personal property. The purpose was to give debtor some time to get things turned around. Debtor's bank issued a letter of credit in exchange for debtor's promissory note, secured by a $20,000 certificate of deposit (CD). The debtor filed for bankruptcy a month later.

The creditor demanded payment under the standby letter of credit for its deficiency claim against debtor. The issuing bank sued the creditor, asking that it be required to cancel the letter of credit and return the CD to the debtor's bankruptcy trustee. Over the creditor's objections, the court found for the bank, nullified the letter of credit, and ordered the bank to turn over the CD to the trustee. The court held that the action was a preference because it was a transfer of the debtor's property (the CD) for the benefit of the creditor, it was on account of the creditor's antecedent debt, and it was within ninety days of bankruptcy.[337]

Commentators seem to agree with the decision reached by the court in *In re Air Conditioning*.[338] The letter of credit transaction allowed the creditor to obtain security for its antecedent debt within ninety days of the bankruptcy. If the creditor had directly taken the CD as security, there is no question that the transaction would be a preference. Allowing a letter of credit transaction to insulate the creditor would be elevating form over substance.

Other commentators assert, however, that the same result could have been obtained without nullifying the letter of credit, thus reconciling the decision with the independence principle of letters of credit. The court could have enforced the letter of credit, requiring the issuer-bank to honor the letter of credit and to pay the creditor the face amount. The next step would have been to require the bank to turn over the CD as property of the debtor that was preferentially transferred within the ninety-day period. It was the grant of the security interest in the CD, and not the issuance of the letter of credit, that violated the preference statute. The bank would then be left with an unsecured claim in its customer's bankruptcy. The method outlined here places the risk of bankruptcy on the issuer, when the transfer of collateral takes place within ninety days of bankruptcy.[339]

To make the issuing bank bear the risk is problematic in this type of case because that bank did not receive property of the debtor to secure an antecedent debt. The bank's obligation to pay the letter of credit was created contemporaneously with the receipt of the collateral from the debtor. The antecedent debt was owed to the creditor but, under the approach suggested, the bank bears the loss while the creditor gets the benefit of the performance. This may be a rare case,

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[337] Id.

[338] See B. Clark, The Law of Bank Deposits, Collections and Credit Cards, ¶ 8.11 (1981 & Cum. Supp. 2 1987); Borowitz & Gross, "A New Twist on *Twist Cap*: Invalidating A Preferential Letter of Credit in *In re Air Conditioning*," 103 Banking LJ 368 (1986).

[339] See B. Clark, supra note 338, at ¶ 8.11.

however, because in most situations a standby letter of credit will be issued as part of a transaction in which there is a contemporaneous exchange of value, not as security for an antecedent debt, as was the case in *In re Air Conditioning.*

On appeal, the district court upheld the decision of the bankruptcy court, but on a different theory.[340] The district court allowed the bank to honor the letter of credit, but held that Section 550 of the Bankruptcy Code required the creditor to turn over the proceeds to the trustee. The court found that the pledge of the CD to the bank was a transfer for the benefit of the creditor, and thus the creditor could be required to return the proceeds to the trustee.[341] The court rejected the creditor's argument that the pledge of the CD was for the benefit of the bank, to secure the bank's independent obligation on the letter of credit, and not for the benefit of the creditor (who had as security the letter of credit itself).

In a third case, *In re Compton Corp.*,[342] the Fifth Circuit reached a result similar to that in *In re Air Conditioning*, but it did so because the court found that the creditor had received an "indirect preference." In *In re Compton*, Blue Quail Energy, a trade creditor, delivered a shipment of oil to debtor Compton Corporation, and debtor failed to make timely payment. Compton induced its bank to issue an irrevocable standby letter of credit on May 6, 1982. Under the terms of the letter of credit, payment for the oil (over $550,000) would be made by the letter of credit if debtor failed to pay Blue Quail by June 22nd of that year. Compton paid the bank over $1,400 to issue the letter of credit, and gave it a promissory note payable on demand for the amount due. The bank had a prior security agreement with Compton, entered into in 1980, which included a future advances provision. The collateral for the security agreement included a variety of Compton's assets.

On May 7, 1982, the day after the bank issued the letter of credit, several of debtor's creditors filed an involuntary bankruptcy petition against Compton. On June 22nd, Blue Quail requested payment under the letter of credit, and the bank honored it. In the subsequent bankruptcy proceeding the bank's secured claims against the debtor, including the letter of credit payment made to the creditor, were paid in full from liquidating the debtor's assets that served as the bank's collateral. The trustee did not contest the payment of the letter of credit, or the bank's subsequent repayment through the debtor's assets. The trustee did,

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[340] In re Air Conditioning, 72 Bankr. 657 (SD Fla. 1987).

[341] 11 USC § 550(a) (Supp. IV 1986) allows the trustee to recover the property transferred under a preference in violation of Section 547, or the value of the property, from the initial transferee or the entity for whose benefit the transfer was made.

[342] 831 F2d 586 (5th Cir. 1987), on reh'g, 835 F2d 584 (5th Cir. 1988) (rehearing was granted for the purpose of remanding an additional matter to the district court: there was a discrepancy in the evidence as to what amount Blue Quail had actually received under the letter of credit, and the court ordered the district court, on remand, to make the factual findings necessary to determine what amount was recoverable against Blue Quail by the trustee).

however, file suit against Blue Quail, asserting that it had received a preference through payment of the letter of credit, and sought to recover the $550,000 payment.

The Fifth Circuit held that the bank properly paid the letter of credit, *upholding the independence principle,* because it was obligated to do so by the terms of the letter. The bank had not transferred any of the debtor's property, and there was no preferential transfer to the bank because the security agreement had been entered into two years prior.

The court went on to hold, however, that Blue Quail had received an indirect preference, and thus was liable to the trustee for the amount it received under the letter of credit.[343] The letter of credit was for an antecedent debt, and the transfer occurred a day before the bankruptcy, when it received the letter of credit, which certainly was within the ninety-day period required for preferences. The court found that a creditor cannot protect itself, at the expense of other creditors, by utilizing a letter of credit.[344] A direct transfer of debtor's assets as security, within the ninety-day period, would have been a clear preferential transfer. The court expressly held that a creditor cannot secure payment of an unsecured antecedent debt through a letter of credit transaction when it could not do so through any other type of transaction.[345] Under Section 550(a)(1),the trustee could recover the value of the transferred property from Blue Quail, the entity for whose benefit such transfer was made.

Thus the courts have been more willing to uphold the independent principle of letters of credit since *Twist Cap.* When a letter of credit has been issued during the preferential period for an antecedent debt, however, the creditor may be required to return the payment received under the letter of credit, either under the *In re Air Conditioning* or *In re Compton* analysis.

[3] The Bank's Right of Setoff and the Automatic Stay

[a] Requirements of General Right of Setoff. The Bankruptcy Code is not a source of a right of setoff; it merely recognizes setoff rights a creditor may have under applicable state law.[346] An important caveat to this rule, however, is that after a petition in bankruptcy has been filed, the right of setoff is permissive, not mandatory. Whether to permit a postpetition setoff, even when that is proper, is

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[343] Id. at 594.

[344] "If the bankruptcy has made a transfer of his property, the *effect* of which is to enable one of his creditors to obtain a greater percentage of his debt than another creditor of the same class, circuity of arrangement will not avail to save it." Id. at 591 (citing National Bank v. National Herkimer County Bank, 255 US 178 (1912)).

[345] Id.

[346] See 11 USC § 553(a) (1982 & Supp. IV 1986).

up to the discretion of the court.[347] For example, where a setoff may jeopardize the success of a reorganization, the court may not allow it.[348]

Similarly, there are certain situations outlined in the Bankruptcy Code where rights of setoff will not be recognized. Such situations include (1) when the creditor's claim is disallowed;[349] (2) when the creditor obtains its claim from someone else after or within ninety days of the filing date and while the debtor was insolvent;[350] and (3) when the debt being set off was incurred by the creditor for the purpose of obtaining a right of setoff during the ninety-day period before filing, and while the debtor was insolvent.[351]

In addition, there are two requirements that the creditor must meet before being able to set off its claim. Firstly, there must be mutuality between the claim the creditor has against the debtor and the debt sought to be set off. Mutuality exists when debts are owing between the same parties acting in the same capacity.[352] Deposits in bank accounts must be collected funds as of the date of the petition, for mutuality to exist.[353] All funds deposited or collected after the filing of the petition are considered property of the estate and may not be set off.[354] Secondly, a creditor may not set off a prepetition debt against a postpetition claim. Both the debt and the claim must be prepetition.[355]

[b] Prepetition Setoff. When a bank sets off mutual debts prior to the debtor filing a petition in bankruptcy, the automatic stay is not involved because it is not yet in effect. If the setoff occurs within a ninety-day period preceding the filing date, however, it may be subject to an action by the trustee to recover any amounts that were set off. As mentioned previously, the trustee may recover the setoff amount when the creditor incurred the debt with the "*purpose* of obtaining

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[347] See Matter of Waller, 28 Bankr. 850 (Bankr. WD Mo. 1983); In re Princess Baking Corp., 5 Bankr. 587 (Bankr. SD Cal. 1980).

[348] See In re Dartmouth House Nursing Home, Inc., 24 Bankr. 256 (Bankr. D. Mass. 1982).

[349] 11 USC § 553(a)(1) (1982 & Supp. IV 1986). See supra ¶ 25.06 on disallowance of claims.

[350] 11 USC § 553(a)(2) (1982 & Supp. IV 1986). For purposes of these exceptions, the debtor is presumed to have been insolvent during the ninety days preceding the filing date. Id. at § 553(c).

[351] 11 USC § 553(a)(3) (1982 & Supp. IV 1986).

[352] See 4 Collier on Bankruptcy ¶ 553.04[2] (15th ed. 1987). See also In re Visiting Home Services, Inc., 643 F2d 1356 (9th Cir. 1981).

[353] In re Springfield Casket Co., 21 Bankr. 223 (Bankr. SD Ohio 1982). See also UCC 4-201 (bank is merely agent until it receives final payment, so there is no debt owed by the bank on yet uncollected funds).

[354] In re All-Brite Sign Serv. Co., 11 Bankr. 409 (Bankr. WD Ky. 1981).

[355] See Boston & Me. Corp. v. Chicago Pac. Corp., 785 F2d 562 (7th Cir. 1986); In re Braniff Airways, Inc., 42 Bankr. 443 (Bankr. ND Tex. 1984); In re Shoppers Paradise, Inc., 8 Bankr. 271 (Bankr. SDNY 1980).

a right of setoff against the debtor."[356] Additionally, regardless of the creditor's purpose, the trustee may recover amounts set off when the position of the bank improves during that ninety-day period under rules in the Code for measuring improvement.[357] Setoffs are exempt from the trustee's power to avoid preferences,[358] but this "improvement of position" test provides similar results.

The trustee may recover the amount set off to the extent that any insufficiency on the date of the set off is less than the insufficiency on the first date, within the ninety days before the petition is filed, when there is an insufficiency.[359] "Insufficiency" is defined as the amount by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of the claim.[360] The following two examples may illustrate:

Example 1

Ninety days prior to the filing of bankruptcy, the debtor owed the bank $50,000, and had $15,000 in its checking account. Just prior to the filing of the petition, the bank set off the mutual debts at a time when the debtor had $18,000 in its account. The insufficiency ninety days prior to the filing date was $35,000. The insufficiency was only $32,000 on the date of the setoff. The trustee may then recover $3,000 ($35,000 − $32,000), because the bank improved its position in the ninety-day period preceding the filing of bankruptcy.

Example 2

Ninety days prior to the filing of bankruptcy, the debtor owed the bank $50,000, and had $20,000 in its checking account. Ten days before debtor filed its petition in bankruptcy, the bank set off the mutual debts at a time when the debtor had $16,000 in its account. The insufficiency ninety days prior to the filing date was $30,000. The insufficiency on the date of setoff was $34,000. The trustee cannot recover any amount, because the insufficiency on the date of setoff was greater than ninety days prior to filing. The bank did not improve its position during the ninety-day period.

If the trustee recovers a setoff under these provisions, the bank's unsecured claim against the estate will be increased by that amount.[361] In this situation, the

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[356] 11 USC § 553(a)(3) (1982 & Supp. IV 1986).

[357] See 11 USC § 553(b) (1982 & Supp. IV 1986).

[358] See 11 USC § 553(a) (Supp. IV 1986).

[359] 11 USC § 553(b)(1) (1982 & Supp. IV 1986). If there is no insufficiency ninety days before the petition is filed, the first date during the ninety-day period in which there is an insufficiency is used as the measuring date. Id.

[360] 11 USC § 553(b)(2) (1982 & Supp. IV 1986). This procedure is a mathematical test, and is not subject to equitable considerations. See In re Assiante, 28 Bankr. 903 (Bankr. D. R.I. 1983).

[361] 11 USC § 502(h) (1982 & Supp. IV 1986).

bank is treated as having an unsecured claim to the extent of the amount the trustee recovers. As discussed subsequently, the bank would have had the status of a secured claimant, had the bank waited until after the petition was filed to set off the debts.[362]

The purpose of this penalty provision is to discourage banks from prepetition setoffs, which frequently precipitate the filing of a bankruptcy petition.

[c] Postpetition Setoff; "Freezing" Accounts. If the bank has not exercised a setoff prior to the debtor filing bankruptcy, it will run into the automatic stay prohibition. Section 362(a)(7) explicitly prohibits a setoff after the filing of the bankruptcy petition.[363] It does not, however, mean that the bank loses its substantive right of setoff. The bank's claim, equalling the amount it would have been able to set off, will be allowed as a secured claim.[364] This provision protects the bank's setoff rights by providing secured creditor status for otherwise unsecured claims, in addition to the right to adequate protection. The bank may then file a motion for relief from the stay or may request adequate protection if necessary.

A hotly contested issue, however, is whether the bank may temporarily freeze the debtor's bank account upon notice that a bankruptcy petition was filed, while also petitioning the court to lift the stay so that the bank can execute the setoff or require that the debtor provide adequate protection if the stay continues.[365] The withdrawal of funds by the debtor or trustee immediately after petitioning for bankruptcy would destroy the bank's right of setoff. One line of cases holds that although the funds are not removed from the debtor's account, a temporary freeze is the equivalent of a setoff, because the bank retains control of

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[362] See 11 USC § 506(a) (1982 & Supp. IV 1986). See infra ¶ 25.09[3][c].

[363] Setoffs exercised without prior court approval are in violation of the stay and are void and of no effect. In re Voight, 24 Bankr. 983 (Bankr. ND Tex. 1982). A creditor who exercises a setoff in violation of the stay loses its right to set off and must return the amount previously set off to the bankruptcy estate. Id.; see also In re Mealey, 16 Bankr. 800 (Bankr. ED Pa. 1982).

[364] 11 USC § 506(a) (1982 & Supp. IV 1986).

[365] For a thorough discussion of this issue, see B. Weintraub & A. Resnick, Bankruptcy Law Manual ¶ 5.10[4] (rev. ed. 1986 & 1987 Supp.). See also In re Wildcat Constr. Co., 57 Bankr. 981 (Bankr. D. Vt. 1986). See generally Ahart, "Bank Setoff Under the Bankruptcy Reform Act of 1978," 53 Am. Bankr. LJ 205 (1979), Freeman, "Setoff Under the New Bankruptcy Code," 97 Banking LJ 484 (1980); Groschadl, "'Freezing' the Debtor's Bank Account: A Violation of the Automatic Stay?," 57 Am. Bankr. LJ 75 (1983); Weintraub & Resnick, "Freezing the Debtor's Account: A Banker's Dilemma Under the Bankruptcy Code," 100 Banking LJ 316 (1983).

the funds.[366] Several other courts take the opposite view and hold that a freeze does not violate the stay.[367]

Essentially four Bankruptcy Code provisions are involved in this dispute. Section 553(a) authorizes creditors to exercise setoff rights that they have under substantive law, subject to the automatic stay and the "improvement of position" test.[368] Section 362(a)(7) explicitly states that setoffs are subject to the automatic stay, while Section 506(a) provides that creditors with setoff rights are secured creditors. Section 363(c)(2) prohibits the trustee or debtor in possession from using cash collateral without first obtaining a court order. (Cash collateral is defined to include deposit accounts.)[369] One authority urges that these provisions, when read together, support the bank's right to freeze the account temporarily. The reasoning of this authority is as follows: because Sections 506(A) and 363(c)(2) restrain the trustee from using the deposit, while at the same time Sections 362(a)(7) and 553(a) limit the ability of the bank to reach the account, this statutory scheme must contemplate a preservation of the status quo through a freeze of the account, until a judicial resolution is possible.[370]

[d] Setoffs and the Involuntary Bankruptcy. If involuntary bankruptcy proceedings are initiated against a debtor, different rules apply as to freezing the bank account. Notwithstanding Section 363's prohibition on the debtor of using cash collateral without obtaining a court order, Section 303(f) governing involuntary bankruptcy proceedings allows an involuntary debtor to continue to use or to dispose of its property as if the involuntary case had not been commenced. Under this scenario, a bank may become liable for wrongful dishonor if it freezes a debtor's bank account. The automatic stay, however, still prohibits the bank from exercising a setoff. To protect the bank's right of setoff, one commentator suggests a temporary freezing of the debtor's bank account, while immediately

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[366] See United States v. Reynolds, 38 Bankr. 725 (WD Va. 1984), aff'd, 764 F2d 1004 (4th Cir. 1985); IRS v. Norton, 717 F2d 767 (3d Cir. 1983); In re Wildcat Constr. Co., 57 Bankr. 981 (Bankr. D. Vt. 1986 (dictum)); In re Burrow, 36 Bankr. 960 (Bankr. D. Utah 1984); In re LHG Resources, Inc., 34 Bankr. 202 (Bankr. WD Tex. 1983); In re Executive Assocs., Inc., 24 Bankr. 171 (Bankr. SD Tex. 1982); In re Mealey, 16 Bankr. 800 (Bankr. ED Pa. 1982); In re Hackney, 20 Bankr. 158 (Bankr. D. Idaho 1982).

[367] In re Edgins, 36 Bankr. 480 (Bankr. 9th Cir. 1984); Stann v. Mid Am. Credit Union, 39 Bankr. 246 (D. Kan. 1984); Kenney's Franchise Corp. v. Central Fidelity Bank, 22 Bankr. 747 (WD Va. 1982); In re Williams, 61 Bankr. 567 (Bankr ND Tex. 1986); In re Hoffman, 51 Bankr. 42 (Bankr. WD Ark. 1985); In re Lee, 40 Bankr. 123 (Bankr. ED Mich. 1984); In re Owens-Peterson, 39 Bankr. 186 (Bankr. ND Ga. 1984); In re Davis, 29 Bankr. 652 (Bankr. WDNY 1983); In re Gazelle, 17 Bankr. 617 (Bankr. WD Wis. 1982); In re Carpenter, 14 Bankr. 405 (Bankr. MD Tenn. 1981).

[368] See supra ¶ 25.09[3][b].

[369] 11 USC § 363(a) (1982 & Supp. IV 1986).

[370] B. Weintraub & A. Resnick, Bankruptcy Law Manual ¶ 5.10[4] (rev. ed. 1986 & 1987 Supp.).

seeking a determination by the court of the bank's right to freeze or set off the funds.[371]

[4] Credit Card Purchases as Nondischargeable Debts

An extension of credit incurred through false pretenses, false representation, or actual fraud will be deemed nondischargeable in bankruptcy under Section 523(a)(2). Much litigation has occurred over whether credit card purchases taking place shortly before a debtor files bankruptcy constitute grounds for nondischargeability under this section. The courts apply a fact-oriented approach, so that the results of these cases may vary. Generally, however, when it appears that the debtor has gone on a last-minute prebankruptcy "shopping spree," the courts will find that the debtor incurred the debts in contemplation of bankruptcy, and thus will find that the debts are nondischargeable.

In *First National Bank v. Roddenberry*,[372] the Eleventh Circuit held that credit card liabilities are dischargeable until the creditor unequivocally and unconditionally revokes the right of the cardholder to possess and use the credit card.[373] When the creditor issued the card, it agreed to trust the cardholder and to extend credit to him. Until the creditor decides that the credit ought to be revoked, it cannot claim that the debtor's actions were fraudulent. This case was decided under the Bankruptcy Act of 1898, and the court left open the question of whether the addition of the phrase "actual fraud" in the new Bankruptcy Code of 1978 would alter its result.[374] The unconditional revocation theory has been criticized, and generally is not followed.[375]

Another line of cases follows the "implied representation" theory. According to this theory, the debtor's use of a credit card is an implied representation that the cardholder has both the ability and the intention to pay for the purchases made.[376] Intent to defraud is inferred from the debtor's payment record, ability to pay at the time the purchases were made, and the timing, number, amount and type of purchase made. For example, in *In re Bono*,[377] the court held that

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[371] Hertzbert & Schubiner, "The Right of Setoff Under the Bankruptcy Code," Practicing Law Institute, 1 Bankruptcy Practice for Bank Counsel 1986, 561, 587.

[372] 701 F2d 927 (11th Cir. 1983).

[373] Id.

[374] Id. at 929–930, n.3.

[375] See In re Faulk, 69 Bankr. 743 (Bankr. ND Ind. 1986) and cases cited therein.

[376] In re Burklow, 60 Bankr. 728, (Bankr. SD Cal. 1986) (each time debtor charged an item to his account with a merchant he impliedly represented that he had both the intention and the ability to pay for the purchases). See also In re Poźucek, 73 Bankr. 110 (Bankr. ND Ill. 1987); In re Lipsey, 41 Bankr. 255 (Bankr. ED Pa. 1984); In re Higgs, 39 Bankr. 181 (Bankr. ND Ohio 1984).

[377] 41 Bankr. 629 (Bankr. D. Mass. 1984).

credit card debts were nondischargeable where (1) the cardholder made purchases totalling $7,817.48 during a three-day period; (2) the previous high balance on the account had been $2,000–$3,000; (3) the charges were over the cardholder's credit limit; (4) the purchases were for luxury items, including an $1,800 watch for his wife; (5) at the time of the purchases the cardholder's salary was $300 a week, he had minimal assets, noncontingent liabilities of $6,400, a tax liability of at least $10,000 for the health club where he was an employee and officer, director, and stockholder, and other personal debts of $16,600 as guarantor of corporate notes of the club; and (6) the health club went out of business a month after the purchases were made. Although the debtor did not file for bankruptcy until five months after the shopping spree, he had signed his bankruptcy petition three months after the debts were incurred, and the court found that his use of the card impliedly and falsely represented that he could and would repay the indebtedness, resulting in the nondischargeability of the purchases. In contrast, the bankruptcy court in *In re Labuda*[378] held that credit card purchases were dischargeable in a case where the debtor anticipated being called back to work during the period in question, and subsequently returned what purchases he could, after learning that he would not be recalled.

In *In re Faulk*,[379] a bankruptcy court rejected the "implied representation" theory and held that credit card purchases are nondischargeable, even if the creditor has not revoked the debtor's right to use the card, only if the creditor proves actual fraud on the part of the debtor.[380] Actual fraud exists when the purchases are made with no intention to repay the debt. The subjective intent required may be inferred from the actions of the debtor. The existence of fraud may be inferred if the totality of the circumstances present a picture of deceptive conduct by the debtor which indicates that the debtor intended to deceive or cheat the creditor.[381] A case by case analysis of the facts is required, and the court gave the following list of factors to consider:

- The length of time between the charges made and the filing of bankruptcy;
- Whether or not an attorney has been consulted concerning the filing of bankruptcy before the charges were made;
- The number of charges made;
- The amount of the charges;
- The financial condition of the debtor at the time the charges are made;
- Whether the charges were above the credit limit of the account;
- Whether the debtor made multiple charges on the same day;

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[378] 37 Bankr. 47 (Bankr. MD Fla. 1984).

[379] 69 Bankr. 743 (Bankr ND Ind. 1986).

[380] Id.

[381] Id. at 755.

- Whether or not the debtor was employed;
- The debtor's prospects for employment;
- The financial sophistication of the debtor;
- Whether there was a sudden change in the debtor's buying habits; and
- Whether the purchases were made for luxuries or necessities.

The court found that the fact that the debtor exceeded her credit limit was not, in and of itself, sufficient evidence of actual fraud to render the debts nondischargeable. Similarly, the creditor's negligence in failing to prevent a debtor from using the credit card after she reached her credit limit is not sufficient to hold that the debt cannot have been incurred through actual fraud.[382]

Under the facts of the case, the court held that the credit card purchases were nondischargeable. They were incurred on just three days, with multiple purchases made on those days, and within two to eighteen days prior to the filing of the bankruptcy petition. The highest monthly balance of the debtor, prior to these charges, was approximately $1,200, just over her credit limit of $1,180, and it occurred in the month preceding the filing of bankruptcy. The purchases made shortly before the bankruptcy amounted to over $1,600. During this eighteen-day period, the cardholder and her dependents exhibited a great increase in buying activity, composed of an inordinate number of small purchases. From the evidence submitted, it was clear that the cardholder had already conferred with an attorney prior to making the bulk of the purchases. The debtor was unemployed, and was two months behind in payments on utility bills and one month behind on her mortgage payment, indicating that she knew she would be unable to make the contractually required payments on the credit card.

A defense similar to that of "actual fraud" is available to credit card issuers in Section 523(a)(2) subsection (C), which provides a presumption of nondischargeability for luxury purchases made within forty days preceding the bankruptcy petition, to the same creditor, aggregating more than $500.[383] Furthermore, cash advances on credit cards, exceeding $1,000 and made within twenty days of the petition, are subject to the same presumption.[384] While the Bankruptcy Code does not define what "luxuries" are, it does state that "luxuries" do not include "goods or services reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor."[385] This subsection was

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[382] Id. at 756.

[383] 11 USC § 523(a)(2)(C) (1982 & Supp. IV 1986).

[384] Id.

[385] Id.

added in 1984 to prevent "loading up"; that is, to prevent the debtor from going on a buying spree in contemplation of bankruptcy.[386]

[5] Employees Who File Bankruptcy

Certain types of discrimination against debtors, that occur solely because the debtor has filed a petition in bankruptcy, are prohibited under Section 525 of the Bankruptcy Code.[387] One of the most important of these types occurs when an employee files bankruptcy. A private employer may not discriminate against an employee solely because the employee is or has been a debtor under the Bankruptcy Code.[388]

It is clear that a bank may not fire or otherwise discriminate against an employee on the basis of a bankruptcy filing, even if the bank management believes that the presence of such an employee will undermine public confidence in the institution. However, the employee must show that the bankruptcy was the sole reason for the discrimination.[389] In *In re Hopkins*,[390] a bank was found liable for firing a teller because she had filed bankruptcy. There was no evidence of poor performance or of employee misconduct, and the bank president's concern for public relations did not legitimize the dismissal.[391] Similarly, in *In re Hicks*,[392] a bank was held to have discriminated against an employee when it transferred her, over her objections, from her teller's position to a bookkeeping position, where she did not handle cash transactions. Mrs. Hicks' supervisor had

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[386] In re Faulk, 69 Bankr. 743, 751 (Bankr. ND Ind. 1986) (citing S. Rep. No. 65, 98th Cong., 1st Sess. 58 (1985)).

[387] 11 USC § 525 (Supp. IV 1986).

[388] 11 USC § 525(b) (Supp. IV 1986). Subsection (b), mandating this result, was added in the 1984 Bankruptcy Amendments.

Prior to the 1984 Bankruptcy Amendments, Section 525 consisted only of subsection (a), which prohibited discrimination by governmental units in both employment and other contexts, such as licensing or granting permits. The issue of whether private employers were subject to the same restrictions was disputed. Several courts held that private employers should also be prohibited from this type of discrimination, on equitable grounds; see In re Olson, 38 Bankr. 515 (Bankr. ND Iowa 1984); In re Green, 29 Bankr. 682 (Bankr. SD Ohio 1983); while others found no such prohibition, based on the rather clear statutory language; see Wilson v. Harris Trust & Sav. Bank, 777 F2d 1246 (7th Cir. 1985); In re Amidon, 22 Bankr. 457 (Bankr. D. Mass. 1982), In re Barbee, 14 Bankr. 733 (Bankr. ED Va. 1981); In re Coachlight Dinner Theatre, 8 Bankr. 657 (Bankr. SDNY 1981).

[389] See In re Stockhouse, 75 Bankr. 83 (D. Wyo. 1987) (debtor failed to establish that he was fired solely because of his bankruptcy where evidence showed employer planned to replace debtor long before the bankruptcy filing took place, debtor had performed poorly in the job, and had been notified of his poor performance).

[390] 66 Bankr. 828 (Bankr. WD Ark. 1986).

[391] Id.

