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IS THE U.C.C. PREPARED FOR THE THRIFTS’ NOWS, NINOWS, AND SHARE DRAFTS?

Fairfax Leary, Jr.*

Now that the Federal Depositary Institutions Deregulation and Monetary Control Act is law, a question arises as to the law applicable to the processing for collection and payment of the new payment instruments which draft on accounts in thrift institutions such as state and federal savings and loan associations and credit unions. This Article addresses the proper legal classification of the new NOWs, NINOWs, share drafts, and similar instruments. Operating within the constraints of a Uniform Commercial Code drafted when these new developments were not even within the penumbra of the draftsmen’s consciousness, will the courts, aided by the contracts of the parties, be able to interpret the U.C.C. to cover these new instruments? Will the Code cover new methods of collection, particularly where at some point after its origination a paper order for payment is converted into an electronic message conveying less than all of the information on the original order?

This Article is not going to discuss the legal aspects of whether state chartered thrift institutions have the charter power to engage in draft programs now that all federal associations may do so. Some battles undoubtedly remain to be fought on that front, but we are here concerned with

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This article is an expanded version of a speech delivered at the 1980 Conference of Credit Union Attorneys on October 2, 1980 at the Broadwater Beach Hotel in Biloxi, Mississippi.


2. NOW is the acronym for Negotiable Order of Withdrawals, NINOW for a Non-Interest Bearing Negotiable Order of Withdrawal account, WOW for a Written (to indicate non-negotiable) Order of Withdrawal, and POW is used for a Payment Order for Withdrawal. These usually refer to accounts in mutual savings banks and savings and loan or building and loan associations. Drafts drawn on credit unions are called “share drafts.”

3. As to credit union share drafts, see Florida Bankers Ass’n v. Leon County Teachers Credit Union, 359 So. 2d 886 (Fla. Dist. Ct. App. 1978) (share drafts authorized), cert. denied, 368 So. 2d 1366 (1979); Bartonville Bank v. Callaghan, No. 77-h-22948 (Ill. Cir. Ct.
legal issues which can arise in the operation of a draft program which we shall postulate as being within the organizational power of the thrift institution to operate.

Since the credit union share draft program raises all of the legal issues, this Article will refer to that program extensively. The credit union share draft program is already big business but, as yet, nowhere near the size of the check handling business.\(^4\) Current information as to the operation of savings and loan drafts is not presently available to the writer. However, the July, 1980 evaluation report by the International Credit Union Service Corporation\(^5\) on the credit union share draft program shows that drafts paid during that month amounted to over a billion and a half dollars in credit union assets. This means an almost thirty per cent annual turnover of deposits, without allowing for the fact that many credit unions, probably the smaller ones, may not yet have share draft programs. The figures indicate an average of about 12,500 share drafts paid per month for each credit union, ranging from a high of 47,777 per credit union for the ten credit unions using First National Bank & Trust Co. of Oklahoma City as their “payable-through” bank, to a low of about 1,000 a month per credit union in the Northeast. The share drafts averaged fifteen and one-half per active account for the month, and the amount of the average draft was $68.32. Even at these figures, a fully allocated unit cost, or per account cost of the share draft program is probably presently comparatively higher than the

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\(^4\) Estimated variously at between 37 billion to 40 billion checks a year.

\(^5\) INTERNATIONAL CREDIT UNION SERVICE CORPORATION, REPORT ON SHARE DRAFT PROGRAM (July, 1980) [hereinafter cited as ICUSC Report].
cost of check processing in commercial banks because of volume differences, although substantial savings are accomplished by the non-return of share drafts to credit union members and the use of the high-speed mechanized equipment of the “payable-through” processors.\(^6\) Perhaps these July, 1980 figures are on the high side due to vacations taken in July. But they do indicate that share drafts are now here in substantial volume.

The big question is, “What law applies to the collection and payment of share drafts?” Put another way, how will the courts allocate the losses arising from wrongful intrusions into the share draft payment process?

