Chapter 1. Checking Accounts as the Paradigm Payment System

Assignment 1: The Basic Checking Relationship and the Bank's Right to Pay Checks

A. The Basic Relationship

What is a deposit? A debt owed by the bank.
"Drawee" or "payor": paying bank
"Drawer" or "issuer": person who wrote the check.
"Payee": person who holds the check in due course.
"Depositary bank": Bank where payee deposits the check
"Intermediary banks": Federal Reserve Banks or other banks between depositary and payor.

Checks are negotiable instruments governed by UCC Art. 3. Also governed by Article 4 (Bank deposits and collections)

What is a check? § 3-104(f).

B. The Bank's Right to Pay

1. When Is It Proper for the Bank to Pay

UCC § 4-401: It is proper to charge a customer's account for a check that is "properly payable".
Cmt. 1: It is properly payable if the customer has authorized the payment.

When a Bank May Charge Customer's Account

§ 4-401	(a) A bank may charge against the account of a customer an item that is properly payable from the account even though the charge creates an overdraft. An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and bank. (b) A customer is not liable for the amount of an overdraft if the customer neither signed the item nor benefited from the proceeds of the item. (c) A bank may charge against the account of a customer a check that is otherwise properly payable from the account, even though payment was made before the date of the check, unless the customer has given notice to the bank of the postdating describing the check with reasonable certainty. The notice is effective for the period stated in Section 4- 403(b) for stop-payment orders, and must be received at such time and in such manner as to afford the bank a reasonable opportunity to act on it before the bank takes any action with respect to the check described in Section 4- 303. If a bank charges against the account of a customer a check before the date stated in the notice of postdating, the bank is liable for damages for the loss resulting from its act. The loss may include damages for dishonor of subsequent items under Section 4- 402. (d) A bank that in good faith makes payment to a holder may charge the indicated account of its customer according to: (1) the original terms of the altered item; or (2) the terms of the completed item, even though the bank knows the item has been completed unless the bank has notice that the completion was improper.
Cmt. 1	1. An item is properly payable from a customer's account if the customer has authorized the

	payment and the payment does not violate any agreement that may exist between the bank and its customer. For an example of a payment held to violate an agreement with a customer, see Torrance National Bank v. Enesco Federal Credit Union, 285 P.2d 737 (Cal.App.1955). An item drawn for more than the amount of a customer's account may be properly payable. Thus under subsection (a) a bank may charge the customer's account for an item even though payment results in an overdraft. An item containing a forged drawer's signature or forged indorsement is not properly payable. Concern has arisen whether a bank may require a customer to execute a stop-payment order when the customer notifies the bank of the loss of an unindorsed or specially indorsed check. Since such a check cannot be properly payable from the customer's account, it is inappropriate for a bank to require stop-payment order in such a case.

UCC §3-301: A check properly transferred to an intermediary makes the intermediary a party entitled to enforce.

Person Entitled to Enforce Instrument

§ 3-301	"Person entitled to enforce" an instrument means (i) the holder of the instrument, (ii) a nonholder in possession of the instrument who has the rights of a holder, or (iii) a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 3- 309 or 3- 418(d). A person may be a person entitled to enforce the instrument even though the person is not the owner of the instrument or is in wrongful possession of the instrument.

a. Overdrafts

UCC §§ 4-401(a), 4-402(a): A bank may either dishonor or pay an NSF check.

When Bank May Charge an Account

§ 4-401(a)	A bank may charge against the account of a customer an item that is properly payable from the account even though the charge creates an overdraft. An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and bank.

Bank's Liability to Customer for Wrongful Dishonor; Time of Determining Insufficiency of Amount

§ 4-402(a)	Except as otherwise provided in this Article, a payor bank wrongfully dishonors an item if it dishonors an item that is properly payable, but a bank may dishonor an item that would create an overdraft unless it has agreed to pay the overdraft.

McGuire v. Bank One, Louisiana, N.A.

Facts:	Plaintiff wrote a post-dated check to Looney. P directed bank to deposit funds to cover from investment account. Looney cashed check immediately, creating a huge overdraft when bank chose to honor. Turns out Looney was a fraudster, and P claims if they hadn't paid and notified her he tried to cash she would have known.
Issue:	Did the bank owe some duty of due care to not overdraw plaintiff's account?
Rule:	UCC 4-401 permits a bank to charge a properly payable check against a customer's account even if it creates an overdraft. Under 4-103, the bank must exercise ordinary care. Since 4-401 authorizes paying the check, that is per se ordinary care.
Held:	No liability for the bank, they were exercising a statutory right.

An overdraft protection agreement overturns the normal rule and gives the bank no discretion on whether to pay. §§ 4-402(a), 4-103

Some courts hold that high overdraft fees are unconscionable or violate the duty of good faith.

Banks may pay checks in any order, usually largest to smallest. 4-303(b).

b. *Stop Payments*

If a customer gives a payor bank timely and adequate notice of the customer's desire the payor refuse a check, the payor loses the right to charge the customer's account. §4-403, 4-403 cmt. 7

Customer's Right to Stop Payment; Burden of Proof of Loss

§ 4-403	(a) A customer or any person authorized to draw on the account if there is more than one person may stop payment of any item drawn on the customer's account or close the account by an order to the bank describing the item or account with reasonable certainty received at a time and in a manner that affords the bank a reasonable opportunity to act on it before any action by the bank with respect to the item described in Section 4- 303. If the signature of more than one person is required to draw on an account, any of these persons may stop payment or close the account. (b) A stop-payment order is effective for six months, but it lapses after 14 calendar days if the original order was oral and was not confirmed in a record within that period. A stop-payment order may be renewed for additional six-month periods by a record given to the bank within a period during which the stop-payment order is effective. (c) The burden of establishing the fact and amount of loss resulting from the payment of an item contrary to a stop-payment order or order to close an account is on the customer. The loss from payment of an item contrary to a stop-payment order may include damages for dishonor of subsequent items under Section 4- 402.
Cmt. 7	A payment in violation of an effective direction to stop payment is an improper payment, even though it is made by mistake or inadvertence. Any agreement to the contrary is invalid under Section 4- 103(a) if in paying the item over the stop-payment order the bank has failed to exercise ordinary care. An agreement to the contrary which is imposed upon a customer as part of a standard form contract would have to be evaluated in the light of the general obligation of good faith. Sections 1- 203 and 4- 104(c). The drawee is, however, entitled to subrogation to prevent unjust enrichment (Section 4- 407); retains common law defenses, e.g., that by conduct in recognizing the payment the customer has ratified the bank's action in paying over a stop-payment order (Section 1- 103); and retains common law rights, e.g., to recover money paid under a mistake under Section 3- 418. It has sometimes been said that payment cannot be stopped against a holder in due course, but the statement is inaccurate. The payment can be stopped but the drawer remains liable on the instrument to the holder in due course (Sections 3- 305, 3- 414) and the drawee, if it pays, becomes subrogated to the rights of the holder in due course against the drawer. Section 4-407. The relationship between Sections 4- 403 and 4- 407 is discussed in the comments to Section 4- 407. Any defenses available against a holder in due course remain available to the drawer, but other defenses are cut off to the same extent as if the holder were bringing the action

Three limitations

1. 4-403(a): Only effective if received at a time and in a manner that affords the bank a reasonable opportunity to act on it before any final action by the bank.
2. 4-403(b): A stop-payment is only valid for six months.

3. The underlying obligation.
   a. The payee has two separate rights to repayment: on the obligation, on the check.
   b. When he accepts the check, the right to collect on the obligation is suspended. 3-310(b)
   c. The suspension ends when the check is dishonored. 3-310(b)(1).

2. Remedies for Improper Payment

Reasons a bank might pay a check not properly payable:

a. Customer didn't write the check (fraud)
b. Forged indorsement
c. Failed to comply with a valid stop payment.

The bank must reverse the transaction and pay consequential damages: return any fees caused by the error and reimburse for proximate damages. 4-402(b)

Bank's Liability to Customer for Wrongful Dishonor; Time of Determining Insufficiency of Account

§ 4-402(b)	A payor bank is liable to its customer for damages proximately caused by the wrongful dishonor of an item. Liability is limited to actual damages proved and 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.

However, the bank subrogates the underlying obligation owed to the payee of the check, and can assert the payee's right to payment.

McIntyre v. Harris

Facts:	P (McIntyre) solicited business from Bennett. Archie quoted Bennett a price to repair her roof. P told Bennett to complete work, Archie needed $2,000. Bennett wrote P a check for $2,000. P then wrote post-dated check to Bennett, saying Bennett could cash Oct. 28 if roof not fixed. On Nov 14, P ordered stop pay. Bennett cashed on Nov 27. The roof wasn't fixed at that point. Check overdrew the account, and D made P sign a promissory note to cover the overdraft. D sued on the note.
Issue:	Was P obligated to cover the overdraft?
Rule:	4-407: if a bank pays an item over a stop payment, the bank may become subrogated to the rights of the payee to prevent unjust enrichment. The burden as to proof of loss is on the customer.
Held:	Bank had right to reimbursement.
Rat:	P deposited money for work he never performed. Bennett had the right to pursue P. Bank became subrogated to Bennett on payment of check.

Assignment 2: The Bank's Obligation to Pay Checks

Two classes of rule:

1. Rules obligating banks to pay.
2. Rules establishing the proper remedy for failure to pay.

A. When Are Funds Available for Payment?

When funds are available, a bank has an obligation to pay. That obligation runs to the drawer, not the payee or holder.

1. Time of Evaluation

Allowing the bank to evaluate the check maximizes the bank's flexibility and minimizes logistical difficulty.

Bank's Liability to Customer for Wrongful Dishonor; Time of Determining Insufficiency of Account

§ 4-402(c)	A payor bank's determination of the customer's account balance on which a decision to dishonor for insufficiency of available funds is based may be made at any time between the time the item is received by the payor bank and the time that the payor bank returns the item or gives notice in lieu of return, and no more than one determination need be made. If, at the election of the payor bank, a subsequent balance determination is made for the purpose of reevaluating the bank's decision to dishonor the item, the account balance at that time is determinative of whether a dishonor for insufficiency of available funds is wrongful.

The bank only needs to make the determination once, notwithstanding credits to the account after the determination.

2. Availability of Funds

Cash deposits made in person to an employee of the bank must be made available on the next business day.

12 CFR § 229.10(a)	Cash deposits. (1) A bank shall make funds deposited in an account by cash available for withdrawal not later than the business day after the banking day on which the cash is deposited, if the deposit is made in person to an employee of the depositary bank. (2) A bank shall make funds deposited in an account by cash available for withdrawal not later than the second business day after the banking day on which the cash is deposited, if the deposit is not made in person to an employee of the depositary bank.

Check deposits drawn on a local branch of the depositary bank must be made available the next business day. Certain other non-cash deposits must also be made available the next business day.

12 CFR § 229.10(c)(1)(vi)	(b) Electronic payments-- (1) In general. A bank shall make funds received for deposit in an account by an electronic payment available for withdrawal not later than the business day after the banking day on which the bank received the electronic payment. (2) When an electronic payment is received. An electronic payment is received when the bank receiving the payment has received both-- (i) Payment in actually and finally collected funds; and (ii) Information on the account and amount to be credited. A bank receives an electronic payment only to the extent that the bank has received payment in actually and finally collected funds.

	(c) Certain check deposits-- (1) General rule. A depositary bank shall make funds deposited in an account by check available for withdrawal not later than the business day after the banking day on which the funds are deposited, in the case of-- (i) A check drawn on the Treasury of the United States and deposited in an account held by a payee of the check; (ii) A U.S. Postal Service money order deposited-- (A) In an account held by a payee of the money order; and (B) In person to an employee of the depositary bank. (iii) A check drawn on a Federal Reserve Bank or Federal Home Loan Bank and deposited-- (A) In an account held by a payee of the check; and (B) In person to an employee of the depositary bank; (iv) A check drawn by a state or a unit of general local government and deposited-- (A) In an account held by a payee of the check; (B) In a depositary bank located in the state that issued the check, or the same state as the unit of general local government that issued the check; (C) In person to an employee of the depositary bank; and (D) With a special deposit slip or deposit envelope, if such slip or envelope is required by the depositary bank under paragraph (c)(3) of this section. (v) A cashier's, certified, or teller's check deposited-- (A) In an account held by a payee of the check; (B) In person to an employee of the depositary bank; and (C) With a special deposit slip or deposit envelope, if such slip or envelope is required by the depositary bank under paragraph (c)(3) of this section. (vi) A check deposited in a branch of the depositary bank and drawn on the same or another branch of the same bank if both branches are located in the same state or the same check processing region; and, (vii) The lesser of-- (A) $100, or (B) The aggregate amount deposited on any one banking day to all accounts of the customer by check or checks not subject to next-day availability under paragraphs (c)(1)(i) through (vi) of this section. (2) Checks not deposited in person. A depositary bank shall make funds deposited in an account by check or checks available for withdrawal not later than the second business day after the banking day on which funds are deposited, in the case of a check deposit described in and that meets the requirements of paragraphs (c)(1)(ii), (iii), (iv), and (v), of this section, except that it is not deposited in person to an employee of the depositary bank.

The Expedited Funds Availability Act (12 U.S.C. §§ 4001-4010, 12 C.F.R. pt. 229, "Reg CC")

Establishes framework for mandatory release of funds.

Local/Nonlocal Check

Nonlocal=outside check-processing region.

Cash withdrawal/Other Withdrawal.

	Local Chek	Nonlocal Check
Noncash	Day 1: $100 Day 2: Remainder	Day 1: $100 Day 5: Remainder
Cash	Day 1: $100 Day 2: $400 Day 3: Remainder	Day 1: $100 Day 5: $400 Day 6: Remainder

Low-Risk Deposits

Type	Date	Citation
In Person, Own Account		
All low-risk items	1st Business Day	12 CFR § 229.10(c)(1)
ATM Deposits, Own Account		
On-us items, Treasure Checks	1st Business Day	12 CFR § 229.10(c)(1)(i), (c)(1)(vi)
Cash, postal money orders, Federal Reserve, local government, and cashier's checks	2nd Business Day	12 CFR § 229.10(c)(2)
3d Party Account		
On-us items	1st Business Day	§ 229.10(c)(1)(vi)
Treasury Checks, Postal MOs	Local Check Rules	§ 229.12(b)(2), (b)(3)
Federal Reserve, local government, and cashier's checks	Local or nonlocal check rules	§ 229.12(b)(4), (c)(1)(ii)

Three considerations justifying expedited funds availability:

1. Reg CC isn't unconditional
   a. Numerous exceptions
      1. New accounts (30 days) (229.13(a)(2)) are immune to the two- and five-day rules. (229.13(a)(1)(iii))
      2. Two- and five- day schedules don't apply to deposits made by check in excess of $5,000 in one banking day. (229.13).
      3. Repeated overdrafts (229.13(d)).
      4. Reasonable cause to believe the check is uncollectible. (229.13(e)).
2. Convenience: People need money right away, and 99% of checks clear just fine.
3. Putting the risk on banks speeds up the collection process.

B. Wrongful Dishonor: What Happens if the Bank Refuses to Pay?

Banks are liable for proximate damages stemming from wrongful dishonor

Bank's Liability to Customer for Wrongful Dishonor; Time of Determining Insufficiency of Account

§ 4-402(b)	A payor bank is liable to its customer for damages proximately caused by the wrongful dishonor of an item. Liability is limited to actual damages proved and 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.

Maryott v. First National Bank

Facts:	Maryott (P) borrowed money from FNB (D) and had a checking account there. Never had a bad check in the entire time. Oconto bought cattle from Maryott, but failed to pay. Two sight drafts on Oconto's line of credit were returned unpaid. D became concerned about P's account due to return of the drafts. D noticed three large checks were processed through P's account (two to Tri-County, one to Schaffer). D had paid checks, but processed late return. D then froze P's account. Central called D to check funds availability on check. Although funds were there (due to the return of the three items) D said would not pay. D then paid down outstanding debt with funds in the account. Central then claimed against P's bond. Schaeffer also claimed on bond. Since claims were more than bonds, P had to surrender dealer's license, shutting down his business.
Issue1:	Did the wrongful dishonor of the checks proximately cause P's damages?
Rule:	If the defendant's conduct was a substantial factor in causing the P's damages, then it proximately causes the damages.

Held:	D is liable
Rat:	Even though there wouldn't have been funds to cover the Central check, Central knew the check wasn't good and would not have claimed against the bond if the account hadn't been frozen. Plus, Schaeffer would not have claimed against bond had his check been paid.
Issue2:	Is P entitled to emotional damages?
Rule:	For emotional damages in this jurisdiction, need intentional or actual physical damages. The UCC doesn't speak to emotional damages in this instance.
Held:	No emotional damages.

Problem 2.1

§ 4-404: Bank can charge a customer for a check presented more than six months and paid in good faith. (honesty in fact and reasonable commercial standards of fair dealing. It appears that this was done in good faith. Nothing the buddy can do.

Problem 2.2

Problem 2.3

Assignment 3: Collection of Checks

A. The Payor Bank's Obligation to the Payee

The UCC characterizes the payee or any bank that acquires the check from the payee as a "person entitled to enforce". UCC § 3-301

UCC § 3-301	"Person entitled to enforce" an instrument means (i) the holder of the instrument, (ii) a nonholder in possession of the instrument who has the rights of a holder, or (iii) a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 3- 309 or 3- 418(d). A person may be a person entitled to enforce the instrument even though the person is not the owner of the instrument or is in wrongful possession of the instrument.

In an ordinary transaction, the payee has no rights against the payor bank.

The payee cannot force the bank to pay even if the account has sufficient funds. UCC § 3-408

UCC § 3-408	A check or other draft does not of itself operate as an assignment of funds in the hands of the drawee available for its payment, and the drawee is not liable on the instrument until the drawee accepts it.

Outdoor Technologies, Inc. v. Allfirst Financial, Inc.

Facts:	6/2/1999 Hechinger wrote a check to Outdoor for $706,735.62. Hechinger drew the check on Omni, although the check showed FNB as drawee bank. Outdoor knew Hechinger was about to file bankruptcy. Instead of depositing check in corporate account, Outdoor's comptroller (Hurt) went to an FNB branch in Baltimore. 6/7/1999, Hurt went to FNB branch. FNB pointed out that Hechinger drew the check on Omni and directed Hurt to FNB's corporate counsel, Thomas. Hurt discovered Bancorp owned Omni and went to corporate office, where he met with Thomas (who was also Omni and Bancorp's counsel). Thomas told Hurt that Omni would negotiate the item if there were sufficient funds, if Hechinger had not filed for BK, and if Hurt presented "proper authorization." No discussion of what proper authorization would be. Hurt got a letter from Outdoor's president saying Hurt could negotiate the item. Omni then refused to negotiate, saying this wasn't proper authorization – needs a resolution from the board.
Issue:	Were Thomas' statements fraudulent?
Rule:	Elements of fraud in Delaware: 1. False representation made by defendant; 2. Defendant's knowledge that the representation was false, or reckless indifference; 3. An intent to induce the plaintiff to action or inaction; 4. Plaintiff's action or inaction taken in justifiable reliance; and 5. Damage to the plaintiff as a result of the action or inaction. Statements which are promissory in nature and expressions as to what will happen in the future are not actionable as fraud unless there is a present intent to not perform.
Held:	No fraud.
Why?	No evidence of a false statement. Thomas said Hurt would need "proper authorization" and never said what that would be.
Issue:	Did Thomas' statements amount to negligent misrepresentation?
Rule:	Elements of negligent misrepresentation are: 1. A pecuniary duty to provide accurate information, 2. Supplying of false information, 3. Failure to exercise reasonable care in obtaining or communicating information, and 4. Pecuniary loss caused by justifiable reliance on the false information..
Issue:	Did Thomas have a duty to Hurt?
Rule:	Legal duties arise from relationships. The law contemplates that a duty of disclosure will arise when the parties are in the midst of a "business relationship" from which they expect to derive

	"pecuniary benefits." Something more than a casual business encounter must be demonstrated before a duty of care will be imposed.
Held:	No legal duty to disclose.
Why?	This was just a casual business encounter.
Note:	Plaintiff is trying to invoke fraud and negligence here to get around § 3-408.

Payees can protect themselves when they're concerned about payor's ability to pay:
Cash only
Certified Check: § 3-409(d).
Cashier's or Teller's Check: §3-104(g),(h).

B. The Process of Collection

1. Obtaining Payment Directly

Payees can obtain payment in two ways:

1. Presentment over the counter. § 4-301(a)
   Presentment over the counter is final. § 4-215(a)(2) and cmt. 4(p. 5)
2. Deposit into an account at the same institution. This turns the check into an "on-us" item.
   If the payor bank provides provisional settlement on the same day, then it still has until the midnight deadline (midnight of the next banking day § 4-104(a)(10)) to decide whether to honor the check. § 4-301(a), (b).

   If the provisional credit is already gone by the time the bank charges the item back, the bank may sue to recover. § 4-214(c), 4-301(b).
   This leaves the payee with the check and the right to sue on the underlying agreement. § 3-310.
   If the bank is unable to recover from the payee, can recover from payor under § 3-414(b) or on common law unjust enrichment. § 1-103.

2. Obtaining Payment through Intermediaries.

a. Payee/Customer to Depositary Bank

Deposit of the item creates an agency relationship between payee and his bank. § 4-201.
The depositary bank becomes a "collecting bank". § 4-105(5).
A collecting bank must exercise ordinary care. § 4-202(a).
The depositary bank generally gives a provisional credit, retaining the right to charge back credit if the payor bank dishonors the check. § 4-214.

b. Depositary Bank to Payor Bank

The depositary bank is free to choose whatever manner it wishes to collect a check, subject to 4-202(a) requirement of ordinary care. § 4-204.
Once the bank processes the check, does MICR encoding, etc, generally goes to one of three options.

i. Multilateral Arrangements (Clearinghouses)

These cover about 1/3 of all transit items.

Starts with the assumption that the payor bank will eventually honor the check.

1. The clearinghouse gives each bank a credit for the amount of each check sent to the clearinghouse each day.
2. The clearinghouse makes a corresponding debit for the amount of any checks sent to the clearinghouse drawn on member banks each day.
3. The clearinghouse then submits the net position to an account, usually the bank's FedRes account.
4. The clearinghouse "presents" the checks for payment to payor banks. § 3-501(a).
   If there's no clearinghouse rule, the payor bank has until the midnight deadline (midnight next banking day) to determine whether it will honor the check.
   Generally, there will be a faster deadline imposed by clearinghouse rule.

If whatever deadline applies isn't met, the bank loses the right to dishonor. § 4-215(a)(3).

If the bank decides to honor the check, doesn't need to inform clearinghouse. By letting the deadline expire, the payment becomes final as to the payor bank.

Whether or not the drawer has sufficient funds, the payor bank may not recover from the clearinghouse, the depositary bank, or the payee. § 4-301.

When the deadline expires, payment also becomes final as between the depositary bank and the payee. § 4-214(a).

United States Bank N.A. v. HMA, L.C. Come Back to This!