[392] 65 Bankr. 980 (Bankr. WD Ark. 1986).

read of the bankruptcy petition in a newspaper article, and transferred her to the non-cash position the next day. The affidavit outlining the transfer, which Mrs. Hicks refused to sign, specifically stated that the purpose of the transfer was to remove her from a "compromising position" and to "protect the image and maintain the customer confidence of" the bank, and was in no way related to previous job performance.[393] The transfer did not decrease her salary, and the opportunity for advancement was the same in each position. The court rejected the bank's reasons for the transfer, and found that the transfer was discriminatory. The court ordered Mrs. Hicks be reinstated in her teller position.

The Bankruptcy Code does not outline what remedy is appropriate for an employee who has been discriminated against by his or her employer. Courts generally find the authority to provide a remedy under Section 105(a), which authorizes the court to enforce the Bankruptcy Code.[394] It appears that given the circumstances of the case, courts will provide an equitable remedy, which may include reinstatement, back pay, injunctions, raises, and other such benefits that, but for the discrimination, would have been awarded. One bankruptcy court, however, found that it did not have the authority to award attorney fees, and, given the facts of the case, saw no reason to change the standard rule that each party bears its own costs.[395] In another case, the same bankruptcy court held that contempt charges were not appropriate as a remedy for violation of this statute.[396]

[6] Environmental Protection, Hazardous Wastes, and the Bankrupt Debtor

In general, there are four issues involving the interplay of federal and state environmental law and bankruptcy law. They are (1) whether injunctions and other cleanup orders against the debtor are subject to the automatic stay once a bankruptcy petition is filed;[397](2) whether fines, injunctions, and other orders for violations of environmental law are dischargeable in bankruptcy;[398] (3) whether, and under what terms, a trustee in bankruptcy may abandon property that is in violation of environmental protection laws and, if abandonment is ordered, who pays for the cleanup; and (4) if the cleanup has already been done on the contaminated property by the federal Environmental Projection Agency (EPA)

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[393] Id. at 981.

[394] 11 USC § 105(a) (Supp. IV 1986) provides that the court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

[395] In re Hicks, 65 Bankr. 980, 985 (Bankr. WD Ark. 1986).

[396] In re Hopkins, 66 Bankr. 828 (WD Ark. 1986).

[397] See supra ¶ 25.05 on the operation of the automatic stay.

[398] See supra ¶ 25.08[1] for a discussion of nondischargeable debts.

or by a state agency, does that agency's claim have priority status under bankruptcy law?

[a] Environmental Proceedings and the Automatic Stay. The courts generally hold that suits by environmental agencies, both federal and state, that seek an order from the court that the debtor cease polluting or be required to clean up property that is in violation of environmental standards, or which seek proceedings to enforce an injunction already obtained, are not subject to the automatic stay.[399] Such suits fall within the exception for proceedings by a governmental unit under its police or regulatory powers.[400] Enforcement of cleanup orders will reduce the assets of the bankrupt by the amount of expenditures necessary for the cleanup, and thus creditors may, in reality, be subsidizing the cleanup costs. If the governmental agency is seeking only reimbursement, or is enforcing a money judgment, however, its action will not fit under these exceptions, and will be stayed by the filing of a bankruptcy petition.

[b] Dischargeability of Orders and Fines Arising From Environmental Violations. In *Ohio v. Kovacs*,[401] the U.S. Supreme Court held that a judgment against the debtor was a "claim," for purposes of the Bankruptcy Code, and was thus dischargeable in a Chapter 7 liquidation.[402] The court's holding, however, is very narrow. The debtor (an individual) was found to have violated state pollution laws in the dumping of toxic wastes. A stipulated judgment enjoined the debtor from further pollution, required that the industrial wastes be cleaned up within one year, and imposed $75,000 damages for injury to wildlife.[403] The debtor did not comply, and pursuant to the judgment a state receiver was appointed to collect the assets of the debtor and to apply them to the cleanup of the toxic wastes. The debtor then filed a voluntary Chapter 11 bankruptcy petition, and later converted to a Chapter 7 liquidation.

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[399] See In re Commonwealth Oil Ref. Co., 805 F2d 1175 (5th Cir. 1986) cert. denied, 107 S. Ct. 3228 (1987); Penn Terra, Ltd. v. Department of Envtl. Resources, 733 F2d 267 (3rd Cir. 1984); United States v. F.E. Gregory & Sons, Inc., 58 Bankr. 590 (WD Pa. 1986).

[400] 11 USC §§ 362(b)(4), 362(b)(5) (1982).

[401] 469 US 274 (1985).

[402] Id. Dischargeability will generally be an issue only in Chapter 7 liquidation cases where the debtor is an individual. Few, if any, cases involving hazardous wastes will be filed under Chapter 12 or 13, and corporate or partnership debtors under Chapter 7 are not entitled to a discharge. See 11 USC § 727(a). Debtors may be discharged after completing the terms of a confirmed plan under Chapter 11, but the governmental agency will be a voting participant in the acceptance of the plan. See 11 USC § 1126 (1982 & Supp. IV 1986). See also supra ¶ 25.02[3] (on acceptance and confirmation of a Chapter 11 plan).

[403] Ohio v. Kovacs, 469 US 274 (1985).

The issue in the case was not whether the judgement was an exception to discharge, but whether the judgment was a "claim" or "debt" subject to discharge under the Bankruptcy Code. The Supreme Court held that because debtor had been ousted and thus could no longer comply with the judgment by cleaning up the hazardous wastes, the claim was, in reality, a claim for damages to repay the state for the costs of cleaning up the property. By its acts, the State of Ohio had converted the obligation into a claim for payment of money. Because it was now a money judgment, it was dischargeable in bankruptcy.

The Court was careful to state that its decision did not determine the dischargeability of other possible toxic pollution liabilities or judgments, such as criminal contempt, fines, monetary penalties, or injunctions against further pollution.[404] In fact, the Court in dicta stated that if it were a fine or monetary penalty imposed prior to bankruptcy, Section 523(a)(7) of the Bankruptcy Code would except it from dischargeability. Section 523(a)(7) excepts from dischargeability noncompensatory penalties payable to a governmental unit.[405] Nondischargeability also might be found if the facts were to indicate willful and malicious injury.[406]

[c] Abandonment of the Property and Liability for Cleanup. As discussed previously, the trustee in general may abandon property of the bankruptcy estate that is burdensome.[407] This right was limited, however, in the context of environmental and hazardous waste regulation, by *Midlantic National Bank v. New Jersey Department of Environmental Protection.*[408] The debtor, Quanta Resources Corporation, owned and operated waste oil storage and processing facilities in New York and New Jersey. Almost 500,000 gallons of PCB-contaminated oil were stored in unguarded and deteriorating containers at two different sites.[409] The debtor was in violation of state environmental laws in both states when it filed a petition for Chapter 11 reorganization, which shortly thereafter was converted to a Chapter 7 liquidation. The trustee intended to abandon the property at both sites, because the costs of complying with federal, state, and local laws would have required substantial expenditures, rendering the property a burden on the estate.

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[404] 469 US at 284-285.

[405] 11 USC § 523(a)(7) (1982). See also supra ¶ 25.08[1].

[406] 11 USC § 523(a)(6) (1982). See supra note 290 for a discussion of willful and malicious injury that may except a debt from discharge.

[407] 11 USC § 554(a) (Supp. IV 1986).

[408] 474 US 494 (1986).

[409] According to the Court's opinion, the oil was stored in leaking and deteriorating containers that presented risks of fire explosion, personal injury or death through contact, and water supply contamination. Midlantic, 474 US at 499, n.3.

The Supreme Court, on appeal, held that a bankruptcy trustee may not abandon property in contravention of a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards. Before authorizing abandonment of the property, the court must formulate conditions that will adequately protect the public's health and safety.

Since *Midlantic*, courts have used a fact-specific analysis to determine whether the property may be abandoned. In *In re Franklin Signal Corp.*,[410] the trustee was allowed to abandon fourteen drums of hazardous waste because the trustee had taken precautionary measures in determining the extent and danger of the hazardous substances, and had reported their existence to the appropriate state and federal agencies. The drums were not judged to be a current threat to public safety. Similarly, another bankruptcy court held that the trustee was allowed to abandon the real estate surrounding an oil refinery in bankruptcy where the pollution did not present an immediate harm to the public health and safety, and abandonment would not aggravate the existing situation or increase the likelihood of disaster or of intensification of polluting agents.[411]

In two other cases, however, the courts used a stricter interpretation of *Midlantic*. In *In re Charles Stevens*,[412] the court held that the trustee could not abandon PCB-contaminated waste oil where abandonment would threaten public safety and contravene state laws reasonably designed to protect the public. Similarly, in *In re Peerless Plating Co.*,[413] the court decided that the bankruptcy trustee could not abandon a hazardous waste site with less than full compliance with environmental law, where the EPA had stated that hazardous materials were present and there was an unspecific amount of cyanide gas in the air.

When the bankruptcy court allows the trustee to abandon property, the issue becomes one of deciding to whom the property is to be abandoned. Title to the property abandoned may vest in any party with a possessory interest in the property to be abandoned.[414] If the debtor is an individual, such individual has an interest as the prior owner, and title to the abandoned property generally will vest in that individual. If the bankrupt is a corporation that liquidates, the possessory interest resides either with a party holding a secured interest in the property, or the corporation's shareholders.

Therein lies the potential liability for lenders with a secured interest in the property, whether it be real property, equipment, or personal property. Under the Comprehensive Environmental Response, Compensation, and Liability Act

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[410] 65 Bankr. 268 (Bankr. D. Minn. 1986).

[411] In re Oklahoma Ref. Co., 63 Bankr. 562 (Bankr. WD Okla. 1986).

[412] 68 Bankr. 774 (D. Maine 1987).

[413] 70 Bankr. 943 (Bankr. WD Mich. 1987).

[414] See S. Rep. No. 989, 95th Cong., 2d Sess. 92, reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 5878.

(CERCLA),[415] the EPA can compel legally responsible parties to clean up a hazardous waste site, or it can clean up the site itself and hold a legally responsible party liable for reimbursement. Under CERCLA, liability is imposed in some circumstances without regard to fault and causation. Current and former "owners or operators" may be held liable for cleanup costs.[416] The term "owner or operator" does not include a person that holds indicia of ownership primarily to protect a security interest, as long as that person does not participate in the management of the facility.[417] Generally this should exclude lenders from liability, except where they are involved in the management and operations of the debtor.

However, courts have held that where a bank was the current owner of a hazardous waste site through a prior foreclosure of its security interest, at the time the EPA did the cleanup, it could not avail itself of the defense that by its security interest it was not an owner or operator.[418] The same interpretation could be given to a bank that had received property abandoned by the bankruptcy trustee. Because the bank is the current owner, the EPA may, in some cases, be able to impose liability without regard to fault and causation.

Environmental regulation and imposition of liability for hazardous waste cleanup on innocent parties such as lenders, particularly in transfers such as foreclosures and abandonment of property in bankruptcy, is unsettled. Defenses may be available to lenders who had no prior knowledge of the hazardous waste, and took reasonable precautions when dealing with debtors in environmentally regulated businesses.[419] Lenders should, however, be aware of their potential liability when property is abandoned to them in the bankruptcy context, and should watch for later developments, perhaps through legislation, in this unsettled area of law.[420]

[d] Priority Status for Claims Resulting from Cleanup. When the EPA, or a state regulatory agency, has expended funds to clean up a hazardous waste site or to decontaminate property of a bankruptcy estate, the agency will generally claim that its costs were administrative expenses of the estate, and thus are entitled to priority in payment. The courts have reacted favorably to this argu-

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[415] 42 USC § 9601–9657 (1982 & Supp. III 1985).

[416] 42 USC § 9607(a) (1982).

[417] 42 USC § 9601(20)(A) (1982).

[418] United States v. Maryland Bank & Trust Co., 632 F. Supp. 573 (D. Md. 1986).

[419] 42 USC § 9607(b) (1982).

[420] For an excellent article on potential lender liability for hazardous waste cleanup, including suggested practices for risk minimization, see Klotz & Siakotos, "Lender Liability Under Federal and State Environmental Law: Of Deep Pockets, Debt Defeat and Deadbeats," 92 Com. LJ 275 (1987).

ment.[421] Because cleanup costs are so great, the environmental claim may exhaust the bankruptcy estate at the expense of other creditors. As a result, the creditors of an environmentally regulated business may take a greater risk than anticipated should the debtor violate environmental regulations.

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[421] See In re Peerless Plating Co., 70 Bankr. 943 (Bankr. WD Mich. 1987); In re Charles Stevens, 68 Bankr. 774 (D. Me. 1987); In re Mowbray Engineering Co., 67 Bankr. 34 (Bankr. MD Ala. 1986).

26

Interest Rate Controls and Credit Practices Regulation

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¶ 26.01 SOURCES OF LAW

It is often thought that consumers operate at a disadvantage in their dealings with commercial parties in sales and credit transactions. Although the consumer who purchases goods, borrows money, or applies for credit in theory enters into a voluntary contract with the seller or creditor, the reality may be that the consumer has little opportunity to bargain, no effective means of obtaining reliable information to evaluate the transaction and possible alternatives to it, and insufficient resources to pursue remedies when sellers or creditors fail to perform their contracts faithfully. Such remedies as may exist under the law may be too expensive or otherwise impractical for the consumer to utilize. Historically, the common law, at first, was not sensitive to the circumstances of consumers. The original approach of the common law was exemplified by the

maxim "caveat emptor"—"Let the buyer beware." Under this approach, the seller of goods had only the obligations to the buyer that the seller expressly made in the contract for sale, and no more. Lacking the economic power to bargain for terms that would give more protection, the consumer had no recourse when the goods proved defective. When the law did afford rights and remedies for consumers, standard form contract provisions, which waived such rights, effectively nullified the law's protection; on the other hand, other provisions of law, such as the holder in due course rule, may have cut off the consumers' rights.

Because of the disadvantages consumers have historically experienced in the commercial world, there have been legislative efforts in more recent years to redress the balance and to provide consumers with special rights and remedies in dealing with commercial parties of various kinds. Consumer legislation is particularly extensive in the field of credit practices and consumer finance. Laws have been enacted on the state and federal levels, administrative agencies have adopted regulations with consumer protection goals in mind, and courts have become sensitive to the special problems consumers confront.

On the state level, many statutes have been enacted to protect consumers. Often they are of a fragmented nature, covering specific areas of interest such as consumer installment lending, door-to-door solicitation sales, home improvement loans, and a variety of similar topics. There is also a body of state law governing the conduct of creditors in collecting debts and enforcing loan agreements. The National Conference of Commissioners on Uniform State Laws proposed a comprehensive Uniform Consumer Credit Code, which was promulgated in 1968 and subsequently revised, including revisions in 1974. Referred to as the UCCC, this code has substantially influenced subsequent consumer legislation, but has actually been enacted by only a relatively few number of states. Even in the states that have adopted the UCCC, there have been substantial revisions to the model language.

The UCCC covers finance charges and related matters dealing with consumer credit sales, consumer loans, and other consumer credit transactions. It contains provisions to regulate consumer credit transactions requiring certain disclosures, such as those required by the federal Truth-in-Lending Act, and it establishes requirements for various terms of consumer credit agreements relating to property taken as collateral, assignments of the obligation, confessions of judgment, balloon payments, and other matters. It deals with credit card holder rights, it covers rights of buyers in home solicitation sales and consumer credit insurance, and it also creates special creditors' and consumers' remedies. This description is not exhaustive of the coverage of the UCCC, but illustrates the wide range of areas in which special consumer legislation may exist. The National Conference of Commissioners on Uniform State Laws also has approved a Uniform Consumer Sales Practices Act, which covers deceptive and unconscionable consumer sales practices.

On the federal level, there are a number of consumer-oriented statutes as well. The Consumer Credit Protection Act is one of the major federal statutes that affect consumer finance transactions. The act applies to many aspects of consumer credit transactions. Title I covers consumer credit cost disclosure or what is popularly known as truth in lending. It deals with credit transactions, credit advertising, credit billing, and consumer leases. Title III of the act contains restrictions on garnishment; Title V contains general provisions; Title VI regulates consumer credit reporting; Title VII contains rules for equal credit opportunity that prohibit discrimination in providing credit; Title VIII deals with debt collection practices; and Title IX covers electronic fund transfers. While this handbook cannot cover all aspects of the broad scope of the Consumer Credit Protection Act, certain of these provisions important to bankers are discussed subsequently.

Other federal legislation exists as well. The Magnuson-Moss Warranty Federal Trade Commission Improvement Act contains important consumer protection provisions.[1] The Federal Trade Commission engages in rule making to prevent unfair and deceptive trade practices. The FTC has adopted rules dealing with holders in due course, credit practices, door-to-door sales regulations, and others. Congress also has become involved in the regulation of interest rates that certain lenders may charge.

The remaining parts of this chapter introduce the reader to this broad body of state and federal regulation. The discussion that follows has been selected to emphasize areas that will be of interest to the banker, and, it is hoped, will provide an understanding of the type of regulation that exists and of the need for caution in the practices followed in consumer credit transactions. This is an area in which there is not only a diverse and extensive body of law, both state and federal, but also numerous administrative regulations that must be observed, including quite complex and detailed regulation under the Truth-in-Lending Act. Banks should consult experienced counsel to review all consumer lending and finance transactions to be sure that the various requirements of state and federal law are satisfied.

¶ 26.02 INTEREST AND USURY

Both federal and state laws regulate the rate of interest that banks may charge in credit transactions. States often have a bewildering variety of laws that establish rules for credit transactions of various sorts and that impose different requirements, depending on the type of the loan, the nature of the lender, and the type of debtor. For example, it is common for a state to have laws that specifically apply to residential real estate loans, consumer installment loans, loans by

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[1] 15 USC § 57a (1982).

consumer finance companies, loans by federally insured depository institutions, and numerous other classifications. In addition to the various state law requirements, federal law affects the rates of interest that may be charged in many commercial transactions entered into by banks. There is a federal statute, discussed later in this chapter, that determines the interest rates a national bank may charge. With the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980, there has been significant federal involvement in the regulation of interest rates charged by other federally regulated depository institutions. The federal law may displace some of the state law constraints.

Regarding the extensive body of law that governs the control of interest rates and similar charges, the discussion that follows is intended to provide an introduction to this body of law to explain the general scope and framework of the law and to supply a background of information to help a banker develop a sensitivity for situations in which problems might exist. As noted previously in this book, this area is a matter of considerable complexity. Correct decisions depended on the facts of the particular situation and the applicable local law. Again, a bank should consult its legal counsel to review its lending practices on a regular basis for advice on the applicability of the law to the particular business of the institution.

[1] State Law Regulating Interest Rates

All states have laws that limit the amount of interest creditors may charge on loans or other credit transactions. These laws have ancient roots. Through the passage of time, many exceptions and distinctions have been constructed, exceptions and distinctions that complicate their application. Except for the application of federal law, which in some cases preempts local usury regulation, each state's laws are unique. Not only do the applicable rate limitations differ, but there are numerous other differences relating to the coverage of the laws. It is essential that lenders consult local counsel as to the law of their particular jurisdiction.

In general, usury amounts to the exaction of more than the legal rate of interest on a loan or forbearance of money with wrongful intent. Although simple to state, the nature of usury in practice is complex. Determining the legal rate of interest depends on the type of transaction and on the identity of the creditor. In addition to the general "legal" interest limit, states usually have different rate limitations[2] for interest agreed upon in written contracts, for

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[2] See Benfield, "Money, Mortgages and Migraine—The Usury Headache," 19 Case W. Res. L. Rev. 819 (1968) (hereinafter Benfield); Morris, "Consumer Debt and Usury: A New Rationale For Usury," 15 Pepperdine L. Rev. 151–179 (1988); Rohner, "Problems of Federalism in the Regulation of Consumer Financial Services Offered by Commercial Banks," 29 Cath. UL Rev. 1, 313 (1979–1980).

interest paid by corporations or other large business enterprises (sometimes corporate borrowers are completely exempt), for interest charged in consumer credit transactions of various kinds, for interest charged on real estate mortgages by approved financial institutions, and so forth. Additional complexity exists because the maximum rates of interest allowed frequently are set by reference to an index, such as the discount rate on commercial paper, in accordance with some formula, or may be adjusted periodically by an administrative agency.

Deciding how much interest the borrower has paid can be complicated. Charges for specific services, such as filing fees and insurance premiums, are usually not treated as interest. Charges that are not for specific services, but are more in the nature of a fee for making the loan, are often regarded as interest, although the law varies among jurisdictions depending on the nature of the charge.[3] The charging of points and commitment fees has also been treated as interest.[4]

Whether a loan guarantee fee constitutes interest subject to the Arkansas usury statute was an issue in *Johnston v. Citizens Bank & Trust Co.*[5] The court held that it was not interest, because the fee was intended to be a reimbursement to the Small Business Administration for a loan commitment fee it charged to the lender. The fee would have been viewed as interest if it had been a charge made to obtain additional profit for the bank or if it had been imposed to offset overhead expenses or general costs or doing business.[6]

A major exception that has been carved out is the "time-price" doctrine, under which sellers of merchandise or services are permitted to charge a higher price for sales in which repayment will occur over a period of time than for sales in which repayment is made immediately in cash. The difference is not regarded as interest. Even this exception is not without its complications, because some states have refused to extend the exception to include revolving charge account arrangements.[7] Thus, some sellers' credit is exempt from usury regulation, while the credit of other sellers is regulated.

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[3] Benfield, supra note 2, at note 1. See Turner v. West Memphis Fed. Sav. & Loan Ass'n, 266 Ark. 530, 532, 588 SW2d 691, 693 (1979); Freeman v. Gonzales County Sav. & Loan Ass'n, 526 SW2d 774, 779 (Tex. Civ. App. 1975), aff'd, 534 SW2d 903 (Tex. 1976).

[4] Kissell Co. v. Gressley, 591 F2d 47, 52 (9th Cir. 1979); Arkansas Sav. & Loan Ass'n v. Mack Trucks, 263 Ark. 264, 266–267, 566 SW2d 128, 130–131 (1978); Abramowitz v. Barnett Bank, 394 So. 2d 1033, 1035 (Fla. Dist. Ct. App. 1981). But see People v. Central Fed. Sav. & Loan Ass'n, 46 NY2d 41, 43, 385 NE2d 555, 557, 412 NYS2d 815, 817 (1978); Stedman v. Georgetown Sav. & Loan Ass'n, 595 SW2d 486, 489 (Tex. 1979). See Note, "*Stedman v. Georgetown Savings and Loan Association*: Reasonableness Is Not a Characteristic of a Bona Fide Commitment Fee," 21 S. Tex LJ 127 (1980); Note, "Usury—A Bona Fide Commitment Fee Is Not Interest for Purposes of Usury Law Violations," 11 Tex. Tech. L. Rev. 971 (1980).

[5] 659 F2d 865, 868–869 (8th Cir. 1981).

[6] Id. at 868.

[7] Wisconsin v. J.C. Penney Co., 48 Wis. 2d 125, 129–130, 179, NW2d 641, 645–646

The form of the transaction often will determine whether it is subject to usury limitations. In *Stoddard v. Stoddard*,[8] the defendant claimed that a transaction that was structured as a sale of land with a repurchase option should be viewed, in fact, as a loan. If the transaction was a bona fide sale, the state usury limit did not apply. If the transaction, on the other hand, was a loan, the terms clearly were usurious. The court resolved this issue, not by considering the function and effect of the transaction, but by considering whether the defendant was the type of "necessitous debtor" whom the usury laws were designed to protect. Finding that the defendant was a businessman who entered into the transaction with a profit motive in view and with no necessitous financial circumstances pressing him to borrow the money, the court held that the form of the transaction as a sale should control. The Washington Supreme Court, on the other hand, took a different approach in holding that certain automobile leasing practices constituted loans subject to state usury limitations. The court said that leases were the functional equivalent of loans and therefore should be subject to the provisions of the state usury law.[9]

Similar problems arise when a corporation is formed to evade the usury rates established for loans to individuals. While courts have upheld the use of corporations to escape the individual usury rates when the loan is for a business purpose,[10] the law of each jurisdiction should be consulted to determine what will be required to uphold the transaction as a bona fide loan and not a sham.

In *Whitaker v. Spiegel, Inc.*,[11] the court held that usury limitations applied to

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(1970). But see Fox v. Federated Dep't Stores, 94 Cal. App. 3d 867, 876, 156 Cal. Rptr. 893, 902 (1979); Kass v. Garfinckel, Inc., 299 A2d 542, 544, (DC 1973); Uni-Serv. Corp. v. Commissioner, 349 Mass. 283, 285, 207 NE2d 906, 908 (1965); Grigg v. Robinson Furniture Co., 78 Mich. App. 712, 719–720, 260 NW2d 898, 905–906 (1977); Sliger v. R.H. Macy & Co., 59 NJ 465, 467, 283 A2d 904, 906 (1971).

[8] 641 F2d 812, 814–815 (9th Cir. 1981).

[9] Rouse v. People Leasing Co., 96 Wash. 2d 722, 726, 638 P2d 1245, 1249 (1982).

[10] See In re LeBlanc, 622 F2d 872, 876–877 (5th Cir. 1982), reh'g denied sub nom. Brinkley v. Chase Manhattan Mortgage & Realty Trust, 627 F2d 239 (5th Cir. 1980). A Michigan court permitted a consumer borrower to assert the defense of usury, although the consumer had established a corporation to borrow the money in order to take advantage of the corporate exemption in the state's usury laws. Although the court indicated that the defense would not be available if the consumer used the loan to further his own personal or commercial enterprises, where the loan was made to an individual to discharge personal debts and obligations, "and not in furtherance of a corporate or business enterprise," the defense is available. In this case, the borrower used the loan to pay arrearages on a home mortgage, make repairs on a residence, and purchase a used truck. The court came to this conclusion although the exemption for corporations in Michigan is available "whether or not [the corporation was] formed at the request of the lender. . . ." Allan v. M&S Mortgage Co., 138 Mich. App. 28, 359 NW2d 238 (1984).

[11] 95 Wash. 2d 408, 412, 623 P2d 1147, 1151 (1981). On rehearing en banc, the court held that except for the instant case its decision would only apply prospectively. 637 P2d 235 (1981), appeal dismissed, 454 US 958 (1981).

a sale of merchandise under a revolving credit plan. The seller argued that the charge was not subject to the usury laws, because it was a time-price differential in which there was merely a different cash price and installment sale price. The court held that this was not a case in which there were truly two set prices, one for cash and another for credit, because the credit price simply consisted of "the cash price coupled with a service charge percentage which remains constant against a fluctuating debt."[12]

In *Collins v. Union Federal Savings & Loan Association*,[13] the court held that a construction loan and permanent takeout loan from the same lender should be viewed as a single loan transaction for the purpose of the state's usury laws. The court also considered when it was proper for the financial institution to charge interest on loan funds not yet disbursed to the borrower.

In another case, the Virginia Supreme Court has held that the protections afforded to consumer borrowers under the state Small Loan Act could not be evaded by structuring the loan in the form of a real estate mortgage loan. If the lender was a person in the business of making loans below the ceiling amount of the Small Loan Act, the provisions of that act applied.[14]

An Arizona intermediate appellate court has interpreted the state consumer fraud act, which covers deceptive acts "in connection with the sale or advertisement of any merchandise," as applying to lending money. The court allowed a consumer to bring suit under the statute for damages for a usurious loan.[15]

In short, usury limits and interest controls are very much a matter of local law. Lending institutions should be careful to consult with counsel to establish appropriate guidelines for each jurisdiction in which they do business.

[2] National Banks

Federal law determines the rate that a national bank may charge on loans, discounts, or on notes or other commercial paper. The federal statute states that a national bank may charge interest

> at the rate allowed by the laws of the State, Territory, or District where the bank is located, or at a rate of 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal Reserve District where the bank is located, whichever may be the greater, and no more, except that where by the laws of any State a different

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[12] 95 Wash. 2d at 413, 623 P2d at 1152. For a collection of decisions on the question whether revolving charge accounts constitute a credit transaction within the meaning of usury statutes, see 95 Wash. 2d at 418, 623 P2d at 1153.

[13] Collins v. Union Fed. Sav. & Loan Ass'n, 99 Nev. 284, 289, 293–294, 662 P2d 610, 615, 619–620 (1983).

[14] Valley Acceptance Corp. v. Glasby, 230 Va. 422, 428, 337 SE2d 291, 297 (1985).

[15] Villegas v. Transamerica Fin. Servs., 147 Ariz. 100, 103, 708 P2d 781, 783 (Ct. App. 1985).

> rate is limited for banks organized under State laws, the rate so limited shall be allowed for associations organized or existing in any such State under this chapter.[16]

[a] Role of State Law. Although federal law controls what a national bank may charge, the state law continues to be relevant under the federal law in two ways. Firstly, a national bank may charge interest at the rate provided by the relevant state law, although such rate may be greater than the federal limit of one percent over the discount rate for ninety-day commercial paper. Secondly, the federal statute puts a national bank on a competitive par with its state bank counterparts by permitting a national bank that is "organized or existing" in a state to charge the rate allowed by the state for banks organized under state law. The implications of these provisions for the lending activities of national banks are discussed later.