As we take our brief journey with gun and camera through the wilderness of Articles 3 and 4 of that treasury of golden wit and humor called the Uniform Commercial Code, we shall be considering the application of those articles to the credit union share draft program\(^7\) and, in general, to other draft accounts of other thrift institutions. We shall assume that the functional purpose for which credit union members and other thrift customers use drafts is to make payment of obligations, or to give gifts to others by the transfer of share draft credit of the members into depositary institution credit at the institution chosen by their creditors or donees. To do this we must look at the payment process on two levels: the message level and the mutual account level. The share draft does not transfer funds. That is done by the debits and credits entered in an underlying network of related mutual accounts in the several institutions through which the share draft or its electronic summary passes on its journey from the payee-creditor to the designated payable-through bank. The share draft is just the message that triggers the posting of the debits and credits until the debit is entered in the thrift institution’s account at the payable-through bank. At that point the message is forwarded to the credit union by an electronic transmission of the encoded Magnetic Ink Character Recognition (MICR) line on the bottom of the share draft. The numbers in this line give the designation of the payable-through institution, then the credit union number and the account number of the member writing the draft, the member’s serial number for the draft, and the encoded amount of the draft. This last amount is placed thereon in magnetic ink characters by the institution in which the draft is deposited or, if that institution does

\(^6\) Many share drafts and thrift drafts are drawn “payable through” a designated commercial bank whose routing numbers are printed in Magnetic Ink Character Recognition (MICR) characters in the first field at the bottom of the draft.

\(^7\) INTERNATIONAL CREDIT UNION SERVICE CORPORATION, STATEMENT OF OPERATIONAL SPECIFICATIONS FOR THE ICU SHARE DRAFT PROGRAM (February, 1980) [hereinafter cited as ICUSC Statement].
not have MICR encoding equipment, by the first institution having such equipment that handles the draft for collection.

The first problem that is encountered is whether only Article 3 of the Uniform Commercial Code applies, or whether Article 4 also applies, because there are fundamental differences in both timing and coverage that hang on that issue.

There is no question but that the form of share draft set forth in the footnote, when filled out in the usual manner, is a commercial paper negotiable instrument subject to Article 3 of the Code. It is a draft payable to the order of a named payee, in a sum certain. No time of payment is

8. Form of Credit Union Share Draft and Self-Carbon

<table>
<thead>
<tr>
<th>JAMES C. MORRISON</th>
</tr>
</thead>
<tbody>
<tr>
<td>1765 SHERIDAN DRIVE</td>
</tr>
<tr>
<td>YOUR CITY, YOUR STATE 12345</td>
</tr>
<tr>
<td>PAY TO THE ORDER OF: Delaware Bay Assn</td>
</tr>
<tr>
<td>Nothing at all</td>
</tr>
<tr>
<td>0000.00</td>
</tr>
<tr>
<td>DOLLARS</td>
</tr>
<tr>
<td>SAMPLE - VOID</td>
</tr>
<tr>
<td>DELUXE CHECK PRINTERS, INC.</td>
</tr>
<tr>
<td>YOUR CITY, U.S.A. 12345</td>
</tr>
<tr>
<td>SELF-MADE CARBON OF ABOVE</td>
</tr>
</tbody>
</table>

9. U.C.C. § 3-102(1)(b).
10. Id. §§ 3-104(a), (b), 3-106.
specified so it is payable on demand.\textsuperscript{11} It names the drawee with sufficient precision.\textsuperscript{12} It is payable through a commercial bank.\textsuperscript{13} It will be signed by the drawer as required.\textsuperscript{14} Clearly it is an “item” under the definition in Article 4.\textsuperscript{15}

If, under its organic law, a credit union is prohibited from using checks or other negotiable orders of withdrawal, then instead of a NOW, it will use a WOW,\textsuperscript{16} by having the share drafts printed “pay to” rather than “pay to the order of,” and the Code makes all of Article 3 applicable except that there can be no holder in due course,\textsuperscript{17} and it will still be an item under Article 4’s definition of that term. But is it just a draft with a non-bank drawee, or is it a “check” defined as a draft payable on demand drawn on a bank?\textsuperscript{18} Why should this make any difference?