Facts:	HMA does real estate development. They deposited a big check (the Woodson Check) in US Bank and wrote a check against that amount to Barnes Bank. US Bank paid the Barnes check. Woodson stopped payment on the Woodson Check, and Wells Fargo returned the check to US Bank. US Bank took the remaining funds from HMA's account to cover and sued HMA on the deficiency. US Bank also foreclosed on deeds of trust securing promissory notes.
Time:	Aug 2: HMA deposited Woodson Check. Aug 2: US Banks sent check to WFC. Aug 2: WFC processed check (late enough that it was August 3 banking day). Aug 3: HMA makes amount of Woodson Check available to HMA. Aug 3: HMA pays Barnes Check
Facts:	WFC returned the check through the Federal Reserve. They also informed Primary Payment Systems
Issue:	Did Wells Fargo make the midnight deadline to return the Woodson Check?

If a bank pulls a check for examination, the bank honors the check if there's not problem.

If a check is drawn against insufficient funds or the bank is dishonoring for another reason, the bank sends a computer message to an individual for review. If the officer doesn't countermand, the bank pays the check.

The payor bank notifies the other parties of its decision to dishonor by "returning" the check. §4-301(a).

§ 4-301(a)	If a payor bank settles for a demand item other than a documentary draft presented otherwise than for immediate payment over the counter before midnight of the banking day of receipt, the payor bank may revoke the settlement and recover the settlement if, before it has made final payment and before its midnight deadline, it (1) returns the item; (2) returns an image of the item, if the party to which the return is made has entered into an agreement to accept an image as a return of the item and the image is returned in accordance with that agreement; or (3) sends a record providing notice of dishonor or nonpayment if the item is unavailable for return. U.C.C. Text § 4-301

Returning a check only requires putting it in the mail.

§ 1-201(b)(36)	"Send" in connection with a writing, record, or notice means: (A) to 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 and, 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; or (B) in any other way to cause to be received any record or notice within the time it would

	have arrived if properly sent.
§ 4-301(d)	An item is returned: (1) as to an item presented through a clearing house, when it is delivered to the presenting or last collecting bank or to the clearing house or is sent or delivered in accordance with clearing-house rules; or (2) in all other cases, when it is sent or delivered to the bank's customer or transferor or pursuant to instructions. U.C.C. Text § 4-301

The UCC does not require prompt notice to the depositary bank.

The physical return:

The bank affixes a new MICR line to the bottom of the dishonored check giving the RTN for the depositary bank.
If the check was direct-send, routed direct return.
If sent correspondent, back to the correspondent
If sent from federal reserve, back to federal reserve
If from clearinghouse, back to clearinghouse.

Assignment 4: Risk of Loss in the Checking System – The Basic Framework

There are two major legal theories to distribute losses in the checking system.

1. Indorsement Liability
2. Warranty Liability

A. Nonpayment

Two fundamental elements of the checking system make nonpayment losses common.

1. Payee's inability when it takes a check to know if it will be honored
2. The delay between the payee's acceptance and his knowledge of a dishonor.

Indorser liability is the primary mechanism for allocating losses. Indorser liability is covered by §3-415.

§ 3-415	(a) Subject to subsections (b), (c), (d), (e) and to Section 3-419(d), if an instrument is dishonored, an indorser is obliged to pay the amount due on the instrument (i) according to the terms of the instrument at the time it was indorsed, or (ii) if the indorser indorsed an incomplete instrument, according to its terms when completed, to the extent stated in Sections 3-115 and 3-407. The obligation of the indorser is owed to a person entitled to enforce the instrument or to a subsequent indorser who paid the instrument under this section. (b) If an indorsement states that it is made "without recourse" or otherwise disclaims liability of the indorser, the indorser is not liable under subsection (a) to pay the instrument. (c) If notice of dishonor of an instrument is required by Section 3-503 and notice of dishonor complying with that section is not given to an indorser, the liability of the indorser under subsection (a) is discharged. (d) If a draft is accepted by a bank after an indorsement is made, the liability of the indorser under subsection (a) is discharged. (e) If an indorser of a check is liable under subsection (a) and the check is not presented for payment, or given to a depositary bank for collection, within 30 days after the day the indorsement was made, the liability of the indorser under subsection (a) is discharged.

The basic role of indorsement is to provide a simple method for transferring checks.

An indorsement need be nothing more than a simple signature of the person selling the check.

§ 3-204	(a) "Indorsement" means a signature, other than that of a signer as maker, drawer, or acceptor, that alone or accompanied by other words is made on an instrument for the purpose of (i) negotiating the instrument, (ii) restricting payment of the instrument, or (iii) incurring indorser's liability on the instrument, but regardless of the intent of the signer, a signature and its accompanying words is an indorsement unless the accompanying words, terms of the instrument, place of the signature, or other circumstances unambiguously indicate that the signature was made for a purpose other than indorsement. For the purpose of determining whether a signature is made on an instrument, a paper affixed to the instrument is a part of the instrument. (b) "Indorser" means a person who makes an indorsement. (c) For the purpose of determining whether the transferee of an instrument is a holder, an indorsement that transfers a security interest in the instrument is effective as an unqualified indorsement of the instrument. (d) If an instrument is payable to a holder under a name that is not the name of the holder, indorsement may be made by the holder in the name stated in the instrument or in the holder's name or both, but signature in both names may be required by a person paying or taking the instrument for value or collection.

A signature-only indorsement is a "blank" indorsement, turning the check into bearer paper. Any party subsequently in possession would be able to enforce it.

§ 3-205(b)	If an indorsement is made by the holder of an instrument and it is not a special indorsement, it is a "blank indorsement." When indorsed in blank, an instrument becomes payable to bearer and may be negotiated by transfer of possession alone until specially indorsed.

To make a check payable to a particular person, identify that person above the signature on the check. A "special" indorsement, which converts the check to order paper. Only the identified party may enforce order paper.

§ 3-205(a)	If an indorsement is made by the holder of an instrument, whether payable to an identified person or payable to bearer, and the indorsement identifies a person to whom it makes the instrument payable, it is a "special indorsement." When specially indorsed, an instrument becomes payable to the identified person and may be negotiated only by the indorsement of that person. The principles stated in Section 3-110 apply to special indorsements.

The payee may also indorse the check "for deposit only" or "for collection" as a restrictive indorsement, restricting the rights of later parties to transfer the check.

§ 3-206	(a) An indorsement limiting payment to a particular person or otherwise prohibiting further transfer or negotiation of the instrument is not effective to prevent further transfer or negotiation of the instrument. (b) An indorsement stating a condition to the right of the indorsee to receive payment does not affect the right of the indorsee to enforce the instrument. A person paying the instrument or taking it for value or collection may disregard the condition, and the rights and liabilities of that person are not affected by whether the condition has been fulfilled. (c) If an instrument bears an indorsement (i) described in Section 4-201(b), or (ii) in blank or to a particular bank using the words "for deposit," "for collection," or other words indicating a purpose of having the instrument collected by a bank for the indorser or for a particular account, the following rules apply: (1) A person, other than a bank, who purchases the instrument when so indorsed converts the instrument unless the amount paid for the instrument is received by the indorser or applied consistently with the indorsement. (2) A depositary bank that purchases the instrument or takes it for collection when so indorsed converts the instrument unless the amount paid by the bank with respect to the instrument is received by the indorser or applied consistently with the indorsement. (3) A payor bank that is also the depositary bank or that takes the instrument for immediate payment over the counter from a person other than a collecting bank converts the instrument unless the proceeds of the instrument are received by the indorser or applied consistently with the indorsement. (4) Except as otherwise provided in paragraph (3), a payor bank or intermediary bank may disregard the indorsement and is not liable if the proceeds of the instrument are not received by the indorser or applied consistently with the indorsement. (d) Except for an indorsement covered by subsection (c), if an instrument bears an indorsement using words to the effect that payment is to be made to the indorsee as agent, trustee, or other fiduciary for the benefit of the indorser or another person, the following rules apply: (1) Unless there is notice of breach of fiduciary duty as provided in Section 3-307, a person who purchases the instrument from the indorsee or takes the instrument from the indorsee for collection or payment may pay the proceeds of payment or the value given for the instrument to the indorsee without regard to whether the indorsee violates a fiduciary duty to the indorser. (2) A subsequent transferee of the instrument or person who pays the instrument is neither given notice nor otherwise affected by the restriction in the indorsement unless the transferee or payor knows that the fiduciary dealt with the instrument or its proceeds in breach of fiduciary duty. (e) The presence on an instrument of an indorsement to which this section applies does not prevent a purchaser of the instrument from becoming a holder in due course of the instrument unless the purchaser is a converter under subsection (c) or has notice or knowledge of breach of fiduciary duty as stated in subsection (d). (f) In an action to enforce the obligation of a party to pay the instrument, the obligor has a defense if payment would violate an indorsement to which this section applies and the payment

	is not permitted by this section.

Indorsement creates an implied contract with subsequent parties entitled to enforce the instrument. That contract obligates the indorser to pay the check if the payor bank dishonors it. § 3-415. Of course, the UCC also imposes liability on the drawer of the check.

§ 3-414(b)	If an unaccepted draft is dishonored, the drawer is obliged to pay the draft (i) according to its terms at the time it was issued or, if not issued, at the time it first came into possession of a holder, or (ii) if the drawer signed an incomplete instrument, according to its terms when completed, to the extent stated in Sections 3-115 and 3-407. The obligation is owed to a person entitled to enforce the draft or to an indorser who paid the draft under Section 3-415.

Indorser liability is not mandatory. An indorser may disclaim liability by indorsing the check "without recourse".

§ 3-415(b)	If an indorsement states that it is made "without recourse" or otherwise disclaims liability of the indorser, the indorser is not liable under subsection (a) to pay the instrument.

B. Forged Signatures

Forged or unauthorized signatures of one kind or another are the major instrument for fraud in the system. The main response to fraud therefore is to devise rules about false signatures.
Of course, you want the forger to bear the loss, but that's not always possible.
Two different problems, forged drawers' signature and forged indorsement.

1. Forged Drawers' Signatures and the Rule of Price v. Neal

A complete forgery: not even signed by the purported drawer.
Who bears the loss will depend on whether the bank is duped or not.

a. Payor Bank Pays the Forged Check

Price v. Neal
A payor bank bears the loss if it fails to notice the forgery and honors the check.

Modern: The check wasn't properly payable. Thus, the payor bank had no right to charge the customer's account. § 4-401(a) and cmt. 1.

Two statutory exceptions to the rule of *Price v. Neal*.

1. The payor bank may seek recovery from the person to whom or for whose benefit payment was made.

§ 3-418(a)(ii)	Except as provided in subsection (c), if the drawee of a draft pays or accepts the draft and the drawee acted on the mistaken belief … the signature of the drawer of the draft was authorized, the drawee may recover the amount of the draft from the person to whom or for whose benefit payment was made or, in the case of acceptance, may revoke the acceptance. Rights of the drawee under this subsection are not affected by failure of the drawee to exercise ordinary care in paying or accepting the draft.

However, if the person took the item in good faith and for value, they can't.

§ 3-418(c)	The remedies provided by subsection (a) or (b) may not be asserted against a person who took the instrument in good faith and for value or who in good faith changed position in reliance on the payment or acceptance. This subsection does not limit remedies provided by Section 3-417 or 4-407.

2. Beach of Presentment Warranty

§ 4-208 creates a series of presentment warranties. If any of them are fales, the payor bank may recover from the party that presented the check to the payor bank or from any previous transferor in the chain of collection.

§ 4-208	(a) If an unaccepted draft is presented to the drawee for payment or acceptance and the drawee pays or accepts the draft, (i) the person obtaining payment or acceptance, at the time of presentment, and (ii) a previous transferor of the draft, at the time of transfer, warrant to the drawee that pays or accepts the draft in good faith that: (1) the warrantor is, or was, at the time the warrantor transferred the draft, a person entitled to enforce the draft or authorized to obtain payment or acceptance of the draft on behalf of a person entitled to enforce the draft; (2) the draft has not been altered; and (3) the warrantor has no knowledge that the signature of the purported drawer of the draft is unauthorized; and (4) with respect to any remotely-created consumer item, that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn. (b) A drawee making payment may recover from a warrantor damages for breach of warranty equal to the amount paid by the drawee less the amount the drawee received or is entitled to receive from the drawer because of the payment. In addition, the drawee is entitled to compensation for expenses and loss of interest resulting from the breach. The right of the drawee to recover damages under this subsection is not affected by any failure of the drawee to exercise ordinary care in making payment. If the drawee accepts the draft (i) breach of warranty is a defense to the obligation of the acceptor, and (ii) if the acceptor makes payment with respect to the draft, the acceptor is entitled to recover from a warrantor for breach of warranty the amounts stated in this subsection. (c) If a drawee asserts a claim for breach of warranty under subsection (a) based on an unauthorized indorsement of the draft or an alteration of the draft, the warrantor may defend by proving that the indorsement is effective under Section 3-404 or 3-405 or the drawer is precluded under Section 3-406 or 4-406 from asserting against the drawee the unauthorized indorsement or alteration. (d) If (i) a dishonored draft is presented for payment to the drawer or an indorser or (ii) any other item is presented for payment to a party obliged to pay the item, and the item is paid, the person obtaining payment and a prior transferor of the item warrant to the person making payment in good faith that the warrantor is, or was, at the time the warrantor transferred the item, a person entitled to enforce the item or authorized to obtain payment on behalf of a person entitled to enforce the item. The person making payment may recover from any warrantor for breach of warranty an amount equal to the amount paid plus expenses and loss of interest resulting from the breach. (e) The warranties stated in subsections (a) and (d) cannot be disclaimed with respect to checks. Unless notice of a claim for breach of warranty is given to the warrantor within 30 days after the claimant has reason to know of the breach and the identity of the warrantor, the warrantor is discharged to the extent of any loss caused by the delay in giving notice of the claim. (f) A cause of action for breach of warranty under this section accrues when the claimant has reason to know of the breach.

§ 4-208(a)(3) imposes warranty liability only if the transferor had knowledge that the signature of the drawer was unauthorized. That means ACTUAL knowledge, not just notice.

Decibel Credit Union v. Pueblo Bank & Trust Company

Facts:	A thief stole one of Decibel's customers' checks. The thief forged the customer's signature on 14 checks totaling $2,350. The thief cashed all of the checks at Pueblo Credit Union. Pueblo sent all of the checks through the Fed, who sent them to Decibel. Decibel timely paid the checks. The customer noticed the problem when he got his bank statement, and immediately notified Decibel.

	Decibel made an immediate demand on Pueblo for reimbursement. Pueblo declined. Here comes the lawyers.
Issue:	Did Pueblo breach any presentment warranties to Decibel?
Rule:	The presentment warranties are contained in § 4-208. The official commentary states that the warranty of (a)(1) is a warranty that there are no unauthorized or missing *indorsements* (not that the signature is unauthorized) on the check; the warranty of (a)(2) is that the draft is unaltered; and the warranty of (a)(3) is that the warrantor has no actual knowledge of a false signature.
Held:	Pueblo did not breach any presentment warranties.
Why?	All of the indorsements are there. There's no allegation the draft was altered. There's no evidence that Pueblo *knew* the check had a forged signature.

Ways to detect forgery of signature:
1. Inspection of each check and comparison with signature card (nobody does this, expensive and slow)
2. Expert system pattern-recognition software.
3. Positive pay systems

b. Payor Bank Dishonors the Forged Check

The presenting bank can do one of two things:
1. Rely on the indorser liability above and recover against their depositor.

To ensure that the rights of payor banks are less than the rights of other banks in the chain, the UCC takes two steps:
1. Creates a special set of warranties that limit claims about forged drawer's signatures
2. It limits payor banks to pursuit of that limited set of warranties. §§ 3-417(a)(3), 4-208(a)(3).

While the *presentment* warranty requires actual knowledge of the fraudulent signature, the *transfer* warranty (which isn't available to the paying bank) is an avowal of the genuineness of the signature. §§ 3-416(a)(2), 4-207(a)(2).

§ 3-416(a)(2)	A person who transfers an instrument for consideration warrants to the transferee and, if the transfer is by indorsement, to any subsequent transferee that … all signatures on the instrument are authentic and authorized;
§ 4-207(a)(2)	A customer or collecting bank that transfers an item and receives a settlement or other consideration warrants to the transferee and to any subsequent collecting bank that … all signatures on the item are authentic and authorized;

However, these rules are only applicable to parties to whom the check was transferred, not presented.

Basically, liability flows back in this case to the earliest solvent person.

NOTE: Article 4 transfer warranties are enforceable against banks and their customers (the people who deposited the check). You can only assert Article 3 transfer warranties against people who handled the check without depositing it in a bank. You may only assert an Article 3 transfer warranty against someone who indorsed it.

The Special Case of Telephone Checks

A payee of a telephone check must retain a verifiable authorization of the transaction for 24 months. 16 CFR § 310.5(a)(5).

Can be either a recording of an oral agreement or in writing. 16 CFR § 310.3(a)(3).

Several states no longer accept telephone checks (ex. Texas, CA)

Recent amendments to UCC 3 and 4 have altered the warranties applicable to telephone checks.

There is now both a transfer and presentment warranty on telephone checks that the purported drawer has authorized the item in the amount in which it was issued. §§ 3-416(a)(6), 3-417(a)(4), 4-207(a)(6), 4-208(a)(4).

2. Forged Indorsements

The rules generally allow the payor bank to pass the loss up the chain to the earliest solvent person.

a. Payor Bank Dishonors the Check Due to Forged Indorsement

The presenting bank has the check and can recover its loss by pursuing transfer warranties.
Neither the forger nor anyone in the chain after the forger is a person entitled to enforce, and the indorsement is itself is forged, there's a breach of transfer warranties under either UCC § 4-207(a)(1) & (2) or UCC § 3-416(a)(1) & (2).

b. Payor Bank Pays the Check Despite Forged Indorsement

The check wasn't properly payable, so the payor bank can't charge the account. §4-401(a) & cmt. 1.
Also, the payor bank can't recover under § 3-418 from someone who took the item in good faith and for value.
However, presentment warranties are still available!
The forger *and everyone after him* is not a person entitled to enforce, because absent a valid indorsement nobody other than the payee can become a person entitled to enforce. § 3-301.
Since the presenting bank is not a party entitled to enforce, § 4-208(a)(1) allows the payor bank to recover from the presenting bank. The presenting bank, in turn, can charge the item back to the person who transferred it to them under § 4-207(a)(1) & (2).

c. Conversion

Normally a forged indorsement situation leads to a problem: the drawer's account isn't charged and the payee hasn't been paid.

> The payee of a stolen item is barred from enforcing the underlying obligation. § 3-310(b)(4).

The payee/victim has an action in tort (conversion) against the thief, but that rarely helps.
The payee/victim also has a conversion action against parties that purchase the check from the thief. Under this, he can pursue the bank that cashed the check for the thief or the payor bank that honors the check over the forged indorsement. § 3-420(a).

> Can't sue an intermediary bank that does nothing but process the check for collection as a representative of the depositary bank's customer. § 3-420(c) & cmt. 3.

There's tension between the ability of the payee to sue the payor bank (§ 3-420(a)) and the inability of the payor bank to deduct the funds for the check (§ 4-401(a)). In the situation where the payor bank has paid both the payee and on the forged check, they are subrogated to the payee's claim and may charge the customer's account. § 4-407(2).

Same deal goes if the payee sues the depositary bank—the depositary bank is equitably subrogated and may pursue against the payor bank, who may then charge the drawer's account.

C. Alteration

Two types of alteration:

1. Change in some relevant aspect

> The bank may only charge the drawer's account for the original terms of the check. § 3-407(c).
> The bank may pursue presentment warranties that the check had not been altered. § 4-208(a)(2).
> The presenting parties may then pursue transfer warranties against earlier parties. § 4-207(a)(3), 3-416(a)93).

2. Addition to an incomplete instrument.

> The payor may enforce the instrument as completed, even if the instrument was stolen and completed after the theft. § 3-407 cmt. 2.

The bank may charge the customer for the item. § 4-401(d)(2).
Policy: If you're dumb enough to sign a blank check, you deserve what you get.

Assignment 5: Risk of Loss in the Checking System – Special Rules

A. Negligence

The special rules revolve around negligence.

HSBC Bank USA v. F & M Bank Northern Virginia	
Facts:	3/31/1999, Lynch bought Check from AIB. Check payable to AMI for US$250.00, handwritten as "Two Hundred + Fifty" on the center line of the Check and US$250.00 handwritten on the upper right-hand side of the check. The writing left less than ½" open space in the numerical portion and less than 1" space in the written portion. The payor of the check was [HSBC]. Before Check was deposited, the amount was altered to $250,000 and adding the letters "Thoud" in the written portion. F&M presented the check to HSBC for payment, warranting pursuant to UCC §4-208(a)(2) that Check was unaltered. HSBC honored the check, debiting AIB's account. AIB notified HSBC of the alteration, HSBC recredited and sued F&M.
Issue:	Did AIB fail to exercise due care by leaving open spaces on the check permitting alteration?
Rule:	The appellate court reviews the district court's findings of fact for clear error.
Held:	It was not clearly erroneous for the district court to find that AIB exercised due care.
Why?	The comments to § 3-406(a) talk about a "large space". A ½" and 1" space aren't "large".

Negligence Contributing to Forged Signature or Alteration of Instrument

§ 3-406	(a) A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection. (b) Under subsection (a), if the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss. (c) Under subsection (a), the burden of proving failure to exercise ordinary care is on the person asserting the preclusion. Under subsection (b), the burden of proving failure to exercise ordinary care is on the person precluded.

This isn't a general right to challenge negligence: only when it leads to a forged signature or alteration of a signature.

The imposition of a duty of care isn't limited to customers. There is a general duty on banks to exercise "ordinary care" in processing and paying checks.

§ 4-103	(a) The effect of the provisions of this Article may be varied by agreement, but the parties to the agreement cannot disclaim a bank's responsibility for its lack of good faith or failure to exercise ordinary care or limit the measure of damages for the lack or failure. However, the parties may determine by agreement the standards by which the bank's responsibility is to be measured if those standards are not manifestly unreasonable.
§ 4-202(a)	(a) A collecting bank must exercise ordinary care in: (1) presenting an item or sending it for presentment; (2) sending notice of dishonor or nonpayment or returning an item other than a documentary draft to the bank's transferor after learning that the item has not been paid or accepted, as the case may be; (3) settling for an item when the bank receives final settlement; and (4) notifying its transferor of any loss or delay in transit within a reasonable time after

	discovery thereof.
§ 4-406(e)	(e) If subsection (d) applies and the customer proves that the bank failed to exercise ordinary care in paying the item and that the failure substantially contributed to loss, the loss is allocated between the customer precluded and the bank asserting the preclusion according to the extent to which the failure of the customer to comply with subsection (c) and the failure of the bank to exercise ordinary care contributed to the loss. If the customer proves that the bank did not pay the item in good faith, the preclusion under subsection (d) does not apply.

A bank establishes a prima facie case of ordinary care if it can establish that its activities conform to general banking usage.

§ 4-103(c)	Action or non-action approved by this Article or pursuant to Federal Reserve regulations or operating circulars is the exercise of ordinary care and, in the absence of special instructions, action or non-action consistent with clearing-house rules and the like or with a general banking usage not disapproved by this Article, is prima facie the exercise of ordinary care.

The problem with the general banking usage standard: discourages innovation.
However, market pressures are generally enough to keep banks innovating.