The Comptroller of the Currency has adopted regulations that apply to the service charges on deposit accounts with national banks. Under these regulations, a national bank may establish "any deposit account service charge" and, if the comptroller's rules are followed, the service charge is effective notwithstanding any state law that prohibits the charge or restricts the amount of the charge.[17] The comptroller specifically indicated that any state law restricting such service charges is "preempted by the comprehensive federal statutory scheme governing the deposit-taking function of national banks."[18]

Notwithstanding the comptroller's regulation and statement of intent to preempt state law,[19] a state court has held that the state law duty of good faith under the UCC is a limitation on the ability of national banks to set fees for the return of checks drawn against insufficient funds.[20] After noting that the comptroller had issued an interpretation clarifying that the comptroller did not intend the rule itself to preempt state law but rather intended only to express the position that the federal statutory scheme preempts state laws that "prohibit or limit the amount of a national bank's deposit account service charges," the court held that the rule did not immunize a national bank from its obligations under general contract law and the UCC to act in good faith in setting charges for

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[16] 12 USC § 85 (1982). When the state law does not fix a rate of interest that may be charged, the federal statute allows a national bank to charge a rate "not exceeding 7 per centum, or 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located, whichever may be the greater, and such interest may be taken in advance, reckoning the days for which the note, bill, or other evidence of debt has to run." Id.

[17] 12 CFR § 7.8000 (1988).

[18] Id.

[19] See discussion of the federal preemption doctrine in Chapter 14.

[20] Best v. United States Nat'l Bank, 303 Or. 557, 563–566, 739 P2d 554, 560–563 (1987).

checks drawn against insufficient funds.[21] The court said that the comptroller's interpretation preempted only state laws that *prohibited* the charge or that *limited* or *restricted* the *amount* of the charge. The doctrine of good faith did not offend these constraints, because it allowed a bank to charge any amount so long as it is within the reasonable expectations of depositors and in accordance with contractual procedures that meet the obligation of good faith.[22]

Federal law also provides a penalty for violation of the federal statute limiting the interest that a national bank may charge. A violation of the federal statute, "when knowingly done, shall be deemed a forfeiture of the entire interest which the note, bill, or other evidence of debt carries with it, or which has been agreed to be paid thereon."[23] When the person has paid the interest in a case where a national bank has charged a rate in violation of the law, the person who has paid it may recover "twice the amount of the interest thus paid from the [national bank] taking or receiving the same. . . ."[24] The federal penalty provision preempts state law penalties for usury violations. According to the Washington Supreme Court, the preemption of the state law does not prevent a state from awarding attorney fees in connection with usury litigation, because the award of attorney fees is regarded as a cost of litigation, not a penalty.[25]

The Comptroller of the Currency also has regulations dealing with other aspects of interest charges by national banks. The regulations clarify the application of the most favored lender doctrine, discussed in the section that follows.[26] The regulations also permit a national bank to take "as consideration for a loan a share in the profit, income or earnings from a business enterprise of a borrower."[27] The share may be "in addition to or in lieu of interest."[28] When such an interest is taken, the borrower's obligation to repay the principal amount of the loan "shall not be conditioned upon the profit, income or earnings of the business enterprise."[29]

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[21] Id. at 605, 739 P2d at 562. The comptroller's interpretation is reported at 49 Fed. Reg. 28,238 (1984).

[22] Id. See also Perdue v. Crocker Nat'l Bank, 38 Cal. 3d 913, 923–924, 702 P2d 503, 513–514, 216 Cal. Rptr. 345, 355–356 (1985), appeal dismissed, 475 US 1001 (1986), where the California Supreme Court held that a cause of action for unconscionable conduct was established by allegations that a California bank's customers were charged $6.00 for each check drawn on insufficient funds, although the cost to the bank of processing such checks was only $0.30.

[23] 12 USC § 86 (1982).

[24] Id. The action must be brought within two years from the time of the usurious transaction. Id.

[25] Detonics '.45' Associates v. Bank of Cal., 97 Wash. 2d 351, 354, 644 P2d 1170, 1173 (1982).

[26] 12 CFR § 7.7310 (1988).

[27] 12 CFR § 7.7312 (1988).

[28] Id.

[29] Id.

The comptroller's regulation on fees for credit reports or credit investigations of a borrower permits a national bank to charge a fee in addition to the highest rate of interest permitted under state law, thus clarifying that such fees ordinarily will not be treated as part of interest. The ability of a national bank to make such additional charges is "subject to contrary or limiting state statute. . . ."[30]

[b] Most Favored Lender Doctrine. As discussed earlier, the interest rate that a national bank may charge is statutorily related to the interest rate permitted in the state in which the bank is located, unless there is federal preemption. Courts have interpreted this incorporation of state interest rates as permitting a national bank to charge the same rate as any similarly situated lender within the state. This so-called most favored lender doctrine will sometimes allow a national bank to charge a higher rate of interest than that charged by state banks.[31]

The Comptroller of the Currency has adopted a regulation that permits a national bank to charge interest at the rate permitted by state law to state-licensed small loan companies or similar institutions for the class of loans specified by the state statute.[32] The regulation further provides that the national bank will be subject only to the provisions of state law that are "material to the determination of the interest rate" for such class of loans.[33] The national bank does not have to be licensed under state law in order to qualify to charge the rate for such loans. If the state denies the usury defense to corporate borrowers, national banks may charge corporate borrowers any rate of interest agreed upon.[34]

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[30] 12 CFR § 7.7315 (1988).

[31] See Northway Lanes v. Hackley Union Nat'l Bank & Trust Co., 464 F2d 855, 864 (6th Cir. 1972). See generally Arnold & Rohner, "The Most Favored Lender Doctrine for Federally Insured Financial Institutions—What Are Its Boundaries?" 31 Cath. UL Rev. 1 (1981).

[32] 12 CFR § 7.7310 (1988).

[33] Id.

[34] Id. See generally Fisher v. First Nat'l Bank, 548 F2d 255, 258 (8th Cir. 1977); Fisher v. First Nat'l Bank, 538 F2d 1284, 1288 (7th Cir. 1976), cert. denied, 97 S. Ct. 786 (1977); Northway Lanes v. Hackley Nat'l Bank, 464 F2d 855, 864 (6th Cir. 1972); Partain v. First Nat'l Bank, 467 F2d 167, 173 n.5 (5th Cir. 1972). But see Deak Nat'l Bank v. Bond, 89 Misc. 2d 95, 97, 390 NYS2d 771, 773 (NY Sup. Ct. 1976). For a discussion of the most favored lender doctrine and to whom it applies, see Burke, "Federal Pre-Emption of State Usury Laws," 37 Bus. Law. 747, 764–765 (1982) (discusses whether the "most favored lender" doctrine applies to depository institutions other than national banks); Burke & Kaplinsky, "Unraveling the New Federal Usury Law," 37 Bus. Law. 1079, 1094–1100 (1982).

[c] Interstate Credit Activities. The rate of interest that a national bank may charge is tied to the bank's location. Under the statute, national banks may charge interest on loans and other credit transactions at the rate allowed by the laws of the state *where the bank is located* or at the rate of one percent over the discount rate for ninety-day commercial paper at the Reserve bank in the Federal Reserve district where the bank is located, whichever rate is greater.[35] The Supreme Court has held that a bank located in one state may "export" that state's interest rate to other states in which the bank does business, even though the other states have lower lending rates. The Supreme Court allowed a Nebraska bank to charge credit-card holders in Minnesota at the interest rate established by the laws of Nebraska, the state of the bank's location, although Minnesota law mandated a lower rate.[36] In this case, both the bank and its credit card program were regarded as being located in Nebraska, although the bank's service corporation would enter into agreements with banks and merchants in Minnesota and solicit accounts of cardholders.[37]

When a national bank acquires a note by assignment or transfer, the provision of the National Bank Act that makes the law of the state in which the bank is located govern the interest rate does not apply. The transaction by the bank is viewed as a purchase of a preexisting debt, and the lawful rate of interest continues to be controlled by the state law that applied at the time the debt was created.[38] It is possible for the federal statute to apply when the bank discounts a note or when the transaction was deliberately structured in this fashion to make it appear that the bank was not the actual lender.[39]

The ability to export the interest rate of a national bank's home state has led to the relocation of the credit card programs of some banks. Although the previous case was decided before enactment of the Monetary Control Act of 1980, which substantially changed the scope of federal regulation of interest rates by federally insured depository institutions, the provisions of the act did not change the result reached by the court.[40]

To facilitate the development of credit card programs that take advantage of state laws in states with liberal interest rate controls on credit card transactions, bank holding companies have established subsidiary banks in such states for the

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[35] 12 USC § 85 (1982). See discussion supra ¶ 26.02[2]. See generally Annot., "Computation of Service or Interest Charge on Bank Credit Cards as Usurious Under National Banking Act (12 U.S.C.S. § 85)," 38 ALR Fed. 805 (1978).

[36] Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 US 299, 309–310, 318 (1978); accord Fischer v. First Nat'l Bank, 548 F2d 255, 288 (7th Cir. 1977).

[37] See Brophy, "State Usury Laws and National Banks," 31 Baylor L. Rev. 169 (1979); Dobson, "Credit Cards," 1979 J. Bus. L. 331 (1979); Note, 3 U. Ark. L. Rev. 115 (1980); Note, 5 J. Corp. L. 189 (1979).

[38] FDIC v. Lattimore Land Corp., 656 F2d 139, 147–149 & n.14 (5th Cir. 1981).

[39] Id. at 148 n.15.

[40] 12 USCA §§ 85, 86 (1982).

purpose of conducting national credit card activities. Before the adoption of the 1987 amendments to the bank holding company laws, some companies established "nonbank banks" in states with favorable interest rate laws to avoid the problems presented by restrictions on interstate banking from locating in such states. The 1987 legislation deals with the use of nonbank banks to avoid restrictions on interstate banking, but contains an important exception for credit card banks.[41]

[3] Federal Preemption of State Usury Law

[a] Depository Institutions Deregulation and Monetary Control Act. The Depository Institutions Deregulation and Monetary Control Act of 1980 made major changes in the usury limitations that apply to depository institutions of all kinds.[42] The act extended the rules relating to national banks discussed previously and freed other federally regulated depository institutions from the constraints of state law.

The act determines what proper interest rate may be charged on loans—a complex process. Depository institutions need to consult legal counsel to be certain that they are satisfying the requirements of the law. While there are different rules for different types of loans, in general, the act establishes four categories: (1) residential real property loans that are secured by first liens (within this category there are special rules for manufactured home loans); (2) obligations of the depository institution; (3) business and agricultural loans of $1,000 or more;[43] and (4) other loans. The maximum interest rates vary according to the type of loan. The role of state law varies as well. There is a federal preemption of state interest limits, but it is not a total preemption, and the nature of the preemption varies according to the type of loan.[44] In some cases,

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[41] This is discussed at ¶ 6.02 on interstate bank expansion by bank holding companies. See also the discussion of nonbank banks in Chapter 5 on bank holding companies. Some states have amended their laws in an effort to court new banking business aggressively. Delaware is one state to enact banking legislation designed to attract bank holding companies to locate in Delaware. One feature of that state's legislation is liberalization of credit controls. See Wash. Fin. Rep. (BNA) at A-3 (1981).

[42] Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified in scattered sections of 12 USC (1982)). Preble & Herskowitz, "Recent Changes in California and Federal Usury Laws: New Opportunities for Real Estate and Commercial Loans?" 13 Loy. LAL Rev. 1 (1979); Note, "The Federal Monetary Control Act of 1980: A Step Toward Deregulation of State Usury Laws," 83 W. Va. L. Rev. 509 (1981).

[43] The amount initially was set at $25,000 or more.

[44] The Arkansas Supreme Court, after initially holding the preemption provisions of the Monetary Control Act of 1980 an unconstitutional exercise of federal power under the commerce clause, reversed its position on rehearing and upheld the federal act. McInnis v. Cooper Communities, Inc., 271 Ark. 503, 508, 611 SW2d 767, 772 (1981).

the states may enact laws to override the federal rules, thus nullifying the federal preemption.

The provisions of the act generally became effective April 1, 1980. However, they do not apply to loans made before that date, except for certain provisions on variable rate loans.[45] Some of the provisions of the act are permanent, but others have terminated.[46] The provisions for business and agriculture loans expired April 1, 1983 or earlier, if the state opted to override specifically the federal rule, as permitted under the act.

Section 501 of the Depository Institution Derègulation and Monetary Control Act gives the Federal Home Loan Bank Board the authority to issue rules and to publish interpretations governing the implementation of the preemption provisions of the act.[47] The Board used this authority to issue an interpretation that the provisions of the act that preempt state laws limiting the rate of interest on first mortgage residential real estate loans apply to state criminal laws. The Board takes the position that Section 501 of the act preempts all state laws, civil and criminal, that expressly limit the amount of interest that may be charged on a federally related residential first mortgage loan.[48]

The question whether state or federal law applied in determining if a loan was usurious was an issue in a case not involving the act. In this case, the Federal Deposit Insurance Corporation purchased the assets of a closed bank and then sued under 12 USC § 1819 and 28 USC § 1345 to foreclose a mortgage it had acquired. The defendant mortgagor tried to raise the defense that the loan violated state usury laws. The court held, alternatively, that the state usury law did not apply because the court's jurisdiction was based on a federal statute and, in any event, the defendant did not show the debt was usurious under state law from the inception of the loan.[49]

[b] Preemption Provisions for Specific Categories Under the Act

[i] Residential real property loans. State law and constitutional provisions that limit the "rate or amount of interest, discount points, finance charges, or other charges" on residential loans do not apply if the loan is secured by a first

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[45] Depository Institutions Deregulation and Monetary Control Act of 1980, 12 USC §§ 86a note, 1730g note, 1735f-7 notes (a)(1)(B), (g) (1982). See generally Burke, "Federal Pre-Emption of State Usury Laws," 37 Bus. Law. 747 (1982).

[46] 12 USC § 86a note (1982).

[47] 12 USC § 1735f-7 note f (1982).

[48] 12 CFR § 590.101 (1988). The Board also has announced that it will continue to follow the views expressed in prior interpretations issued with respect to the interest preemption legislation temporarily in effect before the Monetary Act of 1980. 12 CFR § 590.100 (1988). These prior interpretations can be found at 45 Fed. Reg. 2840 (1980); 45 Fed. Reg. 6165 (1980); 45 Fed. Reg. 8000 (1980); 45 Fed. Reg. 15,921 (1980).

[49] FDIC v. Tito Castro Constr., Inc., 548 F. Supp. 1224, 1226–1227 (D. PR 1982), aff'd on other grounds, 741 F2d 475 (1st Cir. 1984).

lien on residential real property, is made after March 31, 1980, and is either insured under the National Housing Act or made by a lender who is federally insured or regulated institution.[50] Thus, no interest limitations exist with respect to qualifying residential first mortgage loans. The benefit of the federal preemption also applies to mortgage loan transactions that are first liens on certain types of residential cooperative housing units and on residential manufactured homes.[51] The law allowed a state to override these provisions specifically by enacting a measure "which states explicitly and by its terms" that the state does not want them to apply to loans in its state.[52] This override had to have been adopted before April 1, 1983. If no override occurred, the preemption became permanent.

Loans for residential manufactured homes, such as mobile homes, that are secured by a first lien also are within the federal preemption of state usury laws, but further requirements must be met for the loan to qualify for federal preemption. The loan must comply with consumer protection provisions prescribed by the FHLBB. These regulations cover such matters as balloon payments, late charges, notice before repossession, and interest refunds upon prepayment.[53] After March 31, 1980, states could further limit the application of these provisions by adopting laws that limit "discount points" or other charges.[54]

[ii] Obligations of depository institutions. Effective April 1, 1980, the 1980 act preempted state laws that limit interest on "any deposit or account held by, or other obligation" of depository institutions that are insured under the Federal Deposit Insurance Act, the Federal Credit Union Act, the Federal Home Loan Bank Act, or the National Housing Act.[55] Thus, state usury laws cannot apply to bonds and notes issued by federally insured depository institutions or to interest

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[50] 12 USC § 1735f-7 note (a)(1) (1982). The law and regulations of the Federal Home Loan Bank Board also permit certain other lenders to obtain the benefit of the federal preemption. Regulations of the FHLBB list those who qualify. 12 CFR § 590.2(b) (1988). Although portions of the 1980 law expired in 1986, this did not include Section 501(a)(1) of the act, which contains the permanent preemption rules discussed earlier. See 12 CFR § 590.1 (1988).

[51] 12 CFR § 590.3 (1987). In Bank of New York v. Hoyt, 617 F. Supp. 1304, 1315 (RI 1985), the court held that the preemption of state usury law for residential loans applied to a loan issued to persons to construct a residential condominium complex of dwelling units, which would be offered for sale to individual home buyers.

[52] 12 USC § 1735f-7 notes (b)(2), (b)(3) (1982). There are savings provisions for loans entered into before adoption of the override.

[53] 12 USC § 1735f-7 note (c) (1982); 12 CFR § 590.4 (1988). The statute required mobile home loans to contain provisions for refunding precomputed finance charges when the loan is prepaid even before the regulation became effective. 12 USC § 1735f-7 note (d) (1982).

[54] 12 USC § 1735f-7 note (b)(4) (1982).

[55] 12 USC § 1735f-7 note (a)(2)(A) (1982). For the applicability to institutions in Puerto Rico, see 12 USC §§ 1735f-7 note (a)(2)(B), 3506 note (b)(11) (1982).

paid on deposits and accounts. This provision was not subject to state override and is permanent.

[iii] Business and agricultural loans of $1,000 or more. The 1980 law also contained preemption provisions for business and agricultural loans of $1,000 or more. State laws limiting interest to less than 5 percent over the ninety-day commercial paper rate set by the Federal Reserve bank for the Federal Reserve district in which the person is located were preempted, and the lender could charge interest of up to 5 percent over the ninety-day commercial paper rate.[56] These provisions relating to business or agricultural loans became effective April 1, 1980, but are no longer in effect. They ended on either April 1, 1983, or such earlier date that the state adopted a specific legislative override.[57]

[iv] Other loans by federally insured depository institutions. Federally insured depository institutions are generally authorized to make loans at a rate not more than one percent above the ninety-day commercial paper rate established by the Federal Reserve, or at such higher rate as may be permitted by state law.[58] State laws that limit the allowable interest rate to less than one percent over the ninety-day commercial paper rate are preempted, but the state may override the federal preemption by adopting a measure that specifically indicates that it does not want the preemption to apply.[59] These provisions became effective on April 1, 1980, and expire only when the state chooses to override them.[60] There is no deadline for the state to act in deciding to override the federal provisions.

The preemption rules for federally insured depository institutions give all such federally insured institutions the benefit of the same power enjoyed by national banks to charge interest at a rate at least as high as one percent over the Federal Reserve ninety-day commercial paper rate.[61] The purpose for making the national bank rate available to these other insured depository institutions is to avoid discriminatory treatment, particularly with respect to state-chartered institutions.[62] The benefit of the preemption rules extends to state and federally

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[56] 12 USC § 86(a) (1982). The loan amount was originally set at $25,000 and was later reduced to $1,000. For a case raising questions as to the applicability of the preemption for business loans beyond the 1983 termination date, see Union Nat'l Bank v. Nelson, 747 F2d 310, 312–314 (5th Cir. 1984). The case involved a variable rate note entered into prior to the effective date of the act, but the federal preemption rule for business and agricultural loans applied to variable rate loans entered into prior to the act. The court did not have to determine for purposes of its decision whether the variable interest rate on the loan would continue to be subject to the protection afforded by the 1980 preemption rules after the termination of the act's provisions on such loans in 1983. 747 F2d at 312.

[57] 12 USC § 86a note (1982).

[58] 12 USC §§ 1730(g), 1785(g), 1831d (1982).

[59] 12 USC § 1730g note (1982).

[60] Id.

[61] The law relating to national banks is discussed supra ¶ 26.02[2].

[62] See 12 USC § 1831d(a) (1982).

chartered savings and loan associations that are federally insured, federally insured state-chartered banks and mutual savings banks, and federally insured credit unions.[63] According to some authorities, these rules give all federally insured depository institutions the "most favored lender" status that national banks enjoy.[64]

The federal preemption statute also imposes a penalty for knowing violations of the interest rate limits set by the statute. When there is a knowing "taking, receiving, reserving, or charging" a higher rate of interest than the law permits, the entire interest on the indebtedness is forfeited, or, when interest has been paid, the person who paid may recover twice the amount of the interest paid.[65] For all types of loans, if more than one provision of law applies to the same loan, the highest rate applies.[66]

Difficulty may arise in determining the amount of interest the federal preemption entitles the creditor to charge. The federal statute allows the credi-

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[63] 12 USC §§ 1730(g), 1785(g), 1831d (1982). The institutions covered include state-chartered banks and foreign banks insured by the Federal Deposit Insurance Corporation, 12 USC § 1831d (1982); savings and loan associations, both state and federally chartered, that are insured by the Federal Savings and Loan Insurance Corporation, 12 USC § 1730g (1982); and credit unions insured by the National Credit Union Share Insurance Fund, 12 USC § 1785(g) (1982). The language of the latter provision appears to cover both state and federally chartered credit unions, but a question has been raised as to whether federally chartered credit unions qualify. See Burke, "Federal Pre-Emption of State Usury Laws," 37 Bus. Law. 747, 762 (1982). See also Davis v. Redstone Fed. Credit Union, 401 So. 2d 55 (Ala. 1981). A federal district court in Puerto Rico held that a Commonwealth statute that provided for setting maximum interest rates on retail installment contracts did not conflict with the federal Home Owners Loan Act, under which federal savings and loan associations are regulated. Departamento de Asuntos del Consumidor v. Oriental Fed. Sav., 648 F. Supp. 1194, 1197–1198 (1986).

National banks, of course, have always been covered by federal law, 12 USC § 85 (1982), which also authorizes interest at a rate of one percent above the federal discount rate on ninety-day commercial paper.

Federally chartered credit unions have a specific statutory authorization to charge interest at a rate "not to exceed 15 per centum per annum on the unpaid balance inclusive of all finance charges . . ." 12 USC § 1757(5)(A)(vi) (1982). The National Credit Union Board may approve higher interest rate ceilings for periods of eighteen months when economic circumstances require it to protect the safety and soundness of individual credit unions. Id. A knowing violation of the rates required by law results in the forfeiture of *all* interest on the debt or a right in the person who paid to recover all the interest paid. 12 USC § 1757(5)(A)(vii) (1982).

[64] See supra ¶ 26.02[2][b] for a discussion of the most favored lender rights of national banks. See generally, T. Crandall, R. Hagedorn & F. Smith, Jr., Debtor-Creditor Law Manual ¶ 3.01[3][b] (1985); Burke & Kaplinsky, "Unravelling The New Federal Usury Law," 37 Bus. Law. 1079, 1096–1099 (1982). For an interpretation of the FHLBB supporting this view, see [1979-80 Transfer Binder] Federal Banking L. Rep. (CCH) ¶ 98,447 (1980).

[65] 12 USC §§ 1730g(b), 1785(g)(2), 1831d(b) (1982).

[66] 12 USC § 1735f-7 note (1982).

tor, under the federal rate prong of the statutory formula, to charge up to one percent in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve banks in the Federal Reserve district when the lender is located, but does not specify the date on which the federal discount rate shall be ascertained. It seems reasonable to suppose that the statute means to impose a fixed ceiling, determined as of the time the loan is made, rather than a fluctuating interest rate tied to the variations in the federal discount rate, upon all loan transactions. Nevertheless, this is not provided for expressly in the statute. When a lender makes a variable rate loan, there is an obvious question whether the maximum rate to which the interest can float is set at the time the loan is made or must be recalculated with each change in the federal discount rate as the interest rate on the loan floats. Similarly, there is no answer to the question whether the date for determining the federal interest rate ceiling should be the date on which the loan is extended, the date on which a loan commitment is made, or some other time.[67]

[c] State Laws Overriding Federal Interest Limits. A number of states have taken advantage of the opportunity afforded by the federal law to override parts of the federal preemption of their local usury controls.[68] Thus, even in transac-

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[67] For a good discussion of these and related issues, see Burke "Federal Pre-Emption of State Usury Laws," 37 Bus. Law. 747, 760 (1982).

[68] States that have taken action to override part or all of the federal preemption rules are listed later. The specific state statues should be consulted for details of the override and for action by states that may not be included in this listing. Colorado has overridden all federal preemption of state usury laws. Colo. Rev. Stat. §§ 5-13-101–5-13-105 (Supp. 2, 1987). Georgia has overridden federal preemption of state laws relating to loans, mortgages, credit sales, and advances after March 31, 1983. Ga. Code Ann. § 7-4-20 (Harrison Supp. 1 1987). Hawaii has overridden federal preemption of state usury laws regarding residential real property loans and business and agricultural loans. Haw. Rev. Stat. § 478-9 (Supp. 9 1987). Idaho has overridden federal preemption of state laws relating to loans, mortgages, credit sales, and advances. Idaho Code § 28-49-105 (Supp. 5B 1987). Iowa has overridden all federal preemption of state usury laws. 1980 Iowa Acts H.C. 2492, § 32; 2 Consumer Cred. Guide (CCH) ¶ 6410, at 22,638 (1987). Kansas has overridden federal preemption of state usury laws regarding residential real property loans. Kan. Stat. Ann. § 16-207a (1981). Maine has overridden federal preemption regarding mobile home consumer credit transactions and first lien mortgages on real estate granted by supervised lenders. 1 Consumer Cred. Guide (CCH) ¶ 510, at 1113 (1983). Massachusetts has overridden federal preemption of state usury laws regarding residential real property loans, business and agricultural loans, and other loans (not including "Small Business Investment Companies" loans); see generally 15 USCA § 687(i) (West Supp. 1983). Mass. Gen. Laws Ann. ch. 183, § 63 (West Supp. 30 1988). Minnesota has overridden federal preemption of state usury laws regarding residential real property loans. Minn. Stat. Ann. §§ 47.203–47.204 (West 1988). Nebraska has overridden federal preemption of state laws relating to loans, mortgages, credit sales, and advances. Neb. Rev. Stat. § 45-1104 (Supp. 1983). Nevada has overridden federal preemption of state usury laws regarding residential real property loans and business and agricultural loans. 3 Consumer Credit Guide

tions in which the federal preemption rules may apply, a careful check of local law for a possible state override should be made. As discussed at the beginning of this chapter, determination of the applicable legal rate of interest is often a sophisticated legal problem, requiring familiarity with the particular circumstances and with local as well as federal law. It is necessary to check local statutes and administrative rules carefully. Many state legislatures are actively engaged in revising and eliminating existing usury provisions. Advice of legal counsel should be obtained before setting loan rates.

[4] The Prime Rate

The prime rate is the rate of interest banks charge their largest and most creditworthy customers. It is an important economic indicator that financial analysts and economists use in assessing the economy. It is also used as an index for loans and other credit transactions, with the amount of interest payable pegged to the prime rate.

A precise definition of what constitutes a bank's prime rate is elusive. Some studies have concluded that the prime rate does not reflect the lowest interest rates available to corporate customers.[69] A study conducted by the Board of Governors of the Federal Reserve System of large New York City banks concluded that 60 percent of the banks' business loans were below prime.[70] This presents obvious difficulties in interpreting loan agreements that tie the interest rate of the loan to a prime rate. Care should be taken to draft loan agreements so that they specifically state the interest rate intended.

Controversy over the meaning to be given loan arrangements tied to the prime rate has produced litigation. Although the law remains unsettled, with few opinions directly addressing the merits of the issues presented, a significant action has occurred.[71] One case charging a bank with conspiring with other

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(CCH) ¶ 6415, at 35,650 (1987). North Carolina has overridden federal preemption of state mortgage usury laws and state loan rates by insured financial institutions and small business investment companies. N.C. Gen. Stat. § 24-2.3 (Supp. 1986). South Carolina has overridden federal preemption of state usury laws regarding residential real property loans. 1981 S.C. Acts H.B. 2164, § 3; 4 Consumer Cred. Guide (CCH) ¶ 6422, at 48,662 (1984). South Dakota has overridden federal preemption of state usury laws regarding residential real property loans, business and agricultural loans, and small business investment company loans. S.D. Codified Laws Ann. § 54-3-15 (Supp. 15A 1988). Wisconsin has overridden federal preemption of state usury laws regarding extensions, modifications, renewals and refinancing of loans and new loans by federally chartered banks, credit unions, and mutual savings banks on or after November 1, 1981 and before November 1, 1984, or after October 31, 1987. Wis. Stat. Ann. § 138.041 (West Supp. 1987).