The answer is that even in Article 3 there are different rules for drafts and checks as to the time allowed for presentment and, if that time is missed in the collection process, the result is a discharge of drawers and endorsers. This follows since under Article 3 a draft must be presented for payment to the drawer within a reasonable time after the date of its actual issue, or the date stated thereon, whichever is later.\textsuperscript{19} But if the instrument is a check drawn and payable within the United States, then we have two statutory presumptions about reasonable time for presentment. The presumptions apply to the time in which to make presentment or to initiate bank collection. The time for indorsements is seven days, and for the drawer the time is thirty days.\textsuperscript{20} Actually, today, presentment is faster than the period in the presumptions in most cases. But the presumption rules only apply to checks, and checks must be drawn on a bank.

So, for Uniform Commercial Code purposes, is a credit union a “bank?” The Code defines a “bank” as “any person engaged in the business of banking,”\textsuperscript{21} which is almost a Gertrude Stein type of definition drawn from similar language in section 191 of the old 1895 Negotiable Instruments Law. Banking then was done only by commercial banks and per-

\textsuperscript{11} Id. § 3-108.
\textsuperscript{12} Id. § 3-102(1)(b).
\textsuperscript{13} Id. § 3-120 stated that the bank so named is “a” bank to make presentment. The implication is a good presentment may be made by others.
\textsuperscript{14} Id. § 3-104(1)(a).
\textsuperscript{15} Id. § 4-104(g).
\textsuperscript{16} See note 2 supra.
\textsuperscript{17} U.C.C. § 3-805.
\textsuperscript{18} Id. § 3-104(2)(b).
\textsuperscript{19} Id. § 3-503(1)(b).
\textsuperscript{20} Id. § 3-503(2)(a), (b).
\textsuperscript{21} Id. § 1-201(4).
haps by a few savings banks, some of which had checking accounts. Both were called banks. The definition caused no problems. Does the definition refer us to the local law of the state for a more precise definition of the "business of banking?" Or can there be developed a U.C.C. uniform interpretation of "business of banking" limited solely for the purposes of Articles 3 and 4? Or must the parties involved, or at least those most significantly involved, cover the matter by agreement, and how detailed must that agreement be?

First then, let us discuss briefly whether the Code can and should be construed so that for the purpose of handling share drafts, and all the coterie of NOWs, WOWs, NINOWs, and POWs, the term "bank" in Articles 3 and 4 should be construed as covering any depositary institution participating in the payments system through the utilization of third party payment orders. This becomes all the more important now that the Federal Home Loan Banks are being authorized to provide account processing, data processing and sorting, data communications, and transportation and storage of items for savings and loans. What will the rules be there?

The cardinal rule of the Code as to its interpretation is stated to be that: "This Act shall be liberally construed and applied to promote its underlying purposes and policies." The Comment to this section states that its purpose is "to make it possible for the law embodied in this Act to be developed by the courts in the light of unforeseen and new circumstances and practices." The Comment also states that "the proper construction of the Act requires that its interpretation and application be limited to its reason." The Comment goes on to state that courts have recognized the policy embodied in a Uniform Act as applicable in reason to subject matter which was either not expressly included in the language of the Act, or was intentionally excluded from the Act in general language. In an unusual step for U.C.C. Comments, case authority for these conclusions from the Supreme Court of the United States and the New York Court of Appeals is cited in the Comment. Some forty-five years ago James M. Landis, later to be chairman of the Securities and Exchange Commission and Dean of the Harvard Law School, wrote an article entitled Statutes as