The framework contemplates negligence by both customer and the bank: adopts comparative negligence.

B. Bank Statements

The Bank-Statement Rule

When a drawer fails to discover forgery evident from its monthly bank statement, the UCC normally transfers ensuing losses from the payor bank to the drawer by precluding the drawer from challenging the payor bank's decision to honor future checks by the same forger.

§ 4-406(d)(2)	If the bank proves that the customer failed, with respect to an item, to comply with the duties imposed on the customer by subsection (c), the customer is precluded from asserting against the bank: the customer's unauthorized signature or alteration by the same wrongdoer on any other item paid in good faith by the bank if the payment was made before the bank received notice from the customer of the unauthorized signature or alteration and after the customer had been afforded a reasonable period of time, not exceeding 30 days, in which to examine the item or statement of account and notify the bank.

The bank still has to meet reasonable commercial standards in honoring the check. *Federal Insurance Co. v. NCNB National Bank* (11th Cir). Includes ensuring two manual signatures where required.

Apply a comparative negligence standard when both parties at fault.

§ 4-406(e)	If subsection (d) applies and the customer proves that the bank failed to exercise ordinary care in paying the item and that the failure substantially contributed to loss, the loss is allocated between the customer precluded and the bank asserting the preclusion according to the extent to which the failure of the customer to comply with subsection (c) and the failure of the bank to exercise ordinary care contributed to the loss. If the customer proves that the bank did not pay the item in good faith, the preclusion under subsection (d) does not apply.

Stowell v. Cloquet Co-Op Credit Union	
Facts:	CU uses an automated check processing system, and doesn't check signatures on the bottom of checks manually. The CU provides monthly statements as allowed under UCC. CU relies on members to examine their statements per industry practice to bring any forgeries to their attention. Stowell opened CU checking account 5/29/1983. Signed Agreement that provided the statements are the only official record of the transactions on the account. If no objection within 20 days, the accuracy of the statement is final. Everything was hunky-dory for 8 years. Fall 1992, Nelson moved next door and stole a box of checks from Stowell's mailbox. Nelson forged a bunch of checks and stole Stowell's statements from his mailbox. Stowell went to CU to complain he wasn't getting statements, bank verified address and mailed new ones, which Stowell would steal. Stowell never informed the CU he had suspicions about his account, just that he wasn't getting statements. Forgery finally discovered on 9/15/1993, when a check bounced payable to Nelson. Turns out that Nelson had forged checks amounting to $22,329.34. Stowell concedes he could have discovered the forgery from his account statements.
Issue:	May Stowell recover against the Credit Union because he never had an opportunity to examine the statements?
Rule:	UCC 4-406(c): An account holder is generally barred from recovering from a bank the value of a series of forged checks written on the account if the account holder does not exercise reasonable promptness in examining his account statement and informing the bank of the forgery. No definition of "reasonable promptness", but 4-103(a) allows variation by agreement.
Held:	Since the agreement limited it to 20 days, the only inquiry is whether 20 days is manifestly unjust.
Issue:	Is a limitation to 20 days to examine statements from time of *mailing* manifestly unjust?
Rule:	As between the customer and the bank, the customer bears the risk that statements will be intercepted or lost in the mail.
Held:	No manifestly unjust.
Why?	It would be incredibly expensive for banks to have to send each statement by certified mail. The customer knows whether he got the statement or not—lowest cost risk avoider. The statutory language seems to suggest that it's on the customer as well: times all run from when the statement is sent.
Issue:	Is the limitation to 20 days an unreasonable attempt by the CU to avoid the duty to act with due care?
Rule:	Such a limitation does not disclaim a duty to act reasonably. Although it mandates a condition precedent to liability, it does not disclaim the bank's responsibility for its own lack of good faith or failure to exercise due care.
Issue:	Did the bank fail to act with due care by not going further once Stowell said he wasn't getting statements?
Rule:	4-406(e) allows for comparative negligence as between customer and bank. Under 3-103(a)(7), ordinary care is reasonable commercial standards.
Held:	No banking practice mandates an investigation when a customer doesn't get a statement. No failure to act with due care.

If a customer fails to examine a statement within a year, the comparative negligence regime falls away.

§ 4-406(f)	Without regard to care or lack of care of either the customer or the bank, a customer who does not within one year after the statement or items are made available to the customer (subsection (a)) discover and report the customer's unauthorized signature on or any alteration on the item is precluded from asserting against the bank the unauthorized signature or alteration. If there is a preclusion under this subsection, the payor bank may not recover for breach of warranty under Section 4- 208 with respect to the unauthorized signature or alteration to which the preclusion applies.

This can also be varied by agreement. *National Title Ins. Corp. Agency v. First Union Natl. Bank* (shortened to 60 days by agreement).

C. Theft by Employees

Defalcation

The most common case: employee forges indorsement on a check payable to the employer.

Most of the time, the general negligence rule or the bank-statement rule places the loss on the employer.

However, UCC 3-405 places the loss on the employer in every case where the loss is caused by a responsible employee.

Theft by an employee generates a lot of litigation. Who gets the loss? Agency drives the litigation.

§ 3-405	(a) In this section: (1) "Employee" includes an independent contractor and employee of an independent contractor retained by the employer. (2) "Fraudulent indorsement" means (i) in the case of an instrument payable to the employer, a forged indorsement purporting to be that of the employer, or (ii) in the case of an instrument with respect to which the employer is the issuer, a forged indorsement purporting to be that of the person identified as payee. (3) "Responsibility" with respect to instruments means authority (i) to sign or indorse instruments on behalf of the employer, (ii) to process instruments received by the employer for bookkeeping purposes, for deposit to an account, or for other disposition, (iii) to prepare or process instruments for issue in the name of the employer, (iv) to supply information determining the names or addresses of payees of instruments to be issued in the name of the employer, (v) to control the disposition of instruments to be issued in the name of the employer, or (vi) to act otherwise with respect to instruments in a responsible capacity. "Responsibility" does not include authority that merely allows an employee to have access to instruments or blank or incomplete instrument forms that are being stored or transported or are part of incoming or outgoing mail, or similar access. (b) For the purpose of determining the rights and liabilities of a person who, in good faith, pays an instrument or takes it for value or for collection, if an employer entrusted an employee with responsibility with respect to the instrument and the employee or a person acting in concert with the employee makes a fraudulent indorsement of the instrument, the indorsement is effective as the indorsement of the person to whom the instrument is payable if it is made in the name of that person. If the person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss resulting from the fraud, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss. (c) Under subsection (b), an indorsement is made in the name of the person to whom an instrument is payable if (i) it is made in a name substantially similar to the name of that person or (ii) the instrument, whether or not indorsed, is deposited in a depositary bank to an account in a name substantially similar to the name of that person.

Employers will try to shift back with comparative negligence under 3-405(b), but will also claim that the bank participated in the breach of fiduciary duty under UCC 3-307.

§ 3-307	(a) In this section: (1) "Fiduciary" means an agent, trustee, partner, corporate officer or director, or other representative owing a fiduciary duty with respect to an instrument. (2) "Represented person" means the principal, beneficiary, partnership, corporation, or other person to whom the duty stated in paragraph (1) is owed.

	(b) If (i) an instrument is taken from a fiduciary for payment or collection or for value, (ii) the taker has knowledge of the fiduciary status of the fiduciary, and (iii) the represented person makes a claim to the instrument or its proceeds on the basis that the transaction of the fiduciary is a breach of fiduciary duty, the following rules apply: (1) Notice of breach of fiduciary duty by the fiduciary is notice of the claim of the represented person. (2) In the case of an instrument payable to the represented person or the fiduciary as such, the taker has notice of the breach of fiduciary duty if the instrument is (i) taken in payment of or as security for a debt known by the taker to be the personal debt of the fiduciary, (ii) taken in a transaction known by the taker to be for the personal benefit of the fiduciary, or (iii) deposited to an account other than an account of the fiduciary, as such, or an account of the represented person. (3) If an instrument is issued by the represented person or the fiduciary as such, and made payable to the fiduciary personally, the taker does not have notice of the breach of fiduciary duty unless the taker knows of the breach of fiduciary duty. (4) If an instrument is issued by the represented person or the fiduciary as such, to the taker as payee, the taker has notice of the breach of fiduciary duty if the instrument is (i) taken in payment of or as security for a debt known by the taker to be the personal debt of the fiduciary, (ii) taken in a transaction known by the taker to be for the personal benefit of the fiduciary, or (iii) deposited to an account other than an account of the fiduciary, as such, or an account of the represented person.

Cable Cast Magazine v. Premier Bank

Facts:	Cablecast hired Pennington as a temporary employee. Sometime in 1994, Cablecast found shortages in revenue. Pennington had taken checks payable to Cablecast and deposited them to her personal account at Bank One. Pennington got $7,913.04 out of this. Cablecast sues Bank One alleging that they violated 3-307 by accepting instruments with knowledge of Pennington's breach of fiduciary duty. 3-405 applies to cases of fraudulent indorsement by responsible employees. 3-405(a)(3) defines a responsible employee. This was a fraudulent indorsement by a responsible employee.
Issue:	Did Bank 1 act in bad faith by accepting the checks from Pennington because Pennington was depositing checks made payable to Cablecast in her personal account?
Rule:	1-201(19) defines good faith as honesty in fact in the conduct or transaction concerned.
Held:	Bank 1 did not act dishonestly.
Why?	Bank 1 had no actual knowledge that Pennington was a fiduciary. Bank 1 had no rule that Pennington would have to show any documentation to deposit the checks. Cablecast was not registered as a trade name, so no inquiry would have shown that Pennington wasn't herself Cablecast.
Issue:	Did Bank 1 act with ordinary care?
Rule:	Cablecast is not prevented from shifting the loss based on Bank One's failure to exercise due care.
Held:	Nothing in the record that shows lack of ordinary care.

Usually, there's nothing on the face of the check to trigger an inquiry: everything looks fine. Therefore, the business can't go against the payor bank for negligence. They will try to go against the depository bank.

Halifax Corp. v. Wachovia Bank

Facts:	Adams embezzled $15.4 million while employed as comptroller of Halifax. Embezzlement was by check, writing 300 checks on First Union. Adams used a stamp with Halifax' president's signature. Deposited the checks in various accounts with Wachovia. In *Halifax I*, summary judgment in favor of First Union because Halifax failed to notify First Union within a year (4-406(f)). Halifax now sues Wachovia for negligence, gross negligence, and bad faith. Wachovia's managers were aware that Adams was Halifax' comptroller and that the checks she deposited were way out of line with her salary and presented a serious risk of fraud.

Issue:	Does UCC § 3-406, read with §§ 3-404 – 3-405, give rise to an affirmative cause of action for negligence by a depositary bank with respect to a forged signature?
Rule:	§ 3-406 does not create an affirmative cause of action.
Why?	Think about this from the standpoint of what does the plaintiff say to the jury? The claim here is that the bank is negligent, so negligent the risk of loss should shift from the company that employed this woman to the bank that let her. The courts are pretty clear that you have to have facts that show its SO out of the ordinary that the bank can't explain it all away.

D. Impostors

§ 3-404(a)	If an impostor, by use of the mails or otherwise, induces the issuer of an instrument to issue the instrument to the impostor, or to a person acting in concert with the impostor, by impersonating the payee of the instrument or a person authorized to act for the payee, an indorsement of the instrument by any person in the name of the payee is effective as the indorsement of the payee in favor of a person who, in good faith, pays the instrument or takes it for value or for collection.

Two elements:

An impostor.

Indorsement by someone purporting to be a fictitious person.

The UCC places the loss on the least-cost avoider: the person victimized by the fraud.

Meng v. Maywood Proviso State Bank

Facts:	Meng wanted to buy a building in Chicago. HUD held the mortgage on the foreclosed property. Meng hired Parolin to help purchase the home. Parolin had them establish a fund in the amount of the purchase price with cashier's checks. Parolin told them the checks had to be payable to himself and Kelly (who didn't exist). Meng bought three cashiers checks and gave them to Parolin. The checks were cashed at the three defendants. Each check had the signatures of Parolin and Kelly.
Issue:	Does the fictitious payee rule bar the breach of contract claim against the bank that issued and paid the checks upon presentment?
Rule:	UCC 3-404(b)(ii): Where a named payee is a fictitious person, then the indorsement by any person in the name of the name of the payee is effective as the indorsement of the payee.
Held:	Since the check had a signature purporting to be that of the fictitious payee, the check was properly indorsed.
Issue:	Was the check payable to John F. Parolin and David L. Kelly with no conjunction between the two names sufficiently ambiguous to invoke alternative payees?
Rule:	UCC 3-110: If an instrument payable to 2 or more persons is ambiguous as to whether it is payable to the persons alternatively, the instrument is payable to the persons alternatively. C/L gloss: The designation of two payees on a check is ambiguous where no directives are stated on the checks to determine the manner of payment.
Held:	The check was payable alternatively.
Issue:	Did the paying bank have a duty to inquire as to payees of a cashier's check?
Rule:	There is no duty to ask customers about payees of cashier's checks.

Question 5.1:

No. Leaving a check on a seat doesn't contribute to the forged indorsement.

He can sue the depositary institution to recover.

Note that the payee of a lost check [3-310(b)(4)] cannot enforce the underlying obligation, has to enforce the instrument.

However, 3-309 provides that you can go to the payor bank and prove that there's a lost, stolen, or destroyed item and enforce the item. If you can establish this, not paying it would be a wrongful dishonor.

Question 5.2:

a. Did Spode's negligence contribute to the negligence here? Not really.

b. Spode is on the hook here, Stiffy is an impostor

Assignment 6: Truncation and Check 21

A. Payor-Bank Truncation

Procedures designed to limit the need to transport checks back and forth: truncation.

The simplest form of truncation: Not returning checks to customers, just retaining them and sending information on statements.

48 states (NY and SC) adopted §4-406(a), which allows this form of truncation.

UCC § 4-406(a)	A bank that sends or makes available to a customer a statement of account showing payment of items for the account shall either return or make available to the customer the items paid or provide information in the statement of account sufficient to allow the customer reasonably to identify the items paid. The statement of account provides sufficient information if the item is described by item number, amount, and date of payment.

Statements must include:
a. Item number
b. Date paid
c. Amount

Consumer advocates complain that payee information isn't included because of the statement rule. Including this would cause a huge expense: the other info is on the MICR line. How useful would the rest of the information be?

If the payment is wholly unauthorized, the customer should be able to figure it out because they never wrote a check for that amount or that check number.

If an authorized check was stolen or altered, then the bank can't claim the customer should have reasonably known.

This just isn't a big deal.

Some states require banks to provide some or all originals on request free of charge.

B. Depositary Bank Truncation and the Check 21 Act

Electronic Check Presentment (ECP): The depositary bank retains the check or an image, then presents the item electronically to the payor bank.

Most ECP systems require the depositary bank to forward the actual item at some point.

To get the cost savings, have to develop a system of presenting items electronically only and destroying the original item in due course.

Major difficulty with implementation: not everyone on board.

Another major difficulty: Payees don't like it, want the original item returned.

Check 21
12 U.S.C. §§ 5001-5018 eff. 10/2004.

VERY LIMITED SCOPE!
Makes a "substitute" check the legal equivalent of a paper check. It does not authorize ECP.
ECP only available by contractual arrangement.

The process under Check 21 is that banks will agree to accept ECP, and if a paper copy of the check becomes necessary, reconversion of an electronic copy works.

The substitute check:

Check 21 §3(16) 12 CFR § 229.2	The term "substitute check" means a paper reproduction of the original check that – (A) contains an image of the front and back of the original check; (B) bears a MICR line containing all the information appearing on the MICR line of the original check, except as provided under generally applicable industry standards for substitute checks to facilitate the processing of substitute checks; (C) conforms, in paper stock, dimension, and otherwise, with generally applicable industry standards for substitute checks; and (D) is suitable for automated processing in the same manner as the original check.

"Image statements"—reduced-size photocopies of original checks do not qualify!

Check 21 requires a plain English statement "This is a legal copy of your check. You can use it the same way you would use the original check."

Check 21 §4(b)	**Legal equivalence** A substitute check shall be the legal equivalent of the original check for all purposes, including any provision of any Federal or State law, and for all persons if the substitute check-- **(1)** accurately represents all of the information on the front and back of the original check as of the time the original check was truncated; and **(2)** bears the legend: "This is a legal copy of your check. You can use it the same way you would use the original check.

The major advantage of Check 21: allows for ECP for portions of the transaction even if one of the parties in the chain won't accept.

Creates a new series of warranties and indemnities dealing with three problems.

1. Does the image accurately reflect the original check?
   § 5(1): The reconverting bank warrants the substitute check meets the requirements for legal equivalence in § 4(b).
2. Will the original paper check find its way into the check processing system?
   § 5(2): The reconverting bank warrants that no party will be called upon to pay the original item or a subsequent check made from that item.
3. Is the substitute an inadequate substitute in some way?
   § 6: The reconverting bank and subsequent banks must indemnify parties that suffer a loss because of the receipt of a substitute check instead of the original. If the substitute complied with Check 21, then indemnity limited to value of check. If not, indemnity is value of check plus losses proximately caused. § 6(b). Liability in either case is limited to losses incurred before provision of the original item. § 6(d).

4 A consumer who has a claim on a substitute check is entitled to a "prompt" recredit § 7.

Expedited Recredit Right for Consumers

Check 21 §7	**(a) Recredit claims** **(1) In general** A consumer may make a claim for expedited recredit from the bank that holds the account of the consumer with respect to a substitute check, if the consumer asserts in good faith that--

	(A) the bank charged the consumer's account for a substitute check that was provided to the consumer; **(B)** either-- **(i)** the check was not properly charged to the consumer's account; or **(ii)** the consumer has a warranty claim with respect to such substitute check; **(C)** the consumer suffered a resulting loss; and **(D)** the production of the original check or a better copy of the original check is necessary to determine the validity of any claim described in subparagraph (B). **(2) 40-day period** Any claim under paragraph (1) with respect to a consumer account may be submitted by a consumer before the end of the 40-day period beginning on the later of-- **(A)** the date on which the financial institution mails or delivers, by a means agreed to by the consumer, the periodic statement of account for such account which contains information concerning the transaction giving rise to the claim; or **(B)** the date on which the substitute check is made available to the consumer. **(3) Extension under extenuating circumstances** If the ability of the consumer to submit the claim within the 40-day period under paragraph (2) is delayed due to extenuating circumstances, including extended travel or the illness of the consumer, the 40-day period shall be extended by a reasonable amount of time. **(b) Procedures for claims** **(1) In general** To make a claim for an expedited recredit under subsection (a) with respect to a substitute check, the consumer shall provide to the bank that holds the account of such consumer-- **(A)** a description of the claim, including an explanation of-- **(i)** why the substitute check was not properly charged to the consumer's account; or **(ii)** the warranty claim with respect to such check; **(B)** a statement that the consumer suffered a loss and an estimate of the amount of the loss; **(C)** the reason why production of the original check or a better copy of the original check is necessary to determine the validity of the charge to the consumer's account or the warranty claim; and **(D)** sufficient information to identify the substitute check and to investigate the claim. **(2) Claim in writing** **(A) In general** The bank holding the consumer account that is the subject of a claim by the consumer under subsection (a) may, in the discretion of the bank, require the consumer to submit the information required under paragraph (1) in writing. **(B) Means of submission** A bank that requires a submission of information under subparagraph (A) may permit the consumer to make the submission electronically, if the consumer has agreed to communicate with the bank in that manner. **(c) Recredit to consumer** **(1) Conditions for recredit** The bank shall recredit a consumer account in accordance with paragraph (2) for the amount of a substitute check that was charged against the consumer account if-- **(A)** a consumer submits a claim to the bank with respect to that substitute check that meets the requirement of subsection (b); and **(B)** the bank has not-- **(i)** provided to the consumer-- **(I)** the original check; or **(II)** a copy of the original check (including an image or a substitute check) that

	accurately represents all of the information on the front and back of the original check, as of the time at which the original check was truncated; and **(ii)** demonstrated to the consumer that the substitute check was properly charged to the consumer account. **(2) Timing of recredit** **(A) In general** The bank shall recredit the consumer's account for the amount described in paragraph (1) no later than the end of the business day following the business day on which the bank determines the consumer's claim is valid. **(B) Recredit pending investigation** If the bank has not yet determined that the consumer's claim is valid before the end of the 10th business day after the business day on which the consumer submitted the claim, the bank shall recredit the consumer's account for-- **(i)** the lesser of the amount of the substitute check that was charged against the consumer account, or $2,500, together with interest if the account is an interest-bearing account, no later than the end of such 10th business day; and **(ii)** the remaining amount of the substitute check that was charged against the consumer account, if any, together with interest if the account is an interest-bearing account, not later than the 45th calendar day following the business day on which the consumer submits the claim. **(d) Availability of recredit** **(1) Next business day availability** Except as provided in paragraph (2), a bank that provides a recredit to a consumer account under subsection (c) shall make the recredited funds available for withdrawal by the consumer by the start of the next business day after the business day on which the bank recredits the consumer's account under subsection (c). **(2) Safeguard exceptions** A bank may delay availability to a consumer of a recredit provided under subsection (c)(2)(B)(i) until the start of either the business day following the business day on which the bank determines that the consumer's claim is valid or the 45th calendar day following the business day on which the consumer submits a claim for such recredit in accordance with subsection (b), whichever is earlier, in any of the following circumstances: **(A) New accounts** The claim is made during the 30-day period beginning on the business day the consumer account was established. **(B) Repeated overdrafts** Without regard to the charge that is the subject of the claim for which the recredit was made-- **(i)** on 6 or more business days during the 6-month period ending on the date on which the consumer submits the claim, the balance in the consumer account was negative or would have become negative if checks or other charges to the account had been paid; or **(ii)** on 2 or more business days during such 6-month period, the balance in the consumer account was negative or would have become negative in the amount of $5,000 or more if checks or other charges to the account had been paid. **(C) Prevention of fraud losses** The bank has reasonable cause to believe that the claim is fraudulent, based on facts (other than the fact that the check in question or the consumer is of a particular class) that would cause a well-grounded belief in the mind of a reasonable person that the claim is fraudulent. **(3) Overdraft fees** No bank that, in accordance with paragraph (2), delays the availability of a recredit under subsection (c) to any consumer account may impose any overdraft fees with respect to drafts drawn by the consumer on such recredited amount before the end of the 5-day period beginning on the date notice of the delay in the availability of such amount is sent by the bank to the consumer.