[69] Wash. Fin. Rep. (BNA) at A-3 (1981).

[70] Id.

[71] The press reported that settlements have occurred in some lawsuits for millions of dollars. Wall St. J., Apr. 3, 1984, § 2, at 1. See Morosani v. First Nat'l Bank, 703 F2d 1220

banks to set prime interest rates resulted in a judgment against the bank in federal district court of $1.5 million, although the judgment was subsequently set aside.[72]

A number of cases have been brought charging banks with violation of loan agreements with their customers, in instances where the loan documents stated that the interest rates on the loans would be based upon the prime rate, but the banks made loans at lower interest rates to some other customers.[73] Various theories have been advanced to sustain these claims.

Whatever the theory, however, it is necessary to interpret the term "prime rate" as it is used in these loan documents. Although court cases generally refer to the prime rate as the interest charged by large U.S. money-center commercial banks to their best business borrowers,[74] few cases have carefully examined what this language means. The leading case to address this issue is *Kleiner v. First National Bank.*[75] In *Kleiner*, there were two types of notes: a promissory note class, in which the interest was stated as a designated percent "in excess of the rate charged by the bank from time to time to its best Commercial borrowers with respect to ninety (90) day borrowings (the 'Prime Rate')," and a real estate note class, providing for interest at a designated percent "plus the 'prime rate' currently charged from time to time by the bank to its best and most credit worthy customers."[76] Plaintiff argued that these agreements required the bank to identify its best commercial borrowers specifically and to identify the rate it was willing to charge those customers. The bank, on the other hand, argued that it had no contractual limitations on the rate it charged; prime rate simply meant "announced rate" under standard trade meaning, and the references in the notes to "most credit worthy customers," and so forth, were "meaningless formulaic expressions."[77]

(11th Cir. 1983), reversing Kleiner v. First Nat'l Bank, 526 F. Supp. 1019 (ND Ga. 1981); Kleiner v. First Nat'l Bank, 581 F. Supp. 955 (ND Ga. 1984); Kleiner v. First Nat'l Bank, 97 FRD 683 (ND Ga. 1983).

[72] Wilcox Dev. Co. v. First Interstate Bank, 97 FRD 440 (D. Or. 1983), aff'd and remanded by 815 F2d 522 (9th Cir. 1987). In *Wilcox*, the court ultimately concluded that the evidence did not support a finding that a conspiracy to fix the prime interest rate existed, and it entered judgment for the defendants. Wilcox Dev. Co. v. First Interstate Bank, 605 F. Supp. 592, 595–597 (ND Or. 1985). See Nat'l LJ, June 4, 1984, at 3.

[73] See 41 Wash. Fin. Rep. (BNA) No. 20, at 780 (Nov. 21, 1983); 40 Wash. Fin. Rep. (BNA) No. 17, at 909 (Apr. 25, 1983); id. No. 14 at 736 (Apr. 4, 1983). Another pending case is Chemical Bank v. Geller, 727 F2d 61, 63–64, reh'g denied, modified, 734 F2d 132 (2d Cir. 1984).

[74] E.g., Corbin v. Federal Reserve Bank of New York, 475 F. Supp. 1060, 1066 (SDNY 1979), aff'd, 629 F2d 233 (2d Cir. 1980), cert. denied, 450 US 970 (1981).

[75] 581 F. Supp. 955 (ND Ga. 1984).

[76] Id. at 957.

[77] Id. at 958.

The *Kleiner* court considered the two classes of notes separately. As to the first class, the promissory note class, the court held that the language in the note constituted a definition of "prime rate." However, the court went on to conclude that because it would be impossible to determine who the bank's best customers would be in the future or for how long the rate would remain in effect without change, the language in the note should not be read as imposing a duty on the bank to "conduct a daily canvass of its commercial customers to ascertain who were the most creditworthy." Yet the language should be given some meaning that, to the court, was an undertaking to make a "reasonable estimate of the lowest rate it would be willing to charge commercial customers on 90-day loans for the foreseeable future, i.e., until such time as the Bank decides to reset the prime rate." Customers could hold the bank to a duty of good faith in making this estimate, and a claim that the bank had not made "good faith estimates" would be a question of fact for a jury.

The real estate notes, on the other hand, did not supply a definition for "prime rate" in the court's view. The phrase in these notes referring to the rate "currently charged from time to time by the Bank of its best and most credit worthy customers" was not a formula or method for arriving at the prime rate, but a statement as to "the expected uses to which the 'prime rate' would be put." Therefore, the language in these notes did not specify what "prime rate" meant, and whether it should be interpreted as the rate the bank announced as the prime rate or as the rate determined as a result of the bank's good faith estimate of the lowest commercial rate; which meaning the parties intended was a question of fact for the jury.

Under the *Kleiner* court's approach, if the plaintiffs succeeded in persuading a jury that the bank breached a duty of good faith in setting the prime rate, as discussed earlier, they would be entitled to recover for breach of contract. The court also noted that alternative theories might be available, such as common-law fraud and recoupment of an overpayment. It was not necessary for the court to pursue either of these theories.[78]

In *Union National Bank v. Nelson*,[79] the court also considered whether a note containing a reference to a "prime rate" was too vague to be enforceable as a variable rate loan. The case involved the application of the federal rules preempting state usury laws in the Monetary Control Act of 1980. The court concluded that the purpose of the federal preemption rules was to free lenders from the overly restrictive curbs imposed by state interest controls, and so the terms of the note should be interpreted liberally to effect the purposes of the act.[80]

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[78] See the discussion of lender liability for breach of the duty of good faith in ¶ 24.02.

[79] 747 F2d 310, 313–314 (5th Cir. 1984).

[80] This case is discussed further infra ¶ 26.02[5].

Some plaintiffs have raised claims under the civil provisions of the Racketeer Influenced and Corrupt Organizations Act (RICO).[81] Under § 1964(c) of the act, treble damages are available. Two such lawsuits charged violations of Section 1962(c), which makes it "unlawful for any person . . . associated with any enterprise . . . to conduct or participate . . . in the conduct of such enterprise's affairs through a pattern of racketeering activity. . . ." The *Morosani* case[82] involved a claim that such a racketeering pattern existed within the meaning of Section 1962(c), because the bank had committed two or more acts of mail fraud by using the mails to send interest statements that were inflated. Because the case was settled, the *Morosani* court was not called upon to decide if the plaintiff's claim should be dismissed for failure to state a claim.[83]

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[81] 18 USC §§ 1961–1968 (1982). In one prime rate case, the court distinguished breach of contract claims from RICO mail fraud violations. The court stated that although the lender may have breached its contract in the way it interpreted its prime rate, the borrower's allegations failed to specify misrepresentations by the lender that rose to the level of "mail fraud" under RICO. Blount Fin. Servs., Inc. v. Heller, 819 F2d 151, 152–153 (6th Cir. 1987). In NCNB Nat'l Bank v. Tiller, 814 F2d 931, 934, 936 (4th Cir. 1987), the court characterized as frivolous an appeal of a dismissal of a civil RICO fraud case based on alleged failure to charge interest at the prime rate. The court also found that the bank had not exercised control over the operations of the debtor by engaging in customary borrower-lender relations.

The bank obtained summary judgment in a prime rate RICO case in Haroco, Inc. v. American Nat'l Bank & Trust. Co., 662 F. Supp. 590, 595 (ND Ill. 1987). The judge held that in order to prove a "scheme to defraud" under RICO,

> [i]t is not enough that plaintiffs think the phrase [prime rate] should be interpreted differently or thought it was interpreted differently or even that some financial institution defined similar terms somewhat differently. . . . To prevail, plaintiffs would need to establish that the phrase had a commonly understood meaning upon which they relied and that ANB defined it differently without so disclosing for the purpose of defrauding them.

[82] Morosani v. First Nat'l Bank, 581 F. Supp. 945 (ND Ga. 1984). See also Morosani v. First Nat'l Bank, 539 F. Supp. 1171 (ND Ga. 1982). See generally Patton, "Civil Rico: Statutory and Implied Elements of the Treble Damage Remedy," 14 Tex. Tech. L. Rev. 377 (1983).

[83] Also of interest is a case involving a RICO violation relating to the charging of interest that violated state usury laws. The Second Circuit held that a RICO violation of collecting an unlawful debt does not require proof of a criminal violation, because the statute requires only showing the transaction was "*unenforceable* under State or Federal law in whole or in part as to the principal or interest because of the laws relating to usury." Durante Bros. & Sons, Inc. v. Flushing Nat'l Bank, 755 F2d 239, 247 (2d Cir. 1985) (quoting 18 USC § 1961(6)). Thus, there is no basis for requiring proof of a prior conviction of the defendant for usury even under the principles established by the Second Circuit in the *Sedima* case. The court also concluded that the statute of limitations in such a case should not be the one-year state statute governing recovery of overcharges of interest, because RICO was "concerned with evils far more significant than the simple practice of usury." The more appropriate statute was the three-year limitation period provided for actions to enforce a liability created by statute. Id. at 248–249.

[5] Variable Rate and Other Nontraditional Mortgage Transactions

Federally chartered housing lenders, such as federal savings and loan associations and national banks, have offered mortgages to their borrowers that do not follow the traditional pattern of a fixed interest rate, level payments, and fully amortized debt. They make mortgage loans where the interest rate is adjustable during the life of the loan, the debt may mature before full amortization, and other flexible features may exist. Authority to engage in such nontraditional mortgage transactions is not available under state law for many state-chartered housing creditors.

The Garn-St Germain Depository Institutions Act of 1982 eliminates any favored position that the federal institutions have to engage in such nontraditional "alternative mortgage transactions," by providing for the preemption of state laws that limit the state institutions.[84] Under the Garn-St Germain Act, state-chartered depository institutions and other housing creditors may engage in alternative mortgage transactions in the same manner as federally chartered institutions by following the regulations applicable to the federal institutions.[85] States that do not want their state-chartered institutions to have this authority may override the federal authorization by enacting legislation or by having their electors adopt a provision that "states explicitly and by its terms that such State does not want the preemption provided [by the act] to apply" to transactions in such state. The states had three years, until October 15, 1985, to reject the authority granted by the act.[86]

The Garn-St Germain Act authorized national banks to make real estate loans subject to such terms and conditions as the Comptroller of the Currency might establish by order, rule, or regulation. This provision gave the comptroller authority to adopt regulations dealing with adjustable-rate mortgages. The comptroller had adopted regulations permitting national banks to make adjustable-rate mortgages *prior* to the effective date of the Garn-St Germain Act. The comptroller took the position that these regulations preempted state laws, such as usury limitations, that restricted the ability of national banks to make loans pursuant to the comptroller's regulation. Thus, the comptroller claimed authority to override state law, even without the Garn-St Germain legislation.

In *Conference of the State Bank Supervisors v. Conover*,[87] the court upheld the comptroller's authority to adopt these regulations, preempting state law. The

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In another civil RICO case, a court ruled that charging a usurious rate of interest does not constitute a predicate act of an "unlawful debt" as long as the interest is less than the statutorily prohibited rate of "twice the enforceable rate." Blount Fin. Servs. v. Heller, 819 F2d 151 (6th Cir. 1987) (citing 18 USCA § 1961(6)).

[84] Pub. L. No. 97-320, § 802, 96 Stat. 1469 (1982) (codified at 12 USC §§ 3801-3803).

[85] 12 USC § 3803 (1982).

[86] 12 USC § 3804(a) (1982).

[87] 228 App. DC 367, 373–374, 710 F2d 878, 884–885 (1983).

court held that the former provisions of 12 USC § 371(g), which allowed the comptroller to establish regulations governing real estate loans and a general grant of authority to issue rules and regulations in 12 USC § 93(a),[88] provided independent statutory authority for the regulations issued by the comptroller.

Among the miscellaneous provisions in Title XII of the Competitive Equality Banking Act of 1987 is a provision on adjustable rate mortgage loans. This section requires creditors who originate adjustable rate mortgage loans to include a limitation on the maximum interest rate that may apply during the term of the loan.[89] The Federal Reserve Board is authorized to adopt regulations to implement this rule. Violations are treated in the same manner as violations of the Truth-in-Lending Act. This rule applies to "creditors." A creditor is a person who "regularly extends credit for personal, family, or household purposes"[90]; an adjustable rate mortgage loan is "any loan secured by a lien on a one-to four-family dwelling unit . . . where the loan is made pursuant to an agreement under which the creditor may, from time to time, adjust the rate of interest."[91]

A federal case involving the Monetary Control Act of 1980[92] considered whether a note was in fact a variable rate loan. The note contained language that made the initial interest rate subject to "annual review by Payee, and adjustment if indicated by increase in Prime Rate."[93] If the note was a variable rate loan, the provisions of the 1980 act that preempted state usury limits on business and agricultural loans would apply, and the rate charged would not be illegal. The debtor argued that the provision should not apply, because the term was too vague to be enforceable as a variable rate clause. The note itself had no formula for determining the interest rate, and there was no index tying the rate to a prime rate or identifying the "prime rate" to which the note referred. The court rejected the argument and held that the note qualified as a variable rate note although it was "not precisely indexed to the market." The court reasoned that the debtor had not shown "that there is any legal barrier—other than the usury laws—to the right of a bank or other holder of a note to adjust unilaterally the rate of interest on a loan when those are the terms to which the parties agree."[94] Given the purpose of the federal statute to liberate lending from the constraints of state usury limitations, the court concluded that

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[88] Adopted as Section 708 of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980).

[89] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 1204(a), 101 Stat. 551 (hereinafter CEBA).

[90] CEBA § 1204(d).

[91] CEBA § 1204(d)(2). It includes loans for a condominium unit, cooperative housing unit, or mobile home.

[92] See discussion supra ¶ 26.02[2].

[93] Union Nat'l Bank v. Nelson, 747 F2d 310, 310–311 (5th Cir. 1984).

[94] 747 F2d at 314.

> The legal definition of variable rate ought to be read expansively, and the precise mechanics of relating rate to market ought to be viewed as matters of contractual negotiation rather than as definitional limits upon the legal status of variable rate notes. Here [the bank's] unilateral right to adjust the interest charge is limited in some sense by the prime rate, although the precise contours of that limit are matters of contractual interpretation, as is the issue of which 'prime rate' is referenced by the agreement. Whatever be the answers to these contractual questions, the note remains variable in the federal sense.[95]

¶ 26.03 CREDIT DISCLOSURE REGULATION: TRUTH-IN-LENDING ACT

Title I of the Consumer Credit Protection Act is popularly referred to as the Truth-in-Lending Act.[96] This act imposes an obligation on each creditor who enters into a consumer credit transaction or consumer lease to disclose certain specific information concerning the terms of the transaction to the consumer who is obligated.[97] The form of disclosure required is regulated by the Board of Governors of the Federal Reserve System.[98] The statutes provide only a basic framework. The precise duties placed on creditors can be understood only by reference to the detailed provisions of the Board's regulations.

The approach of the Truth-in-Lending Act is to force disclosure of credit terms. The act does not require a creditor to extend credit on any particular terms; credit may be extended at any legal rate as long as the disclosures mandated by truth in lending are made. The philosophy underlying this approach is that adequate disclosure will enable consumers to judge for themselves the desirability of entering into any particular credit transaction and to shop among creditors for the best terms. Whether or not this is a realistic philosophy is a matter of some dispute.

In 1976, the Truth-in-Lending Act was amended to cover most consumer lease transactions involving not more than $25,000. Although prior to the 1976 amendments, lease transactions that were the equivalent of credit sales were

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[95] Id.

[96] 15 USC § 1601 note (1982).

[97] 15 USC 1631(a)(1982).

[98] 15 USC §§ 1604, 1631, 1632 (1982). The Board's regulations are contained in Regulation Z, 12 CFR pt. 226 (1988). The Board also issues interpretations of Regulation Z. In Philbeck v. Timmers Chevrolet, Inc., 499 F2d 971, 976–977, reh'g denied, 502 F2d 1167 (5th Cir. 1974), the court held that Board interpretations should be given "great deference." After the revision of Regulation Z to incorporate the Simplification and Reform Act Amendments, the staff of the Federal Reserve Board published a commentary explaining the requirements of the new regulation. 46 Fed. Reg. 50,288 (Oct. 9, 1981). The staff commentary is revised periodically. 12 CFR pt. 226, (Supp. I 1988).

subject to the act's disclosure requirements,[99] the 1976 leasing provisions greatly extended the scope of the act. In 1980, Congress enacted the Truth-in-Lending Simplification and Reform Act as part of the Depository Institutions Deregulation and Monetary Control Act.[100] Except for provisions giving the enforcement agencies the power to require creditors to make restitution to consumers, the Simplification and Reform Act became effective October 1, 1982. One feature of the Simplification and Reform Act is a requirement that the Federal Reserve Board issue model disclosure forms. Although creditors are not required to use the model forms, they will be automatically in compliance with the disclosure provisions of the act if they do.[101]

[1] Scope and Requirements of the Act

The Truth-in-Lending Act provides that "a creditor or lessor shall disclose to the person who is obligated on a consumer lease or a consumer credit transaction the information" required to be disclosed by the act.[102] By these terms, disclosures will be required of a "creditor" or "lessor" when there is either a "consumer lease" or a "consumer credit transaction." Consumer lease credit disclosures are discussed later in this chapter. This section and the intervening ones discuss consumer credit transactions.

Regulation Z provides a general description of the transactions to which the disclosure requirements apply by listing the following four elements:

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[99] 15 USC § 1602(g) (1982). See infra ¶ 26.03[3].

[100] Although a lender had an option, during the transition period for revisions to the Truth-in-Lending Act, to comply with either the former regulations under the act or the new regulations, the lender had to elect one or the other and could not choose to use those provisions from each that the lender found most beneficial. Cox v. First Nat'l Bank, 751 F2d 815, 820–821 (6th Cir. 1985).

See generally Boyd, "The Truth-in-Lending Simplification and Reform Act—A Much Needed Revision Whose Time Has Finally Come," 23 Ariz. L. Rev. 1–85, 549 (1982); Griffith, "Closed-End Transactions and the Revised Truth in Lending—Some Highlights," 33 Mercer L. Rev. 723 (1982): Pettit, "Representing Consumer Defendants in Debt Collection Actions: The Disclosure Defense Game," 59 Tex. L. Rev. 255 (1981); Sasamoto, "Rescission Under the Truth-in-Lending Act: Protecting Debtor and Creditor Alike," 20 Urb. L. Annot. 169 (1981); Murphy, "Class Actions Under the Truth in Lending Act," 26 Loy. L. Rev. 333 (1980); Note, "Truth in Lending Simplification and Reform Act: Changes Affecting Disclosure Requirements in Home Mortgage Transactions," 12 St. Mary's LJ 1130 (1981).

[101] 15 USC §§ 1604(b), 1604(d) (1982). For an excellent discussion of the Truth-in-Lending Act, see Landers, "The Scope of Coverage of the Truth-in-Lending Act," 1976 Am. B. Found. Res. J. 565 (1976).

[102] 15 USC § 1631(a) (1982). See generally Annot., "Lease with Option to Purchase Agreement as Credit Sale or Consumer Lease Under Definitions in Truth-in-Lending Act (15 USC §§ 1602(g), 1667(1); and Applicable Regulations)," 58 ALR Fed. 929 (1982).

1. The credit is offered or extended to a consumer;
2. The individual or business offering or extending the credit does so "regularly";
3. "The credit is subject to a finance charge or is payable by a written agreement in more than 4 installments";
4. "The credit is primarily for personal, family, or household purposes."[103]

The four elements referred to in the regulation summarize the requirements set forth in the definitions of "consumer credit," "creditor," and "credit" in the act and in the regulations. For example, consumer credit is "credit" that is "offered or extended" to a "consumer," "primarily for personal, family, or household purposes."[104] Further, a consumer must be a natural person.[105] Although at one time the classification of consumer uses included "agricultural purposes," the Simplification and Reform Act deleted "agricultural purposes" from the definition of "consumer credit." Because the requirement is only that the consumer purpose be the "primary" purpose, there may be transactions within the disclosure requirements of the act for which there is a mixture of business and consumer purposes. A person might acquire a personal computer, for example, for both personal and business uses. The Official Commentary to Regulation Z stated that "[t]here is no precise test for what constitutes credit offered or extended for personal, family, or household purposes, nor for what constitutes the primary purpose."[106]

The definition of "creditor" is more involved.[107] To begin with, the creditor must be someone who "regularly" extends consumer credit. Although the act does not quantify what is meant by "regularly," the regulations do, and there is a numerical test based on the number of extensions of credit made during the preceding year for determining whether the creditor "regularly" extends credit.[108] As a result, the individual who extends credit in isolated or casual instances will not be subject to the requirements of the act.

Additionally, there must be a transaction involving either a finance charge for the credit given or an installment payment arrangement in which there is a

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[103] 12 CFR § 226.1(c)(1) (1988). When a financial institution makes a mortgage loan to a developer knowing that a consumer will assume the loan from the developer, the disclosure requirements of the Truth-in-Lending Act apply. Adiel v. Chase Fed. Sav. & Loan Ass'n, 810 F2d 1051, 1054 (11th Cir. 1987).

[104] 12 CFR § 226.2(a)(12) (1988).

[105] 12 CFR § 226.2(11) (1988).

[106] Official Staff Commentary on Regulation Z § 2(a)(12), 12 CFR pt. 226, (Supp. I, ¶ 2(a)(12) 1988).

[107] See generally Annot., "Who is 'Creditor' Within Meaning of § 103(f) of Truth-in-Lending Act (15 U.S.C.S. § 1620(f))," 28 ALR Fed. 548 (1976).

[108] 12 CFR § 226.2(a)(17) n.3 (1988).

written agreement to pay in more than four installments.[109] When there is an express finance charge imposed for the credit, "the obligation to pay the finance charge need not be in writing" for the act to apply. When the transaction involves payments of more than four installments without a stated finance charge, the agreement must be written.[110] Thus, the transaction must be either one in which there is an expressly stated finance charge that is oral or written or one in which there is a series of installments. In the absence of the installment payment provision, the coverage of the act could be avoided by changing the form of an installment contract from one in which an interest rate or a finance charge is expressly stated to one in which the charge is hidden by inclusion in the amount of the installments, rather than set out separately.

A creditor under the definition may be a seller as well as a lender. (A credit sale is defined as a sale where the seller is a creditor.)[111] The official commentary makes clear that if the seller is one who directs or assists the consumer purchaser in obtaining a loan with a financial institution in which the consumer obtains "a direct loan from a financial institution and the consumer's note is payable to the financial institution, the transaction is a loan and only the financial institution is a creditor."[112] Before 1982, the act included in its definition of "creditor" persons who regularly "arranged" for the extension of consumer credit, but the 1982 revision to the definition eliminated the reference to "arrangers."[113]

The creditor must also be a person "to whom the obligation is initially payable, either on the face of the note or contract, or by agreement when there is no note or contract."[114] Under this definition, a person is a creditor although the person subsequently assigns the obligation to another. In fact, the official commentary includes, within its definition of a creditor, a person who "simultaneously assigns" an obligation to a financial institution, and it gives as an example an arrangement between an auto dealer and a bank in which the dealer uses contracts supplied by the bank that make the buyer's obligation payable to the dealer, but with immediate assignment to the bank. The dealer is a creditor because the obligation is initially payable on its face to the dealer, even though

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[109] 12 CFR § 226.2(a)(17) (1988).

[110] Official Staff Commentary on Regulation Z § 2(a)(17), 12 CFR pt. 226 (Supp. I ¶ 2(a)(17) 1988). The commentary also provides that "[a] letter that merely confirms an oral agreement does not constitute a written agreement for purposes of the definition." Id.

[111] 12 CFR § 226.2(a)(16) (1988).

[112] Official Staff Commentary § 2(a)(16), 12 CFR pt. 226 (Supp. I 1988).

[113] 15 USC § 1602(f) (1982); Ford Motor Credit Co. v. Cenance, 452 US 155, 158 (1981). For a description of the prior history of this provision, see Boyd, "The Truth-in-Lending Simplification and Reform Act—A Much-Needed Revision Whose Time Has Finally Come," 23 Ariz. L. Rev. 1, 19 (1981).

[114] 12 CFR § 226.2(a)(17)(i) (1988).

the contract between the dealer and the buyer may not be executed until the bank gives its credit approval.[115]

When there are two or more creditors in the transaction, only one set of disclosures should be given, and the creditors must agree as to who among them will provide the disclosure. However, all of the creditors to whom the regulation applies remain responsible.[116] Special rules exist for transactions involving credit cards.[117]

The disclosure under the act must be made "to the person who is obligated on a consumer lease or a consumer credit transaction. . . ."[118] When there is more than one obligor in a transaction, the creditor may make only one disclosure "if the obligor given disclosure is a primary obligor."[119] At the creditor's option, disclosure may be made to additional obligors. When a right of rescission is involved, the creditor must make the disclosures to each consumer who has a right to rescind. Otherwise, according to the official commentary, it is enough to make a disclosure to either obligor on a joint account or to either of two joint obligors as long as the disclosure is given to an obligor with "primary" liability on the obligation. Disclosure to sureties and guarantors does not suffice.[120]

Credit is defined as "the right to defer payment of debt or to incur debt and defer its payment."[121] The previous discussion, as to who is a "creditor," provides assistance in determining what is meant by "credit." Additionally, the Official Staff Interpretations identify certain transactions that the Federal Reserve Board views as not constituting credit transactions. These transactions include the following:

1. Layaway plans where the consumer is not legally obligated to continue making payment;

2. Certain debts created involuntarily, including tax liens, tax assessments, court judgments, and court approvals of reaffirmation of debts in bank-

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[115] Official Staff Commentary § 2(a)(17)(i)(2), 12 CFR pt. 226 (Supp. I 1988). Compare *Ford Motor Credit*, supra note 113, interpreting a prior version of the act. Because the obligation is not "initially payable" to the assignee, the assignee does not have the responsibilities of a "creditor" under the current version of the act and regulations.

[116] 15 USC § 1631(b) (1982); 12 CFR §§ 226.5(d), 226.17(d) (1987). Both the regulations provide that when there are multiple creditors "only one set of disclosures shall be given and the creditors shall agree among themselves which creditor must comply . . . ." See also the Official Commentary, which interprets the regulation as requiring only one disclosure.

[117] Credit cards are discussed in Chapter 18.

[118] 15 USC § 1631(a) (1982).

[119] Id.

[120] 12 CFR §§ 226.5(d), 226,17(d) (1987); Official Staff Commentary §§ 5(d), 17(d), 12 CFR pt. 226 (Supp. I 1988).

[121] 12 CFR § 226.2(a)(14) (1988).

ruptcy, so long as there is no third party utilized by the consumer to finance such obligations;

3. Insurance plans in which each premium purchases an amount of future insurance coverage as long as there is no legal commitment to continue making payments;
4. Progress payments on home improvement transactions where payments are made as the work progresses with no obligation to continue making payments;
5. Borrowing against "the accrued cash value of an insurance policy or a pension account, if there is no independent obligation to repay";
6. Letters of credit;
7. Entering into option contracts;
8. "Investment plans in which the party extending capital to the consumer risks the loss of the capital advanced"; and
9. Mortgage assistance plans administered by a government agency, where there is a subsidy to the consumer for which no finance charge is imposed on the subsidy amount, and the subsidy amount "is due in a lump-sum payment on a set date or upon the occurrence of certain events."[122]

The regulation also exempts from its coverage transactions that fall into certain categories. The exempt transactions are the following:

1. Business, commercial, agricultural, or organizational credit. This category covers credit extended "primarily" for these purposes and credit extended to entities "other than a natural person," such as government agencies.[123]
2. Credit over $25,000 that is not secured by real property or a dwelling. This includes both extensions of credit and circumstances in which there is "an express written commitment to extend credit in excess of $25,000." The reference to "dwelling" includes "personal property used or expected to be used as the principal dwelling of the consumer," so that mobile homes, which might be categorized under local tax law as personal property, would not be exempt.
3. Public utility credit. This applies to credit extended for public utility services, where the credit arrangements are "filed with or regulated by any government unit." It does not include "the financing of durable goods or home improvements by a public utility. . . ."

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[122] Official Staff Commentary §§ 2(a)(14), 12 CFR pt. 226 (Supp. I 1988).

[123] See generally Annot., "What Constitutes 'Business or Commercial' Purpose Within Meaning of § 104(1) of Truth-in-Lending Act (15 U.S.C.S. § 1063(1)) Exempting Business or Commercial Credit Transactions From Act," 54 ALR Fed. 491 (1981).