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22. See note 2 supra.
24. U.C.C. § 1-102(1).
Sources of the Law,26 which also contains much helpful precedent on the application of the principles of statutes to cases not specifically covered by deciding by analogy to the statute. Can one rely on all courts in all states to reach this result by either interpreting the word “bank” in the Code, and using the Code, or using the Code sections as precedent by analogy.27 Recent experience indicates that in advising clients this may not be a safe course to follow, even though in logic and reason courts should reach this result for the collection problems involved. Thrifts have had to litigate with commercial bankers over the share draft program in several jurisdictions.28 So have the investment bankers with their “draft-on-your-securities-accounts” programs.29 But while this litigation involves classification for a far different purpose, nevertheless, by reason of it a result contrary to that here urged could be reached under the U.C.C. The argument would be that “the business of banking” means the business expressly authorized to be performed by the institutions organized and operating under a statute called the banking law, as distinguished from those incorporated under a credit union act or a building and loan act. The courts are divided on whether the necessary and incidental powers clause in the charter powers granted these institutions includes the power to operate NOW or NINOW accounts. A very conservative court could say banking means the business of commercial banks and suggest that change is for the legislature. It should not, but it might.

How difficult would it be to obtain legislation changing the Code definition of a bank? The change need only be that the clause “bank means any person engaged in the business of banking”30 be amended by adding to that definition the following:

26. Landis, Statutes as Sources of the Law, HARVARD LEGAL ESSAYS 213ff (1934) (in honor of Joseph Henry Beale and Samuel Williston) referring to the doctrine of the Equity of the Statute and the approach of early English Law. Wherein Plowden said “... sometimes the sense is more confined and contracted than the Letter, and sometimes it is more large and extensive.” Eyston v. Studd, Plowd. 459, 465 (1573) (as cited in Landis).

27. Consideration must be given to state statutory construction acts. For example, subsection (b) of the Pennsylvania Statutory Construction Act, 1 PA. CONS. STAT. ANN. § 1921(b) (Purdon Supp. 1980) reads: “When the words of a statute are clear and free from all ambiguity, the letter of it is not to be disregarded under the pretext of pursuing its spirit.” However, id. § 1927 reads: “Statutes uniform with those of other states shall be interpreted and construed to effect their general purpose to make uniform the laws of those states which enact them.” In context, recent developments do make the terms “bank” and “business of banking” as used in the U.C.C. not free from all ambiguity.

28. See note 3 supra.

29. See Opinion of Attorney General (Wash. May 30, 1978) (did constitute business of banking). The Colorado Banking Department accepted a plan limiting drafts to $500 and up, as not the business of banking.

30. See text accompanying note 21 supra.
and solely for the purposes of Articles 3 and 4 of this Act, includes any mutual savings bank, savings or building and loan association, credit union, or industrial bank or other institution having the power to offer accounts subject to withdrawal by negotiable or nonnegotiable third party payment order even though the account is subject to an option of the institution to require a stated period of advance notice before the institution is under obligation to its customer to honor the order.

With the Depositary Institutions Deregulation and Monetary Control Act on the books, the opposition of the commercial banks may not be as great. But amending the U.C.C. would be difficult given any commercial bank opposition. The difficulty is increased because the American Law Institute and the Commissioners on Uniform State Laws are even now contemplating substantial revisions to Articles 3 and 4 and could urge that no change be made until their proposals are complete. This might require a period of time measured in years.

So the safe course is to proceed by contract, to the extent that the application of Articles 3 or 4 is needed and continue to urge the courts to interpret the term “bank” as covering credit unions and other thrifts for the purposes of Articles 3 and 4 of the U.C.C. or to apply the rules to the thrift institutions by analogy.

The discussion in this Article will cover the extent of the needed contract under three topics. First will be the account relationship between the credit union and the member. Second, we will consider the processing of items both as to time limits and as to the truncation process. Finally, we will discuss the allocation of losses from wrongful intrusions into the payments process. Under each of these topics we shall first consider the impact on the issues of a determination of whether the credit union is regarded as a bank or that the rules of the Code are to be applied by analogy to what are near-bank situations; and then examine the extent to which contract provisions between a thrift institution and its customers as to the deposit draft account will reach the desired result.