	(e) Reversal of recredit A bank may reverse a recredit to a consumer account if the bank-- **(1)** determines that a substitute check for which the bank recredited a consumer account under subsection (c) was in fact properly charged to the consumer account; and **(2)** notifies the consumer in accordance with subsection (f)(3). **(f) Notice to consumer** **(1) Notice if consumer claim not valid** If a bank determines that a substitute check subject to the consumer's claim was in fact properly charged to the consumer's account, the bank shall send to the consumer, no later than the business day following the business day on which the bank makes a determination-- **(A)** the original check or a copy of the original check (including an image or a substitute check) that-- **(i)** accurately represents all of the information on the front and back of the original check (as of the time the original check was truncated); or **(ii)** is otherwise sufficient to determine whether or not the consumer's claim is valid; and **(B)** an explanation of the basis for the determination by the bank that the substitute check was properly charged, including a statement that the consumer may request copies of any information or documents on which the bank relied in making the determination. **(2) Notice of recredit** If a bank recredits a consumer account under subsection (c), the bank shall send to the consumer, no later than the business day following the business day on which the bank makes the recredit, a notice of-- **(A)** the amount of the recredit; and **(B)** the date the recredited funds will be available for withdrawal. **(3) Notice of reversal of recredit** In addition to the notice required under paragraph (1), if a bank reverses a recredited amount under subsection (e), the bank shall send to the consumer, no later than the business day following the business day on which the bank reverses the recredit, a notice of-- **(A)** the amount of the reversal; and **(B)** the date the recredit was reversed. **(4) Mode of delivery** A notice described in this subsection shall be delivered by United States mail or by any other means through which the consumer has agreed to receive account information. **(g) Other claims not affected** Providing a recredit in accordance with this section shall not absolve the bank from liability for a claim made under any other law, such as a claim for wrongful dishonor under the Uniform Commercial Code, or from liability for additional damages under section 5005 or 5009 of this title. **(h) Clarification concerning consumer possession** A consumer who was provided a substitute check may make a claim for an expedited recredit under this section with regard to a transaction involving the substitute check whether or not the consumer is in possession of the substitute check. **(i) Scope of application** This section shall only apply to customers who are consumers.

If a customer asserts an item is not properly payable or there is a breach of a § 5 warranty, the customer can claim a recruit. § 7(1)

Must make claim within 40 days of the date the bank delivered the substitute check and relevant bank statement. § 7(2).

The bank must then provide the recredit if it cannot demonstrate to the customer that that the substitute check was properly charged to the consumer account. § 7(c)(1). The recredit must be

made by the end of the business day after the business day the bank determines the claim is valid. § 7(c)(2).
Pending investigation, the recredit must be made no later than the end of the tenth business day after the submission of the claim. If more than $2,500, can delay for 45 days.

Chapter 2. Electronic Payments

Assignment 7: The Credit-Card System

A. The Issuer – Cardholder Relationship

Four major participants in the credit-card system:

1. Purchaser who holds the card
2. The merchant
3. Acquirer
4. Issuer

There's also the network. Visa or MC don't directly participate in the transaction, more operate as facilitators.

The principal regulations affecting credit cards:
TILA (15 USC §§1661-1667e) (All citations are to the Consumer Credit Protection Act).
Reg Z (12 C.F.R. Pt. 226)

Regulations focus on the credit aspect.

TILA defines Credit Card: "Any card…or other credit device existing for the purpose of obtaining money, property, labor, or services on credit."

TILA § 103(k)	The term "credit card" means any card, plate, coupon book or other credit device existing for the purpose of obtaining money, property, labor, or services on credit.

TILA is mostly limited to consumer transactions.
With one exception, limited to credit extended to individuals, and does not apply to credit extended primarily for business, commercial, or agricultural purposes. Does not apply to transactions over $25,000

TILA § 104(1)	Credit transactions involving extensions of credit primarily for business, commercial, or agricultural purposes, or to government or governmental agencies or instrumentalities, or to organizations.
12 C.F.R. § 226.3(a)	This regulation does not apply to the following:[4] (a) Business, commercial, agricultural, or organizational credit. (1) An extension of credit primarily for a business, commercial or agricultural purpose. (2) An extension of credit to other than a natural person, including credit to government agencies or instrumentalities.
TILA § 104(3)	Credit transactions, other than those in which a security interest is or will be acquired in real property, or in personal property used or expected to be used as the principal dwelling of the consumer and other than private education loans (as that term is defined in section 1650(a) of this title), in which the total amount financed exceeds $25,000.

Banks may not issue credit cards except in response to an application or request.

TILA § 132	No credit card shall be issued except in response to a request or application

	therefor. This prohibition does not apply to the issuance of a credit card in renewal of, or in substitution for, an accepted credit card.
12 C.F.R. §226.12(a)	(a) Issuance of credit cards. Regardless of the purpose for which a credit card is to be used, including business, commercial, or agricultural use, no credit card shall be issued to any person except-- (1) In response to an oral or written request or application for the card; or (2) As a renewal of, or substitute for, an accepted credit card.

Reg Z requires a "clear and conspicuous" disclosure of the applicable rules, which are enforceable by a private right of action under TILA.

12 C.F.R. § 226.5(a)(1)	(a) Form of disclosures. (1) General. (i) The creditor shall make the disclosures required by this subpart clearly and conspicuously. (ii) The creditor shall make the disclosures required by this subpart in writing,[7] in a form that the consumer may keep,[8] except that: (A) The following disclosures need not be written: Disclosures under § 226.6(b)(3) of charges that are imposed as part of an open-end (not home-secured) plan that are not required to be disclosed under § 226.6(b)(2) and related disclosures of charges under § 226.9(c)(2)(iii)(B); disclosures under § 226.9(c)(2)(vi); disclosures under § 226.9(d) when a finance charge is imposed at the time of the transaction; and disclosures under § 226.56(b)(1)(i). (B) The following disclosures need not be in a retainable form: Disclosures that need not be written under paragraph (a)(1)(ii)(A) of this section; disclosures for credit and charge card applications and solicitations under § 226.5a; home-equity disclosures under § 226.5b(d); the alternative summary billing-rights statement under § 226.9(a)(2); the credit and charge card renewal disclosures required under § 226.9(e); and the payment requirements under § 226.10(b), except as provided in § 226.7(b)(13). (iii) The disclosures required by this subpart may be provided to the consumer in electronic form, subject to compliance with the consumer consent and other applicable provisions of the Electronic Signatures in Global and National Commerce Act (E–Sign Act) (15 U.S.C. 7001 et seq.). The disclosures required by §§ 226.5a, 226.5b, and 226.16 may be provided to the consumer in electronic form without regard to the consumer consent or other provisions of the E–Sign Act in the circumstances set forth in those sections.
TILA § 130	Too long

The credit-card relationship is the opposite of the checking relationship.

Even in a secured credit card situation, the issuer cannot simply offset charges against predeposited funds. They CAN periodically deduct an amount from the funds to pay a prearranged portion of the charges.

TILA § 169	**(a) Offset against consumer's funds** A card issuer may not take any action to offset a cardholder's indebtedness arising in connection with a consumer credit transaction under the relevant credit card plan against funds of the cardholder held on deposit with the card issuer unless-- **(1)** such action was previously authorized in writing by the cardholder in accordance with a credit plan whereby the cardholder agrees periodically to pay debts incurred in his open end credit account by permitting the card issuer periodically to deduct all or a portion of such debt from the cardholder's deposit account, and **(2)** such action with respect to any outstanding disputed amount not be taken by the card issuer upon request of the cardholder.

	In the case of any credit card account in existence on the effective date of this section, the previous written authorization referred to in clause (1) shall not be required until the date (after such effective date) when such account is renewed, but in no case later than one year after such effective date. Such written authorization shall be deemed to exist if the card issuer has previously notified the cardholder that the use of his credit card account will subject any funds which the card issuer holds in deposit accounts of such cardholder to offset against any amounts due and payable on his credit card account which have not been paid in accordance with the terms of the agreement between the card issuer and the cardholder. **(b) Attachments and levies** This section does not alter or affect the right under State law of a card issuer to attach or otherwise levy upon funds of a cardholder held on deposit with the card issuer if that remedy is constitutionally available to creditors generally.
12 C.F.R. § 226.12(d)(3)	This paragraph does not prohibit a plan, if authorized in writing by the cardholder, under which the card issuer may periodically deduct all or part of the cardholder's credit card debt from a deposit account held with the card issuer (subject to the limitations in § 226.13(d)(1)).

Most of the profit in the system comes from interest. Leads to oddity where most credit-worthy consumers (convenience users) are the ones that the bank hates.
Banks
1. Impose annual fees.
2. Features that will encourage usage.
    a. Get interchange fees.

TILA § 169(a) severely limits the right of a bank to offset against a consumer's bank account for a credit card.
1. Must consent in writing in connection with a plan to obtain monthly automatic payments. § 169(a)(1)
2. Can't deduct payment if it's for a charge the consumer disputes and the cardholder asks them not to. § 169(a)(2).

B. Using the Credit-Card Account

Step 1: The merchant swipes the card and the terminal reads the magnetic strip.
Mag strip: description of bank, account number, and card verification value.
Step 2: Terminal conducts an authorization trhasaction.
Sends encrypted message identifying card number, CVC, expiration date, amount, location, and Standard Industry Classification.
Step 3: Issuer determines if it's a valid card and if the amount OK. Also compares CVC to determine if counterfeit card.
Also checks for undue risk of fraud—the SIC is big in this, as is the location. Neural networks.

C. Collection by the Payee

1. The Mechanics of Collection

To turn the credit slip into money, the merchant has to turn it in to his network.

To collect, the merchant must have an agreement with a member of the applicable network, VISA, MC, Discover, whatever.

Tiers of discount rates to give the merchant a strong incentive to take care with their decision to accept a card.

Networks used to forbid cash discounts, but those agreements now forbidden.

TILA § 167	**(a) Cash discounts** With respect to credit card which may be used for extensions of credit in sales transactions in which the seller is a person other than the card issuer, the card issuer may not, by contract, or otherwise, prohibit any such seller from offering a discount to a cardholder to induce the cardholder to pay by cash, check, or similar means rather than use a credit card. **(b) Finance charge** With respect to any sales transaction, any discount from the regular price offered by the seller for the purpose of inducing payment by cash, checks, or other means not involving the use of an open-end credit plan or a credit card shall not constitute a finance charge as determined under section 1605 of this title if such discount is offered to all prospective buyers and its availability is disclosed clearly and conspicuously.
12 C.F.R. § 226.12(f)	Discounts; tie-in arrangements. No card issuer may, by contract or otherwise: (1) Prohibit any person who honors a credit card from offering a discount to a consumer to induce the consumer to pay by cash, check, or similar means rather than by use of a credit card or its underlying account for the purchase of property or services; or (2) Require any person who honors the card issuer's credit card to open or maintain any account or obtain any other service not essential to the operation of the credit card plan from the card issuer or any other person, as a condition of participation in a credit card plan. If maintenance of an account for clearing purposes is determined to be essential to the operation of the credit card plan, it may be required only if no service charges or minimum balance requirements are imposed.

The merchant typically delivers slips to his acquirer on a daily basis. The terminal will also send a batched message to the acquirer describing the day’s transactions.

The acquirer typically gives provisional credit to the merchant’s account for the charges processed that day. The funds become available a few days later subject to the acquirer’s right to chargeback if the cardholder refuses to pay.

The provisional credit to the merchant is less than the gross amount of the transaction.

1. Percentage discount
2. Per item discount

Merchants selling in high risk situations (ie mail order or telephone) typically pay higher discounts.

Generally a higher charge for “non-qualifying” purchases (card unreadable or whatever, just punch it in the terminal)

The acquirer passes the slips along to get payment
Sorts into:

- On-us
- Transit
    - Separate piles for each network.
    - Sends transit items in batch message to network
    - Network deducts interchange fee and credits acquirer’s account.

Network separates into issuer, deducts from issuer account.

2. Finality of Payment

Consumers have the right to cancel payment much broader than in the other systems.

Cardholders have the right to withhold payment on the basis of any defense that could be asserted against the original merchant, including common-law warranties.

TIlA § 170(a)	**Claims and defenses assertible** Subject to the limitation contained in subsection (b) of this section, a card issuer who has issued a credit card to a cardholder pursuant to an open end consumer credit plan shall be subject to all claims (other than tort claims) and defenses arising out of any transaction in which the credit card is used as a method of payment or extension of credit if (1) the obligor has made a good faith attempt to obtain satisfactory resolution of a disagreement or problem relative to the transaction from the person honoring the credit card; (2) the amount of the initial transaction exceeds $50; and (3) the place where the initial transaction occurred was in the same State as the mailing address previously provided by the cardholder or was within 100 miles from such address, except that the limitations set forth in clauses (2) and (3) with respect to an obligor's right to assert claims and defenses against a card issuer shall not be applicable to any transaction in which the person honoring the credit card (A) is the same person as the card issuer, (B) is controlled by the card issuer, (C) is under direct or indirect common control with the card issuer, (D) is a franchised dealer in the card issuer's products or services, or (E) has obtained the order for such transaction through a mail solicitation made by or participated in by the card issuer in which the cardholder is solicited to enter into such transaction by using the credit card issued by the card issuer.

Card-issuing networks generally pass this risk along to the merchant by contract.

Otherwise, merchants would have bad incentives.

The cardholder's right under TILA § 170(a) is only a right to withhold payment, not a right to claw payments back. The right dissipates as the cardholder pays off the balance generated by the transaction.

TILA 170(b)	**Amount of claims and defenses assertible** The amount of claims or defenses asserted by the cardholder may not exceed the amount of credit outstanding with respect to such transaction at the time the cardholder first notifies the card issuer or the person honoring the credit card of such claim or defense. For the purpose of determining the amount of credit outstanding in the preceding sentence, payments and credits to the cardholder's account are deemed to have been applied, in the order indicated, to the payment of: (1) late charges in the order of their entry to the account; (2) finance charges in order of their entry to the account; and (3) debits to the account other than those set forth above, in the order in which each debit entry to the account was made.
12 C.F.R. 226.12(c)	Right of cardholder to assert claims or defenses against card issuer.[24] (1) General rule. When a person who honors a credit card fails to resolve satisfactorily a dispute as to property or services purchased with the credit card in a consumer credit transaction, the cardholder may assert against the card issuer all claims (other than tort claims) and defenses arising out of the transaction and relating to the failure to resolve the dispute. The cardholder may withhold payment up to the amount of credit outstanding for the property or services that gave rise to the dispute and any finance or other charges imposed on that amount.[25] (2) Adverse credit reports prohibited. If, in accordance with paragraph (c)(1) of this section, the cardholder withholds payment of the amount of credit outstanding for the disputed transaction, the card issuer shall not report that amount as delinquent until the dispute is settled or judgment is rendered. (3) Limitations. (i) General. The rights stated in paragraphs (c)(1) and (c)(2) of this section apply only if: (A) The cardholder has made a good faith attempt to resolve the dispute with the person honoring the credit card; and (B) The amount of credit extended to obtain the property or services that result in the assertion of the claim or defense by the cardholder exceeds $50, and the disputed

	transaction occurred in the same state as the cardholder's current designated address or, if not within the same state, within 100 miles from that address.[26] (ii) Exclusion. The limitations stated in paragraph (c)(3)(i)(B) of this section shall not apply when the person honoring the credit card: (A) Is the same person as the card issuer; (B) Is controlled by the card issuer directly or indirectly; (C) Is under the direct or indirect control of a third person that also directly or indirectly controls the card issuer; (D) Controls the card issuer directly or indirectly; (E) Is a franchised dealer in the card issuer's products or services; or (F) Has obtained the order for the disputed transaction through a mail solicitation made or participated in by the card issuer.

Cardholder must also make a good-faith effort to resolve with the merchant. TILA § 170(a)(1)

Can't withhold payments outside the state of residence and more than 100 miles from the billing address. § 170(a)

Hyland v. First USA Bank

Facts:	2/94 FUSA issued a gold card to Hyland. Hyland used the card to purchase a carpet from Evangelinos in Greece. Evangelinos made express warranties regarding the carpet which turned out the be false. Hyland contacted FUSA, FUSA told him to send it back. Greek customs seized the carpet when Hyland refused to pay duty. Hyland told FUSA they would hold FUSA liable for the seizure. Hyland claims that FUSA told him they'd refund the money if he returned the carpet and gave FUSA a return receipt. FUSA says the consumer protection doesn't extend to transactions outside the USA.
Issue:	May Hyland pursue his breach of warranty action against FUSA under TILA § 170(a)?
Rule:	A card issuer who has issued a credit card to a cardholder…shall be subject to all claims (other than tort claims) and defenses arising out of any transaction in which the credit card is used as a method of payment or extension of credit. § 170(a). However, this is limited to situations where the initial transaction was in the same State or less than 100 miles from the consumer's billing address.
Held:	The complaint doesn't satisfy the geographical limitations on § 170(a).
Issue:	Did FUSA waive their defense by telling Hyland to return the carpet?
Rule:	A waiver is a voluntary and intentional relinquishment or abandonment of a known right.
Held:	Plaintiffs sufficiently alleged waiver to proceed.
Why?	The plaintiffs allege the bank told them they'd help out, knowing the transaction was in Greece.

Not clear if the 100 mile limitation applies to mail order.

Lots of banks don't enforce their rights under the 100 mile limitation.
    Pisses off the customer
    High transaction costs involved in defending.

CitiBank (South Dakota), N.A. v. Mincks

Facts:	9/18/1999 Mary applied for Platinum Credit Card. The application did not indicate whether for business or consumer credit. Citi issued $8k card. Mary added Chuck as authorized user. Chuck bought some stuff from PPBG to contact customers. Sent order form on 2/24/2000 by fax from MO to OH. Four weeks later, hadn't gotten the stuff and contacted PPBG. Waited a month, contacted again. 5/2000, found out the product was discontinued. 5/18/2000 asked for replacement goods. 6/13/2000 asked again. 8/1/2000: give me my money back. 9/1/2000: PPBG shuts down. 9/28/2000, Mary sent letter to Citi telling them what's going on. Citi said tough shit, not within 60 days of disputed charge. 2/2002, Minks stopped making payments on remaining balance—only the stuff from PPBG.

Big Issue:	Is Mary entitled to assert PPBG's non-delivery as a defense against Citi, who sought to recover the purchase price as PPBG's assignee?
Issue 1:	Do the provisions of TILA and Reg. Z apply to Mary's credit card?
Rule:	TILA is remedial in nature and must be strictly construed against creditors and liberally in favor of debtors.
Rule:	TILA covers open end consumer credit plans. 15 U.S.C. § 1637.
Rule:	Consumer characterizes the transaction as one in which the party to whom credit is offered or extended to a natural person, and the money…which are the subject of the transaction are primarily for personal, family, or household purposes. 15 USC § 1602(h).
Rule:	Open-end credit plan: One which the creditor reasonably expects repeated transactions under.
Held:	This was a consumer open-ended credit card.
Issue:	Was this a business transaction and not covered by Reg Z and TILA?
Rule:	Construing Reg Z liberally in favor of the debtor, transaction can mean either the purchase or the extension of credit. Since it should be liberally construed, the most favorable reading is to mean the extension of credit.
Held:	The extension of credit was opening the credit line, which was for consumer purposes.

Assignment 8: Error and Fraud in Credit-Card Transactions

A. Erroneous Charges

TILA § 161 and 12 C.F.R. § 226.13 provide detailed instructions on resolving billing errors related to credit cards.

Broad meaning to the term “Billing Error”: Not only claims that the cardholder didn’t make the charge, but claims the merchant failed to deliver the goods and requests for clarification about the charge.

If a cardholder alleges that the merchant failed to deliver the goods or services covered by the charge, the issuer can’t reject the claim without “conducting a reasonable investigation and determining the property or services were actually delivered.” 12 C.F.R. § 226.13(f) n. 31.

Must send acknowledgement of notice within 30 days and resolve the claim within two billing cycles. Must provide a written explanation of why not going to honor request within 2 billing cycles. § 161(a), 12 CFR §226.13(c).

Can’t close or restrict the account for failure to pay the disputed amount during pendency. § 161(d), 12 CFR § 226.13(d).

Can accrue finance charge against the purchase, but can’t apply until they determine the charge is legit. 12 C.F.R. §§226.13(d)(1) n.30 226.13(g)(1).

$50 penalty for failure to follow dispute procedures. TILA § 161(e).

Belmont v. Associates National Bank (Delaware)

Facts:	Belmont cosigned a card for his son. Later on, paid off the card and sent letter saying he wanted off the account. The bank cashed the payoff check, but didn’t remove him from the account (didn’t have to, of course). Associates kept sending statements to son’s address with Belmont’s name on them. Son filed for bankruptcy. Associates removed son’s name from account and made Belmont primary account holder and started sending statements to him. Shit starts popping now. 5/15/1998 Belmont sent letter stating he wasn’t an obligor on the account, and that putting his name on the account constituted a billing error. Belmont requested any documentary evidence of his indebtedness. 6/23/1998, Belmont sent a second letter. 6/25/1998, Associates responded with a dunning letter. 6/20/1998, Associates sent a letter acknowledging the dispute. 6/20/1998, Associates sent another letter saying can’t find copy of the original application and said he’d have to get with Boatmen’s on that. 7/22/1998, Associates sent another duning letter. 7/29/1998, Belmont sent another letter saying billing error. Associates then tells Belmont he doesn’t have a right to the original application, his name’s on the account, and to eff off and die. Associates reports him delinquent to TU.
Issue:	Is this a billing error under the meaning of 15 U.S.C. § 1666(b)?
Rule:	§1666(b)(1), a billing error includes a statement of credit which was not made to the obligor…§ 1666(b)(2) request for clarification including documentary evidence invokes billing error.
Held:	This would seem to fall under this.
Why?	Looks right, and remember TILA is construed liberally in favor of the debtor.
Issue:	Did Belmont comply with the notice requirements of §1666?

Held:	Yes. He repeatedly stated his name and account number and indicated the reason he believed a billing error occurred. It's doubtful Associates has ever received a more clear notice of billing error. Plus, Associates knew damn well it was a billing error dispute.
Issue:	Did Associates comply with the notice and resolution requirements of § 1666
Rule:	§ 1666(a)(3)(A) requires a creditor to acknowledge receipt of a notice of billing error within 30 days.
Held:	No, they didn't
Why?	Duh. Also, the argument that they mailed within two billing cycles is stupid: that's the time to resolve, not the time to acknowledge. The resolution was similarly flawed: you don't get to just say something and be done, you have to either make corrections to the account or send a written explanation of why not, including copies of requested documentary evidence.
Note:	The court also discussed remedies. In this case, just because Associates ended up deleting the TU hit and forgiving the debt, that wasn't enough. There's a penalty that allows damages of twice the finance charges imposed up to $1000—even if they eventually didn't pay it.

Although the issuer is the one who can't collect, the risk gets passed back up the system by contract to the issuer then to the merchant.

B. Unauthorized Charges

These are the more serious deal. It's an attempt by someone to obtain goods and services without paying for them, leaving others to bear the costs.

There are strong protections for cardholders.

1. Cardholder liability limited to $50. TILA § 133(a)(1)(B). This is an absolute cap no matter what. 12 C.F.R. § 226.12(b)(1).
2. Cardholder is absolutely immune to any charge after they report the card lost or stolen. TILA § 133(a)(1)(E).
3. VISA and MC voluntary policies: cardholders are free from responsibility if they report the card lost or stolen within two business days after loss.

TILA § 133(a)(1)(B)	A cardholder shall be liable for the unauthorized use of a credit card only if--the liability is not in excess of $50;
TILA § 133(a)(1)(E)	A cardholder shall be liable for the unauthorized use of a credit card only if-- the unauthorized use occurs before the card issuer has been notified that an unauthorized use of the credit card has occurred or may occur as the result of loss, theft, or otherwise;

Regardless, a court may determine that a cardholder's behavior is so negligent that they forfeit the protection of § 133.