4. Securities or commodities accounts. Transactions with a broker-dealer registered with the Securities and Exchange Commission or the Commodities Futures Trading Commission are exempt.
5. Home fuel budget plans. The purchase of home fuels under an installment agreement where no finance charge is imposed. This permits utilities to charge for seasonal fuel bills by billing arrangements that spread the charges over the year.
6. Student loan programs that provide guaranteed student loans under federal law.[124]

[2] Closed-End and Open-End Credit Arrangements

The disclosures required by the Truth-in-Lending Act vary, depending on whether the credit extended is classified as "closed-end" or "open-end." Open-end credit is credit extended under an arrangement in which the creditor contemplates repeated transactions. A finance charge is generally computed from time to time on the outstanding balance of the credit, and the amount of credit that may be extended to the consumer continues to be available up to the credit line approved whenever the debtor reduces the outstanding balance.[125] A common example of an open-end credit plan is the revolving charge account in which the holder of the account has discretion to make installment payments on the outstanding obligations.

Closed-end credit is defined simply as credit other than open-end credit.[126] It is credit that is extended for a specific period of time. The total amount of credit is fixed, and the dates when payment is due are established in advance. Closed-end credit arrangements are discussed first.

[a] Closed-End Credit Disclosure Requirements. In closed-end consumer credit transactions, the creditor as a general rule must make the required disclosures to the consumer "before consummation of the transactions."[127] Consummation does not occur until "the time that a consumer becomes contractually obligated on a credit transaction."[128] The time at which a contractual commitment arises is a matter decided by state law, but under the act it must be a legal obligation to enter into a credit arrangement. For example, although a consumer may become obligated to purchase an item and to make a down payment on it, there is no "consummation" of a credit transaction until the consumer becomes

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[124] 12 CFR § 226.3 (1988). See 15 USC § 1603 (Supp. IV 1986).

[125] 12 CFR § 226.2(20) (1988) (Regulation Z). See generally Annot., "Validity and Construction of Revolving Charge Account Contract or Plan," 41 ALR3d 682 (1972).

[126] 12 CFR § 226.2(10) (1988).

[127] 12 CFR § 226.17(b) (1988).

[128] 12 CFR § 226.2(a)(13) (1988).

obligated to accept a credit arrangement.[129] There are special timing rules when the credit transaction involves a real estate mortgage that is covered by the Real Estate Settlement Procedures Act.

There is one very limited situation in which the creditor may delay making disclosure until the time that the first payment becomes due. This circumstance exists when the consumer makes a mail or a telephone request for credit that the creditor had not solicited by prior face-to-face or telephone contact, and for which the credit information (for "representative amounts or ranges of credit") had been previously supplied either to the individual consumer or to the public generally, through catalogs, brochures, advertisements, or similar material. The exception does not apply when the creditor has solicited the request for credit through a direct face-to-face contact or by telephone.[130]

The form of the disclosures is important. As the regulations provide:

> (1) The creditor shall make the disclosures required . . . clearly and conspicuously in writing, in a form that the consumer may keep. The disclosures shall be grouped together, shall be segregated from everything else, and shall not contain any information not directly related to the disclosures required. . . . The itemization of the amount financed . . . must be separate from the other disclosures under that section.
>
> (2) The terms 'finance charge' and 'annual percentage rate,' when required to be disclosed . . . together with a corresponding amount or percentage rate, shall be more conspicuous than any other disclosure, except the creditor's identity.[131]

Thus, the disclosures must (1) be clear and conspicuous; (2) be segregated and grouped together; (3) contain only information directly related to the required disclosures; and (4) provide for more conspicuous display when a "finance charge" and an "annual percentage rate" must be displayed.

The information disclosed must be based on the legal obligations of the parties. This is normally what is contained in the written terms of the note or contract, but those terms may be modified. Not every informal modification affects the duty to disclose. As the official commentary explains, "If the parties informally agree to a modification of the legal obligation, the modification should not be reflected in the disclosures unless it rises to the level of a change in the terms of the legal obligation." Unenforceable oral modifications do not require a change in the information disclosed under this test. Additionally, an informal creditor practice of allowing consumers to defer payments for holiday season or because of seasonal employment does not necessitate a change in the

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[129] Official Staff Interpretations § 2(a)(13), 12 CFR pt. 226 (Supp. I 1988).

[130] 12 CFR § 226.17(g) (1988).

[131] 12 CFR § 226.17(a) (1988).

information required to be disclosed from that contained in the regular payment plan under the contract.[132]

There are times when a creditor will be required to disclose information without knowing what the amount will be for the item that must be disclosed. The cost of insurance that will be obtained from third parties or the amount of taxes or other fees may be unknown at the time at which the creditor must disclose. In these cases, the creditor may estimate the amount "based on the best information reasonably available," but the creditor must label the disclosure as an estimate, and may have to supply more accurate information later.[133] Also, when events occur after a creditor has delivered a disclosure to the consumer that make the delivered disclosure inaccurate, there is no violation of the disclosure provisions, although there may be a need to make a new disclosure to correct the inaccuracy.[134] New disclosures are required when the creditor refinances an existing obligation and when there is an assumption by a new consumer of an obligation relating to a residential mortgage transaction.[135]

There are numerous special rules to take account of situations where there is an irregularity in the payment schedule, where the obligation is payable on demand, where there is an arrangement for a series of advances, and so forth.[136] The treatment of complex financing arrangements involving wraparound loans, adjustable rate mortgages, and the like also is the subject of Official Staff Interpretations.[137]

The regulations prescribe that the following information must be disclosed when it is relevant to the transaction:

1. The identity of the creditor.
2. The amount financed, calculated by first determining the principal loan amount or cash price and then subtracting any down payment; adding other amounts financed that are not part of the finance charge; and subtracting any prepaid finance charge.
3. There must be an itemization of the amount financed, in writing, that shows the amount of any proceeds distributed directly to the consumer; the amount credited on the account of the consumer to the creditor; amounts paid to other persons on the consumer's behalf; and the prepaid finance charge. The consumer may waive the right to receive this itemization in writing.

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[132] Official Staff Interpretations § 17(c)(1), 12 CFR pt. 226 (Supp. I 1988).

[133] 12 CFR § 226.17(c)(2) (1988). See Official Staff Interpretations § 226.17(c), 12 CFR pt. 226 (Supp. I 1988); 12 CFR §§ 226.17(f), 226.19 (1988).

[134] 12 CFR § 226.17(e) (1988).

[135] 12 CFR § 226.20 (1988).

[136] See 12 CFR § 226.17(c) (1988).

[137] See Official Staff Interpretations § 17(c)(1), 12 CFR pt. 226 (Supp. I 1988).

4. The finance charge "using that term, and a brief description such as 'the dollar amount the credit will cost you.'"
5. The annual percentage rate "using that term, and a brief description such as 'the cost of your credit as a yearly rate.'"
6. The creditor must disclose information relating to the circumstances under which the rate may increase and the extent of the increase.
7. The payment schedule (number, amounts, and timing of payments).
8. The total of payments "using that term, and a descriptive explanation such as 'the amount you will have paid when you have made all scheduled payments.'"
9. The existence of an obligation to pay on demand when that is the case.
10. The total sale price "using that term and a descriptive explanation (including the amount of any down payment) such as 'the total price of your purchase on credit, including your down payment of $ ___.'" The total sale price is the sum of the cash price, other amounts that are being financed but that are not part of the finance charge, and the finance charge.
11. The information concerning the possible assessment of a prepayment penalty or a possible rebate of finance charges, on prepayment, depending on the type of credit transaction.
12. The charges for late payments.
13. "The fact that the creditor has or will acquire a security interest in the property purchased as part of the transaction, or in other property identified by item or type."
14. The premiums for insurance that are not part of the finance charge.
15. The amount of certain charges and fees relating to the security interest taken to secure the obligation.
16. A statement advising the consumer to consult the contract for information about the consumer's rights regarding "nonpayment, default, the right to accelerate the maturity of the obligation, and prepayment rebates and penalties."
17. A statement explaining whether subsequent purchasers of the dwelling from the consumer may assume the obligation on the original terms when a residential mortgage transaction is involved.
18. A statement that the annual percentage rate does not take into account the effect of the deposit when the credit requires a deposit as a condition to the transaction.[138]

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[138] 12 CFR § 226.18 (1988).

[b] Open-End Credit Disclosure Requirements. With open-end credit, as discussed previously, repeated credit transactions are anticipated in situations where additional credit will be extended. Thus, for transactions in this category, the regulations require that the creditor provide an *initial* disclosure statement before any transaction with the consumer occurs, followed by subsequent *periodic* statements at the end of each billing cycle.[139]

The initial disclosure statement must be supplied "before the first transaction is made under the plan [for open-end credit]."[140] Under the Official Staff Interpretations, certain revocable events may occur prior to the consumer's receipt of the disclosure statement. The creditor may collect a membership fee without having first submitted the disclosure statement, as long as the consumer can reject the credit plan and receive a refund of the fee. A creditor may give a cash advance check to a consumer simultaneously with the disclosure statement without violating the timing requirement as long as the consumer is entitled to return the advance check without further obligation. The creditor may charge application fees of the type that are not regarded as part of the finance charges prior to delivering the disclosure statement. The creditor may activate an account suspended for violation of credit limits, and so on, without supplying a new initial disclosure statement; however, when a closed account is reopened, the creditor must give a new statement. Also, when closed-end credit is converted to an open-end plan, the creditor must give the initial disclosures required under the regulation.[141]

The timing of the periodic disclosure statements is keyed to the billing cycle. The creditor must "mail or deliver a periodic statement . . . for each billing cycle at the end of which an account has a debit or credit balance of more than $1 on which a finance charge has been imposed." This obligation to supply a periodic statement is suspended in the case of uncollectible accounts, delinquent debts where the creditor has initiated collection procedures, or cases in which there might be a violation of federal law.[142]

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[139] 15 USC § 1637(a) (1982); 12 CFR § 226.5 (1988).

[140] 12 CFR § 226.5(b)(1) (1988);

[141] Official Staff Interpretations § 226.5(b)(1), 12 CFR pt. 226 (Supp. I 1988).

[142] 12 CFR § 226.5(b)(2) (1988). The interpretations also provide exemptions for accounts where the address is inaccurate and the statement is undeliverable. Official Staff Interpretations § 226.5(b)(2), 12 CFR pt. 226 (Supp. I. 1988). The timing for supplying the periodic statement requires sending it "at least 14 days" before the consumer incurs any additional finance or other charges that the creditor must disclose. (It is not affected by charges that may be imposed regardless of the timing of the disclosure statement—the interpretations give an example of this, namely, transaction or activity charges.) The timing rules do not apply when "an act of God, war, civil disorder, natural disaster, or strike" prevents the creditor from complying. 12 CFR § 226.5(b)(2) n.10 (1988). But a computer malfunction is not a natural disaster or other excusing event. Official Staff Interpretations 226.5(b)(2)(ii)(2), 12 CFR pt. 226 (Supp. I 1988).

The form of the disclosures must be clear and conspicuous and must be "in writing in a form that the consumer may keep." This requires that the statement be "reasonably understandable." Unlike the closed-end credit disclosures, the disclosures do not have to be set apart or segregated from other material on the disclosure statement. The disclosure of the "finance charge" and the "annual percentage rate" must be given special emphasis by printing in bold print or in a contrasting color or in capital letters, so that they will be "more conspicuous."[143]

As in the case of closed-end credit, the regulations allow for estimates when exact information is unknown at the time of disclosure. Also, inaccuracies "attributable to events occurring after disclosures are made" are not violations, although there are some cases in which the creditor may need to make subsequent disclosures.[144]

The creditor under an open-end credit plan may need to make additional disclosures. An annual statement outlining the consumer's billing rights with respect to matters such as the correction of billing errors, unauthorized use of credit cards, and rescission rights in certain transactions involving liens on the consumer's dwelling must be sent, unless it is part of the information supplied with the periodic statement.[145] If the creditor adds credit features to the consumer's account or furnishes a credit device to the consumer, additional disclosures may be necessary. (A new credit feature could be the addition of a check overdraft authorization where none previously existed; sending a consumer a package of blank checks that could be used to access a line of credit that the consumer has is an example of a "credit device.")

When there are no changes in the terms of credit and the device or new credit feature is made available to the consumer within thirty days after the initial credit disclosure, no additional disclosures need be made. There are disclosure requirements, however, whenever the creditor changes the credit terms or if the new arrangements occur more than thirty days after the initial disclosure. The disclosure is simpler if the credit terms remain unchanged, because all that is needed is a simple "reminder that the new device or feature is covered by the earlier disclosures."[146] Although changes in credit terms trigger a requirement to make a new disclosure that satisfies the requirements for the

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[143] 12 CFR § 226.5(a) (1988); Official Staff Interpretations § 226.5(a), 12 CFR pt. 226 (Supp. I 1988). In a Tenth Circuit court case, although the lender printed the rate in capital letters and boldface type, the lender failed to disclose the "annual percentage rate" of its loan in a conspicuous manner when over thirty other terms and phrases in the lender's disclosure statement were printed in a similar style. As the error was one of legal judgment, the court did not excuse the lender from liability under the bona fide error provisions of the regulations. Herrera v. First N. Sav. & Loan Ass'n, 805 F2d 896, 900–901 (10th Cir. 1986).

[144] Official Staff Interpretations § 226.5(e), 12 CFR pt. 226 (Supp. I 1988).

[145] 12 CFR §§ 226.5(b)(2), 226.9(a) (1988).

[146] 12 CFR § 226.9(b) (1988); Official Staff Interpretations § 226.9(b), 12 CFR pt. 226 (Supp. I 1988).

initial disclosure statement, as previously indicated, there is no need for an additional disclosure when the change has been previously explained in a proper disclosure statement. For example, a creditor may offer a variable rate credit plan under this approach without making a new initial disclosure statement if the variable rate arrangement was properly explained in the original statement.[147] A creditor may send a notice of a termination or suspension of credit privileges (an obvious change in credit terms) simultaneously with the termination, because no change-in-terms notice is required at all.[148] The creditor, however, may have a duty to give notice under other law, such as the Equal Credit Opportunity (ECOA).[149] Additionally, the billing dispute procedures may be applicable and may give rise to liability if they are not followed.[150]

In making disclosures, the creditor should use terminology in the initial disclosure statement that is consistent with that on the periodic statements, although identical language is not necessary.[151] The initial disclosure statement should contain the following information:[152]

1. Information regarding the finance charge: namely, when it will be imposed and how it will be determined. This specifically includes the following:
   a. When the finance charges will begin to accrue. This should make clear to the consumer if there is any period of time in which payment may be made without incurring a finance charge.
   b. What periodic rate will be used to compute the finance charge and the range of the balances to which the rate will apply. The corresponding annual percentage rate must be shown.
   c. How the balance on which the finance charge will be computed is determined.

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[147] 12 CFR § 226.9(c) (1988); Official Staff Interpretations § 226.9(c), 12 CFR pt. 226 (Supp. I 1988). In most cases, the creditor must give notice of the changes within a specified number of days before the effective date of the change. 12 CFR § 226.9(c). The regulation states:

> No notice under this section is required when the change involves late payment charges, charges for documentary evidence, or over-the-limit charges; a reduction of any component of a finance or other charge; suspension of future credit privileges or termination of an amount or plan; or when the change results from an agreement involving a court proceeding, or from the consumer's default or delinquency (other than an increase in the periodic rate or other finance charge).

12 CFR § 226.9(c)(2) (1988).

[148] 12 CFR § 226.9(c)(2) (1988).

[149] See infra ¶ 26.06[5].

[150] See infra ¶ 26.03[5].

[151] 12 CFR § 226.6 (1988).

[152] Id.

d. How the finance charge will be determined. How the amount will be calculated and whether any charges other than those based on the periodic rate will be imposed.

2. The amount of charges that may be imposed, in addition to a finance charge imposed as part of the time credit plan.

3. The fact that the creditor has or will acquire a security interest in the property purchased under the plan or in other property, identified by item or type.[153]

4. The consumer's rights and the creditor's responsibilities with respect to the handling of billing disputes, unauthorized use of credit cards, and so forth.

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[153] Id. The Official Staff Interpretations § 226.6(c), 12 CFR pt. 226 (Supp. I 1988) explain:

> 1. **General.** Disclosure is not required about the type of security interest, or about the creditor's rights with respect to that collateral. In other words, the creditor need not expand on the term "security interest." Also, since no specified terminology is required, the creditor may designate its interests by using, for example, "pledge," "lien," or "mortgage" (instead of "security interest").
>
> 2. **Identification of property.** Identification of the collateral by type is satisfied by stating, for example, "motor vehicle" or "household appliances." The creditor may, at its option provide a more specific identification (for example, a model and serial number.)
>
> 3. **Spreader clause.** The fact that collateral for pre-existing credit extensions with the institution is being used to secure the present obligation constitutes a security interest and must be disclosed. (Such security interests may be known as "spreader" or "dragnet" clauses, or as "cross-collateralization" clauses.) A specific identification of that collateral is unnecessary, but a reminder of the interest arising from the prior indebtedness is required. This may be accomplished by using language such as "collateral securing other loans with us may also secure this loan." At the creditor's option a more specific description of the property involved may be given.
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> 4. **Additional collateral.** If collateral is required when advances reach a certain amount, the creditor should disclose the information available at the time of the initial disclosures. For example, if the creditor knows that a security interest will be taken in household goods if the consumer's balance exceeds $1,000, the creditor should disclose accordingly. If the creditor knows that security will be required if the consumer's balance exceeds $1,000, but the creditor does not know what security will be required, the creditor must disclose on the initial disclosure statement that security will be required if the balance exceeds $1,000, and the creditor must provide a change-in-terms notice . . . at the time the security is taken.
>
> 5. **Collateral from third party.** In certain situations, the consumers' obligation may be secured by collateral belonging to a third party. For example, an open-end credit plan may be secured by an interest in property owned by the consumer's parents. In such cases, the security interest is taken in connection with the plan and must be disclosed, even though the property encumbered is owned by someone other than the consumer.

The creditor must disclose the following matters in the periodic disclosure statements.[154]

1. The account balance that was outstanding at the beginning of the billing cycle. (Credit balances must be apparent as credit, not debt.)
2. The identification of each credit transaction. The extent of the information required to be shown on the statement varies, depending on whether the creditor supplies a copy of a sales receipt (in sales transactions). If the transaction involves a sale of property in which the seller is also the creditor, the disclosure need only contain the amount of the transaction and the date on which the transaction took place or the date on which the consumer's account was charged when the receipts accompany the periodic statement. When there is no receipt or credit document included, the description must identify the transaction more specifically. In the case of creditors who are not the sellers (as with some credit card arrangements), the creditor must disclose, in addition to the amount and date of the transaction, the name of the seller and the place of the sale.[155]
3. A statement of credits to the account during the billing cycle.
4. The periodic rate used to compute the finance charge, the range of balances to which it applies, and the corresponding annual percentage rate must be disclosed, whether or not the rate is applied during the billing cycle.
5. The explanation of how the balance on which the finance charge is computed, as well as the amount of the balance, is determined.
6. The amount of any finance charge added to the account during the billing cycle; it must specifically be identified as a "finance charge."
7. The "annual percentage rate," labeled as such, when there is a finance charge imposed during the billing cycle.
8. An itemization of charges to the account that are other than finance charges.
9. The closing date of the billing cycle with the account balance that is outstanding on that date.
10. The date by which or the time period within which "the new balance or any portion of the new balance must be paid to avoid additional finance charges." When the creditor states such a "free-ride period," the credi-

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[154] 12 CFR § 226.7 (1988).

[155] In transactions involving shared-use ATM systems, where the cardholder may be charged a transaction fee by the institution that owns the terminal, but the institution is not the one that issued the card, the card issuing institution does not have to disclose separately the fee on the periodic statement. Official Staff Interpretations § 226.7(b), 12 CFR pt. 226 (Supp. I 1988).

tor may still, at its option without further disclosure, decide not to impose any finance charge for payments received after the free-ride period.

11. The address to be used for sending notice of billing errors. This address could be included on the billing rights statement discussed previously as an alternative.

[3] Consumer Leases

Prior to 1976, the disclosure provisions of the Truth-in-Lending Act applied to leases only to the extent that such leases came within the definition of a credit sale. The 1976 amendments greatly extended the coverage of the act to include consumer leases. Under the amendments, a consumer lease is any lease of personal property by a natural person for over four months, which lease is for a total obligation that does not exceed $25,000. The transaction must be entered into "primarily for personal, family, or household purposes." It is covered by the act, whether or not a purchase option is part of the arrangement.[156] The Federal Reserve Board has implemented the amendments by promulgating Regulation M on consumer leasing.[157]

Where there is a consumer lease transaction, before consummation of the lease, the lessor must give the lessee a dated written statement that discloses information about the lease specified in the regulation.[158] These disclosures "shall be made clearly, conspicuously, in meaningful sequence, and in accordance with the further requirements" of the Board's rules.[159] Numerical amounts and percentages must be stated in figures and printed in a type of minimum size or be "legibly handwritten."[160] The disclosure obligations fall on lessors. The definition of who is a lessor requires that the lessor be one who *regularly* engages in leasing transactions in the *ordinary course of business.*[161] The Board requires disclosure of the following information:

1. A description of the leased property;
2. The total amount of any payment required at the beginning of the lease;
3. The number, amount, and due dates of payments scheduled, including the total amount of these periodic payments;

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[156] 15 USC § 1667 (1982). A consumer lease does not include a lease for "agricultural, business or commercial purposes or one made to an organization." 12 CFR § 213.2(a)(6) (1988).

[157] 12 CFR pt. 213 (1988). There is an official staff commentary. Id. pt. 213 (Supp. I 1988).

[158] 12 CFR § 213.4(g) (1988) (Regulation M).

[159] 12 CFR § 213.4(a) (1988).

[160] Id.

[161] 15 USC § 1667(3) (1982); 12 CFR § 213.2(a)(8) (1988).

4. The amount to be paid for official fees;
5. The amount of other charges payable by the lessee, not included in the periodic payment, with a description of the charges, including the amount of the lessee's liability at the end of the term;
6. A description of the insurance provided or paid for by the lessor or required of the lessee;
7. A statement identifying all express warranties and guarantees made by the manufacturer or lessor;
8. Identification of the party responsible for maintaining or servicing the property and the standards used for wear and use;
9. A description of any security interests held or retained by the lessor, with an identification of the property to which the security interest attaches;
10. Penalties or charges for late payments and default;
11. A description of any purchase option terms;
12. A statement of conditions allowing the lessee or lessor to terminate the lease before the end of the stated term, and the amount of any penalty or other charges for early termination;
13. A statement that the lessee shall be liable for the difference between the estimated value of the property and its realized value at early termination or at the end of the lease term, if such liability exists;
14. Where the lessee's liability at early termination or at the end of the lease term is based on the estimated value of the leased property, a statement of the lessee's right to obtain, at the lessee's expense, a binding appraisal from an independent third party; and
15. Where the lessee's liability at the end of the lease term is based on the estimated value of the leased property, a calculation of the difference between the value of the leased property at the beginning of the lease and the total lease obligations, an explanation of when the estimated value at the end of the lease will be presumed unreasonable, and a statement that the lessee may consent to any final adjustment concerning this liability.[162]

[4] Disclosures and Rescission Rights in Real Estate Transactions

The Truth-in-Lending Act applies to consumer credit transactions that involve real estate. As discussed previously, the $25,000 limitation upon transactions, subject to the provisions of the act, does not apply in the case of

[162] 12 CFR § 213.4(g) (1988).

residential real estate transactions.[163] Generally, the information that must be disclosed is the same as that required in other consumer credit transactions. In addition, however, when the transaction results in a lien on the consumer's residence, the consumer has a special right of rescission. This rescission right is discussed later.

Two other federal statutes impose disclosure requirements on real estate transactions: the Interstate Land Sales Full Disclosure Act[164] and the Real Estate Settlements Procedures Act.[165] These acts also require extensive disclosure, and cannot be described in any detail here. In general, however, the Interstate Land Sales Full Disclosure Act requires anyone who sells 100 or more lots of unimproved land in interstate commerce to register with the Department of Housing and Urban Development and to comply with other disclosure requirements. The act is patterned after the registration and disclosure requirements in the federal securities laws. The Real Estate Settlements Procedures Act applies to federally related mortgage transactions involving residential dwellings, and it requires lenders to provide borrowers with a uniform settlement statement that itemizes the charges imposed and makes other disclosures.

Consumer credit transactions involving the creation of a security interest in the principal resident of the debtor were thought by Congress to be so consequential to the debtor that a right of rescission should be provided.[166] In such transactions, the consumer has an absolute right to cancel the deal until midnight of the third business day, following either consummation of the transaction or delivery to the consumer of a statement of disclosure of the consumer's right to rescind and a form for accomplishing the rescission, *whichever is later.*[167]

The right of the consumer to rescind is an absolute right. It does not depend on the establishment of any breach of conduct or violation of the act by the creditor. Because the rescission period runs from the time the required disclosure and rescission forms are supplied, the time within which the consumer may rescind the transaction may extend for a considerable period after the consummation of the credit transaction. If a creditor fails to deliver the proper forms or fails to make the proper disclosures as required by the law, the consumer will have a right of rescission that entitles the consumer to cancel the transaction and to receive a complete refund. There is a limitation, however; the right to rescind terminates three years from the date of consummation of the transaction or when the property is sold, whichever occurs first.[168]

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[163] See 12 CFR § 226.3(b) (1988).
[164] 15 USC §§ 1701–1720 (1982).
[165] 12 USC §§ 2601–2617 (1982).
[166] 15 USC § 1635 (1982).
[167] 15 USC § 1635(a) (1982).
[168] 15 USC § 1635(f) (1982).

The rescission right does not apply to purchase money security transactions in which the consumer obtains credit to finance the purchase or initial construction of a residence when the credit is secured by a mortgage, deed of trust, or equivalent instrument that creates a security interest in the dwelling.[169] It also does not cover a refinancing or consolidation of an existing obligation and accrued finance charges, so long as it is by the same creditor, it is secured by an interest in the same property, and it does not involve any further advances.[170] It does not apply when a state agency is the creditor in the transaction.[171] There is also an exemption for certain transactions under an open-end credit plan. This exemption applies whenever there is a "pre-existing" plan, when the security interest had previously been retained or acquired, and when the advances are made following "a previously established credit limit" for the plan.[172] Because of the broad definition of "dwelling," the right to rescind includes any structure containing one to four family housing units, a mobile home, and individual units of condominiums or cooperatives.[173]

Upon giving notice of rescission, the consumer is not liable for any amount, including any finance charge, and the security interest in the property is void.[174] The creditor is obligated to return within twenty days any down payment or other property given by the consumer.[175] The consumer may keep any property that has been transferred to him or her by the creditor until the creditor returns the consumer's down payment and executes appropriate documents to erase any record of the security interest. Upon the creditor's compliance with these obligations, the consumer must tender back the property of the creditor unless return is "impractical or inequitable"; it is then sufficient for the consumer to tender its reasonable value.[176] The consumer may tender return of the property at the location of the property or the residence of the consumer, whichever the consumer elects. Under the Simplification and Reform Act of 1980, effective October 1, 1982, if the creditor fails to take possession of the money or property within twenty calendar days after the tender, the consumer may keep it without any further obligation.[177]

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[169] 15 USCA § 1635(e)(1)(A) (Supp. 1988) See 12 CFR §§ 226.2(a)(24), 226.15(f), 226.23(f) (1988).

[170] 15 USCA § 1635(e)(1)(B) (Supp. 1988).

[171] 15 USCA § 1635(e)(1)(C) (Supp. 1988).

[172] 15 USCA § 1635(e)(1)(D) (Supp. 1988).

[173] 15 USCA §§ 1602(v), 1602(w) (Supp. 1988).

[174] 15 USC § 1635(b) (1982), 12 CFR § 226.15(d) (1988).

[175] 15 USC § 1635(b) (1982).

[176] Id.

[177] Id. 12 CFR § 226.15(d) (1988) (Regulation Z). Rescission rights exist regardless of whether the credit arrangement is classified as open end or closed end. 12 CFR §§ 226.15, 226.23 (1988). Although the consumer may tender property back to the creditor at the location of the property or the consumer's residence, as the consumer elects, the rules for

[5] General Provisions of the Act

[a] Duty to Revise Prior Disclosures. When a creditor discloses information as required by the act and when such disclosure is an accurate one when made, but when subsequent acts or events make the disclosure inaccurate, there is no violation of the act.[178] The creditor does not have to make a revised disclosure statement. There are certain situations in open-end credit arrangements, however, for which Board regulations require additional disclosures when the credit terms change or when a new credit feature is added to the consumer's account.[179] Additionally, in closed-end transactions, when a refinancing occurs or a subsequent consumer assumes an obligation, the creditor must make further disclosures.[180]

[b] Regulation of Credit Advertising. The Truth-in-Lending Act regulates the advertisement of consumer credit arrangements.[181] The statute requires disclosures about the credit terms when the advertising makes reference to the availability of credit. Even more fundamentally, the regulations require that the credit be available when there is advertising of credit arrangements. The regulations state that an advertisement for credit "shall state only those terms that actually are or will be arranged or offered by the creditor."[182] The regulations are more demanding than the act, which requires only that the creditor "usually and customarily arranges" credit as advertised.