31. A 3-4-8 Committee has been appointed, under the Chairmanship of Robert Haydock, Esq. of Bingham, Dana & Gould, Boston, Mass., with Professor Harold Scott of Harvard as reporter, to propose revisions of Articles 3 and 4 of the U.C.C. into a code for all payments systems.

32. Since many sections of the Code have been applied by analogy in other circumstances, why not here? For example, consider the cases applying the Article 2 warranties to other than sale of goods cases, other parts of Article 2 to sales of intangibles, and the general effect of the U.C.C.'s contractual provisions on the drafting of the Restatement (Second) of Contracts.

33. Indeed, the Canadian term for depositary institutions that are not chartered as commercial banks is “near banks.”
I. THE ACCOUNT RELATIONSHIP

Most of the rules bearing on the account relationship are in Part 4 of Article 4 of the U.C.C. This is the Part that, if applicable, would most directly deal with the relationship between a thrift institution as drawee, and its customer as drawer. But unfortunately, this part of the Code is phrased in terms of a bank's relationship to its customer, defined as "any person having an account with a bank or for whom a bank has agreed to collect items." Nevertheless a credit union and its members, or a savings and loan and its customers clearly may agree that the rules applicable to bank and customer under the U.C.C. may apply to and govern the relations between them with respect to the share draft account, so far as their mutual rights and duties as against each other are concerned.

The Code permits a bank to charge otherwise properly payable items to the customer's account even though the charge creates an overdraft, and hence a loan made without the formalities of a loan. One purpose of the section, of course, is to prevent the customer from claiming an improper payment and that the check should have been returned "N.S.F." rather than having been paid. The basic share draft agreement suggested for credit unions provides that the credit union is "under no obligation to pay" a draft creating an overdraft, but does not give the credit union immunity if it should do so, by mistake or otherwise. The authorization to pay share drafts signed by the member may be interpreted as covering only those against good funds. As between institution and customer, the customer should bear the burden of an inadvertent loan, particularly when the loan may not be an authorized one.

The Code permits the charge to the account of an obviously completed item without inquiry as to the authority of the person completing it. The rule requires the bank to act in good faith, and to be without knowledge that the completion was improper. This precludes litigation based on allegations that obvious completions raise a duty of inquiry as to the authority of the person completing. A thrift institution should have these protections, and can get them by contract with its customers.

34. U.C.C. § 4-104(1)(e).
35. Clearly where, by the organic law under which the institution is chartered, the account relationship is to be established by the "by laws" or "rules and regulations" of the institution, the provisions suggested should be so adopted.
36. U.C.C. § 4-401(1). A question can arise whether this type of loan is authorized under the applicable organic law of the thrift institution.
37. See note 7 supra.
38. U.C.C. § 3-401(2).
Wrongful dishonor can result in substantial damages, and, since the dishonor carries a sting, the rules of defamation used to apply. The Code limits liability when the wrongful dishonor occurs through mistake to the actual damages proved, including consequential damages proved. Being subject to this rule could be helpful to thrift institutions where slander of credit allegations are involved in wrongful dishonor cases. Contracts could so provide.

The next section governs stop payment orders. This problem is not covered in the proposed agreement form suggested for credit unions. The Statement of Operations Specifications, in a paragraph, appropriately numbered 13, treats of stop payments. It provides that the order "must be received so that the credit union has a reasonable opportunity to act on it prior to its deadline for returning the item." The official version of the Code provides that, unless confirmed in writing, the oral order is effective for only fourteen days. The written order is what is effective for six months. The section also provides that the order must be received "at such a time and in such a manner" as to give the bank a reasonable time to act on it. Today, courts are holding banks liable for not making clear to the customer just what data must be furnished to enable the bank's data processing procedure to handle the stop order. Where the key item was the exact amount of the check to be stopped, the bank not telling this very specifically to the customer has been held liable under the pre-U.C.C. cases holding an "approximate" amount sufficient when the payee's name was given. Some revision in the language of agreement and operating specifications will be helpful, especially as the credit union in authorizing payment by its payable-through processor will not know the name of the payee. This is a situation where a little greater description in the documentation that will come before the court can have a most helpful impact on the judicial approach to the problem.