DBI Architects, P.C. v. American Express Travel-Related Services Co.

Facts:	DBI has an AMEX corporate credit card account. Moore was DBI's accounting manager. Moore requested that AMEX add her as an authorized user on the AMEX account without DBI's approval, which AMEX did. Moore would cut checks to pay the AMEX bill as they came in and stamp the checks with the CEO's signature. This went on for ten billing cycles, until DBI discovered the problem, fired Moore, and notified AMEX of the fraudulent charges.
Issue:	Were these charges authorized under the meaning of 15 U.S.C. § 1643?
Issue:	Did Moore's apparent authority make her an authorized user?
Rule:	Whether apparent authority exists is determined by state law. 12 C.F.R. § 226.12(b)(1)
Rule:	A principal may be estopped from denying apparent authority if the principal intentionally or negligently created an appearance of authority in the agent, on which a third party relied in changing its position.

Held:	The failure to inspect the statements did not create apparent authority, as there is no affirmative duty to inspect statements. However, they did create apparent authority by paying the bills each month.
Why?	The plain language of § 1643 does not require a cardholder to inspect monthly billing statements to invoke its protection. However, a cardholder has certain responsibilities to prevent fraudulent use, and paying over and over without protest when they could have cut the fraud out earlier gives the bank the impression everything's OK. This is an imposition of the statement rule from check land.

New Century Financial Services v. Dennigar

Facts:	2/1/2001, AT&T issued a card in the name of Dennigar. The card now has $14,752 owing. Dennigar says he doesn't know about the card and he didn't open it. However, he did live with Knutson from 1999-2003. Dennigar was sickly and allowed Knutson to manage his household affairs, including finances and mail. Dennigar knew Knutson was signing his names to checks and was OK with that.
Issue:	Were Knutson's transactions on the card (and even the issuance of the card) unauthorized?
Rule:	A principal is accountable for the conduct of his agent acting within the scope of his authority even though the conduct is unauthorized and the principal receives no benefit. Since the principal put the agent in the position where he had the power to perpetuate the wrong, the principal rather than the innocent third party should bear the loss.
Held:	The trial judge found as a fact that Knutson was Dennigar's agent for these purposes, and there is no reason to disturb that finding.
Why?	Remember, TILA protections are for UNAUTHORIZED use. Knutson had authority.

TILA protections against unauthorized charges apply in both a consumer and business setting.

However, issuers servicing businesses can opt out.

Any business that issues cards to at least ten employees can accept liability for losses without regard to § 133. TILA § 135. Can't pass that loss along to the employees.

TILA § 135	The exemption provided by section 1603(1) of this title does not apply to the provisions of sections 1642, 1643, and 1644 of this title, except that a card issuer and a business or other organization which provides credit cards issued by the same card issuer to ten or more of its employees may by contract agree as to liability of the business or other organization with respect to unauthorized use of such credit cards without regard to the provisions of section 1643 of this title, but in no case may such business or other organization or card issuer impose liability upon any employee with respect to unauthorized use of such a credit card except in accordance with and subject to the limitations of section 1643 of this title.

In face-to-face transactions, the network rules state that the issuer bears the loss from unauthorized transactions as long as the merchant followed the right procedures.

In phone, mail, or internet (remote) transactions, the merchant bears the risk of loss.

Two types of clear fraud, where there's no authority issues:
1. Intercepted card
2. Counterfeit card

Assignment 9: Debit Cards

A. Payment with a Debit Card

A debit card always serves as an adjunct to some kind of depositary account.
It's a device to facilitate access to funds already in the account or available through an overdraft.

Credit and debit cards can be combined on the same plastic, but rarely are. 12 C.F.R. § 205.12.

Replaces the paper check with an electronic impulse.

This qualifies under EFTA, 15 U.S.C. § 1693 *et seq*. Title IX §§901-920 of the CCPA.

EFTA § 903	As used in this subchapter-- **(1)** the term "accepted card or other means of access" means a card, code, or other means of access to a consumer's account for the purpose of initiating electronic fund transfers when the person to whom such card or other means of access was issued has requested and received or has signed or has used, or authorized another to use, such card or other means of access for the purpose of transferring money between accounts or obtaining money, property, labor, or services; **(2)** the term "account" means a demand deposit, savings deposit, or other asset account (other than an occasional or incidental credit balance in an open end credit plan as defined in section 1602(i) of this title), as described in regulations of the Board, established primarily for personal, family, or household purposes, but such term does not include an account held by a financial institution pursuant to a bona fide trust agreement; **(3)** the term "Board" means the Board of Governors of the Federal Reserve System; **(4)** the term "business day" means any day on which the offices of the consumer's financial institution involved in an electronic fund transfer are open to the public for carrying on substantially all of its business functions; **(5)** the term "consumer" means a natural person; **(6)** the term "electronic fund transfer" means any 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. Such term includes, but is not limited to, point-of-sale transfers, automated teller machine transactions, direct deposits or withdrawals of funds, and transfers initiated by telephone. Such term does not include-- **(A)** any check guarantee or authorization service which does not directly result in a debit or credit to a consumer's account: **(B)** any transfer of funds, other than those processed by automated clearinghouse, made by a financial institution on behalf of a consumer by means of a service that transfers funds held at either Federal Reserve banks or other depository institutions and which is not designed primarily to transfer funds on behalf of a consumer; **(C)** any transaction the primary purpose of which is the purchase or sale of securities or commodities through a broker-dealer registered with or regulated by the Securities and Exchange Commission; **(D)** any automatic transfer from a savings account to a demand deposit account pursuant to an agreement between a consumer and a financial institution for the purpose of covering an overdraft or maintaining an agreed upon minimum balance in the consumer's demand deposit account; or **(E)** any transfer of funds which is initiated by a telephone conversation between a consumer and an officer or employee of a financial institution which is not pursuant to a prearranged plan and under which periodic or recurring transfers are not contemplated;

	as determined under regulations of the Board; **(7)** the term "electronic terminal" means an electronic device, other than a telephone operated by a consumer, through which a consumer may initiate an electronic fund transfer. Such term includes, but is not limited to, point-of-sale terminals, automated teller machines, and cash dispensing machines; **(8)** the term "financial institution" means a State or National bank, a State or Federal savings and loan association, a mutual savings bank, a State or Federal credit union, or any other person who, directly or indirectly, holds an account belonging to a consumer; **(9)** the term "preauthorized electronic fund transfer" means an electronic fund transfer authorized in advance to recur at substantially regular intervals; **(10)** the term "State" means any State, territory, or possession of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or any political subdivision of any of the foregoing; and **(11)** the term "unauthorized electronic fund transfer" means an electronic fund transfer from a consumer's account initiated by a person other than the consumer without actual authority to initiate such transfer and from which the consumer receives no benefit, but the term does not include any electronic fund transfer (A) initiated by a person other than the consumer who was furnished with the card, code, or other means of access to such consumer's account by such consumer, unless the consumer has notified the financial institution involved that transfers by such other person are no longer authorized, (B) initiated with fraudulent intent by the consumer or any person acting in concert with the consumer, or (C) which constitutes an error committed by a financial institution.

1. Establishing the Debit-Card Relationship

EFTA establishes two procedural requirements to complicate adding debit-cards to a banking relationship.

1. Cannot send a validated card to the customer. § 911(b)
2. Must include upfront disclosures about the terms and conditions of the debit card relationship. 12 C.F.R. § 205.7(a).

2. Transferring Funds with a Debit Card

Two basic uses of a debit card:

1. Depositing and withdrawing money from an account without having to go to the bank.
2. Point-of-sale (POS) transactions.
   EFTA § 906(a) requires that the merchant provide a paper record of the transaction.

3. Collection by the Payee

Two types of collection networks

1. PIN-based
2. Signature (or PIN-less).

a. PIN-based ("Online") Debit Cards

The cardholder swipes the card. Two transmissions:

1. Encrypted signal with the PIN
   Description of the request (amount, account, PIN)
   The payor bank checks the PIN and balance. If all goes well:
2. Transmission from payor bank to merchant with authorization.
   Typical network rules: This is <u>final</u>. Payee's risk is limited to insolvency of payor bank.

b. PIN-less ("Offline") Debit Cards

These are Visa CheckCards and MasterCard MasterMoney cards.
In a typical network, the bank can charge a transaction back to a merchant only if the merchant knew at the time there was a failure of the authentication system.

Signature-based transactions cost as much as credit card transactions, much more than PIN-based.

Tension between banks and merchants: merchants want people to use PIN-based, banks want people to use signature based.

The major difference between signature-based debit-cards and credit cards is finality of payment. They're not governed by TILA, so the cardholder doesn't have the TILA § 133 rights.

B. Error and Fraud in Debit-Card Transactions

The risk of non-payment by the cardholder is extremely low because of the finality of payment. Therefore, the major risk in the system for loss is from either erroneous transactions and fraudulent transactions.

1. Erroneous Transactions.

If the system fails and produces false authorizations, the system allocates the risk to the paying bank: the network and paying bank can mitigate losses more easily by charging the customer's account into overdraft.

2. Fraudulent Transactions

Features of the system to minimize losses:

1. No unsolicited mailing of activated debit cards
2. Mailing PINs separately
3. PIN encryption at the terminal.
4. Terminals destroy the encryption key if tampered with

There's almost no reported litigation around this.

The system must resolve two questions when losses arise from false authorizations.

1. Who bears the loss as between the merchant and the bank?
   Networks allocate to the bank, as the bank is the best able to mitigate loss.
2. Who bears the loss as between the bank and the customer?
   Federal law provides two protections for customers:
   1. Threshold level of security for confirming transactions: signature verification, PIN, photo ID, biometrics. Without that minimal security, can't charge fraudulent transaction to the customer. EFTA § 909(a).
   2. These limitations apply to a series of related unauthorized transactions. 12 C.F.R. § 205.6
      a. The bank can hold the customer liable for up to $50 of any loss before the bank knows about the loss of card. § 909(a).
      b. The bank can hold the customer liable for up to $500 if the customer does not inform the bank of the lost card "promptly" (2 days). § 909(a).
      c. A bank statement rule: if the customer doesn't report unauthorized transactions within 60 days from when the statement showing the transactions is sent, they're SOL: They bear the responsibility for any transactions that would have been stopped had the consumer reported the loss within 60 days. § 909(a); 12 C.F.R. § 205.6(b)(3).

   EFTA has a non-preemption clause: states can make rules that shift the balance more towards consumers. EFTA § 919.

   Both major networks limit exposure to $50 for the consumer.

Framework for resolving disputes about whether a transaction was authorized. § 908(a).

1. Customer must give notice of the transaction that's supposedly unauthorized within 60 days of the bank mailing the statement with the transaction on it.

2. The bank must conduct an investigation and provide the customer with a written explanation of its conclusion within 10 business days or give a provisional credit. (VISA and MC do 5 days).
3. The bank must complete the investigation within 90 days.

Failure to comply with the above requirements can result in treble damages if:
1. Bank fails to recredit within 10 days.
2. Bank unreasonably rejects a claim of error.

§ 908, 12 CFR § 205,11(c)(3).

Hopsicomm, Inc. v. Fleet Bank

Facts:	Hopsicomm provided management services for Hamilton. On 4/15/2003, Hopsicomm terminated Martinez. After the termination, Hopsicomm found that Martinez had made several withdrawals from Hamilton's accounts at Fleet bank through an ATM card: 400 transactions for more than $148k. Hopsicomm reimbursed Hamilton. The ATM card was issued without Hopsicomm or Hamilton's authorization or knowledge.
Issue:	Did Fleet violate their duty of good faith under Article 4 by issuing Martinez a debit card?
Rule:	Article 4 only applies to items. Items are "instrument[s] or promise[s] to pay money handled by a bank for collection or payment". §4-104. An instrument is a negotiable instrument. A negotiable instrument is a writing sighed by the maker, containing an unconditional promise to pay a sum certain, payable on demand or at a definite time to order or a bearer. §3-104.
Held:	An ATM transaction is not an item under the meaning of Article 4, so the Article 4 duty of good faith doesn't apply.
Why?	Article 4 doesn't apply by its own terms. Further, EFTA controls electronic funds transfers. While EFTA doesn't preempt, Article 4A specifically states that EFTA controls this type of transaction.

Heritage Bank v. Lovett

Facts:	Lovetts employed Bennett. Bennett, while working for Lovetts, stole a Heritage ATM card from Buells. Bennett stole about $10k through ATM transactions.
Issue 1:	Can Heritage use a claim of common-law subrogation to recover against the Lovetts?
Rule:	Subrogation…is granted to a person secondarily liable for a debt who has paid it and is designed to allow that part to enforce the creditor's right of exoneration against one that has been unjustly enriched.
Held:	No subrogation here.
Why?	Heritage suffered the loss in its own right: a bank deposit transfers title to the money to the bank. Further, a subrogee's rights are the same as the subrogor's. The Buells didn't suffer a legal injury: although the money was debited against their ledger balance, they were still legally entitled to the money.
Issue 2:	Can Heritage use the statutory subrogation provision of § 4-407?
Rule:	Article 4 only applies to items, ATM transactions aren't items.
Held:	Since this involved ATM transactions, not covered by Article 4.

Assignment 10: Electronic Checks and Automated Clearing House Payments

A. True Electronic Checks

The ultimate goal is an eCheck, but it's not there yet.

The big thing here is that the checking system comes with a panoply of legal rules for consumer protection. The checking system is also very inexpensive for payor and payee.

Closest thing they've come up with is eCheck™. Never really adopted, and it wasn't governed by Art. 4. UETA and e-Sign also exclude Art. 3 and 4.

Until they amend Art. 3 and 4, this is kind of dead in the water.

B. ACH Transfers

1. The Basics of ACH Transfers

The ACH network is generally governed by NACHA.
- -not-for-profit
- -36 regional clearinghouses
- -Closely aligned with the Federal Reserve.

Also governed by EFTA.
EFTA applies to "electronic fund transfers".

EFTA §903(6)	the term "electronic fund transfer" means any 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. Such term includes, but is not limited to, point-of-sale transfers, automated teller machine transactions, direct deposits or withdrawals of funds, and transfers initiated by telephone. Such term does not include-- **(A)** any check guarantee or authorization service which does not directly result in a debit or credit to a consumer's account: **(B)** any transfer of funds, other than those processed by automated clearinghouse, made by a financial institution on behalf of a consumer by means of a service that transfers funds held at either Federal Reserve banks or other depository institutions and which is not designed primarily to transfer funds on behalf of a consumer; **(C)** any transaction the primary purpose of which is the purchase or sale of securities or commodities through a broker-dealer registered with or regulated by the Securities and Exchange Commission; **(D)** any automatic transfer from a savings account to a demand deposit account pursuant to an agreement between a consumer and a financial institution for the purpose of covering an overdraft or maintaining an agreed upon minimum balance in the consumer's demand deposit account; or **(E)** any transfer of funds which is initiated by a telephone conversation between a consumer and an officer or employee of a financial institution which is not pursuant to a prearranged plan and under which periodic or recurring transfers are not contemplated; as determined under regulations of the Board;

a. The Basic Terminology

"Entry"—a instruction for payment. It can originate from either the payor or payee.

Either a credit entry initiated by the payor or debit entry initiated by the payee.

Each ACH transfer involves at least five participants:
Originator: The party that makes the entry initiating the transaction. NACHA § 14.1.42
Originating Depositary Financial Institution (ODFI): The originator's financial institution. NACHA § 14.1.40
ACH Operator: The party that carries commications and funds from the ODFI to the RDFI. NACHA § 14.1.1. Normally the Federal Reserve Bank except in the New York FR District.
Receiving Depositary Financial Institution (RDFI): The financial institution of the Recipient. Normally the bank where the account receiving the funds lives. NACHA § 14.1.55.
Receiver: The party to which the entry is directed. NACHA § 14.1.53. Can either be the payor or payee.

b. *The Mechanics*

1. Message from the Originator to the ODFI, generally sent by batch.
   Each entry is in a standardized format with the type of entry and the specific information needed for the ODFI to process.
2. ODFI receives a batch
   Examines the data to ensure that all the data is comprehensible.
   Directly processes "on-us" entries.
   Merges "transit" entries and sends the data to the ACH Operator. <u>This binds the ODFI to pay the ACH Operator for all credit transfers</u>. NACHA § 7.2
3. ACH Operator receives the batch from the ODFI.
   The ACH Operator sorts the batch into regions.
   It retains its own transactions and sorts (with batches sent from other regions) into each RDFI it services.
   Transmits to the RDFI
4. The RDFI sorts by account and posts the transaction to the Receiver's account.
   The Receiver must give immediate credit to the Originator on credit transactions.

Each entry has a settlement date on it. The funds transfers happen through net transfers on designated Federal Reserve bank accounts, then the transactions post to the Originator and Receiver accounts on the settlement date. (Warehousing)

A debit entry must be transmitted one day in advance.
A credit transaction is usually transmitted 1-2 days in advance.
    This means that ACH transactions are kind of bad for POS transactions.

c. *Types of ACH Entries*

Regular ACH transactions:
    Payroll direct deposit
    Automatic payments
Specialized transactions.
    XCK: A destroyed check entry for a check lost or destroyed in processing. NACHA §§2.7 and 14.1.72
    RCK: Processed on returned item so that the payee bank can collect faster. NACHA §§ 2.8 and 14.1.51. This is an exception to the rule that you need prior authorization to debit a consumer account. § 2.1.3.
    POP: Point-of-purchase
    TEL: Telephone transactions
    WEB: Internet transactions
    ARC: Accounts-receivable conversion

d. *Finality, Error, and Fraud in ACH Transfers*

Finality with respect to credit entries:

1. The point at which the RDFI loses the right to return the item

There's no general substantive constraint on the right of the RDFI to reject. NACHA § 6.1.1 (Any reason)
However, the return must be made in time to be received by the OFDI by the open of business on the second day following the settlement date. NACHA § 6.1.2. Banking day defined in NACHA § 14.1.14.

2. The point at which the OFDI or Originator loses the right to return
Generally, neither the Originator nor the ODFI has any right to stop or recall an entry once received by the Originating Operator.
The Receiver of a debit entry can stop payment on the entry by providing notice "at such time and in such manner as to allow the RDFI a reasonable opportunity to act upon the stop payment before acting on the debit entry." NACHA § 8.5 (similar to UCC § 4-403(a)).
Consumer Accounts: A consumer who wants to stop payment on a "normal" entry must provide notice to the RDFI three days prior to the transfer date. NACHA Rules § 8.4.

Procedures to prevent innocent or fraudulent mistakes:

1. Pre-notes
When the Originator sends the pre-note, they have to wait six business days before it can initiate entries to the Reciever's account.
The RDFI can send a Notice of Change (NOC) and the Originator must comply with the NOC. NACHA §§ 2.3, 6.3
2. Duplicate Files or Entries
    a. Duplicate files
    The ODFI can reverse a whole file within 5 banking days AND 24 hours of discovery. § 2.4.2.
    The ODFI must indemnify all participating financial institutions and ACH Operators for all losses related to compliance with either the original or reversing transaction. NACHA § 2.4.5
    b. Single entry
    The OFDI has until through the settlement date to retract. NACHA § 2.5.1.
    The OFDI still has to indemnify the RFDI and ACH Operator for any loss. NACHA § 2.5.2.
3. Erroneous Debit Entries
The Receiver must act within 14 calendar days that the RDFI sends a statement showing the debit.
The Receiver must inform the RDFI in the form of an affidavit in the form required by the RDFI declaring the entry to be not authorized. NACHA §§ 8.6.1, 8.6.2.
The RDFI must recredit the account "promptly". NACHA § 8.6.1.

Security First Network Bank v. C.A.P.S., Inc.

Facts:	12/28/1999, Sykes opened an account at Security First using the name "Melvin L. Goldman". Sykes then used ACH transactions to debit accounts at Northern Trust (C.A.P.S.) and LaSalle Bank (Saks). 1/14/2000, Security First started investigating the Goldman account because several ACH transactions were rejected. Security First froze the Goldman account with about $900,000 in it.
Issue:	Can Saks assert NACHA warranties against Security First?
Rule:	The ODFI warrants to each RDFI, ACH Operator, and Association that each entry transmitted by the OFDI is in accordance with the proper authorization provided by the Originator and the Receiver. NACHA § 2.2.1.1
Rule:	A party to a contract that incorporates NACHA provisions and is bound by its obligations may enforce its provisions.
Held:	Since Security First Bank warranted that the transaction was authorized, the warranties run to the RDFI, and Saks may enforce that warranty.

2. POS Conversion

POS Conversion=POP Entry.

Although this is an EFT, it looks like a check transaction to the consumer.
1. The merchant records MICR information from the check.
2. Writes “VOID” on the check
3. Hands the check back to the customer.
NACHA § 2.12.2
4. Merchant sends the information to their bank.

BOC (Back-office Conversion) Entry
Allows retailers to convert checks in back office instead of at the register.
Avoids customer idiocy.

These are designed to eliminate float, which gets people riled up sometimes.
1. Can’t really complain about the merchant getting paid faster.
2. Local checks cleared pretty quickly anyhow.

There’s special NACHA rules for POP transaction stop-payment

The customer can stop payment if they give notice to the paying bank at a time that allows them a reasonable opportunity to act before it becomes obligated on the item. NACHA § 8.4.

Risk of Fraud

The ODFI bears the responsibility for fraud on a POP. NACHA § 2.2.1.1
The ODFI will likely transfer that risk by contract to the merchant.

C. Telephone-Initiated Payments

Prior the common practice was to get pre-authorized check with “Authorized by Drawer” or “Signature on File”.
Now ACH TEL entries are available.

FTC Regulations: the payee must retain a verifiable authorization of the transaction for 24 months. This could be in writing or a voice recording.

16 C.F.R. § 310.5(a)(5)	Any seller or telemarketer shall keep, for a period of 24 months from the date the record is produced, the following records relating to its telemarketing activities: All verifiable authorizations or records of express informed consent or express agreement required to be provided or received under this Rule.
16 C.F.R. § 310.3(a)(3)	Prohibited deceptive telemarketing acts or practices. It is a deceptive telemarketing act or practice and a violation of this Rule for any seller or telemarketer to engage in the following conduct: Causing billing information to be submitted for payment, or collecting or attempting to collect payment for goods or services or a charitable contribution, directly or indirectly, without the customer's or donor's express verifiable authorization, except when the method of payment used is a credit card subject to protections of the Truth in Lending Act and Regulation Z,[661] or a debit card subject to the protections of the Electronic Fund Transfer Act and Regulation E

New amendments to UCC-3 and -4 address potential fraud by those using pre-authorized checks. Each transferor makes a transfer AND presentment warranty that the drawer has authorized the item in the amount it was issued.