The definition of "advertising" is broad. It encompasses any "commercial message in any medium that promotes, directly or indirectly, a credit transaction." Oral messages qualify, as well as those in print and on television. Point-of-sale displays and price tags fall within the definition. Telephone solicitations also are included.[183]The advertising requirements of the Truth-in-Lending Act apply to "all persons." The Official Staff Interpretations expressly state that

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tender back of money are different. Tender of money back to the creditor must be made at the creditor's designated place of business. 12 CFR §§ 226.15, 226.23 (1988). The consumer may waive his or her right to rescind when he or she certifies the credit is needed to meet "a bona fide personal financial emergency." 12 CFR §§ 226.15(e), 2226.23 (1988).

[178] 15 USC § 1634 (1982).

[179] 12 CFR § 226.7 (1988) (Regulation Z).

[180] 12 CFR § 226.20 (1988) (Regulation Z).

[181] 15 USC § 1662 (1982). Under a ruling of the Sixth Circuit, there is no implied private remedy for violations of the Consumer Credit Protection Act provisions relating to credit advertising, 15 USC § 1664 (1982). Smeyres v. General Motors Corp., 820 F2d 782, 783–784 (6th Cir. 1987). Accord LeVick v. Skaggs Co., 701 F2d 777, 779 (9th Cir. 1983), overruling Stewart v. Traveler's Corp., 503 F2d 108 (9th Cir. 1974).

[182] 12 CFR §§ 226.16(a), 226.24(a) (1988).

[183] 12 CFR § 226.2(a)(2) (1988). See Official Staff Interpretations § 226.2(a)(2), 12 CFR pt. 226 (Supp. I 1988). It does not include oral communications in negotiating specific transactions, however.

"home builders, merchants, and others who are not themselves creditors must comply with the advertising provisions of the regulation if they advertise consumer credit transaction."[184] The media in which the message appears, however, are not responsible for compliance with the act.[185]

The credit disclosures in the advertising must meet the general "clear and conspicuous" standards, although no particular format, type, size, or location requirements are imposed.[186] When the advertising medium is a catalog or other multipage format, the advertiser may use a table or schedule of representative amounts. Only positive assertions regarding credit terms trigger disclosure obligations. The statement, for example, that there is "no annual membership fee" does not trigger a need to disclose.[187]

When the advertising refers to items that fall within the terms required to be disclosed in the initial disclosure statement, in the case of open-end credit plans, the regulations require certain minimum disclosures. The advertising must state:

1. Any minimum, fixed charge, such as a transaction fee;
2. Any periodic rate that may be applied, expressed as an annual percentage rate; and
3. Any membership or participation fee.[188]

When the advertising involves closed-end credit transactions, the finance charge rate must be stated as an "annual percentage rate." Additionally, when the advertising refers to key credit terms such as the amount of a down payment, the amount of a finance charge, the number of payments, or period of repayment, there must be disclosure of certain minimum credit information:

1. The amount or percentage of the down payment;
2. The terms of repayment, including the number of payments, period of repayment, and amount of payments; and
3. The annual percentage rate and, if such rate may increase, a statement that it may be increased.[189]

When a creditor supplies credit information orally, the creditor must state the annual percentage rate. The creditor is limited by the regulations as to how much additional rate information may be given to the consumer. In some cases, information may be supplied about the periodic rate or the simple annual rate of

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[184] Official Staff Interpretations § 226.2(a)(2), 12 CFR pt. 226 (Supp. I 1988).

[185] 15 USC § 1665 (1982).

[186] 12 CFR §§ 226.16, 226.24 (1988).

[187] Official Staff Interpretations § 226.16(b), 12 CFR pt. 226 (Supp. I 1988).

[188] 12 CFR § 226.16(b) (1988).

[189] 12 CFR § 226.24 (1988).

interest. The rules vary, depending on whether open-end or closed-end credit is involved. [190]

[c] Effect of Truth-in-Lending on State Law. The federal Truth-in-Lending Act overrides state laws that require disclosure of credit information only when the state law is inconsistent with the provisions of the federal act.[191] A procedure is established under the Simplification and Reform Act of 1980 that permits a creditor to seek a ruling from the Board of Governors of the Federal Reserve System when the creditor is in doubt as to the validity of a state disclosure provision. If the Board then determines that the state-required disclosure is inconsistent with the federal act, creditors located in the state need not make disclosures under the inconsistent state law. The creditors will be protected by the Board's determination from any liability under the law of the state for failure to comply with state law, even when the Board's determination may subsequently be reversed or determined to be invalid.[192]

The Truth-in-Lending Act does not otherwise affect the laws of any state that deal with the types, amounts, or rates of charges permitted in that state in connection with the extension of consumer credit.[193] Thus, state usury provisions and regulation of consumer finance agencies under state law are not affected by the Truth-in-Lending Act.

[d] Credit Billing. The Truth-in-Lending Act contains provisions that regulate the procedures used by creditors to bill consumers and that give consumers rights when a dispute arises as to the amount owed.[194] When a creditor receives a written notice from a consumer stating that the bill sent to the consumer contains an error, the creditor is required to determine whether an error has been made and to report the findings of this investigation to the consumer.[195] The creditor must respond within certain time limits established in the act. The creditor is first required to acknowledge receipt of the notice within thirty days, unless the dispute is resolved before that time.[196] The creditor then has two billing cycles (which together can be no more than ninety days) after receipt of the notice from the consumer either to correct the account or to send a written explanation to the consumer stating the reasons why the creditor believes the

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[190] 12 CFR § 226.26 (1988). See 15 USC § 1665a (1982) (added by the Truth-in-Lending Simplification and Reform Act of 1980).

[191] 15 USC § 1610(a)(1) (1982); 12 CFR § 226.28 & App. A (1988).

[192] 15 USC § 1610(a)(2) (1982); 12 CFR § 226.28 (1988).

[193] 15 USC § 1610(b) (1982).

[194] 15 USC § 1666 (1982).

[195] 15 USC § 1666(a) (1982).

[196] 15 USC § 1666(a)(3)(A) (1982).

account is accurate.[197] Until these procedures have been completed, the creditor cannot take any action to collect the amount in dispute.[198] However, if the creditor makes clear to the consumer that payment of the disputed amount is not required, the creditor may continue to send statements to the consumer that include the amount in dispute and any financing charges computed on it.[199] The creditor may treat the disputed amount as a use of the credit limits extended to the consumer.[200] The creditor cannot close the account because of the consumer's failure to pay the amount indicated as an error.[201]

In *Gray v. American Express Co.*,[202] the company canceled a credit card while a billing dispute was pending without giving notice of the cancellation, claiming that a provision in the credit card agreement with the customer gave the company the right to cancel the account at any time, without notice, for any cause or for no cause at all. The first time that the customer learned of the cancellation was after presenting the card to pay for a wedding anniversary dinner that he and his wife had consumed. A federal court of appeals held that the cancellation was not effective. Labeling the company's argument "audacious" in view of the express statutory language forbidding a credit card issuer from closing an account because of failure of the customer to pay a disputed amount unless the company sends a written explanation to the customer, the court said that a "waiver of statutory rights, particularly by a contract of adhesion, is hardly consistent with the legislature's purpose."[203] In view of the facts in the case, the court refused to permit the company to contend it terminated the account for reasons other than the dispute over the charges, and it further held that the customer had a cause of action under state law because the company's interpretation of the contract to permit termination without notification to its customer was unreasonable.[204]

When the consumer debtor gives notice that the billing statement reflects goods not delivered to the consumer, in accordance with the agreement made at the time of the transaction, the creditor is under an obligation to determine that "such goods were actually delivered, mailed, or otherwise sent to the obligor" before the creditor can send the consumer a statement indicating that the account is accurate.[205] Under the act, any item on a billing statement representing "goods or services not accepted" or "not delivered" to the consumer, in

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[197] 15 USC § 1666(a)(3)(B) (1982).

[198] Id.

[199] 15 USC § 1666(c) (1982).

[200] 15 USC § 1666(d) (1982).

[201] Id.

[202] 240 App. DC 10, 13, 743 F2d 10, 13 (1984).

[203] 240 App. DC at 15–16, 743 F2d at 15–16.

[204] 240 App. DC at 19, 743 F2d at 19.

[205] 15 USC § 1666(a) (1982).

accordance with the agreement made at the time of the credit transaction, is a billing error subject to the procedures set forth previously.[206]

Billing errors that are subject to the procedures of the act include computational errors, the inclusion of credit that was not given, failure to reflect properly payments made, charges for goods or services not accepted or delivered, and extensions of credit for which the consumer requested additional clarification "including documentary evidence."[207]

In order to trigger the billing error resolution procedures, the consumer must give notice to the creditor within sixty days after the creditor has sent a statement to the consumer.[208] Failure to comply with the act's billing error requirements will lead to the forfeiture of the creditor's right to collect the amount that the consumer has indicated is erroneous and to collect any finance charges on it up to a maximum of $50.[209]

When the creditor receives a notice of a billing error, the creditor may not report or threaten to report adversely on the consumer's credit rating to any person.[210] When the creditor complies with the error resolution procedures, the consumer must be allowed the normal number of days permitted under the credit agreement to make payment of the resolved amount.[211] When the consumer continues to dispute the amount owed after receiving a report from the creditor that the account is accurate, the creditor may not report to any third party that the consumer's account is delinquent in payment unless the creditor also reports that the amount is in dispute and notifies the consumer of each party to whom the creditor is reporting information concerning the delinquency.[212] If the creditor makes a report of delinquency to any party, the creditor must make a supplemental report to those persons when the credit dispute is resolved.[213]

When the credit plan gives the consumer a period of free credit before any finance charge will be imposed, the billing statement must be sent to the consumer at least fourteen days before the date when the finance charge will become effective.[214] The creditor is obligated to credit promptly payments received under open-end credit plans.[215] It must also promptly refund the portion of any payment exceeding the outstanding balance of the account when the consumer

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[206] 15 USC § 1666(b)(3) (1982).
[207] 15 USC § 1666(b) (1982).
[208] 15 USC § 1666(a) (1982).
[209] 15 USC § 1666(e) (1982).
[210] 15 USC § 1666a(a) (1982).
[211] Id.
[212] 15 USC § 1666a(b) (1982).
[213] 15 USC § 1666a(c) (1982).
[214] 15 USC § 1666b(a) (1982).
[215] 15 USC § 1666c (1982).

so requests, or credit the excess payment to the consumer's account.[216] Under the Simplification and Reform Act of 1980, when the excess credit balance remains in the account for more than six months and is over one dollar, the creditor is required to make a good faith effort to refund the amount to the consumer.[217]

The Supreme Court considered the application of the act in a case in which the creditor had issued a credit card to a company, but an individual also was liable on the account.[218] A suit was brought against the creditor, claiming failure to follow the procedures for error correction in Section 161(a) of the Fair Credit Billing Act.[219] In order for the act to apply, the creditor must have transmitted a statement of the account "in connection with an extension of consumer credit."[220] The Court said that there were at least three possible interpretations of what might constitute an extension of consumer credit. One view would be to find an extension of consumer credit if the account had been opened primarily for consumer use. Another view would be to find such an extension if the particular transaction involved was a consumer transaction. A third interpretation would be to apply the act if either the purpose for opening the account was primarily for consumer use or if the particular transaction was a consumer transaction. The Supreme Court found it unnecessary to decide which one of these views should be adopted, because none of the circumstances fit the case before it. The card issued was primarily for business purposes, and the transactions involved were business transactions. The Court admitted that it would not always be easy to tell if the opening of a credit account involved an extension of consumer credit, but acknowledged that this was the approach mandated by the act.[221]

[6] Civil Liability and Administrative Enforcement

[a] Creditor Liability for Damages. Creditors who fail to comply with the requirements imposed by the Truth-in-Lending Act or by Regulation Z are liable for any actual damages caused as a result of the violation, for costs (including reasonable attorney fees in any successful action), and for a statutory penalty in the case of an individual action.[222] The statutory penalty is twice the amount of

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[216] 15 USC § 1666d (1982).

[217] Id.

[218] American Express Co. v. Koerner, 452 US 233, 237 (1981).

[219] 15 USC § 1666(a) (1982).

[220] Id.

[221] *American Express Co.*, 452 US at 242–245.

[222] 15 USC § 1640(a) (1982). Any violation of the Board's regulations is a violation of the act. See generally Annot., "Award of Attorney's Fees Under § 130(a) of Truth-in-Lending Act (15 U.S.C.S. § 1640(a))," 29 ALR Fed. 906 (1976); "Civil Remedies of Consumer for Violations of Truth-in-Lending Act (15 U.S.C. §§ 1601–1644, 1661–1665)," 11 ALR Fed. 815 (1972).

any finance charge involved in the transaction or, when a consumer lease is involved, 25 percent of the total amount of the monthly payments under the lease. In all cases, the penalty is confined to a range of a minimum of $100 and a maximum of $1000.[223] The statute does not give a penalty or minimum recovery when a class action is brought. The total recovery in a class action for claims based on the same failure to comply with the act by the same creditor is a maximum of $500,000 or one percent of the net worth of the creditor, whichever is less.[224]

When there are multiple failures to disclose the information required by the act to a particular consumer, that consumer has only one cause of action for damages.[225] The statutory penalty cannot be multiplied by each violation. Similarly, when one consumer credit transaction or lease involves more than one consumer who is obligated, there can be only one recovery of the statutory penalty for all of the obligors.[226]

[i] **Creditor defenses.** A creditor will have no liability when prompt action is taken to correct any error made. Under the Simplification and Reform Act of 1980, if the creditor takes action within sixty days after discovering an error and acts prior to the receipt of any written notice of the error from the obligor and before any action has been initiated against the creditor for violation of the act, the creditor will have no liability. But the creditor must give notice of the error to the person concerned and must make any adjustments needed to assure that the consumer will not be required to pay any amount in excess of the charge actually disclosed.

A creditor also has a defense to any action brought by a consumer for violation of the disclosure requirements if the creditor shows that the violation was not intentional and that it resulted from "a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error." Examples given by the Simplification and Reform Act of 1980 include clerical errors, calculation errors, computer malfunction and programming errors, and printing errors.[227] Errors in legal judgment as to the creditor's obligations under the act are not within this defense.[228]

The Truth-in-Lending Simplification and Reform Act of 1980 narrows the liability of the creditors in another fashion. The statutory penalty, which is

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[223] 15 USC § 1640(a)(2)(A)(i) (1982).

[224] 15 USC § 1640(a)(2)(B) (1982).

[225] 15 USC § 1640(g) (1982).

[226] 15 USC § 1640(d) (1982).

[227] 15 USC § 1640(c) (1982). See generally Annot., "Good Faith Defense to Truth-in-Lending Act Liability, Under § 130(f) of Act (15 U.S.C.S. § 1640(f))," 50 ALR Fed. 201 (1980); "what Constitutes Truth-in-Lending Act Violation Which 'Was Not Intentional and Resulted From Bona Fide Error' Within Meaning of § 130(c) of Act (15 U.S.C.S. § 1640(c))," 27 ALR Fed. 602 (1976).

[228] 15 USC § 1640(c) (1982).

available in individual actions involving violation of the disclosure requirements, applies only to certain disclosures: namely, annual percentage rate; amount financed; finance charge; total of payments; number, amount, and due dates of payments; and the statement describing the security interest.[229]

Good faith reliance on Federal Reserve Board regulations and interpretations is also a defense. This defense applies to both acts and omissions in reliance on the administrative rule, notwithstanding subsequent invalidation of the rule or interpretation.[230]

Consumers are not permitted to offset any amount for which a creditor might be liable under the act against amounts owing by the consumer to the creditor until the creditor's liability has been determined by judicial action.[231] Thus, the consumer cannot use the creditor's violations of the act as an excuse for nonpayment of the debt. Under the Simplification and Reform Act of 1980, the consumer is permitted to set up the violation of the creditor as a "defense or counterclaim" to an action brought by the creditor to collect the debt.[232] This is probably intended as a clarification of, not a change in, the prior law.

[ii] Liability of assignee from a creditor. Assignees of creditors who fail to comply with the provisions of truth in lending may be liable for the violations of their assignor. An action may be maintained against the assignee when the violation is "apparent on the face of the disclosure statement," except when the assignment was involuntary.[233] When an action is brought against an assignee of a creditor, the consumer's execution of a written statement acknowledging receipt of the disclosure statement is "conclusive proof" as against an assignee, who had no knowledge to the contrary at the time of acquisition of the obligation, (1) that the statement was delivered to the consumer and (2) that the creditor complied with the act[234] unless a violation is "apparent on the face of the disclosure statement."[235] A consumer who has the right to rescind a transaction, however, may do so against any assignee.[236] Prior to the Simplification and

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[229] 15 USC § 1640(a) (1982).

[230] 15 USC § 1640(f) (1982).

[231] 15 USC § 1640(h) (1982).

[232] Id. See generally Hernandez v. O'Neal Motors, 480 F. Supp. 491 (DNM 1979), rev'd in part, dism. in part, 638 F2d 153 (10th Cir. 1980); Smith v. No. 2 Galesburg Crown Fin. Corp., 615 F2d 407 (7th Cir. 1980); Teel v. Thorp Credit, 609 F2d 1268 (7th Cir. 1979); Haynes v. Logan Furniture Mart, 503 F2d 1161 (7th Cir. 1974); Ratner v. Chemical Bank N.Y. Trust, 329 F. Supp. 270 (SDNY 1971); Ray v. Acme Fin. Corp., 367 So. 2d 186 (Miss. 1979).

[233] 15 USC § 1641(a) (1982).

[234] 15 USC § 1641(b) (1982).

[235] 15 USC § 1641(a). The statute further defines when a violation is "apparent on the face of the disclosure statement." It includes, but is not limited to, statements that are incomplete and obviously inaccurate, and that fail to use correct terminology. Id.

[236] 15 USC § 1641(c) (1982).

Reform Act of 1980, in cases involving security interests in real property, the act required the consumer to establish that the assignee and the original creditor were in a "continuing business relationship." The amendments of the Simplification and Reform Act eliminated this requirement.[237]

With the change in the definition of "creditor," which eliminated an arranger of credit from the definition, it is unlikely that an assignee will come within the rules that apply to creditors. Under the act, a creditor is someone who "regularly extends . . . consumer credit" and who "is the person to whom the debt arising from the consumer credit transaction is initially payable on the face of the evidence of the indebtedness or, if there is no such evidence of indebtedness, by agreement."[238] If the transaction involves an open-end credit plan with a credit card, the previous definition is not applicable, and any card issuer or person who honors the credit card and offers a discount that is a finance charge is a creditor.[239]

[b] Administrative Enforcement. Enforcement of the act is entrusted in the case of national banks to the Comptroller of the Currency; in the case of member banks of the Federal Reserve System (other than national banks) to the Board of Governors; in the case of banks insured by the FDIC (other than the banks already mentioned) to the Board of Directors of the FDIC; in the case of institutions insured by the Federal Savings and Loan Insurance Corporation or chartered by the FHLBB to the FHLBB; and, in the case of federal credit unions, to the administrator of the National Credit Union Administration.[240] A violation of the Truth-in-Lending Act constitutes a violation of the acts giving general regulatory power to these agencies and triggers any enforcement authority available under those provisions.[241]

Under the Simplification and Reform Act of 1980, the enforcement agencies may require those who violate the act by inaccurately disclosing an annual percentage rate or finance charge to make restitution to the consumer involved. These amendments establish a range of tolerance or margin of error for which restitution will not be required unless the errors are willful. The enforcement agency does not have to order restitution in cases where the error is of a minor nature and did not result from the following:

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[237] See Rogers v. Frank Jackson Lincoln-Mercury, 458 F. Supp. 1387, 1389–1390 (ND Ga. 1978), aff'd in part, rev'd in part on other grounds, 621 F2d 130 (5th Cir. 1980); Joseph v. Norman's Health Club, Inc., 532 F2d 86, 92–93 (8th Cir. 1976); Childs v. Ford Motor Credit Co., 470 F. Supp. 708 (ND Ala. 1979); Jennings v. Edwards, 454 F. Supp. 770 (MDNC 1978), aff'd, 598 F2d 614 (4th Cir. 1979).

[238] 15 USCA § 1602(f) (West Supp. 1988).

[239] Id.

[240] 15 USC § 1607(a) (1982).

[241] 15 USC § 1607(b) (1982).

1. A clear and consistent pattern or practice of violations;
2. Gross negligence; or
3. A willful violation intended to mislead the person to whom the credit was extended.[242]

Further, the agency is not required to order restitution, but may impose such remedial action as it believes will be equitable, even in cases involving a pattern of violations or gross negligence, in certain specified types of cases, as long as the disclosure error did not result from "a willful violation which was intended to mislead the person to whom credit was extended. . . ."[243] The enforcement agency cannot order a creditor to make an adjustment that would "have significantly adverse impact upon the safety or soundness of the creditor."[244] In these cases, however, the agency may require a partial restitution or a series of adjustments over a period of time. The enforcement agency must follow the procedures for obtaining a cease and desist order to require the creditor to make restitution.[245]

[c] **Reliance on Model Forms.** Under the Simplification and Reform Act of 1980, the Board is required to publish model disclosure forms and clauses for use by creditors.[246] The creditor is not required to use these model forms, but, if such forms are used, the creditor shall be deemed to be "in compliance with the disclosure provisions" of the act other than those specific numerical disclosures depending on the particular transaction.[247] The creditor may change the format of the model form when it does not affect "the substance, clarity, or meaningful sequence of the disclosure."[248]

¶ 26.04 CONSUMER CREDIT PROTECTION ACT

In addition to the disclosure rules discussed previously, the Consumer

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[242] 15 USC §§ 1607(e)(1), 1607(2) (1982). Unlike the other provisions of the Simplification and Reform Act, these became immediately effective with enactment of the act on March 31, 1980.

[243] 15 USC § 1607(e)(2) (1982).

[244] 15 USC § 1607(e)(3) (1982).

[245] 15 USC §§ 1607(e)(3), 1607(e)(4) (1982).

[246] 15 USC § 1604(b) (1982).

[247] Id.

[248] Id. The forms could be used by creditors before the effective date of the Simplification and Reform Act amendments in 1982.

Credit Protection Act[249] regulates other consumer credit practices as well. It restricts the use of garnishment, it regulates consumer credit reports, it prohibits discrimination in the extension of credit, and it imposes standards upon debt collection. This section will briefly review these provisions.

[1] Restrictions on Garnishment

The Consumer Credit Protection Act restricts the extent to which a creditor may garnish earnings of a consumer.[250] As a general rule, creditors may garnish up to 25 percent of the consumer's weekly disposable earnings or up to the amount the consumer's weekly disposable earnings exceed thirty times the federal minimum hourly wage, whichever is less.[251] When the garnishment is undertaken as the result of a judicial order to enforce a support obligation, a greater percentage of the debtor's disposable income may be garnished.[252] Disposable earnings are defined as the balance of an individual's earnings remaining after deductions required by law have been withheld.[253] Garnishments of earnings to collect state or federal taxes are not subject to the restrictions of the act.[254] Orders of bankruptcy courts are similarly exempt.[255]

Although the act speaks in terms of garnishment of earnings, and does not specify that the garnishment must be a procedure directed at an employer, courts have held that garnishment restrictions do not apply to earnings deposited in a bank account.[256]

There is special treatment for garnishment of wages to enforce a support order of a court or an administrative agency whose procedures satisfy due process and afford an opportunity for judicial review.[257] When there is such a court or administrative order, the general limitations on wage garnishment do not apply; there are other limitations. When the garnishment is directed at the wages of an individual who is supporting a spouse or dependent child other than

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[249] 15 USC §§ 1631–1665, 1671–1677 (1982). See generally Annot., "Validity, Construction, and Application of Consumer Credit Protection Act Provisions (18 U.S.C. §§ 891–896) Prohibiting Extortionate Credit Transactions," 7 ALR Fed 950 (1971).

[250] 15 USC § 1671 (1982). See generally Annot., "Validity, Construction, and Application of §§ 301–307 of Consumer Credit Protection Act (15 U.S.C. §§ 1671–1677) Placing Restrictions on Garnishment of Individual's Earnings," 14 ALR Fed. 447 (1973).

[251] 15 USC § 1673 (1982).

[252] 15 USC § 1673(b) (1982).

[253] 15 USC § 1672(b) (1982).

[254] 15 USC § 1673(b)(1) (1982).

[255] Id.

[256] Usery v. First Nat'l Bank, 586 F2d 107, 110 (9th Cir. 1978); Dunlop v. First Nat'l Bank, 399 F. Supp. 855, 856 (DC Ariz. 1975); John O. Melby & Co. Bank v. Anderson, 88 Wis. 2d 254, 257, 276 NW2d 274, 277 (1979).

[257] 15 USC §§ 1673(b)(1)(A), 1673(b)(2) (1982).

the spouse or child for which the support order was entered, the garnishment is limited to 50 percent of the individual's disposable earnings for the week.[258] When the garnishment is of the wages of one who is not supporting a spouse or other dependent child, the garnishment is limited to 60 percent of the individual's disposable earnings for that week.[259] The act prohibits execution or enforcement by any court, court officer, or agency of any order or process that violates the provisions of the Act.[260] The act does not disturb state laws that are more restrictive than the act in limiting the extent to which garnishment is allowed and in prohibiting employers from discharging employees for garnishments for more than one indebtedness.[261]

The act also prohibits any employer from discharging an employee because his or her earnings have been subjected to garnishment for any *one* indebtedness.[262] Employer violations of this provision can result in a fine of up to $1,000 or imprisonment for up to one year, or both.[263] There are no private remedies under the act for violation of these restrictions on garnishment.[264] The Secretary of Labor has authority to enforce these provisions of the act.[265]

[2] Debt Collection Practices

Congress enacted the Debt Collection Practices Act in 1977 to control abusive, deceptive, and unfair debt collection procedures used by many debt collectors. This act is a subchapter of the Consumer Credit Protection Act.[266] It applies to procedures used by debt collectors in collecting debts in consumer credit transactions.

The act has little application to banks or financial institutions because its provisions do not apply to creditors who act to collect debts owed to them.[267] The

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[258] 15 USC § 1673(b)(2)(A) (1982). This 50 percent limit increases to 55 percent when the support order relates to a period of time more than twelve weeks earlier. Id. § 1673(b)(2) (1982).

[259] 15 USC § 1673(b)(2)(B)(1982). This limit increases to 65 percent when the garnishment action is to enforce a support order relating to a period of time more than twelve weeks earlier. Id. § 1673(b)(2) (1982).

[260] 15 USC § 1673(c) (1982).

[261] 15 USC § 1677 (1982).

[262] 15 USC § 1674(a) (1982).

[263] 15 USC § 1674(b) (1982).

[264] LeVick v. Skaggs Co., 701 F2d 777, 779 (9th Cir. 1983), overruling Stewart v. Traveler's Corp., 503 F2d 108 (9th Cir. 1974); McCabe v. City of Eureka, 500 F. Supp. 59, 60–61 (ED Mo. 1980), aff'd, 664 F2d 680 (8th Cir. 1981).

[265] 15 USC § 1676 (1982).

[266] 15 USC §§ 1692–1692o (1982).

[267] 15 USC § 1692a(4) (1982). See generally Annot., "What Constitutes 'Debt' and 'Debt Collector' for Purposes of Fair Debt Collection Practices Act (15 U.S.C. § 1692(5)(6)." 62 ALR Fed. 544 (1983).

act controls "debt collectors." A debt collector is someone who regularly collects debts due to another person or who is engaged in a business whose principal purpose is to collect debts.[268] A creditor is not within these definitions.[269] The definition does not apply even when the creditor acquires a debt by assignment from another person, as long as the assignment is not after the debt is in default and is not solely for the purpose of collecting the debt for another.[270]

Debt collectors to whom the act applies are restricted in their communications with third parties about the consumer's debt.[271] Their communications with the debtor must be at a reasonable time and place and, when the consumer is represented by an attorney, with the attorney rather than the debtor.[272] Upon receipt of a written notice from the consumer, the debt collector must stop any further communication with the consumer, except to give notice of the pursuit of a specific creditor's remedy.[273] The act prohibits harassing or abusive tactics, false or deceptive representations, and unfair or unconscionable means of collecting the debt.[274] The provisions of the act are generally enforced by the FTC,

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[268] 15 USC § 1692a(6) (1982). An early version of the act excluded attorneys who are collecting debts on behalf of a client from the definition of "debt collector." Amendments in 1986 deleted the attorney exception. 15 USC § 1692a, as amended by Pub. L. No. 99-361, 100 Stat. 768 (1986). To bring a lawyer within the definition of "debt collector," the "principal purpose" or "regular collection" tests previously referred to would have to be satisfied.