UCC § 3-416(a)(6)	A person who transfers an instrument for consideration warrants to the transferee

	and, if the transfer is by indorsement, to any subsequent transferee that: with respect to a remotely-created consumer item, that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn.
UCC § 3-417(a)(4)	If an unaccepted draft is presented to the drawee for payment or acceptance and the drawee pays or accepts the draft, (i) the person obtaining payment or acceptance, at the time of presentment, and (ii) a previous transferor of the draft, at the time of transfer, warrant to the drawee making payment or accepting the draft in good faith that: with respect to any remotely-created consumer item, that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn.
UCC § 4-207(a)(6)	A customer or collecting bank that transfers an item and receives a settlement or other consideration warrants to the transferee and to any subsequent collecting bank that: with respect to any remotely-created consumer item, that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn.
UCC § 4-208(a)(4)	If an unaccepted draft is presented to the drawee for payment or acceptance and the drawee pays or accepts the draft, (i) the person obtaining payment or acceptance, at the time of presentment, and (ii) a previous transferor of the draft, at the time of transfer, warrant to the drawee that pays or accepts the draft in good faith that: with respect to any remotely-created consumer item, that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn.
12 C.F.R. § 229.34(d)	Transfer and presentment warranties with respect to a remotely created check. (1) A bank that transfers or presents a remotely created check and receives a settlement or other consideration warrants to the transferee bank, any subsequent collecting bank, and the paying bank that the person on whose account the remotely created check is drawn authorized the issuance of the check in the amount stated on the check and to the payee stated on the check. For purposes of this paragraph (d)(1), "account" includes an account as defined in § 229.2(a) as well as a credit or other arrangement that allows a person to draw checks that are payable by, through, or at a bank. (2) If a paying bank asserts a claim for breach of warranty under paragraph (d)(1) of this section, the warranting bank may defend by proving that the customer of the paying bank is precluded under U.C.C. 4-406, as applicable, from asserting against the paying bank the unauthorized issuance of the check.

These DON'T apply to TEL transactions, which aren't covered by UCC 3 or 4. NACHA and EFTA cover these, which means the risk is on the ODFI.

Assignment 11: The Wire-Transfer System

A. Introduction

The three largest networks:

1. Fedwire
2. CHIPS (Clearinghouse of Interbank Payment Systems)
   Predominantly used for international transfers denominated in dollars
3. SWIFT (Society for Worldwide Interbank Financial Telecommunications)
   Predominant method for international transfers not denominated in dollars.

Article 4A of the UCC controls "credit" wire transfers (transfers initiated by the one making payment).

§ 4A-102	Except as otherwise provided in Section 4A-108, this Article applies to funds transfers defined in Section 4A-104. § 4A-102. Subject Matter., Unif.Commercial Code § 4A-102
4A-104 cmt. 4	Defines credit transactions and says that 4A only applies to them.

Fedwire adopts Article 4A. 12 C.F.R. pt. 210.

Article 4A excludes transfers covered by EFTA (ACH or debit card transactions). §4A-108.

EFTA limits itself to transfers made on systems primarily designed to transfer funds on behalf of a natural person, which excludes the wire transfer system. EFTA §903(6)(B).

B. How Does it Work?

1. Initiating the Wire Transfer: From the Originator to the Originator's Bank

In terms of Article 4A:

The Customer is the "originator" of a "funds transfer" to be implemented by the "originator's bank" sent to the "beneficiary's bank" and credited to the "beneficiary." § 4A-105.

Each step in the chain is a "payment order", involving a "sender" and a "receiving bank". §§4A-103, 104.

Why not a sending bank and receiving bank?

§4a-103 defines a payment order as an instruction to a bank to pay funds to a third party. The person instructing can be anyone, doesn't have to be a bank.

An originating bank may reject the originator's payment order if it cannot obtain payment at the time of the transfer and is unwilling to rely on its ability to collect later. § 4A-210(a).

Article 4A grants the originator's bank a right to collect payment from the originator if it executes the payment order as drected.

§4A-402(c): Receiving bank entitled to payment on acceptance of the order.
§4A-209(a): Receiving bank accepts an order when it executes it
§4A-301(a): Receiving bank executes an order with it issues a new payment order carrying out the payment order it received.

Trustmark Ins. Co. v. Bank One

Facts:	Trustmark had two accounts with Bank One. Trustmark sent Bank One a letter instructing them to make sure that there was $10,000 in the second account, and send anything over that to Harris Bank if the account got to $110k. Bank One automated its wire department and sent Trustmark a letter saying that Bank One needed a new funds transfer agreement for the account, and if they didn't get one couldn't guarantee continued wire transfers. Trustmark says they never got it. Bank One stopped making the wire transfers for Trustmark. Finally, Bank One mentioned the huge balance in the account to Trustmark. Trustmark flipped their shit and moved the almost $20mm out of the account. Trustmark wants all the interest it lost as a result of the transfer not being made.

Issue:	Was the letter of instruction from Trustmark a payment order under the meaning of UCC Article 4A?
Rule:	§ 4A-104(1): A payment order is an unconditional (other than time of payment) instruction of a sender to a receiving bank to pay a beneficiary a fixed or determinable amount of money.
Held:	This was not a payment order because it subjected Bank One to a condition of payment other than the time of payment.
Why?	Cmt 3 to 4A-104 discusses the mechanical nature of wire transfers and how that's an advantage of the system. The fact that the letter required Bank One to make an ongoing and continuous inquiry into Trustmark's balance defeats this goal. The court also disfavors a rule that imposes large liability on receiving banks, because it would defeat the goal of the system being cheap. Powell said a bunch of shit about determinability.

If the beneficiary's bank rejects the payment order, then the originator's bank is excused from payment as sender. § 4A-402(c).

The originator bank must then refund payment to the originator. § 4A-402(d).

Banco de la Provincia v. BayBank Boston, N.A.

Facts:	BPBA made a loan to Banco Feigen. BPBA disbursed the loan to an account at BPBA. Banco Feigen failed. BPBA froze Banco Feigen's account, then exercised their right of setoff. While the account was frozen, Banco Feigen sent a letter of instruction to BPBA to wire $240k from the account to BayBank.
Issue:	Did BPBA wrongfully refuse the payment order?
Rule:	§ 4A-209(1): A receiving bank other than the beneficiary's bank accepts a payment order when it executes the order. This gives receiving banks other than the beneficiary's bank general discretion in choosing whether to accept or reject payment orders.
Held:	BPBA's rejection was neither an abuse of discretion nor bad faith.
Why?	At the time of rejection, BF's account was frozen, and BF's activities were suspended by Argentina. Plus, BF owed BPBA more than was in the account.
Issue:	Did BPBA have a duty to BF or BayBank to complete the wire transfer?
Rule:	Liability of receiving banks arises only if the receiving bank accepts a payment order or there is an express agreement between the sender and the receiving bank which requires the receiving bank to execute payment orders.
Held:	Since BPBA properly rejected the payment order, no liability.
Issue:	Did BPBA unlawfully convert the funds by exercising their right of setoff?
Rule:	Conversion is any act of dominion wrongfully exerted over the personal property of another inconsistent with that person's rights in the property.
Held:	No conversion.
Why?	BayBank didn't get an ownership interest in the money on delivery of the payment order. BPBA didn't intend to deprive BayBank of any property. BPBA was supposed to transfer money to BF's account, not BayBank's.

2. Executing the Transfer: From the Originator's Bank to the Beneficiary's Bank

In the absence of an instruction from the customer, the originator's bank is ordinarily free to use any funds transfer system if that system is <u>reasonable in the circumstances</u>. § 4A-302(b)(i).

The bank may even ignore the originator's instructions if the bank in <u>good faith</u> determines it is not feasible to follow the instruction or that following the instruction would <u>unduly delay completion of the funds transfer</u>. § 4A-302(b).

In some cases, a transfer may be accomplished simply by transferring to an account on the bank's books.

In other cases, the originating bank must find a way to do two things:

1. Notify the beneficiary bank.
2. Forward payment to the beneficiary bank.

a. Bilateral Systems (SWIFT)

The originator bank just sends a message directly to the beneficiary bank. Usually by tested telex. The banks will typically have accounts at each other's institutions and debit the accounts as necessary to pay for the instruction. This discharges the originating bank's obligation. § 4A-403(a)(3).

One enhancement is "bilateral netting". All the transactions are settled out at the end of the day. This also satisfies all payment orders for that day. § 4A-403(c).

b. CHIPS

Bilateral systems kind of suck: costly, inefficient. CHIPS is an example of a multilateral system. Everyone sends their messages through a central clearinghouse. CHIPS uses a netting system to transfer value as fast as it can through the day. At the beginning of each day, participants fund CHIPS accounts at the NY FRB. Usually, transactions are settled immediately out of these accounts.

c. Fedwire

This is the dominant system. Fedwire provides for immediate settlement between 10,000 financial institutions.

Fedwire is very low-cost

Participants must have a Federal Reserve Bank account.

Initiation of a transfer by Fedwire:

1. Originating bank sends a funds-transfer request to the local FRB.
   Must identify beneficiary and the beneficiary's bank.
   Must conform to a standardized format.
2. Federal Reserve Bank then turns around and sends a payment order to either the beneficiary bank or Federal Reserve Bank in the receiving bank's district.
   As soon as that next bank accepts the payment order, the original FRB is obligated to pay on it. § 4A-402(b) & (c). Therefore, the FRB will first make sure the sender has adequate funds to cover.
   a. The FRB maintains a working balance for each institution,
   b. The working balance may have a "daylight overdraft" which must be cleared at the end of business day. (Reg J, 12 C.F.R. §210.28(b)(1)(i))
   c. Federal Reserve regulates overdrafts closely.
      i. 0.5% fee for overdrafts.
      ii. Hard caps
         A. *de minimis*: $10mm or 20% of bank capital (larger)
         B. Higher caps: require greater scrutiny of bank's capital and operations.
   d. The FRB may satisfy the payment obligation of the originating bank by debiting their working balance. § 4A-402(c). Reg J, 12 C.F.R. § 210.28(a).
   c. The FRB may then either credit the working balance of the beneficiary's bank, Reg J, 12 C.F.R. § 210.29(a), or send the money on to the beneficiary's FRB, 12 C.F.R. § 210.30(b).

3. Completing the Funds Transfer: From the Beneficiary's Bank to the Transferee

The beneficiary bank technically can reject a payment order. § 4A-201, 4A-209 cmt 8.

Allows a beneficiary bank worried about payment to protect themselves.

A beneficiary bank that accepts a payment order becomes obligated to pay the beneficiary even if the beneficiary bank never obtains payment from the sender. § 4A-404(a).

Rarely happens.

There is a presumption in the system that if a bank does not reject promptly, it accepts.

If the receiving bank has been paid or has sufficient funds on deposit from the sender, acceptance occurs at the beginning of the next business day unless the receiving bank rejects within the first hour of that business day. § 4A-209(b)(3).

Therefore, when the receiving bank has funds on hand that it could take as payment for an order, the passage of that deadline automatically results in acceptance, the beneficiary's entitlement to payment from his bank, and the beneficiary's bank's entitlement to payment frim the sender. § 4A-402(b), 4A-404(a).

However, if there is no automatic acceptance under the foregoing, the order is rejected by operation of law on the fifth business day after the receipt by the receiving bank. § 4A-211(d), § 4A-211 cmt. 7

None of this applies to Fedwire: acceptance of the beneficiary's bank is implied at the moment it receives the Fedwire message, because Fedwire makes payment at the same time. UCC §§ 4A0298(b)(2), 4A-209 cmt 6.

Therefore, the beneficiary's bank takes the obligation to pay the beneficiary at the moment of receipt. §4A-404(a), Reg. J, § 210.31.

The beneficiary's bank must notify the beneficiary by the end of the next day. §4A-404(b) but usually does so in a matter of minutes.

Fedwire accepts the risk that a bank may go tits up before they receive settlement of an overdraft. This serves important policy goals in swiftness and finality of wire payments.

C. Discharge of the Originator's Underlying Obligation

A payment by wire transfer generally discharges an underlying obligation as of the moment the beneficiary's bank accepts a payment order. § 4A-406(a).

Reflects the common belief that once the payor causes a bank to make a binding commitment, the obligation is discharged.

However, a wire transfer does not discharge an underlying obligation if the wire transfer is done in a manner that violates the underlying contract specifying the obligation. § 4A-406(b).

Fee Deductions:

The original payment discharges the obligation even if bank charges reduce the actual payment below the obligation amount if the payor makes *prompt* restitutiom. § 4A-406(c).

§ 4A-406	(a) Subject to Sections 4A-211(e), 4A-405(d), and 4A-405(e), the originator of a funds transfer pays the beneficiary of the originator's payment order (i) at the time a payment order for the benefit of the beneficiary is accepted by the beneficiary's bank in the funds transfer and (ii) in an amount equal to the amount of the order accepted by the beneficiary's bank, but not more than the amount of the originator's order. (b) If payment under subsection (a) is made to satisfy an obligation, the obligation is discharged to the same extent discharge would result from payment to the beneficiary of the same amount in money, unless (i) the payment under subsection (a) was made by a means prohibited by the contract of the beneficiary with respect to the obligation, (ii) the beneficiary, within a reasonable time after receiving notice of receipt of the order by the beneficiary's bank, notified the originator of the beneficiary's refusal of the payment, (iii) funds with respect to the order were not withdrawn by the beneficiary or applied to a debt of the beneficiary, and (iv) the beneficiary would suffer a loss that could reasonably have been avoided if payment had been made by a means complying with the contract. If payment by the originator does not result in discharge under this section, the originator is subrogated to the rights of the beneficiary to receive payment from the beneficiary's bank under Section 4A-404(a). (c) For the purpose of determining whether discharge of an obligation occurs under subsection (b), if the beneficiary's bank accepts a payment order in an amount equal to the amount of the originator's payment order less charges of one or more receiving banks in the funds transfer,

	payment to the beneficiary is deemed to be in the amount of the originator's order unless upon demand by the beneficiary the originator does not pay the beneficiary the amount of the deducted charges. (d) Rights of the originator or of the beneficiary of a funds transfer under this section may be varied only by agreement of the originator and the beneficiary. § 4A-406. Payment by Originator to Beneficiary; Discharge of Underlying Obligation., Unif.Commercial Code § 4A-406

D. Finality of Payment

Aleo International, Ltd. v. CitiBank, N.A.

Facts:	An Aleo VP instructed Citi to make a wire transfer to a customer at Dresdner Bank in Germany. Citi sent the payment order, and at 3:00am the next morning Dresdner informed Citi the beneficiary was credited. At about 9am, the VP came back and tried to stop the wire.
Issue:	Was Citi required to stop the wire transfer?
Rule:	§ 4A-211(2): A communication by the sender cancelling or amending a payment order is effective to cancel or amend the order if notice of the communication is received at a time and in a manner affording the receiving bank a reasonable opportunity to act on the communication before the bank accepts the payment order. § 4A-209(2): A beneficiary bank accepts a payment order at the earliest of the following times: (a) when the bank (i) pays the beneficiary…or (ii) notifies the beneficiary of receipt of the order or that the account of the beneficiary has been credited with respect to the order.
Held:	Payment and acceptance occurred before the cancellation, so the cancellation was ineffective.

Assignment 12: Error in Wire-Transfer Transactions

A. Recovering from Parties in the System

Each party generally bears risk for their own errors.
However, parties that participate after the error have no duty to discover or correct errors.
A party that makes a mistake in a payment order has little recourse against later parties that execute the mistake, no matter how easy to detect or correct.
The sender must pay any payment order that the receiving bank executes as instructed. § 4A-402(b), (c).

1. Errors by the Originator

Wire-transfer systems generally hold an originator responsible for their own mistakes.
The rule applies even if the mistake is caused by a third-party communication system (the sender has a choice of what communication system to use.) § 4-206(a).
Ex: Duplication of a payment order due to a web browser glitch.

Originators bear losses from ambiguous orders.
A beneficiary's bank can rely on the account number indicated on the order, even if the name on the account doesn't match. §4A-207(b), (c); Reg. J, § 210.27(b).
A beneficiary bank may also rely on a RTN. Reg. J § 210.27(a).

Corfan Banco Asuncion Paraguay v. Ocean Bank

Facts:	Corfan initiated a wire transfer via Swiss Bank to Ocean Bank. Ocean notice an error in the account number and contacted their customer. They corrected the error, and deposited the money in the corrected account. Ocean didn't talk to Corfan or Swiss Bank. Corfan noticed the error the next day and sent a corrected payment order without noting it was a correction. Both wire transfers were deposited in the customer's account. The customer ganked the money and ran. Corfan demanded that Ocean return the money, and Ocean refused.
Issue:	Was Ocean obligated to return the money to Curfan?
Rule:	**UCC 4A-207(1)**: Subject to subsection (2), if, in a payment order received by a beneficiary's bank, the name, bank account number, or other identification of the beneficiary refers to a nonexistent or unidentifiable person or account, no person has rights as a beneficiary of an order and acceptance of the order cannot occur.
Held:	Although the payment order correctly identified the beneficiary, it referred to a nonexistent account number. Under the clear and unambiguous terms of the statute, acceptance could not have occurred.
Why?	Although commentators adopt Ocean Bank's view: the "or" in 4A-207(1) is conjunctive, not disjunctive; the court holds the plain language of the statute is disjunctive, and if ANY of the three things is wrong you can't accept. This seems to be a minority view.
Issue:	Did the adoption of Article 4A abrogate the common law cause of action for negligence relating to a wire transfer?
Rule:	Commentary seems to suggest so.
Held:	Don't reach the issue, because the duty here is the same as what's alleged in count one.
Dissent:	Construction of the statute as a whole shows the "or" is conjunctive, and construing this way serves the system's goal of speed in transfers. This wasn't a case of a nonexistent or unidentifiable beneficiary. Further, 4A doesn't abrogate common law equitable principles of commercial practice, and the party most easily able to avoid the loss bears the loss. Here, Corfan could have simply said "This is a correction", which would have put Ocean on notice.

Of course, the best thing to do would have been for Ocean to notify Corfan of the error.

The per se rules do more than shift losses to the originator:
1. They give the originator strong incentives to implement good security and controls.
2. The limit costs for the receiving bank.

Banks may contract with each other around the per se rules by implementing specific steps to identify errors. Any error that would have been detected had the receiving bank complied with those steps is allocated to the receiving bank. § 4A-205(a)(1).

§ 4A-205(a)(1), (2) seem to suggest that such an arrangement excuses all errors by the originating bank. This isn't the case.

Four Party Callback
1. Originator's employee places payment order.
2. One receiving bank employee receives the order.
3. Another receiving bank employee calls the originator, looking for a different employee than the first.
4. Another employee at the originator confirms.

2. Errors in the System

Two classes of potential error:
1. Sending the beneficiary too much money
2. Sending funds that are inadequate or untimely.

a. Sending Excessive Funds
1. Amount too high
2. Duplicate order sent
3. Funds sent to the wrong party

First Part of the Remedy: Only liable for what's authorized.
For 1 and 2, the originator is liable for the original amount only. § 4A-402(b), (c); 4A-303(a).
For 3, the originator isn't liable for anything. § 4A-303(c).

Second Part of the Remedy: Refund of Interest
The originator's bank may have to refund any money collected to pay the wire with interest. § 4A-402(d).

b. Sending Inadequate Funds
1. Error in the amount
2. Funds sent to the wrong person
3. Funds sent to the right person for the right amount, but untimely.

Again, the originator is only responsible for the amount actually sent. § 4-303(b).
However, the originating bank can correct their error in situation one by sending the rest. § 4A-303(b).

The originating bank must return the difference between the amount collected and the amount sent plus any interest on the excess funds. § 4A-402(d).

What about the damages to the originator? His underlying obligation may be in default.
1. If the problem was delay, the bank must pay interest to compensate for their retention of the funds. § 4A-305(a).
2. If the bank fails to correct the error, the bank must compensate both for interest, but the originator's expenses in the transaction. § 4A-305(b), (d).
3. No consequential damages allowed. § 4A-305(c). Can be K'd around.
Policy: Protects against large unforeseeable damages. Keeps the system cheap.

c. Bank-statement Rule

Two tiers to the bank-statement rule:

1. The originator has a duty of ordinary care to review bank statements regarding wire transactions. § 4A-304.
   If the originator does not use ordinary care, he is not entitled to any refund of interest under § 4A-402(d)

No real definition of "ordinary care", but there is a safe harbor where 90 days is conclusively not ordinary care. § 4A-304.

However, the originator can lose their entitlement to interest based on circumstances indicating the originator would have discovered the error sooner if they had used ordinary care. § 4A-402 cmt. 2
If the payment order was sent to a Federal Reserve Bank, 30 days is the presumptive reasonable time. Reg J, § 210.28

2. The originator only has one year to challenge any debit from its account from the date the originating bank gave notice of the debit. § 4A-505.

3. Circuitry of Recovery

Grain Traders, Inc. v. CitiBank, N.A.

Facts:	Grain Traders initiated a wire transfer to Kramer through BCN. The transfer required BCN to debit Grain Traders' account at BCN for $310k, then issue a payment order to CitiBank. CitiBank would then debit BCN's account for $310k and credit that to BCIL's account at CitiBank. CitiBank was then to issue a payment order instructing BCIL to transfer $310k to Extrader. Extrader was to deposit the $310k to Kraemer's account at Extrader. At the stage where CitiBank credited to BCIL, shit got hairy. BCIL suspended operations. BCN asked Citibank to cancel the whole transaction. CitiBank tried to get BCIL to authorize debit of the funds from BCIL's account, but they wouldn't. CitiBank then told BCN they couldn't get the money bank.
Issue:	Does § 4A-402 give Grain Traders a right to recover against CitiBank?
Rule:	§ 4A-402 only gives a right as between a sender and the receiving bank it paid—a rule of absolute privity. See § 4A-402 cmt. 2.
Held:	Grain Traders has no right to recover against CitiBank.
Why?	The policy behind 4A-402 cmt. 2 is to allocate risk to the person who first designated the bank that failed. Under 4A-402(5), all intervening senders are entitled to receive and retain payment—the party that designated the failed bank bears the burden of recovery by being subrogated to the right of the sender that paid the failed bank.

B. Recovering from the Mistaken Recipient

If the originator makes the error, he can recover in restitution against the incorrect beneficiary.

§ 4A-207(d): Error in description of beneficiary
§ 4A-209(d): Error in date of execution
§ 4A-211(c)(2): Erroneous order canceled after acceptance by beneficiary

If the bank makes the error, the bank can also recover in restitution.

§ 3A-303(a), (c): Excessive funds.
Reg J. § 210.32(c): Error by Federal Reserve Bank

Banque Worms v. Bank America International

If the mistaken recipient has an independent claim against the originator, they can retain the funds.

General Electric Capital Corp. v. Central Bank

Duchow's Marine tried to defraud GECC. GECC floor planned Duchow's inventory. Proceeds from the sale of boats was to go to a blocked account, and Duchow could not remove funds without GECC approval. Duchow instructed a customer to send purchase funds to an unblocked account. One of the banks in the chain dropped the account number by mistake. When the payment order got to Duchow's bank, they put it in the blocked account, since that's where it normally went. Duchow wanted the money moved to the unblocked account. Judge Easterbrook held that GECC's entitlement to the funds barred Central Bank from moving the money. Once the beneficiary's bank properly executed the order *it received*, payment into the account was final.

Criticism of *Banque Worms* and *GECC*

Both decisions narrow the common law right of restitution, which isn't really justified from the text of Article 4A.

Assignment 13: Advanced Topics in Wire-Transfer Transactions

A. Fraud

Wire transfers are a target of fraudsters:

1. Big money involved
2. The system is mostly automated.

Wide variety of security procedures.