[269] When a creditor uses someone else's name so that it appears that a third person is acting as a debt collector, the creditor is subject to the act, even though the creditor is acting to collect his own debts. 15 USC § 1692a(6) (1982).

[270] 15 USC § 1692a(4) (1982). See Kizer v. Finance Am. Credit Corp., 454 F. Supp. 937, 939 (DC Miss. 1978).

[271] 15 USC § 1692b (1982).

[272] 15 USC § 1692c (1982).

[273] Id.

[274] 15 USC §§ 1692d, 1692e, 1692f (1982). A debtor has standing to complain of violations of the Fair Debt Collection Practices Act, although the debtor does not contest the validity of the debt. Baker v. G.C. Serv. Corp., 677 F2d 775, 777 (9th Cir. 1982). The *Baker* court further held that the creditor must give the debtor notice that the debtor may dispute the validity of the debt. A request for verification of the debt does not satisfy this requirement. Also, the prohibition of the act against deceptive practices applied to language in the collection agency's letter that implied that the agency might take legal action to collect the debt when the agency in fact had a policy of not pursuing legal action. The act gives debt collectors a defense for bona fide errors, like that in the Truth-in-Lending Act, but the court held that this was intended to apply to unintentional clerical errors, as in the Truth-in-Lending Act, not to mistakes of law, even if in good faith and in reliance on advice of counsel. Finally, the court held that the complainant could recover statutory damages and attorney fees although no actual damages had been established. 677 F2d at 778–780.

except that the banking regulatory agencies have jurisdiction over the depository institutions subject to their authority.[275]

[3] Credit Reporting

The Federal Fair Credit Reporting Act[276] regulates the activities of consumer reporting agencies and users of credit reports prepared by these agencies. A consumer reporting agency is any person who, for a fee, or on a cooperative nonprofit basis, "regularly engages" in the practice of assembling or evaluating consumer credit information for the purpose of furnishing consumer reports to third parties.[277] The definition, thus, does not include someone who assembles information for the person's own purposes. There must be dissemination of the information to third parties.

A consumer report is any written, oral, or other communication by a consumer reporting agency about a consumer's creditworthiness, character, general reputation, and so forth, that is to be used in establishing the consumer's eligibility for consumer credit, insurance, or employment, or for certain other limited purposes.[278] Reporting on one's own transactions with the consumer is

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[275] 15 USC § 1692*l* (1982). See generally Annot., "Validity, Construction, and Application of State Statutes Prohibiting Abusive or Coercive Debt Collection Practices," 87 ALR3d 786 (1978); Annot., "Recovery of Debtor, Under Tort of Intentional or Reckless Infliction of Emotional Distress, for Damages Resulting From Debt Collection Methods," 87 ALR3d 201 (1978).

[276] 15 USC § 1681–1681t (1982). See generally Note, "Fair Credit Reporting: Are Misleading Reports Reasonable?" 55 NYU L. Rev. 111 (1980); Annot., "Construction and Application of Fair Credit Reporting Act (15 USC § 1681 et. seq.)," 17 ALR Fed. 675 (1973).

[277] 15 USC § 1681a(f) (1982).

[278] 15 USC § 1681a(d) (1982). A firm that provides a check guarantee service to merchants, which service contains a code that identifies persons who have given bad checks, is a company that issues "consumer reports" under the act. Failure to follow reasonable procedures to assure maximum possible accuracy of information constitutes a violation. Alexander v. Moore & Assoc. Inc., 553 F. Supp. 948, 951–952 (D. Haw. 1982). In Kiblen v. Pickle, 33 Wash. App. 387, 388, 392, 653 P2d 1338, 1339, 1343 (1982), the court held that a report from a detective agency investigating an insurance claim under a disability policy was not a consumer report within the meaning of 15 USC § 1681a(d), because that section applies only to reports used in establishing eligibility for insurance. Subsequent use of the report to deny benefits to the claimant or to cancel or fail to renew the policy could bring the report within the language of the section, but the court did not reach this issue in the case, because it found substantial compliance with the act. A report requested by an insurance company on a person who had sued its insured is not a consumer report, although it was prepared by a consumer reporting agency using information originally gathered for credit purposes, because there was no "consumer relationship . . . between the party requesting the report and the subject of the report." The purpose of the report was not within those enumerated in the definition of an investigative consumer report. Houghton v. New Jersey Mfrs. Ins. Co., 795 F2d 1144, 1148–1149 (3d Cir. 1986).

not a consumer report under the act.[279] Also, authorization of the extension of credit through the use of a credit card is not treated as a consumer report.[280] Transactions in which a third party makes a request for an extension of credit to a consumer also are not covered, as long as the third party advises the consumer of the person to whom the request for the extension of credit was made and the third party makes the required disclosures.[281] The act distinguishes between a consumer report and an "investigative consumer report."[282] The latter is a report or a portion of a report "in which information on a consumer's character, general reputation, personal characteristics, or mode of living is obtained through personal interviews with neighbors, friends, or associates of the consumer. . ." or others who may have knowledge about such matters relating to the consumer.[283]

Consumer reporting agencies are limited in the circumstances in which they may issue a consumer report.[284] The permitted purposes include those approved in writing by the consumer, as well as any submissions to persons whom the reporting agency "has reason to believe" intend to use the information in connection with a credit transaction involving the consumer.[285] It is also proper to furnish a consumer report to those whom the reporting agency "has reason to believe" will use the information for employment purposes or in connection with underwriting insurance for consumers or in determining the eligibility of the consumer for a license or other benefit granted by a governmental agency in cases where the law requires consideration of the applicant's financial responsibility or status.[286] There is also a broad general category that permits a reporting agency to supply a report to one who "otherwise has a legitimate business need for the information in connection with a business transaction involving the consumer."[287] The reporting agency is under an obligation to eliminate obsolete information from its report.[288] The agency must, upon request of the consumer, disclose to the consumer the nature of information in its files, the sources of the

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In Kates v. Crocker Nat'l Bank, 776 F2d 1396, 1397–1398 (9th Cir. 1985), a consumer debtor had no right to obtain disclosure of a credit investigation requested by the creditor bank when the investigation was not conducted after the consumer paid his account.

[279] 15 USC § 1681a(d) (1982).

[280] Id.

[281] Id.

[282] 15 USC §§ 1681a(d), 1681a(e) (1982).

[283] 15 USC § 1681a(e) (1982).

[284] 15 USC § 1681b (1982).

[285] Id.

[286] 15 USC § 1681b(3) (1982).

[287] 15 USC § 1681b(3)(E) (1982).

[288] 15 USC § 1681c (1982).

information (except for certain investigative reports), and the recipients of any reports made by the agency.[289]

The act provides a procedure for resolving disputes between the agency and the consumer as to the accuracy of any information in the file.[290] When the dispute cannot be resolved, the consumer is entitled to file a brief statement setting forth the nature of the dispute. The statement must, in turn, be transmitted to all persons who subsequently receive a consumer report containing the disputed information.[291] The consumer reporting agency also is limited in the extent to which it may disclose adverse information contained in investigative reports regarding a consumer's character or general reputation in subsequent reports.[292] The information can only be used in a subsequent consumer report if either the subsequent report is made within three months of obtaining the adverse information or the reporting agency again verifies the information.[293] These restrictions do not apply to information that is a matter of public record.[294]

A credit reporting agency that transmits inaccurate information may be liable for damages under the Fair Credit Reporting Act, even if the information it transmits was supplied by creditors and the agency accurately reported the information supplied to it. At issue is the interpretation of Section 607(b) of the Fair Credit Reporting Act.[295] That statute requires a consumer reporting agency to do more than simply report information supplied by creditors. It provides that "[w]henever a consumer reporting agency prepares a consumer report it shall follow reasonable procedures to assure maximum possible accuracy of the information concerning the individual about whom the report relates."[296] Although liability under this statute is not automatic when inaccurate information is transmitted, there is liability when the credit reporting agency fails to (1) follow reasonable procedures and (2) assure maximum possible accuracy of

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[289] 15 USC § 1681g (1982).

[290] 15 USC § 1681i (1982).

[291] 15 USC § 1681i(c) (1982). Under the statute, a consumer reporting agency has a duty to reinvestigate facts in a consumer's credit file when they are disputed by the consumer. 15 USC § 1681i(a). In Dynes v. TRW Credit Data, 652 F2d 35, 36 (9th Cir. 1981), the court held that this duty to reinvestigate continued if the credit reporting agency's reinvestigation produced a report that also contained inaccurate information disputed by the consumer.

[292] 15 USC § 1681*l* (1982).

[293] Id.

[294] Id.

[295] 15 USC § 1681e(b) (1982).

[296] Id.

the information concerning the individual about whom the information relates.[297]

Section 607(b) of the Fair Credit Reporting Act also was at issue in *Equifax Inc. v. FTC*.[298] This was an action by the FTC to enforce the act administratively. The FTC claimed Equifax was following procedures that placed pressure on its field offices to increase the production of adverse information about consumers, thus creating an unreasonable risk that false information would be generated. The FTC argued that unlike private actions to enforce the section, when the FTC brought an enforcement proceeding, it should not be necessary to establish specific examples of inaccurate information as long as the company procedures created an unreasonable risk. The court set aside the FTC's administrative order. The FTC was required "to ascertain whether the procedures followed by the agency pose an unreasonable risk of producing error."[299] As the court found that there was no unreasonable risk of error in the company procedures, it did not have to reach the question posed by the FTC as to whether the FTC must show "that the risk of error manifested itself in concrete instances of detriment to the credit consumer."[300]

Users of consumer reports also are subject to regulation by the act. A person cannot arrange for the preparation of an investigative report on a consumer's general reputation and character unless it is clearly disclosed to the consumer that such a report may be made, and unless the consumer is informed of his or her right to request information on the nature of the investigation.[301] The only exception to the duty to make such disclosure is when the purpose of the report is related to employment for which the consumer has not specifically applied.[302] When the consumer is denied credit or the charge for such credit is increased because of information contained in a consumer report from a consumer reporting agency, the creditor who has used the report must advise the consumer of this fact, and must give the name and address of the consumer reporting agency to the consumer.[303] Moreover, when credit is denied or the charges for such credit

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[297] Bryant v. TRW, Inc., 689 F2d 72, 78 (6th Cir. 1982). See also Thompson v. San Antonio Retail Merchants Ass'n, 682 F2d 509, 513 (5th Cir. 1982) (consumer recovered damages of $10,000 for humiliation and mental distress against a credit reporting agency that failed to program its computer to protect against excessive error and that did not have procedures to detect error).

[298] 678 F2d 1047, 1050–1051 (11th Cir. 1982).

[299] Id. at 1052.

[300] Id.

[301] 15 USC § 1681d(a) (1982).

[302] Id.

[303] 15 USC § 1681m (1982). The duty to disclose information about the consumer credit report exists even when the denial of credit is not based upon adverse information in the report but is taken because of insufficient evidence of financial capacity to handle the credit. Fischl v. General Motors Acceptance Corp., 708 F2d 143, 150 (5th Cir. 1983). The *Fischl* court left open the question whether oral disclosure to the consumer would

are increased because of information on a consumer's credit or general reputation that is obtained from a person other than a consumer reporting agency, the creditor must disclose the nature of the information to the consumer upon the consumer's written request.[304] The right of the consumer to make such a request must be disclosed to the consumer at the time that the adverse action is communicated to the consumer.[305]

There are civil penalties under the act for failing to comply with its provisions. When the noncompliance is willful, any consumer reporting agency or user of information may be liable to the consumer in an amount equal to any actual damages sustained, plus punitive damages and costs, including attorney fees.[306] The act establishes criminal penalties for officers and employees of consumer reporting agencies who "knowingly and willfully" give information from the agency's files to unauthorized persons.[307] It also imposes criminal penalties on those who "knowingly and willfully" obtain information about a consumer from a consumer reporting agency under false pretenses.[308]

The FTC has general authority to enforce the provisions of the act.[309] The enforcement authority over depository institutions is entrusted to the federal regulatory agencies who have general jurisdiction over them.[310]

¶ 26.05 OTHER CONSUMER CREDIT-RELATED LAWS

[1] Unfair or Deceptive Practices—Federal Trade Commission Improvement Act

The Federal Trade Commission Improvement Act[311] requires the Federal Reserve Board to prescribe regulations to prevent banks from engaging in unfair

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satisfy the statutory requirements. The *Fischl* court also held that the consumer could recover damages, although the consumer succeeded in locating on his own a copy of the consumer credit report within a brief time after learning of the adverse action.

[304] 15 USC § 1681m(b) (1982).

[305] Id.

[306] 15 USC § 1681n (1982). The statute of limitations for bringing actions under the act may be tolled when there is a material and willful misrepresentation of information. In Houghton v. Ins. Crime Prevention Inst., 795 F2d 322 (3d Cir. 1986), the tolling provision did not apply, because the information alleged to have been willfully and fraudulently given to a credit bureau was not information covered by the disclosure requirements of the act.

[307] 15 USC § 1681r (1982).

[308] 15 USC § 1681q (1982).

[309] 15 USC § 1681s (1982).

[310] Id.

[311] Federal Trade Commission Improvement Act of 1975 § 202(a), 15 USC § 57a (1982).

or deceptive practices that affect commerce, including those which are unfair or deceptive to consumers. It provides that whenever the FTC prescribes rules under the parent act, the Federal Reserve Board must, within sixty days after the rules come into effect, adopt substantially similar rules unless it finds that such acts or practices by banks are not unfair or deceptive, or that implementation of similar regulations would conflict with the monetary policies of the Board.

The implementation of the regulations regarding banks insured by the FDIC is left to the appropriate federal supervisory agency. The law requires that each such agency establish a separate division of consumer affairs responsible for receiving and taking appropriate action and complaints. Savings and loan associations, credit unions, and other thrift institutions also are subject to FTC rules.

The FTC has adopted rules defining unfair and deceptive practices of creditors.[312] The FTC rules do not apply to banks, but the Board of Governors of the Federal Reserve System has adopted regulations that are similar to the FTC rules.[313] The rules prohibit the use of consumer credit contracts that contain confession of judgment clauses, waivers of exemptions, assignment of future wages, and repossession of household goods beyond those for which the creditor extended credit. The rules require specific disclosures to cosigners of consumer credit obligations of the nature of the liability of a cosigner has.[314] It is an unfair act or practice under the rules for a bank to levy a late charge on a payment when the only reason for the charge is that a late fee was charged for an earlier payment and the current installment payment is timely and is otherwise a full payment.[315]

[2] Plain English Laws

Mass-market legal transactions (consumer loans, credit sales, and the like) require preprinted, unnegotiated contract forms. But consumers can no more expect contract terms adapted to fit their particular requirements than they can expect to have their appliances custom-made. Realizing that standard forms, normally drafted by creditors or sellers, will not necessarily be understood by the consumer-debtor, many states have enacted consumer-protection laws giving the courts the power to enjoin the use of agreements that are deceptive or that breach standards of fair dealing. Even without such statutes, courts have regularly used their inherent equity powers to strike down boilerplate clauses, hang-

[312] 16 CFR pt. 444 (1988).

[313] 12 CFR pt. 227 (1988). The FHLBB has adopted similar rules for savings and loan associations. 12 CFR pt. 535 (1988). The U.S. Court of Appeals for the District of Columbia has upheld the Consumer Credit Practice Rule adopted by the FTC in American Fin. Servs. Ass'n v. FTC, 247 App. DC 167, 201, 767 F2d 957, 991 (DC Cir. 1985), cert. denied, 475 US 1011 (1986).

[314] 12 CFR § 227.14 (1988).

[315] 12 CFR § 227.15 (1988).

ing their opinions on such legal pegs as absence of consent, fraud, unconscionability, or some similar doctrine.

The modern approach to the standards for conscionability in consumer contracts is reflected in § 5.108 of the UCCC (1974). That section gives a court, as a matter of law, the right to enjoin unconscionable conduct and to award damages that may have been sustained. In determining whether conduct is in fact unconscionable, the UCCC sets up a series of standards, one of which is "inability to understand the language of the agreement." Lawyers should take this language seriously in drafting consumer agreements.

This handbook cannot canvass all the state laws applicable to the drafting of consumer contracts; however, the following example may help to illustrate the development of the law in this area. New York State enacted a law that went into effect on June 2, 1978 requiring the basic consumer contracts be in easily understandable language.[316] The statute covers residential leases and contracts for money, property, or services used primarily for "personal, family, or household purposes." These must be

1. Written in non-technical language and in a clear and coherent manner using words with common and everyday meanings;
2. Appropriately divided into and captioned by its various sections.

Connecticut also has enacted a "plain-English" law.[317] Other states have such legislation under consideration.[318]

¶ 26.06 CREDIT DISCRIMINATION AND THE EQUAL CREDIT OPPORTUNITY ACT[319]

[1] Scope of the Act

The ECOA[320] makes it unlawful for any creditor to discriminate against any applicant with respect to any aspect of a credit transaction on the basis of race,

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[316] N.Y. Gen. Oblig. Law § 5-702(b) (1978). See Note, "New York's Plain English Law," 8 Fordham Urb. LJ 451 (1979–1980). See generally Annot., "What Constitutes 'Fraudulent' or 'Unconscionable' Agreement or Conduct Within Meaning of State Consumer Credit Protection Act," 42 ALR4th 293 (1985).

[317] Conn. Gen. Stat. Ann. § 36-393a (West 1987).

[318] See Siegel, "Simplicity: An Old Solution With Continuing Appeal," Nat'l LJ, Sept. 25, 1978. See also Blumberg, "Lawyers Can Write Clearly and Coherently," 51 NYS BJ 478 (1979); Plack, "Plain Language Movement: An Overview With Recent Developments," 36 Mo. BJ 40 (1980).

[319] The principal author of ¶ 26.06 on the Equal Credit Opportunity Act is Cherry Lee Croushore.

[320] 15 USC §§ 1691–1691f (1982 & Supp. IV 1986).

color, religion, national origin, sex, marital status, or age.[321] The ECOA also makes it unlawful to discriminate because all or part of the applicant's income derives from any public assistance program or because the applicant has in good faith exercised any right afforded under the Consumer Credit Protection Act.[322]

The prohibitions in ECOA against discrimination in credit transactions are not limited to *consumer* credit transactions. To some extent, these regulations treat business credit transactions differently from consumer credit transactions.[323] However, the basic directive against discrimination applies regardless of whether the transaction is a commercial or consumer one. The act prohibits *creditors* from engaging in the prohibited discriminatory conduct. A creditor, under the definitions in the act, is any "person who regularly extends, renews, or continues credit; any person who regularly arranges for the extension, renewal, or continuation of credit; or any assignee of an original creditor who participates in the decision to extend, renew, or continue credit."[324] The scope of the act is, thus, considerably broader than the credit transactions subject to the Truth-in-Lending Act and Regulation Z.[325]

Any deferral of a debt is a credit transaction within the act if it is granted by a creditor.[326] As a result, the act treats certain transactions as those involving credit, although there is no finance charge or installment payment plan. The Board classifies these transactions as "incidental credit" transactions and excepts such credit from some of the procedural requirements specified in the Board's Regulation B.[327] Examples of incidental credit are transactions in which

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[321] 15 USC § 1691(a)(1) (1982). See generally Anderson & Malliard, "Women's Banks and Women's Access to Credit: Competition Between Marketplace and Regulatory Solutions to Gender Discrimination," 20 Loy. LAL Rev. 771 (1987); Blakely, "Credit Opportunity for Women: The ECOA and Its Effects," 1981 Wis. L. Rev. 665; Matheson, "The Equal Credit Opportunity Act: A Functional Failure," 21 Harv. J. Legis. 371 (1984); Schafer, "A Program for Compliance With the Equal Credit Opportunity Laws," 99 Banking LJ 422 (1982). See also Annot., "Discrimination Against Credit Applicant on Basis of Marital Status Under Equal Credit Opportunity Act (15 USCS §§ 1691 et. seq.)," 55 ALR Fed. 458 (1981).

[322] 15 USC §§ 1691(a)(2), 1691(a)(3) (1982).

[323] See 12 CFR § 202.3(d)(2) (1988), providing that the parts of the regulation dealing with information about marital status and certain parts dealing with furnishing credit information do not apply to business credit.

[324] 15 USC § 1691a(e) (1982). Under ECOA, a person is not only a natural person but also a corporation, governmental agency, trust, or other organization. Id. § 1691a(f).

[325] Official Staff Interpretations § 202.1(a), 12 CFR pt. 202 (Supp. I, 1988). The Truth-in-Lending Act and Regulation Z are discussed supra ¶ 26.03.

[326] 15 USC § 1691a(d) (1982). See Official Staff Interpretations § 202.1(a), 12 CFR pt. 202 (Supp. I 1988).

[327] 12 CFR § 202.3(c) (1988); Official Staff Interpretations § 202.3(c), 12 CFR pt. 202 (Supp. I 1988).

a service provider, "such as a hospital, doctor, lawyer or retailer . . . allows the client or customer to defer the payment of a bill. . . ."[328]

Credit transactions within the act, according to the Board's regulations, include "every aspect of an applicant's dealings with a creditor regarding an application for credit or an existing extension of credit. . . ."[329] Consistent with this broad scope, the regulations establish standards for taking credit applications, evaluating applicants for credit, extending or modifying the terms of credit previously granted, giving notice of action taken on credit applications, furnishing credit information to others, and retaining information on credit transactions.

The Federal Reserve Board takes the position that ECOA does not extend to leasing transactions that are not "credit sales." The U.S. Court of Appeals for the Ninth Circuit does not agree with the Board's view, and has held that ECOA does apply to leasing transactions and that it forbids discrimination on the basis of sex or marital status in such transactions.[330]

The purpose of the ECOA is to promote the availability of credit to all creditworthy applicants. The essential concept of nondiscrimination in the extension of credit is that each individual who applies for credit has a right to be evaluated on his or her individual creditworthiness. An evaluation of an individual's creditworthiness must be based on the individual's ability and willingness to repay an extension of credit and not on some generalization or stereotype about persons who are similarly situated with regard to race, color, national origin, religion, age, sex, or marital status.

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[328] Id.

[329] 12 CFR § 202.2(m) (1988). The regulation goes on to give as examples "information requirements; investigation procedures; standards of creditworthiness; terms of credit; furnishing of credit information; revocation, alteration, or termination of credit; and collection procedures." Id.

[330] Brothers v. First Leasing, 724 F2d 789, 793 (9th Cir.), cert denied, 469 US 832 (1984). The Federal Reserve Board stated when it revised Regulation B in 1985 that it believed that "Congress did not intend the ECOA, which on its face applies only to credit transactions, to cover lease transactions unless the transaction results in a 'credit sale' as defined in the Truth in Lending Act and Regulation Z." 50 Fed. Reg. 48,020 (1985). The Board "has not applied Regulation B to leasing," because it believes that the *Brothers* decision, by defining "credit" too broadly, is contrary to the intent of Congress, and because it believes that "there is little evidence of discrimination of lessors based on the personal characteristics of lessees" (as there was with credit transactions when Congress enacted the ECOA), while there is evidence that application of the Board's regulation "could impose significant burdens for certain segments of the industry. . . ." 50 Fed. Reg. 48,020 (Nov. 20, 1985). The Board identified furniture and appliance leasing as areas that would likely be burdened and suggested that there was no need in other areas where lessors, such as financial institutions engaged in automobile leasing, are already complying with Regulation B. The Board will enforce the *Brothers* decision in the Ninth Circuit and will monitor its results. 50 Fed. Reg. 48,019–48,020.

The ECOA authorizes the Board of Governors of the Federal Reserve System to promulgate regulations to carry out these purposes.[331] The Board in its Regulation B has adopted rules to effectuate the unbiased extension of credit to all creditworthy applicants.[332] Although too extensive to be set out in detail here, the regulations prohibit discrimination on any of the grounds proscribed by the statute and establish rules on extending credit, taking applications, and evaluating applications. The regulations except certain classes of transactions, create enforcement procedures and penalties, and provide detailed requirements for notice.[333] The Board has model application and notification forms, the use of which deems a creditor in compliance with provisions of Regulation B.[334]

The act gives the FTC general responsibility for enforcement of ECOA and related Federal Reserve Board regulations.[335] In the case of banks, the traditional banking regulatory agencies have the enforcement power.[336] When the agency with enforcement authority is unable to obtain compliance with a requirement of ECOA, the FTC is "authorized to refer the matter to the Attorney General with a recommendation that an appropriate civil action be instituted."[337] The Attorney General is then empowered to "bring a civil action in any appropriate United States district court for such relief as may be appropriate, including

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[331] 15 USC § 1691b(a) (1982).

[332] See 12 CFR § 202.1(b) (1988) (Regulation B).

[333] Id. Regulation B was extensively rewritten and revised in 1985, but the revised regulation contained few major substantive changes. For a good discussion of the substantive changes see Schellie, "Equal Credit Opportunity," 41 Bus. Law. 1029 (1986). To compare the texts of the current Regulation B and the old Regulation B (prior to 1985 revision), see G. Azzata, Equal Credit Opportunity Act (1986 Cumulative Supp.) (Apps. I, J, respectively).

[334] See 12 CFR pt. 202, apps. B, C (1987) (Regulation B).

[335] 15 USC § 1691c(c) (1982). The FTC's enforcement authority is limited to the extent that enforcement of the requirements of ECOA are specifically committed to another regulatory agency. See 15 USC § 1691c(a) (1982 & Supp. IV 1986). See also 12 CFR § 202.14 (1988) (Regulation B). A violation of ECOA is also deemed a violation of the Federal Trade Commission Act. 15 USC § 1691c(c) (1982). The Federal Trade Commission Act is at 15 USC §§ 41–77 (1982 & Supp. IV 1986).

[336] The comptroller has authority for enforcement with respect to national banks, the Federal Reserve Board for member banks other than national banks, and the FDIC for FDIC-insured banks other than member banks. 15 USC § 1691c(a)(1) (1982). The FHLBB, the FSLIC, and the administrator of the National Credit Union Administration have enforcement powers over the depository institutions they regulate. 15 USC §§ 1691c(a)(2), 1691c(a)(3) (1982). Similar delegations of power are made to the Farm Credit Administration, the Securities and Exchange Commission, and some other regulatory agencies. 15 USC § 1691c(a) (1982 & Supp. IV 1986).

[337] 15 USC § 1691e(g) (1982).

injunctive relief."[338] The scope of the civil liability imposed by ECOA is discussed later in this chapter.[339]

[2] What Constitutes Discrimination Under ECOA

As noted earlier, although ECOA makes it unlawful for any creditor to discriminate against any applicant with respect to any aspect of a credit transaction on the basis of race, color, religion, national origin, sex, age, marital status, or other prohibited basis,[340] the act does not define "discrimination." It simply makes it unlawful for a creditor "to discriminate" on any prohibited basis in the act.[341] The Board's regulations take the view that Congress intended "an effects test" to apply in determining whether a creditor's evaluation of creditworthiness violated the act.[342] The Board also takes the view, in its Official Staff Interpretations, that "prohibited basis" not only refers to the status of credit applicants but also to "the characteristics of individuals with whom an applicant is affiliated or with whom the applicant associates."[343] The staff interpretation states that

> a creditor may not discriminate against an applicant because of that person's personal or business dealings with members of a certain religion, because of the national origin of any persons associated with the extension of credit (such as the tenants in the apartment complex being financed), or

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[338] 15 USC § 1691e(h) (1982). See United States v. ITT Consumer Fin. Corp., 816 F2d 487, 489 (9th Cir. 1987); United States v. Landmark Fin. Servs., 612 F. Supp. 623, 626 (D. Md. 1985). See also United States v. Meadors, 753 F2d 590 (7th Cir. 1985); United States v. American Future Sys., Inc., 743 F2d 169 (3d Cir. 1984). See generally Ilgenfritz, "The Failure of Private Actions as an ECOA Enforcement Tool: A Call For Active Government Enforcement and Statutory Reform," 36 U. Fla. L. Rev. 447 (1984).

[339] See infra ¶ 26.06[6].

[340] See 15 USC § 1691(a) (1982); 12 CFR § 202.4 (1988) (Regulation B).

[341] See 15 USC § 1691(a) (1982).

[342] 12 CFR § 202.6 n.2 (1988). The Board relies on the legislative history of the act. Id. The Official Staff Interpretations state:

> The Act and regulation may prohibit a creditor practice that is discriminatory in effect because it has a disproportionately negative impact on a prohibited basis, even though the creditor has no intent to discriminate and the practice appears neutral on its face, unless the creditor practice meets a legitimate business need that cannot reasonably be achieved as well by means that are less disparate in their impact. For example, requiring that applicants have incomes in excess of a certain amount to qualify for an overdraft line of credit could mean that women and minority applicants will be rejected at a higher rate than men and nonminority applicants. If there is a demonstrable relationship between the income requirement and creditworthiness for the level of credit involved, however, use of the income standard would likely be permissible."