Fedwire: On-line transfers take an identification code and a confidential password.
Off-line transfers use "four-party call-back"

Others: Four-party
"Listen Back"—second employee listens to a recording of the request.
Contractual overdraft limits: a bank will refuse to honor a wire-transfer order that will exceed the balance in the account. UCC § 4A-203 cmt. 3.

Not even the best procedures are 100% secure.

Customers are ordinarily only liable for orders they actually placed.

§ 4A-202(a)	A payment order received by the receiving bank is the authorized order of the person identified as sender if that person authorized the order or is otherwise bound by it under the law of agency.

This gives the banks a strong incentive to develop security procedures, since the loss will lie with them.

However, a customer will be deemed to have approved an order made in conformity with preapproved security procedures.

§ 4A-202(b)	If a bank and its customer have agreed that the authenticity of payment orders issued to the bank in the name of the customer as sender will be verified pursuant to a security procedure, a payment order received by the receiving bank is effective as the order of the customer, whether or not authorized, if (i) the security procedure is a commercially reasonable method of providing security against unauthorized payment orders, and (ii) the bank proves that it accepted the payment order in good faith and in compliance with the security procedure and any written agreement or instruction of the customer restricting acceptance of payment orders issued in the name of the customer. The bank is not required to follow an instruction that violates a written agreement with the customer or notice of which is not received at a time and in a manner affording the bank a reasonable opportunity to act on it before the payment order is accepted.

Three limits on the security procedure rule:

1. The security procedure must be commercially reasonable. § 4A-202(b)(i).
   If the bank offered a commercially reasonable security procedure and the customer declined, this limit is waived. § 4A-202(c). § 4A-203 cmt. 4.

§ 4A-202(c)	Commercial reasonableness of a security procedure is a question of law to be determined by considering the wishes of the customer expressed to the bank, the circumstances of the customer known to the bank, including the size, type, and frequency of payment orders normally issued by the customer to the bank, alternative security procedures offered to the customer, and security procedures in general use by customers and receiving banks similarly situated. A security procedure is deemed to be commercially reasonable if (i) the security procedure was chosen by the customer after the bank offered, and the customer refused, a security procedure that was commercially reasonable for that customer, and (ii) the customer expressly agreed in writing to be bound by any payment order, whether or not authorized, issued in its name and accepted by the bank in compliance with the security

	procedure chosen by the customer.

2. The bank must show it processed the order in accordance with the agreement with the customer. § 4A-202(b)(ii).
   So the bank can't charge a customer if it didn't follow the commercially reasonable security procedure, or if the order would violate some other agreement (such as an overdraft limit).
3. A customer can pass the liability back to the bank if the customer can:
   a. identify the breach of the security procedure; and
      Obviously, easier said than done, though the drafters didn't think so. § 4A-203 cmt. 5
   b. demonstrate that the information allowing the breach was not obtained from a source controlled by the customer.
      "Controlled by the customer" is ambiguous. What about "man-in-the-middle" attacks? § 4A-206 suggests that the telephone system would be viewed as an agent of the customer.

§ 4A-203(a)(2)	The receiving bank is not entitled to enforce or retain payment of the payment order **if the customer proves** that the order was not caused, directly or indirectly, by a person (i) entrusted at any time with duties to act for the customer with respect to payment orders or the security procedure, or (ii) who obtained access to transmitting facilities of the customer or who obtained, from a source controlled by the customer and without authority of the receiving bank, information facilitating breach of the security procedure, regardless of how the information was obtained or whether the customer was at fault. Information includes any access device, computer software, or the like.
§ 4A-105(a)(7)	"Prove" with respect to a fact means to meet the burden of establishing the fact

What happens when the system executes a fraudulent order?

If the order is treated as authorized under the security procedure rules, the customer is treated as the sender under § 4A-402(d) and is obligated to pay under § 4A-402(c).

OK, great, what if you can't treat it as authorized under § 4A-202?

1. The bank must refund any sums the customer has already paid with interest.

§ 4A-204(a)	If a receiving bank accepts a payment order issued in the name of its customer as sender which is (i) not authorized and not effective as the order of the customer under Section 4A-202, or (ii) not enforceable, in whole or in part, against the customer under Section 4A-203, the bank shall refund any payment of the payment order received from the customer to the extent the bank is not entitled to enforce payment and shall pay interest on the refundable amount calculated from the date the bank received payment to the date of the refund. However, the customer is not entitled to interest from the bank on the amount to be refunded if the customer fails to exercise ordinary care to determine that the order was not authorized by the customer and to notify the bank of the relevant facts within a reasonable time not exceeding 90 days after the date the customer received notification from the bank that the order was accepted or that the customer's account was debited with respect to the order. The bank is not entitled to any recovery from the customer on account of a failure by the customer to give notification as stated in this section.

Notice that the customer can lose his right to interest if he fails to complain within a reasonable time, with a 90 day safe harbor.

As usual, Federal Reserve Banks limit the reasonable time to 30 days from notification. Reg J. § 210.28(c).

Of course, banks have a large incentive to ensure people think wire transfers are safe, so will typically refund losses they may not have to just to keep people happy.

B. System Failure

System failure isn't a big deal for SWIFT users, because it's bilateral. Banks only accept a transfer from another bank when satisfied with their ability to pay the transfer. The worst thing that could happen is the other bank fails, but it's going to be a kind of minimal amount all told.

System failure also isn't a big deal for those using Fedwire. The Federal Reserve takes the risk that a Fedwire participant will fail.

CHIPS: everyone could be fucked. Transfers about $1.4T per day. No government backing of CHIPS. However, CHIPS transactions don't settle until CHIPS receives payment from the sender, so the risk gets managed.

C. Nature of the Wire Transfer

Winter Storm Shipping, Ltd. v. TPI

Facts:	Winter Storm chartered a vessel to TPI. Winter Strom says that TPI didn't pay the full freight due. Winter Storm got a judgment against TPI and served a writ of garnishment on BNY. At the time, BNY didn't hold any funds for TPI. However, BNY placed a stop order on any funds relating to TPI passing through. TPI had an account at BA. BA has an account at BNY. TPI entered into a transaction with Oppsal. Oppsal has an account with RBS. TPI was to pay Oppsal in US dollars. TPI submitted a transfer order to BA, who sent a transfer order and payment to BNY for credit to Oppsal's RBS account. However, BNY refused to complete the payment order by transferring to Oppsal, instead holding the funds per the writ of garnishment. Amiralty Rule B allows attachment of funds of a party who is not to be found within the district.
Issue:	Were the funds in the BNY account TPI's property?
Rule:	There is no question that federal admiralty law regards a defendant's bank account as property subject to attachment under Rule B.
Rule:	An EFT while it takes the form of a bank credit at an intermediary bank is clearly as seizable *res* under the forfeiture statues.
Rule:	EFT funds in the hands of an intermediary bank may be attached pursuant to Admiralty Rule B(1)(a).
Held:	The attachment was proper.
Issue:	Does U.C.C. § 4A-503 preclude attachment under Admiralty Rule B(1)?
Rule:	A state cannot abrogate maritime or admiralty law.
Held:	Even though § 4A-503 would preclude a state attachment of funds in an intermediary bank in this manner, it can't block the attachment under the federal admiralty jurisdiction.

§ 4A-503	For proper cause and in compliance with applicable law, a court may restrain (i) a person from issuing a payment order to initiate a funds transfer, (ii) an originator's bank from executing the payment order of the originator, or (iii) the beneficiary's bank from releasing funds to the beneficiary or the beneficiary from withdrawing the funds. A court may not otherwise restrain a person from issuing a payment order, paying or receiving payment of a payment order, or otherwise acting with respect to a funds transfer.

Regions Bank v. The Provident Bank, Inc.

Facts:	Regions and Provident are commercial banks acting as "warehouse lenders" in the real estate market. Provident had a warehouse loan agreement with Morningstar (Provident Line). If Morningstar couldn't find a buyer for a house financed under the Provident line, they would repurchase the house. Provident ended up calling the Provident Line on 4/3/2000. Morningstar's president (Dadione) said she would wire funds into Morningstar's DDA account at Provident to pay the loan.

	4/4/2000, Provident found out that First Union had the original note for one of Provident's home loans. First Union forwarded the funds to pay for the loan to Chase for deposit into Morningstar's Paine Webber account. 4/4/2000, Morningstar got the Regions Warehouse Line. Morningstar asked Regions to send funds to the escrow account of W&M (closing attorneys) at Fleet. 4/10/2000, Morningstar asked Regions to send $171,720 to fund a loan for Aguado by wiring funds to W&M with instructions to fund for Aguado. 4/11/2000, Morningstar asked Regions to fund $465,000 for Crawford loan. Regions wired to the W&M account at Fleet with instructions that the funds were for Crawford. 4/11/2000, W&M contacted Dadione: What are we doing with this money? Dadione: Oh, that money is in the wrong account, it should be in my account. Dadione: Wire $171,720 to Morningstar's DDA account at Provident. The wire stated "Orig to BNF info: Re: Aguado-Morningstar Mortgage Bankers, Inc." Dadione then told Provident to pull the $171,720 from her account to pay down the Provident Bank line. 4/11/2000, FBI told Regions that they're trying to build a case against Dadione. 4/13/2000, Dadione told Fleet to wire the other $627,000 from the W&M escrow account to the Morningstar DDA. The wire stated "Orig to BNF info: Re Graziosi $162,000 Crawford $465,000." Dadione then told Provident to pull the money and apply against the Provident Line. Fleet bank called Provident. An employee of Provident told Fleet that the money was still in the MMA and that it belonged to Morningstar. Fleet told Provident that it was possible the funds got sent to the wrong institution. Immediately after this conversation, Robison at Fleet tried to recall the transfers. Robison was told she would have to draft a supporting memo. Robison did and sent to the EFT department at Fleet. No further action taken on that day. 4/13/2000, Regions' attorney (Aldridge) called W&M and asked him to try to reverse the wire transfers. Aldridge says he was under the impression that W&M had talked to Fleet and they were taking care of it. Regions did not attempt to contact Provident directly until 4/17/2000. 4/14/2000, 10am, Provident applied the $627,000 against four outstanding loans in the Provident Line. Around 4:30pm, Provident received an *in rem* foreclosure complaint from the FBI. The same afternoon, Provident got a fax from Fleet regarding possible fraud with the wires. Regions sued Provident asserting state law causes of action for conversion, unjust enrichment, receipt of stolen property, wrongful set-off, and violations of racketeering statutes.
Issue:	Are Regions' state law claims preempted by Article 4A of the UCC?
Rule:	Transfers occurring by Fedwire are governed by Article 4A. Reg. J incorporates Article 4A (Reg. J. § 210.25(b)(1).
Rule:	Reg. J governs the rights and obligations of the parties to a funds transfer if any part is carried out through Fedwire. § 210.25(b)(2)(b).
Rule:	The rules of the UCC are intended to be the exclusive means of determining the rights, duties and liabilities of the affected parties in any situation covered by the particular provisions of the Article. § 4A-102 cmt.
Rule:	Article 4A is not the exclusive means by which a plaintiff can seek to redress an alleged harm arising from a funds transfer, and is replete with references to common law remedies.
Rule:	The only restraint on a plaintiff is that resort to principles of law or equity outside of Article 4A is not appropriate to create rights, duties and liabilities *inconsistent* with those stated in this article. § 4A-102 cmt.
Held:	The state law claims are not precluded by Article 4A.
Why?	Article 4A has nothing to say about claims based on the theory that the beneficiary bank accepted funds it knew or should have known were fraudulently obtained. Therefore, there's no inconsistency. To the contrary, § 4A-105(a)(6) defines good faith as honesty and fact and the observance of reasonable commercial standards, and § 1-304 imposes an obligation of good faith on every transaction. It would be absurd to say that the import of the UCC was to shield fraudulent activity.
Issue:	Did Provident know or should Provident have known that the funds received by Morningstar were obtained by fraud at the time they received title to the funds?
Issue:	When did Provident receive putative title to the funds?
Rule:	Title to funds in a wire transfer passes to the beneficiary bank upon acceptance of the payment order. §4A-102 comment.

Rule:	A beneficiary bank accepts a payment order when it receives payment of the entire amount of the sender's order. § 4A-209(b)(2).
Held:	Title passed to Provident on 4/11/2000 and 4/13/2000 upon acceptance of the two payment orders, so long as Provident had no knowledge or reason to know the funds were obtained fraudulently.
Issue:	Did Provident know or have reason to know the funds were obtained fraudulently on 4/11 or 4/13?
Held:	Provident did not know or have reason to know.
Why?	The first direct statement to someone at Provident that there was a problem was the phone call late on 4/13, after both wires were accepted. Regions says there were "red flags", like Morningstar's failure to pay the Provident Line promptly or to sell loans promptly. However, that's a red flag of being shitty at your job, not fraud. Provident knowing that Morningstar was under FBI investigation for forging a signature is also not an indicator that funds were obtained by fraud. Although Provident knew that Morningstar had used the same collateral to get funding from both Provident and First Union, that was not enough to put Provident on notice that the money it received was the product of fraud.
Held:	The state law claims fail as a matter of law, since someone acting in good faith may obtain title to money from a thief—good faith purchaser for value exception to *nemo dat*.

Chapter 6 Negotiability

Assignment 22: Negotiable Instruments

A. Negotiability and Liquidity

An active market for payment obligations aids the financial position of operating business that generate payment obligations when they sell things to their customers.

The business can sell the negotiable instrument to a third party. The third party takes the instrument as a holder in due course, able to enforce the instrument without being subject to defenses of the drawer or maker.

The negotiable instrument is the oldest device still used for enhancing liquidity.

1. Negotiable instruments are an easy way to verify a party's power to transfer an enforceable interest in the instrument.
   -All transfers of right are reflected on the instrument.
2. The defense-stripping rule. A negotiable instrument is enforceable by a holder in due course without being subject to many of the defenses against the original payee.

A negotiable instrument is a piece of paper: a writing. (E-sign and UETA specifically do not apply to UCC-3 and -4.

Evidence of transfer takes the form of indorsements on the instrument.

Holder-in-due-course status can only apply to a person in possession of the instrument.

B. A Typical Transaction

A draft will typically look like:

[Date]. Upon presentation of this original draft, pay to the order of [Payee] [sum certain]. To [Drawee].

[Signature of Drawer]

Notice this looks like a letter to the Drawee.

C. The Negotiability Requirements

The basic terms:

The Drawer: The party that directs payment. UCC § 3-103(a)(3). Also "issuer". UCC § 3-105(c).
Remitter: The person who caused the drawer to issue the instrument. UCC §3-103(a)(11).
Payee: The person entitled to payment on the instrument.
Drawee: The person upon whom the payee enforces the instrument.

UCC § 3-103(a)(3)	"Consumer transaction" means a transaction in which an individual incurs an obligation primarily for personal, family, or household purposes.
UCC § 3-105(c)	
UCC § 3-103(a)(11)	"Principal obligor," with respect to an instrument, means the accommodated party or any other party to the instrument against whom a secondary obligor has recourse under this article.

§ 3-104 sets out seven requirements for negotiability (though Powell says eight).

UCC § 3-104(a)	(a) Except as provided in subsections (c) and (d), "negotiable instrument" means an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it: (1) is payable to bearer or to order at the time it is issued or first comes into possession of a holder; (2) is payable on demand or at a definite time; and (3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money, but the promise or order may contain (i) an undertaking or power to give, maintain, or protect collateral to secure payment, (ii) an authorization or power to the holder to confess judgment or realize on or dispose of collateral, or (iii) a waiver of the benefit of any law intended for the advantage or protection of an obligor.

1. Unconditional
2. Promise or order to pay (has to be in writing, which Powell says is an 8th requirement)
3. Money
4. Fixed amount (with or without interest or other charges described in the instrument)
5. Payable to bearer or to order
6. Payabe on demand or at a definite time.
7. Does not state any other undertaking or instruction by the person promising or ordering to do any act in addition to the payment of money.

1. The Promise or Order Requirement

"Promise" and "order" defined and distinguished in UCC §§ 3-103(a)(8) and 3-103(a)(12).

UCC § 3-103(a)(8)	"Order" means a written instruction to pay money signed by the person giving the instruction. The instruction may be addressed to any person, including the person giving the instruction, or to one or more persons jointly or in the alternative but not in succession. An authorization to pay is not an order unless the person authorized to pay is also instructed to pay.
UCC § 3-103(a)(12)	"Promise" means a written undertaking to pay money signed by the person undertaking to pay. An acknowledgment of an obligation by the obligor is not a promise unless the obligor also undertakes to pay the obligation.

Implicitly requires the instrument be in a writing.
A writing is an intentional reduction to tangible form. UCC § 1-201(b)(43).

A promise is a direct commitment to pay.
The party promising is the "maker" UCC § 3-103(a)(7).
The instrument containing the promise is a "note" UCC § 3-104(e).

An order does not contain a direct promise to pay. It is an instruction from one person to another to pay money.
The person instructing is the drawer. UCC §3-103(a)(5).
The person directed is the drawee. UCC § 3-103(a)(4).
The instrument containing the order is a draft. UCC § 3-104(e).

UCC § 3-104(f), (g), and (h) define the three most common types of draft:

A check (a draft drawn on a bank)

UCC § 3-104(f)	"Check" means (i) a draft, other than a documentary draft, payable on demand and drawn on a bank or (ii) a cashier's check or teller's check. An instrument may be a check even though it is described on its face by another term, such as "money order."

A cashier's check (a draft drawn by a bank on itself)

UCC § 3-104(g)	"Cashier's check" means a draft with respect to which the drawer and drawee are the

	same bank or branches of the same bank.

A teller's check (a draft drawn by a bank on another bank)

UCC § 3-104(f)	"Teller's check" means a draft drawn by a bank (i) on another bank, or (ii) payable at or through a bank.

2. The Unconditional Requirement

If a document includes a conditional promise to pay, it is not a negotiable instrument. § 3-106(a)(i).

If the issuer is unwilling to create an unconditional promise to pay, the document is not negotiable.

DBA Enterprises, Inc. v. Findlay

Facts:	Sellers wish to enforce a promissory note. Sellers sold "The Lawn Doctor" to Purchasers. Part of the purchase prices was a promissory note. Sellers executed a bill of sale including a non-compete covenant. Sellers twice provided services prohibited by the non-compete. Purchasers end up defaulting on the note, and Sellers start competing their hearts out. The promissory note contains the language "Maker's obligation under this note is subject to the conditions recited in that Bill of Sale and Covenants not to Compete between the parties of even date."
Issue:	May Sellers enforce the promissory note as a negotiable instrument?
Rule:	To be a negotiable instrument a promissory note must be an unconditional promise to pay. UCC 3-104.
Held:	The quoted language contains a conditional promise. The note is not a negotiable instrument. It may be enforceable as a contract though.

A document is not negotiable if it states that it "is subject to or governed by" another writing or if it states "that rights or obligations with respect to the instrument are stated in another writing."

UCC § 3-106(a)(ii)	
UCC § 3-106(a)(iii)	

If you had to search other documents to discover terms of payment, it would be too large a burden on the system.

Two important exceptions to the unconditional requirement:

1. References to writings describing rights to the collateral and the payee's remedies upon default.
2. Payment limited to a particular source (ie nonrecourse mortgages).

UCC § 3-106(b)	

3. The Money Requirement

The UCC conception of money is broad: includes both domestic and foreign currency. UCC 1-201(b)(24). This is mainly a limitation that you can't denominate a negotiable instrument in commodities.

4. The Fixed-Amount Requirement

The sum can't be based on something indeterminate at the time of issuance.

§ 3-104(a) allows a fixed amount to include interest and other charges described in the instrument.

§ 3-112(b) a variable interest rate is allowable.

Nagel v. Cronebaugh

Facts:	The big deal here is that the parties had a mortgage contract which said the principal sum to be paid would be determined upon demand, upon sale of the house, or on death of the makers.

Issue:	Is this contract a negotiable instrument?
Rule:	For an instrument to be negotiable under the UCC, it must contain an unconditional promise to pay a sum certain. UCC §3-104.
Held:	Since there's no fixed principal amount, the note is not a negotiable instrument.

5. The Payable to Bearer or Order Requirement

If an instrument does not contain magic words to satisfy § 3-109, it's not a negotiable instrument.

UCC § 3-109	(a) A promise or order is payable to bearer if it: (1) states that it is payable to bearer or to the order of bearer or otherwise indicates that the person in possession of the promise or order is entitled to payment; (2) does not state a payee; or (3) states that it is payable to or to the order of cash or otherwise indicates that it is not payable to an identified person. (b) A promise or order that is not payable to bearer is payable to order if it is payable (i) to the order of an identified person or (ii) to an identified person or order. A promise or order that is payable to order is payable to the identified person. (c) An instrument payable to bearer may become payable to an identified person if it is specially indorsed pursuant to Section 3- 205(a). An instrument payable to an identified person may become payable to bearer if it is indorsed in blank pursuant to Section 3-205(b).

Two types of bearer instrument:
1. "Payable to bearer" or "payable to the order of bearer"
   Otherwise indicates that the person in possession of the promise or order is entitled to payment.
2. Payable to no particular person.
   Payable to the order of ___________
   Payable to cash.

Two ways to make payable to order:
1. "Pay to the order of [Person]
2. "Pay to [Person] or order"

THESE ARE MAGIC WORDS!
Note: Pay to order is not order paper, it is bearer paper. UCC §3-109(a)(2)

EXCEPTION:
A check may fail the bearer-or-order requirement and still be a negotiable instrument if it satisfies all other requirements. UCC § 3-104(c).

Sirius LC v. Erickson

Facts:	Promissory note from Erickson to Sirius included the wording "for value received, the undersigned Bryce H. Erickson promises to pay to SIRIUS LC … the sum of Twenty Nine Thousand One Hundred Seventy Three Dollars and Thirty Eight Cents ($29,173.38) bearing 10% interest due and payable on June 1, 2001."
Issue:	Is this promissory note enforceable as a negotiable instrument?
Rule:	For a writing to be a negotiable instrument, it must be payable to bearer or to order at the time it is issued or first comes into possession of a holder. UCC § 3-104(1)(a).
Issue a:	Is it payable to bearer?
Rule:	To be payable to bearer, a writing may not be payable to a specific person.
Held:	This is not payable to bearer, as it identifies SIRIUS as payee.
Issue b:	Is it payable to order?
Rule:	To be payable to order, it must contain the magic words "to order".
Held:	No magic words.
Held:	Not a negotiable instrument.

6. The Demand or Definite-Time Requirement
§3-108 defines these terms.

UCC § 3-108	(a) A promise or order is "payable on demand" if it (i) states that it is payable on demand or at sight, or otherwise indicates that it is payable at the will of the holder, or (ii) does not state any time of payment. (b) A promise or order is "payable at a definite time" if it is payable on elapse of a definite period of time after sight or acceptance or at a fixed date or dates or at a time or times readily ascertainable at the time the promise or order is issued, subject to rights of (i) prepayment, (ii) acceleration, (iii) extension at the option of the holder, or (iv) extension to a further definite time at the option of the maker or acceptor or automatically upon or after a specified act or event. (c) If an instrument, payable at a fixed date, is also payable upon demand made before the fixed date, the instrument is payable on demand until the fixed date and, if demand for payment is not made before that date, becomes payable at a definite time on the fixed date.