Official Staff Interpretations § 202.6(a)(2), 12 CFR pt. 202 (Supp. I 1988). See generally Baer, "The Equal Opportunity Act and the 'Effects Test'," 95 Banking LJ 241 (1978).

[343] Official Staff Interpretations § 202.2(z)(1), 12 CFR pt. 202 (Supp. I 1988).

because of the race of other residents in the neighborhood where the property offered as collateral is located.[344]

Credit practices that are discriminatory take many and varied forms. Some violations are obvious. The denial of credit or the offering of credit on less favorable terms solely because the applicant is a minority applicant, is elderly, or is female is an example of obvious discrimination.

Determining what amounts to prohibited discrimination poses different issues, depending on whether the prohibited basis of the discrimination is race, sex, marital status, age, or one of the other prohibited grounds. There are extensive rules that deal with when a creditor may consider the possible interests of a spouse in property owned by a married applicant without violating the prohibition against discrimination on the basis of marital status. These rules are discussed later in this chapter.

There are equally thorny problems with regard to age discrimination. There are two ways in which a creditor may evaluate a credit application. When the creditor uses "an empirically derived, demonstrably and statistically sound, credit scoring system,"[345] the applicant's age may be a predictive variable as long as the age of someone who is elderly (62 or older) is not given a negative value.[346] In a judgmental system of credit evaluation, "a creditor may not take age directly into account in any aspect of the credit transaction."[347] However, the creditor may consider, according to the Board's staff, the "applicant's occupation and length of time to retirement to ascertain whether the applicant's income (including retirement income) will support the extension of credit to its maturity."[348]

Likewise, it is impermissible to discriminate on the basis that the applicant receives public assistance, but the creditor may take into account "the length of time an applicant will likely remain eligible to receive such income. . ." and

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[344] Id.

[345] The Board's regulations specify the requirements for such a system. See 12 CFR § 202.2(p) (1988). See also Taylor, "Meeting the Equal Credit Opportunity Act's Specificity Requirement: Judgmental and Statistical Scoring Systems," 29 Buffalo L. Rev. 73 (1980).

[346] 12 CFR § 202.6(b)(2) (1988).

[347] Official Staff Interpretations § 202.6(b)(2), 12 CFR pt. 202 (Supp. I 1988). This Official Staff Interpretation is slightly different from the language of the regulation, which states that in a judgmental system, the creditor "may consider an applicant's age. . .only for the purpose of determining a pertinent element of creditworthiness." 12 CFR § 202.6(b)(2)(iii) (1988). The staff interpretation concludes that this only permits relating the applicant's age to other information considered in determining creditworthiness, such as the sources and continuation of the applicant's income. Official Staff Interpretations § 202.6(b)(2), 12 CFR pt. 202 (Supp. I 1988).

[348] Official Staff Interpretations § 202.6(b)(2), 12 CFR 202 (Supp. I 1988).

whether the creditor can "attach or garnish the income" in case of default.[349] The ECOA specifically prohibits discrimination based on national origin, but one case has held that a private lender may discriminate on the basis of alienage without violating ECOA.[350] In this case, Bhandari, a citizen of India and lawful permanent resident of the United States, applied to First National Bank for a credit card. First National denied the application based on Bhandari's alienage and short employment history at his then current job. Bhandari received a letter from First National stating only that his credit application had been denied because he was not a U.S. citizen. Bhandari then brought action against First National alleging civil rights violations[351] and violations of ECOA arising from the bank's denial of his credit card application. The court found no factual basis for Bhandari's claim that he was discriminated against on the basis of his national origin,[352] but did find that First National had discriminated against him on the basis of his alienage. The court went on to hold that although discrimination on the basis of national origin is violative of ECOA, ECOA does not prohibit discrimination against credit applicants on the basis of alienage.[353]

ECOA details activities that do not constitute discrimination. For example, ECOA provides that it is not discrimination for a creditor to engage in the following:

> (1) To make an inquiry of marital status if such inquiry is for the purpose of ascertaining the creditor's rights and remedies applicable to the particular extension of credit and not to discriminate in a determination of creditworthiness; (2) to make an inquiry of the applicant's age or of whether the

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[349] Id.

[350] Bhandari v. First Nat'l Bank, 808 F2d 1082, 1100–1101, reh'g granted on other grounds, 812 F2d 936 (5th Cir. 1987).

[351] For analysis of the civil rights violations, see id. at 1085–1100. On rehearing of the alleged civil rights violations, the court found that 42 USC § 1981 did not prohibit alienage discrimination by private persons, even though the U.S. Supreme Court had held that the statute forbade racial discrimination by private persons. Bhandari v. First Nat'l Bank, 829 F2d 1343, 1351–1352 (5th Cir. 1987). See Runyan v. McCrary, 427 US 160, 172 (1976).

[352] *Bhandari*, 808 F2d at 1101. Bhandari could have shown national origin discrimination in two ways—that the bank actually discriminated against him because of his Indian origin or that the bank's facially permissible alienage discrimination had the effect of specifically discriminating against Indians. The court held that Bhandari failed to sufficiently establish either ground.

[353] Id. at 1085, 1101. The distinction between national origin discrimination and alienage discrimination is set out in Espinoza v. Farah Mfg. Co., 414 US 86, 95 (1973), an employment case involving identical language under the Equal Employment Opportunity Act. The *Bhandari* court found the Court's holding in *Espinoza* controlling.

The *Bhandari* court went on to hold that First National had violated ECOA on other grounds. Specifically, First National had violated ECOA's notice provisions, which require the creditor to furnish a complete list of specific reasons for adverse action. See 15 USC § 1691(d) (1982). See also discussion infra ¶ 26.06[5].

applicant's income derives from any public assistance program if such inquiry is for the purpose of determining the amount and probable continuance of income levels, credit history, or other pertinent element of creditworthiness as provided in regulations of the Board; (3) to use any empirically derived credit system which considers age if such system is demonstrably and statistically sound in accordance with regulations of the Board, except that in the operation of such system the age of an elderly applicant may not be assigned a negative factor or value; or (4) to make an inquiry or to consider the age of an elderly applicant when the age of such applicant is to be used by the creditor in extension of credit in favor of such applicant.[354]

As this discussion indicates, the requirements of ECOA and the Board's regulations are varied and complex. Bankers need to consult with counsel to determine the application of these rules to credit transactions in the states in which they do business.

[3] Prohibited Discrimination in Credit Application and Evaluation

Detailed rules govern the application and evaluation stages of a credit transaction. These rules cover advertising[355] and the type of information that a creditor may request.[356] The rules are particularly detailed with respect to the information that may be obtained about marital status. There are strict limitations on inquiry about income from alimony, child support, or separate maintenance, inquiries about childbearing or childrearing practices and intentions, and information about spouses.[357]

The manner in which a creditor analyzes an applicant's creditworthiness also is subject to strict standards.[358] For example, the regulations prohibit a creditor from discounting or excluding from consideration income from part-time employment or from a pension.[359] Child support payments must be considered as income of the applicant "to the extent that they are likely to be consistently made."[360]

The rules on taking credit applications and evaluating them are too extensive to be canvassed completely here. With the assistance of counsel, creditors should carefully consult the Board's regulations, interpretations, and model forms.[361]

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[354] 15 USC § 1691(b) (1982).

[355] See 12 CFR § 202.5(a) (1988).

[356] See generally 12 CFR § 202.5 (1988).

[357] Id.

[358] See generally 12 CFR § 202.6 (1988).

[359] 12 CFR § 202.6(b)(5) (1988).

[360] Id.

[361] The Board's regulations are published at 12 CFR pt. 202 (1987).

[4] Special-Purpose Credit Programs

It is not discrimination for a creditor to refuse to extend credit offered pursuant to the following:

> (1) Any credit assistance program expressly authorized by law for an economically disadvantaged class of persons; (2) any credit assistance program administered by a nonprofit organization for its members or an economically disadvantaged class of persons; or (3) any special purpose credit program offered by a profit-making organization to meet special social needs which meet standards prescribed in regulations by the Board. . . .

if the creditor's refusal to extend credit is required by or made pursuant to such program.[362]

This provision for special-purpose credit programs responsive to special needs of a class of persons carves out an important exception. The legislative history of this exception indicates that Congress intended to give the Federal Reserve Board authority to exempt classes of transactions when it has been clearly demonstrated that the consumers involved would effectively be denied credit without such an exemption. Therefore, when the Board's regulations permit, credit programs may intentionally prefer members of certain economically disadvantaged classes.[363] The essential prohibition of ECOA is directed at discrimination *against* applicants.

In *United States v. American Future Systems, Inc.*[364] the court reviewed an alleged special-purpose credit program and found that it violated ECOA. In this case the creditor was a company, American Future Systems (AFS), which admittedly directed its efforts at selling kitchenware on a credit basis to a target group of young, single, white female coeds. Under its credit program, minorities, males, and married persons were treated less favorably. AFS contended that its credit practices were a special purpose credit program allowed under ECOA[365] and argued that its program was based on the social need of persons in the age group of eighteen to twenty-one who were excluded from the customary credit market.

The court stated that a special purpose credit program satisfies ECOA if credit applicants either "would not receive such credit" or "probably would receive it on less favorable terms than ordinarily available to other applicants applying to the organization for similar type and amount of credit."[366] The

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[362] 15 USC § 1691(c) (1982); 12 CFR § 202.8 (1988) (Regulation B).

[363] H.R. Rep. No. 873, 94th Cong., 2d Sess. 8, reprinted in 1976 U.S. Code Cong. & Admin. News 403, 428; S. Rep. No. 589, 94th Cong., 2d Sess. 7, reprinted in 1976 U.S. Code Cong. & Admin. News 403, 409.

[364] 743 F2d 169 (3d Cir. 1984).

[365] See 15 USC § 1691(c)(3) (1982).

[366] 743 F2d at 177. See 12 CFR § 202.8(a)(3)(ii) (1988) (Regulation B).

ECOA permits a special-purpose credit program to differentiate between credit applicants on the basis of race, color, religion, national origin, sex, age, or marital status to enhance credit opportunities for disadvantaged groups with an established social need. The court here found that extension of credit to persons in the age group of eighteen to twenty-one met the requirements of ECOA in establishing a social need group, but found that because each person within the defined social need class did not receive the same credit terms solely because of the person's sex, race, or marital status, AFS's special purpose credit program violated ECOA.[367]

[5] Notice Requirements

In addition to providing what does and does not constitute discrimination, the ECOA provides specific requirements regarding notice.[368] Within thirty days after receipt of a completed application for credit, a creditor must notify the applicant of its action on the application.[369]

A 1987 case considered when ECOA regards a credit application as "complete" for purposes of triggering the notice requirement.[370] In *High v. McLean Financial Corp.*, the court held that loan applicants were not entitled to notice within thirty days after submitting their application, because the application was not complete until the creditor had obtained verifying information and other reports or information ordinarily required to evaluate a loan.[371]

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[367] 743 F2d at 180. The court went on to hold that AFS further violated ECOA because its credit program was not formally described in writing or designated as a "special purpose credit program" as required by the Board's regulations. Id. at 177. See 12 CFR § 202.8(a)(3)(i) (1987) (Regulation B).

[368] See 15 USC § 1691(d) (1982); 12 CFR § 202.9 (1988) (Regulation B). Although the regulatory scheme is paramount, courts have emphasized the need to harmonize the regulatory scheme with the purpose of ECOA. See Thompson v. Galles Chevrolet Co., 807 F2d 163, 168 (10th Cir. 1986). In this case, plaintiffs filed two credit applications with the same entity, General Motors Acceptance Corporation (GMAC), for the purchase of a single Chevrolet pickup truck. Even though the first application was deemed incomplete and written notification was not given to plaintiffs, credit was granted on the second application, a more complete version of the first and filed within two weeks of the first. The court held that the manner in which GMAC melded the two applications resulting in the grant of credit fulfilled the underlying purpose of ECOA, and that strict adherence to the regulatory scheme would have advanced a result contrary to that purpose.

See also Brothers v. First Leasing, 724 F2d 789, 793 (9th Cir.), cert. denied, 469 US 832 (1984) (literal language of the ECOA must be construed so as to effectuate its underlying purposes); Jochum v. Pico Credit Corp., 730 F2d 1041, 1047 (5th Cir. 1984) (a regulation should be interpreted in a manner that effectuates its central purposes).

[369] 15 USC § 1691(d)(1) (1982).

[370] High v. McLean Fin. Corp., 659 F. Supp. 1561, 1563–1566 (DDC 1987).

[371] Id. at 1563–1564. See also 12 CFR § 202.2(f) (1988) ("A completed application means an application in connection with which a creditor has received all the information

If a creditor takes adverse action on an application, the creditor must provide to the applicant a statement of reasons for the action.[372] The creditor must provide either a written statement of reasons or a written notification of the applicant's right to a written statement of reasons.[373] The statement of reasons must be specific as to the reasons for the adverse action taken.[374] The term "adverse action" is defined. It "means a denial or revocation of credit, a change in the terms of an existing credit arrangement, or a refusal to grant credit in substantially the amount or on substantially the terms requested."[375] Adverse action does not include "a refusal to extend additional credit under an existing credit arrangement where the applicant is delinquent or otherwise in default, or where such additional credit would exceed a previously established credit limit."[376] Adverse action is further defined and refined in Regulation B.[377]

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that the creditor regularly obtains and considers in evaluating applications for the amount and type of credit requested. . . .").

[372] 15 USC § 1691(d)(2) (1982).

[373] Id.

[374] 15 USC § 1691(d)(3) (1982); 12 CFR § 202.9(b)(2) (1988) (Regulation B). See Bhandari v. First Nat'l Bank, 808 F2d 1082, 1085 reh'g granted on other grounds, 812 F2d 936 (5th Cir. 1987) (bank that denied credit card application on basis of alienage and short employment history violated ECOA notice requirements, because statement of reasons only specified alienage and therefore was not complete); Fischl v. General Motors Acceptance Corp., 708 F2d 143, 148 (5th Cir. 1983) (statement that "credit references are insufficient" was not a specific enough reason).

[375] 15 USC § 1691(d)(6)((1982). But see Dorsey v. Citizens & S. Fin. Corp., 678 F2d 137, 139 (11th Cir. 1982), aff'd, 706 F2d 1203 (1983) (en banc), which held that the refusal to grant credit substantially as requested does *not* constitute adverse action when the rejection is coupled with an offer to grant credit on other terms and the consumer accepts the counteroffer.

[376] 15 USC § 1691(d)(6) (1982).

[377] Under 12 CFR § 202.2(c) (1988) (Regulation B) adverse action means:

(i) A refusal to grant credit in substantially the amount or on substantially the terms requested in an application unless the creditor makes a counteroffer (to grant credit in a different amount or on other terms) and the applicant uses or expressly accepts the credit offered;

(ii) A termination of an account or an unfavorable change in the terms of an account that does not affect all or a substantial portion of a class of the creditor's accounts; or

(iii) A refusal to increase the amount of credit available to an applicant who has made an application for an increase.

(2) The term does not include:

(i) A change in the terms of an account expressly agreed to by an applicant.

(ii) Any action or forbearance relating to an account taken in connection with inactivity, default, or delinquency as to that account;

(iii) A refusal or failure to authorize an account transaction at a point of sale or loan, except when the refusal is a termination or an unfavorable change in the terms

[6] Civil Liability for Violation of ECOA

Any creditor who fails to comply with any requirement of ECOA is liable for actual damages to the aggrieved applicant.[378] Actual damages may include out-of-pocket monetary losses, injury to credit reputation, mental anguish, humiliation, or embarrassment.[379] The act also provides for recovery of punitive damages up to a specified amount. In individual actions, the aggrieved applicant may recover up to $10,000. In class actions, the total recovery may not exceed $500,000 or one percent of the net worth of the creditor, whichever is less.[380]

The language of ECOA, literally read, makes punitive damages mandatory once an ECOA violation is found.[381] Although the statute sets out a number of factors to be considered in determining the amount of punitive damages,[382] none of these requires that the underlying violation be intentional or reckless. The courts, however, have not construed the statute literally. In *Fischl v. General Motors Acceptance Corp.*,[383] the statute was interpreted to mean that punitive damages may be awarded "if the creditor's conduct is adjudged wanton, malicious or oppressive, or if it is deemed to have acted in reckless disregard of the applicable law." in *Anderson v. United Finance Co.*,[384] the court said that punitive damages could be awarded "even though there was no specific intention to discriminate on unlawful grounds" in order to increase the incentive for creditor

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of an account that does not affect all or a substantial portion of a class of the creditor's accounts, or when the refusal is a denial of an application for an increase in the amount of credit available under the account;

(iv) A refusal to extend credit because the creditor does not offer the type of credit or credit plan requested.

(3) An action that falls within the definition of both paragraphs (c)(1) and (c)(2) of this section is governed by paragraph (c)(2).

See also Annot., "Notification of Adverse Action on Credit Application Under Equal Credit Opportunity Act (15 U.S.C.S. §§ 1691 et. seq.) and Regulations Promulgated Thereunder (12 CFR Part 202)," 65 ALR Fed. 906 (1984).

[378] 15 USC § 1691e(a) (1982).

[379] See Fischl v. General Motors Acceptance Corp., 708 F2d 143, 148 (5th Cir. 1983); Anderson v. United Fin. Co., 666 F2d 1274, 1277 (9th Cir. 1982).

[380] 15 USC § 1691e(b) (1982).

[381] The statute states that "*any* creditor . . . who fails to comply with *any* requirement imposed under this subchapter *shall be liable* to the aggrieved applicant for punitive damages . . . ." 15 USC § 1691e(b) (1982) (emphasis added).

[382] The statute states that in determining the amount of punitive damages, the court must consider "among other relevant factors, the amount of any actual damages awarded, the frequency and persistence of failures of compliance by the creditor, the resources of the creditor, the number of persons adversely affected, and the extent to which the creditor's failure of compliance was intentional." 15 USC § 1691e(b) (1982).

[383] 708 F2d 143, 148 (5th Cir. 1983). See also Anderson v. United Fin. Co., 666 F2d 1274 (9th Cir. 1982).

[384] 666 F2d 1274, 1278 (9th Cir. 1982).

compliance. *Bhandari v. First National Bank*,[385] relying on *Fischl*, also denied the award of punitive damages.

Besides actual and punitive damages, ECOA also provides for equitable relief,[386] attorney fees, and costs.[387] Civil liability, however, is not imposed if a creditor acts in good faith in conformity with official rules and regulations.[388]

[7] Relationship to State Laws Establishing Marital and Other Property Rights

A creditor cannot refuse to grant a separate, individual account to a creditworthy applicant on the basis of sex, marital status, or other prohibited basis.[389] Other, less obvious, discriminatory practices may include requiring the signature of a married applicant's spouse when the married applicant qualifies individually under the creditor's lending standards,[390] inquiring about an applicant's marital status when the applicant neither resides in a community property state nor is relying on community property to qualify for the credit,[391] refusing to

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[385] 808 F2d 1082, 1103, reh'g granted on other grounds, 812 F2d 936 (5th Cir. 1987).

[386] 15 USC § 1691e(c) (1982).

[387] 15 USC § 1691e(d) (1982). See also 12 CFR § 202.14(b) (1988) (Regulation B).

[388] 15 USC § 1691e(e) (1982).

[389] 12 CFR § 202.7(a) (1988) (Regulation B).

[390] 12 CFR § 202.7(d) (1988). It is generally unlawful to require an applicant's spouse to sign any credit instrument that is not a joint credit application if the applicant qualifies under the creditor's standards of creditworthiness for the credit requested. 12 CFR § 202.7(d)(1) (1988). When an applicant for unsecured credit relies on property that is owned jointly with another person to obtain the credit, it is permissible for the creditor to require the other person's signature on the instruments the creditor reasonably believes are necessary under state law to permit the creditor to have recourse against the property in the event of default or death of the applicant. 12 CFR § 202.7(d)(2) (1988). In community property states, when a married person applies for unsecured credit, the creditor may require the spouse to sign an instrument the creditor reasonably believes to be necessary to make recourse against the community property possible if the state law does not give the applicant the power to manage enough community property to qualify for the credit and the applicant does not have enough separate property. 12 CFR § 202.7(d)(3) (1988). When the applicant requests credit that is to be secured by some property, the creditor may require the spouse to sign or may require other persons with an interest in the property to sign when the creditor reasonably believes the signature is needed under the law for the creditor to obtain a security interest in the property which, in the event of default, would permit the creditor to reach the property to satisfy the debt free from the interest of the other. 12 CFR § 202.7(d)(4) (1988). When an applicant cannot qualify for credit, the creditor may require a cosigner or guarantor, but the creditor may not require that the spouse be the additional party obligated for the credit. 12 CFR § 202.7(d)(5) (1988).

[391] See 12 CFR § 202.5(d) (1988). If a married person resides in a community property state, the earnings of the person during marriage will be viewed as community property in which the person's spouse will have an interest. Although property may be held in the

permit an applicant to have an account in the applicant's birth-given surname or in a surname that combines the spouse's surname and the birth-given surname,[392] and furnishing credit information to a consumer reporting agency that fails to reflect the participation of both spouses in the credit transaction for which the information is supplied.[393] Determining when creditor action discriminates on the basis of marital status is complicated by the need to consider if the relevant state property law treats married persons in a way that makes some creditor consideration of marital status reasonable.

Some of the rules governing discrimination on the basis of marital status derive from the express language of the act. ECOA provides that a creditor is not engaging in discrimination by asking for the signature of both parties to a marriage "for the purpose of creating a valid lien, passing clear title, waiving inchoate rights to property, or assigning earnings. . . ."[394] The act also stipulates that "consideration or application of State property laws directly or indirectly affecting creditworthiness shall not constitute discrimination for purposes of this subchapter."[395] Additional directives exist that make inapplicable "[a]ny provision of State law which prohibits the separate extension of consumer credit to each party to a marriage. . . in any case where each party to a marriage voluntarily applies for separate credit from the same creditor. . . ."[396] The act prohibits aggregating the separate accounts of both parties to a marriage "for purposes of determining permissible finance charges or permissible loan ceilings" under state or federal law.[397] To carry out these legislative directives, the Board has detailed regulations on how marital property laws affect what constitutes prohibited discrimination under the act.

State laws on the rights of a married person in the property of the other party to the marriage, in property acquired jointly, and other rights in property based on the marital status are complex, and vary from state to state. In most states, the common-law system of marital property rights prevails. In some of these states, the law may create special marital rights in each spouse in the property of the

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name of one spouse only, it may still be community property in which the other spouse has an interest and which the spouse may have legal authority to spend and to commit as security for community debts. The regulations contain rules as to when it is appropriate to request information about a spouse, 12 CFR § 202.5 (1988), and to require the spouse's signature. 12 CFR § 202.7(d) (1988).

[392] 12 CFR § 202.7(b) (1988).

[393] 12 CFR § 202.10 (1988).

[394] 15 USC § 1691d(a) (1982). This provision "shall not be construed to permit a creditor to take sex or marital status into account in connection with the evaluation of creditworthiness of any applicant." Id.

[395] 15 USC § 1691d(b) (1982).

[396] 15 USC § 1691d(c) (1982). But when such a state law is preempted, the act makes "each party to the marriage . . . solely responsible for the debt so contracted." Id.

[397] 15 USC § 1691d(d) (1982).

other. The common-law right of dower in real property is an example. A spouse also may have certain homestead rights under the laws of some states. The law of each state necessarily must be consulted to determine the scope of the marital rights recognized in that state. Eight states follow a regime of community property. In these states, property acquired during the marriage, regardless of in what name the title is held, may be classified as community property if the state law requirements for community property are met. For example, the earnings of the parties to the marriage, and property acquired with such earnings, are usually classified as community property. Both parties to the marriage have an ownership interest in the community property, and, depending on the particular state law, each spouse may have rights of management, control, and disposition, which rights may or may not require the consent of the other spouse. The Board's regulations address some of the questions associated with these laws on marital property rights.

Under the Board's regulations, when a party to a marriage applies for credit that is to be secured by a lien or security interest in property, it is not discrimination for the creditor to require the signature of both parties when that is necessary to pass a clear title, create a valid lien, or waive rights in the property that may exist in the spouse as a result of the state property law.[398] Two cases will illustrate.

In *Evans v. Centralfed Mortgage Co.*,[399] the creditor conditioned approval of a loan for nonhomestead property to Evans, a married woman, on the inclusion of her husband as a grantee on the warranty deed and his signature on the deed of trust. Evans brought suit, claiming that Centralfed's conditional title requirements discriminated against her on the basis of her sex and marital status. The court reviewed Centralfed's conditional requirements on two grounds: (1) whether they were discriminatory under ECOA and (2) whether they were commercially reasonable under Regulation B.

The court held that the conditional title requirements did not violate ECOA for several reasons. Firstly, Centralfed did not require Evans' husband to sign a promissory note or to assume any personal obligation for his wife. Secondly, the determination of Evans's creditworthiness and her ability to repay the loan was made independent of her husband's creditworthiness. Finally, the title requirements imposed by Centralfed were solely to eliminate any concern that Evans' husband might have a community property interest in the property, which would not be subject to Centralfed's security interest.[400] In the court's view, Centralfed had reasonable concerns about the effect of the state community property laws on the marketability of the title in this transaction.[401] The court

[398] 15 USC § 1691d(a) (1982). See 12 CFR § 202.7(d)(4) (1988).

[399] 815 F2d 348, 348–349 (5th Cir. 1987).

[400] Id. at 349, 350.

[401] Id. at 351, n.3. See 12 CFR § 202.7(d)(3) (1988) (Regulation B).

noted that Centralfed was supported in its position by the similar practice of the Federal National Mortgage Association (FNMA) to require the nonborrowing spouse to execute a deed of trust in community property states.[402]

In another 1987 decision, *United States v. ITT Consumer Financial Corp.*,[403] the lender followed a practice of requiring a married applicant's spouse to cosign a promissory note as a prerequisite to considering the future earnings of that spouse in assessing the creditworthiness of the applicant for an unsecured loan in a community property state where each spouse, separately, had equal rights to act as manager for the marital community and to enter into debts that bound the community. Plaintiffs argued that this practice discriminated on the basis of marital status. The defendant lenders argued that, even in a community property state where each spouse has equal management authority, a married applicant cannot obligate his or her spouse's future earnings, because those future earnings may not be community property.[404] The marriage could be dissolved by death or divorce, and so the proper character of the earnings can only be established at the time that they are earned.[405] Thus, although a married applicant may have control over community property, there is no control over the applicant spouse's future earnings. To commit the applicant spouse's future earnings to repay a loan, the spouse must agree to become liable for the debt by signing a promissory note or other document to evidence such intent.

On this reasoning, the court concluded that the lender was justified in requiring the spouse's signature when the applicant relied on his or her spouse's future earnings to qualify for the loan.[406] The court said that defendant's practice "involves nothing more than a consideration of state law as it affects the applicant's creditworthiness," and that such a practice does not violate the ECOA.[407]

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[402] *Evans*, 815 F2d at 351, n.3. FNMA has since changed its underwriting standards. Id.

[403] 816 F2d 487 (9th Cir. 1987).

[404] Id. at 489.

[405] Id. at 490–491.

[406] In reaching this conclusion, the court distinguished the lending practice here from that in Anderson v. United Fin. Co., 666 F2d 1274 (9th Cir. 1982). In *Anderson*, the court held that the ECOA and Regulation B were violated when a lender required a married applicant's spouse to cosign for a loan to the applicant even though the applicant qualified individually under the lender's standard for credit. No cosigner would have been required if the applicant had not been married. Here, the applicant did not qualify individually under ITT's standard of credit. Therefore, ITT was justified in requiring a cosigner just as it would have of a similarly situated unmarried applicant.

[407] *ITT*, 816 F2d at 491. See 15 USC § 1691d(b) (1982) ("consideration or application of State property laws directly or indirectly affecting creditworthiness shall not constitute discrimination for purposes of this subchapter").

See also Taylor, "The Equal Credit Opportunity Act's Spousal Cosignature Rules and Community Property States: Regulatory Haywire," 37 Sw. LJ 1039 (1984).

[8] Relationship to Other State Laws

In addition to the detailed rules with respect to the consideration a creditor may give to state laws affecting marital property rights, the ECOA provides that state laws on credit discrimination remain effective except to the extent that they may be inconsistent with the ECOA.[408] The act authorizes the Board to make the determination of whether a state law is inconsistent with the federal act. The Board has adopted detailed regulations to implement this part of the act. These regulations make clear that there is no inconsistency if the state law provides a greater protection to an applicant than does the ECOA.[409]

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[408] 15 USC § 1691d(f) (1982).

[409] 12 CFR § 202.11(a) (1988).

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