A demand obligation includes an obligation payable on demand or on sight and an obligation which specifies no time for payment. § 3-108(a).

This also includes notes where the holder can extend the time for payment. § 3-108(b).

This also includes notes that permit for acceleration or prepayment. § 3-108(b).

This can also include extensions at the option of the maker if the instrument limits extensions to a further definite time or automatically upon or after a specified act or event.

Only obligation that would fail: Document giving the issuer a completely unqualified option o extend or a qualified option to extend that does not state a date to which it would run.

7. The No-Extraneous-Undertakings Requirement

Can't have a promise for payment of anything other than money. The "courier-without-luggage" requirement. Comes from a PA Supreme Court decision analogizing that the instrument transmit money only without attendant baggage.

Three exceptions:

1. Undertaking to give, maintain, or protect collateral
2. Confess judgment, realize on or dispose of collateral
3. Waiver of borrower's legal protections.

Assignment 23: Transfer and Enforcement of Negotiable Instruments

A. Transferring a Negotiable Instrument

The advantage of the negotiable instrument system is the ease of transfer of clean and verifiable title.
Transfer of a negotiable instrument never requires more than
1. Delivery
2. Indorsement.

1. Negotiation and Status as a Holder

Two central concepts:
1. Holder

§ 1-201(b)(21)	"Holder" means: (A) the person in possession of a negotiable instrument that is payable either to bearer or to an identified person that is the person in possession; or (B) the person in possession of a document of title if the goods are deliverable either to bearer or to the order of the person in possession.

No person can be a holder without possession of the instrument.
Any person in possession of bearer paper is a holder, no matter how bad their claim to ownership is.
    Even a thief. §3-203 cmt.1
Order paper must always be payable to a certain, identified person. § 3-109.
    That identified person is the ONLY person who can be a holder.
    If an instrument is apayable to "or" then payable alternatively and either can be a holder. §3-110(d).
    If an instrument is payable to "and" the npayable jointly, and they are only a holder together. § 3-310(d).
    If an instrument is payable to an account number, it is deemed payable to the owner. § 3-110(c)(1).
        Unless payable to a person and a wrong account number, then to the person.
        Same.

2. Negotiation

2. Special and Blank Indorsements

To make a purchaser of order paper the identified person who may be a holder, the seller must indorse the instrument.

The UCC presumes that any signature on an instrument is an indorsement unless the circumstances unambiguously indicate it's not. § 3-204(a). Ex: signature in lower right corner is presumed not indorsement, but the signature of the issuer. § 3-204 cmt. 1.

§ 3-204(a)	"Indorsement" means a signature, other than that of a signer as maker, drawer, or acceptor, that alone or accompanied by other words is made on an instrument for the purpose of (i) negotiating the instrument, (ii) restricting payment of the instrument, or (iii) incurring indorser's liability on the instrument, but regardless of the intent of the signer, a signature and its accompanying words is an indorsement unless the accompanying words, terms of the instrument, place of the signature, or other circumstances unambiguously indicate that the signature was made for a purpose other than indorsement. For the purpose of determining whether a signature is made on an instrument, a paper affixed to the instrument is a part of the instrument.

Two types of indorsement:
1. "Special"
    Identifies a person to whom an instrument is payable. § 3-205(a).

§ 3-205(a)	If an indorsement is made by the holder of an instrument, whether payable to an identified person or payable to bearer, and the indorsement identifies a person to whom it makes the instrument payable, it is a "special indorsement." When specially indorsed, an instrument becomes payable to the identified person and may be negotiated only by the indorsement of that person. The principles stated in Section 3-110 apply to special indorsements.

2. "Blank"
Any indorsement made by a holder that does not indicate an identified person.

§ 3-205(b)	If an indorsement is made by the holder of an instrument and it is not a special indorsement, it is a "blank indorsement." When indorsed in blank, an instrument becomes payable to bearer and may be negotiated by transfer of possession alone until specially indorsed.

Any indorsement that does not identify a person.
Transforms order paper to bearer paper. § 3-109(c) § 3-205(b).
Blank endorsement on bearer paper creates liability for the indorser under § 3-415.

§ 3-415	(a) Subject to subsections (b), (c), (d), (e) and to Section 3-419(d), if an instrument is dishonored, an indorser is obliged to pay the amount due on the instrument (i) according to the terms of the instrument at the time it was indorsed, or (ii) if the indorser indorsed an incomplete instrument, according to its terms when completed, to the extent stated in Sections 3-115 and 3-407. The obligation of the indorser is owed to a person entitled to enforce the instrument or to a subsequent indorser who paid the instrument under this section. (b) If an indorsement states that it is made "without recourse" or otherwise disclaims liability of the indorser, the indorser is not liable under subsection (a) to pay the instrument. (c) If notice of dishonor of an instrument is required by Section 3-503 and notice of dishonor complying with that section is not given to an indorser, the liability of the indorser under subsection (a) is discharged. (d) If a draft is accepted by a bank after an indorsement is made, the liability of the indorser under subsection (a) is discharged. (e) If an indorser of a check is liable under subsection (a) and the check is not presented for payment, or given to a depositary bank for collection, within 30 days after the day the indorsement was made, the liability of the indorser under subsection (a) is discharged.

Special Rules for Checks Transferred to Banks:

1. A depositary bank automatically becomes a holder of a check deposited by its customer, even if it's unindorsed order paper. § 4-205(1).
2. A bank does not need to indorse a check when it transfers it to another bank. § 4-206, 12 C.F.R. 229.35.

§ 4-205	If a customer delivers an item to a depositary bank for collection: (1) the depositary bank becomes a holder of the item at the time it receives the item for collection if the customer at the time of delivery was a holder of the item, whether or not the customer indorses the item, and, if the bank satisfies the other requirements of Section 3-302, it is a holder in due course; and (2) the depositary bank warrants to collecting banks, the payor bank or other payor, and the drawer that the amount of the item was paid to the customer or deposited to the customer's account.
§ 4-206	Any agreed method that identifies the transferor bank is sufficient for the item's further transfer to another bank.

3. No party other than a bank may become a holder of a check once it has been indorsed by a bank. The only way a party other than a bank can become a bearer of such a check is by special indorsement by the bank or for the bank to return the check to the person who deposited it. Reg. CC, 12 C.F.R. § 229.35(c).

3. Restrictive and Anomalous Indorsements

1. Restrictive Indorsements § 3-206(a) – (b)

§ 3-206(a)	An indorsement limiting payment to a particular person or otherwise prohibiting further transfer or negotiation of the instrument is not effective to prevent further transfer or negotiation of the instrument.
§ 3-206(b)	An indorsement stating a condition to the right of the indorsee to receive payment does not affect the right of the indorsee to enforce the instrument. A person paying the instrument or taking it for value or collection may disregard the condition, and the rights and liabilities of that person are not affected by whether the condition has been fulfilled.

Most restrictive indorsements are invalid except "For Deposit Only" and "For Collection."

A party that pays or purchases the item in violation of one of these indorsements commits conversion unless the proceeds are received by the indorser or applied consistently with the indorsement. § 3-206(c)

§ 3-206(c)	If an instrument bears an indorsement (i) described in Section 4-201(b), or (ii) in blank or to a particular bank using the words "for deposit," "for collection," or other words indicating a purpose of having the instrument collected by a bank for the indorser or for a particular account, the following rules apply: (1) A person, other than a bank, who purchases the instrument when so indorsed converts the instrument unless the amount paid for the instrument is received by the indorser or applied consistently with the indorsement. (2) A depositary bank that purchases the instrument or takes it for collection when so indorsed converts the instrument unless the amount paid by the bank with respect to the instrument is received by the indorser or applied consistently with the indorsement. (3) A payor bank that is also the depositary bank or that takes the instrument for immediate payment over the counter from a person other than a collecting bank converts the instrument unless the proceeds of the instrument are received by the indorser or applied consistently with the indorsement. (4) Except as otherwise provided in paragraph (3), a payor bank or intermediary bank may disregard the indorsement and is not liable if the proceeds of the instrument are not received by the indorser or applied consistently with the indorsement.

2. Anomalous Indorsement

An indorsement by a person who was not a holder at the time of indorsement.

No effect on who is a bearer, but it turns the indorser into an accommodation party, and they are now a guarantor!

§ 3-419(c)	A person signing an instrument is presumed to be an accommodation party and there is notice that the instrument is signed for accommodation if the signature is an anomalous indorsement or is accompanied by words indicating that the signer is acting as surety or guarantor with respect to the obligation of another party to the instrument. Except as provided in Section 3-605, the obligation of an accommodation party to pay the instrument is not affected by the fact that the person enforcing the obligation had notice when the instrument was taken by that person that the accommodation party signed the instrument for accommodation.

B. Enforcement and Collection of Instruments

1. The Right to Enforce an Instrument

Any holder is a person entitled to enforce the instrument. § 3-301(i).

A holder has the legal right to call for payment from any party obligated to pay the instrument EVEN if he has no lawful right to payment.

§ 3-301	"Person entitled to enforce" an instrument means (i) the holder of the instrument, (ii) a nonholder in possession of the instrument who has the rights of a holder, or (iii) a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 3-309 or 3-418(d). A person may be a person entitled to enforce the instrument even though the person is not the owner of the instrument or is in wrongful possession of the instrument.

You do not have to be a holder to become a person entitled to enforce.

A party may transfer its rights to enforce to a third party, who then has the right to enforce under property law. §3-203(b).

A transferee in this situation can compel the seller to indorse the item and make the purchaser a holder. § 3-203(c).

§ 3-203	(a) An instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument. (b) Transfer of an instrument, whether or not the transfer is a negotiation, vests in the transferee any right of the transferor to enforce the instrument, including any right as a holder in due course, but the transferee cannot acquire rights of a holder in due course by a transfer, directly or indirectly, from a holder in due course if the transferee engaged in fraud or illegality affecting the instrument. (c) Unless otherwise agreed, if an instrument is transferred for value and the transferee does not become a holder because of lack of indorsement by the transferor, the transferee has a specifically enforceable right to the unqualified indorsement of the transferor, but negotiation of the instrument does not occur until the indorsement is made. (d) If a transferor purports to transfer less than the entire instrument, negotiation of the instrument does not occur. The transferee obtains no rights under this Article and has only the rights of a partial assignee.

2. Presentment and Dishonor

Two-step process for the collection of instruments.

1. Presentment

    The demand of payment by a person entitled to enforce. § 3-501(a).

        Note: Demand to maker
        Draft: Demand to drawee

    The party to whom the demand is made may require the holder exhibit (present) the instrument. § 3-501(b)(2).

§ 3-501	(a) "Presentment" means a demand made by or on behalf of a person entitled to enforce an instrument (i) to pay the instrument made to the drawee or a party obliged to pay the instrument or, in the case of a note or accepted draft payable at a bank, to the bank, or (ii) to accept a draft made to the drawee. (b) The following rules are subject to Article 4, agreement of the parties, and clearing-house rules and the like: (1) Presentment may be made at the place of payment of the instrument and must be made at the place of payment if the instrument is payable at a bank in the United States; may be made by any commercially reasonable means, including an oral, written, or electronic communication; is effective when the demand for payment or acceptance is received by the person to whom presentment is made; and is effective if made to any one of two or more makers, acceptors, drawees, or other payors. (2) Upon demand of the person to whom presentment is made, the person making presentment must (i) exhibit the instrument, (ii) give reasonable identification and, if presentment is made on behalf of another person, reasonable evidence of authority to do so, and (iii) sign a receipt on the instrument for any payment made or surrender the instrument if full payment is made. (3) Without dishonoring the instrument, the party to whom presentment is made may (i) return the instrument for lack of a necessary indorsement, or (ii) refuse payment or acceptance for failure of the presentment to comply with the terms of the instrument, an agreement of the parties, or other applicable law or rule. (4) The party to whom presentment is made may treat presentment as occurring on the next business day after the day of presentment if the party to whom presentment is made has established a cut-off hour not earlier than 2 p.m. for the receipt and processing of instruments presented for payment or acceptance and presentment is made after the cut-off hour.

2. Response

    "Honor" or "dishonor"

The system assumes a party wishes to dishonor if it does not take affirmative action to honor it. If an item is payable when presented, it is dishonored if it is not paid on the day of presentment. § 3-502(a)(1).
The opposite rule for checks. § 3-502(b)(1)

3. Defenses to Enforcement

If someone isn't a holder in due course, Article III allows any defense the obligor has against the payee. § 3-305(a)(2) and (a)(3).

§ 3-305(a)(2)	(a) Except as stated in subsection (b) otherwise provided in this section, the right to enforce the obligation of a party to pay an instrument is subject to the following: a defense of the obligor stated in another section of this Article or a defense of the obligor that would be available if the person entitled to enforce the instrument were enforcing a right to payment under a simple contract;
§ 3-305(a)(3)	a claim in recoupment of the obligor against the original payee of the instrument if the claim arose from the transaction that gave rise to the instrument; but the claim of the obligor may be asserted against a transferee of the instrument only to reduce the amount owing on the instrument at the time the action is brought.

Turman v. Ward's Home Improvement, Inc.

Facts:	Turman executed a DOT payable to Ward to build a house. Ward assigned the note to Pomerantz, but did not indorse. Ward did not complete building the house. Turman defaulted on the note.
Issue:	Whether an assignee of the payee of a negotiable instrument is a holder in due course, and as such immune to the defenses that the makers might raise against the payee of the negotiable instrument.
Rule:	If an instrument is payable to an identified person, negotiation requires its indorsement by the holder. § 3-201(b).
Held:	Pomerantz is not a holder in due course, Turman can assert normal defenses.
Why?	No indorsement on the note, so it wasn't negotiated, so no holder in due course. Pomerantz still has rights, but they are derivative of Ward's, and Turman could assert this defense against Ward. § 3-305(a)(2).

C. Liability on an Instrument

What parties are liable on a particular instrument?

No party is liable on an instrument unless it has signed the instrument (excluding transfer and presentment warranties). § 3-401

§ 3-401	(a) A person is not liable on an instrument unless (i) the person signed the instrument, or (ii) the person is represented by an agent or representative who signed the instrument and the signature is binding on the represented person under Section 3-402. (b) A signature may be made (i) manually or by means of a device or machine, and (ii) by the use of any name, including a trade or assumed name, or by a word, mark, or symbol executed or adopted by a person with present intention to authenticate a writing.

Standard UCC definition of a signature here.

What about when someone is signing an instrument as an agent or representative?

Use normal principles of agency law to determine if a represented party is liable. § 3-402(a).
The UCC doesn't define these principles, however.
What about the agent?

§3-402(b)(1): No liability if

1. the signature shows unambiguously that he is signing on behalf of the represented person.
2. the instrument identifies the represented person.

§3-402(b)(2): Otherwise personal liability.

4 Different Categories of Signer, Different Liability

1. The Issuer: Absolute liability. § 3-412.
2. The Drawee:
   - No liability when the check is issued. § 3-408
   - If the drawee accepts (only need a signature), direct liability. § 3-413(a)
3. Drawer (unless drawee)
   - Not liable unless dishonored. § 3-414(c)
4. Indorser
   - Not liable unless dishonored. §3-415(a)
   - This liability is discharged if a bank accepts after indorsement. §3-415(d).
   - An indorser can liimt liability by signing "without recourse". §§ 3-414(e), 3-415(b).

D. The Effect of the Instrument on the Underlying Obligation

Payment obligations ordinarily are given in satisfaction of some underlying obligation.
The issuer of a negotiable instrument incurs liability on the instrument without regard to the terms of the underlying transaction.

§3-310 separates effects on the underlying obligation into two classes of instrument: near-cash and ordinary instruments.

§ 3-310(a) & (c): Near Cash: Certified Checks, Cashier's Checks, and Teller's Checks.
  Acceptance of one of these items by the obligee discharges the underlying obligation.
§ 3-310(b): Ordinary instruments
  When an obligee takes an ordinary instrument, the underlying obligation is suspended.
    If the item is dishonored, then the obligation is reinstated and the obligee can enforce the underlying obligation or the item. § 3-310(b)(3).
    If the item is paid, then the obligation is discharged. § 3-310(b)(1)

Discharge under § 3-310 is only effective to the amount of the instrument.

HOWEVER, § 3-311 generally supports the use of instruments to resolve disputes.
  A check marked "PAID IN FULL" will discharge the entire obligation if
  (a) tendered as full satisfaction of a disputed claim
  (b) the payor conspicuously notifies the payee that it intends the instrument to constitute full satisfaction of the claim
  (c) the payee successfully obtains payment of the instrument.

McMahon Food Corp. v. Burger Dairy Co.

Facts:	MFC and Burger met about MFC's overdue account. MFC told Burger that everything up to February was paid. Burger then calculated debt from February to June, and MFC gave a check with a voucher attached saying "payment in full". Burger found out MFC was lying, and Burger crossed out the "payment in full" language.
Issue:	Did Burger's negotiation of the check constituted an accord and satisfaction.
Rule:	In order to establish an accord and satisfaction, the burden is on the one tendering to prove good faith under § 3-311(a).
Held:	There was no honest dispute, MFC deliberately misled Burger, no good faith, no accord and satisfaction.

Assignment 24: Holders in Due Course

A. Holder-in-Due-Course Status

Holder-in-due-course status increases liquidity: the HIDC doesn't have to worry about a bunch of defenses on the underlying obligation.

1. The Requirements for Holder-in-Due-Course Status

1. Must become a holder through negotiation.
2. Must receive the item:
    a. for value
    b. in good faith
    c. with no notice of certain problems.

a. Value

§3-302(a)(2)(i) (defined §3-303(a).) Excludes transfers as a gift. More strict than consideration, though. A future promise of performance will ordinarily not stand as value until performance is rendered. § 3-303(a)(1).

b. Good Faith

Normal UCC definition of good faith.

§ 1-201(b)(20). "Honesty in fact and observance of reasonable commercial standards."

General Investment Corp. v. Angelini

A close relationship between a lender and a retail operation can raise a presumption of bad faith when using HDIC status to shield themselves from defenses.

Related but not good faith: so close that no cognizable sale occurred. *St. James v. Diversified Commercial Finance Corp.*

c. Notice UCC §3-302(a)(2)(iii)-(iv).

HDIC rests on the assumption that there's an anonymous unknowing purchaser who can't be charged with problems in the transaction. If the transferee had notice, this assumption collapses.

Notice is not knowledge. "Reason to know" standard. §1-202(a)(1).

1. Overdue, dishonored, in default. § 3-302(a)(2)(iii)
    Overdue? §3-304
        Demand instrument, the day after the demand.
        Checks, 90 days after the date of the check.
        Failure to make scheduled payments or an acceleration event.
            Note: interest payments missed only are not default or overdue. Only amortizing payments.
    Dishonor? §3-502, an instrument presented to a party to pay and the party fails to pay.
2. Forgery or alteration. § 3-302(a)(2)(iv)
3. 3rd Party Claims to own part or all of the instrument. § 3-302(a)(2)(v)
4. The obligor has a defense or claim that would limit enforcement. § 3-302(a)(2)(vi)

2. Rights of Holders in Due Course

A holder in due course is immune from most ordinary contract claims or defenses. § 3-305(b).

There are four "real" defenses available against a HDIC: § 3-305(a)(1)

1. Infancy. §3-305(a)(1)(i), 305 cmt. 1
2. Duress, lack of legal capacity, or illegality. § 3-305(a)(1)(ii)
    Narrowly interpreted.
    Must be void by operation of law, not voidable. *Bankers Trust Co. v. Litton Systems*
3. Fraud that induced issuance of the instrument with neither knowledge nor reasonable opportunity to learn of its character or essential terms. § 3-305(a)(1)(iii).
    Also interpreted narrowly.

"If he has eyes, and can see, he ought to examine; if he can read, he ought to read…if he relies on the word of a stranger he makes that stranger his agent … and … cannot disaffirm the acts of the agent." *Ort v. Fowler*

4. Discharge of the obligor in insolvency (bankruptcy).

Remember: a forged signature is the signature of the forger, not the signature of the putative obligor.

State Street Bank & Trust Co. v. Strawser

Facts:	Strawser executed a note in favor of Homestead. The note was secured by four parcels of land, and some farming and industrial equipment. Homestead assigned the note to State Street. Paragraph 7(C) of the note says that on default the holder could send notice of default and accelerate. State Street sent a notice of default and said would accelerate in 30 days. Strawser claims that the note was illegal because of some Pennsylvania LTV requirements. Strawser sent a letter to Homestead saying that the note was illegal under this PA law.
Issue:	Did State Street have notice of a possible defense of illegality?
Rule:	A person has notice of a fact when 1) he has actual knowledge of it; 2) he has received a notice or notification of it; or 3) from all of the facts and circumstances known to him at the time in question he has reason to know that it exists.
Held:	State Street had no notice and is a HDIC.
Why?	Strawser sent the letter to Homestead and did not establish that State Street ever knew about it. There's nothing in the record showing that the LTV requirement wasn't met, particularly as the appraisals all seemed in line. Note that even if HDIC hadn't been allowed, the underlying claim still wasn't there.

3. Payment and Discharge

The fact that a party has partially paid an instrument does not suggest a problem that bars HDIC status. The fact that one party has been discharged also does not suggest such a problem.

For example, an accommodation party might be discharged if a holder grants an extension of a due date. § 3-605. This doesn't bar a future purchaser from becoming a HIDC who can enforce against the principal obligor. Can contract around also: if note allows extension of guaranty, then extension does not extend.

Two-step solution.

1. HIDC status isn't precluded by notice of payment or discharge (other than in bankruptcy). §3-302(b).
2. Any whole or partial discharge is effective against anyone who takes with notice of the discharge. § 3-302.
    - A purchaser who takes a promissory note with notice of any payments is bound to recognize the reduction in the amount owed.
    - A purchaser is on notice of a discharge of a guarantor under § 3-605 (like if the document even has an extension of a due date noted) the discharge is effective against the HIDC. § 3-601(b)

HOWEVER, a discharge is not effective as against a purchaser without notice. § 3-601(b).

- Can get around by taking steps to ensure nobody could take without notice, but this isn't realistic. While the UCC obligates a holder to surrender an instrument on payment §3-501(b)(2)(iii), most contract around.
- Can also get around by noting partial payments on the face of the document. Again, not practical.

The Restatement of Mortgages §5.5 rejects the UCC rule and says a payment to a person the obligor believes is the holder is effective.

4. Transferees Without Holder-in-Due-Course Status

Two rules make the position of a purchaser not in due course better than the purchaser of a nonnegotiable instrument.

1. If the only failure of HIDC status is the failure to get an indorsement, § 3-203(c) obligates the seller to indorse.
2. "Shelter rule"
   A purchaser of property obtains all of the rights that the seller had in the purchased property.
   A party who fails to obtain HIDC status can enforce the HIDC status of the seller. § 3-203(b).

B. The Fading Role of Negotiability

1. The Declining Use of Negotiable Instruments

The FTC now defines it as an unfair trade practice to receive a promissory note in a consumer credit sale transaction without the following language:

> Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods and services obtained pursuant hereto or with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder.

16 C.F.R. § 433.2(a)

This makes HIDC status for consumer credit nonexistent. The UCC now provides that a consumer promissory note will be construed to contain this phrase even if it doesn't. § 3-405(e).
GO TO ASSIGNMENT 11 NEXT