And stop payments are a problem, averaging fifteen per month per credit union in the share draft program. In July, 1980, return items as a percent of total items paid ran from 0% in Maine to 2.6% in Iowa, with an average for those reporting of about 1.01%. But stop orders ranged from

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40. U.C.C. § 4-402.
41. Id. § 4-403(1).
42. See ICUSC Statement, supra note 7.
44. See ICUSC Report, supra note 5.
a high of 18% of returns for items paid through Chase Manhattan Bank to
a low of zero stop orders. The average, weighted by the large processors,
showed just under 12% of returns were for stop orders or 12 hundredths of
1% of all share drafts processed. Yet missing a stop can cause customer
dissatisfaction let alone consequential damages. In this area there does not
seem to be much difference between the U.C.C. and the contract forms
used. Neither works very well but the U.C.C. limitation of damages where
the failure to stop was by mistake will be helpful.

There are a few points in the Code that are not covered in the agree-
ments or specifications proposed for credit unions. Section 4-404 of the
U.C.C. provides that while a bank is not under obligation to pay a check
that is presented more than six months after its date, it is protected if it
does so in good faith. An interesting section is 4-405, providing that a
bank’s authority to pay is not automatically revoked by the death or in-
competence of a customer. Only knowledge of the death or knowledge of
an adjudication of incompetence affects the bank. Under subsection (2) of
that section, even with knowledge the bank may, for ten days after the date
of death, pay checks drawn before death unless directed by someone
claiming an interest in the account not to pay.45 This ability to pay would
also be helpful to thrift institutions. The U.C.C. cannot affect bankruptcy
law, but there is a provision in the new bankruptcy code which covers the
issue for bankruptcy.46

These last mentioned provisions affect the rights of third parties. It is
difficult to see how a contract between credit union and member, or other
thrift and customer, can accomplish the same result. But treating a credit
union or other thrift as a bank for Article 4 purposes would.47

Article 3 has no provisions governing the drawer-drawee relationship.
There are provisions governing the liability of the drawee to third parties.
Thus section 3-401 provides that no person is liable on an instrument un-
less that person’s signature appears thereon. This was considered suffi-
ciently important to be repeated again in section 3-409 providing that a

45. This is an instance in which one not a “customer” on the account in question can
order a stop. The Code does not specify how the order is to be given, or whether it can apply
only to specific items or must cover the entire account. When asserted by taxing authorities,
all payments are usually stopped. Any other claimant specifying a particular item could be,
under U.C.C. § 1-103, estopped from claiming that more should have been stopped. The
rules of §§ 4-403 and 4-303 would apply to timing.
46. Bankruptcy Code, § 521 (1978), which codifies the result reached in Bank of Marin
47. If the rule is in the deposit contract, parties succeeding to the depositor’s interest
would be bound. The payee certainly cannot object to being paid. The estate creditors
would be estopped by their failure to order a stop claiming a creditor interest in the account.
draft, of itself, is not an assignment. The section goes on to say that the drawee is not liable on an instrument until the drawee accepts it. Elsewhere, in section 3-410, "acceptance" is defined as the drawee's signed engagement to honor the draft as presented. Acceptance occurs when the drawee signs the instrument, usually across the face. If the instrument is a check, acceptance is called certification. Under section 3-411, where a check is certified at the request of a holder, the drawer and all who have indorsed prior to the certification are discharged. Unless a credit union or other thrift is treated as a bank, this discharge would not happen if the institution certified one of the drafts drawn on it.

One final point should be made in our discussion of the drawer-drawee relationship. Is there a rule of law or of contract governing the drawee's obligation to the drawer where, on one given day, the total number of drafts presented for payment calls for a sum of money exceeding the balance of the account, but several are for lesser sums? Which ones should the drawee pay? Must a drawee pay in the order of receipt? Must the greater number be paid, or the ones having the largest dollar amount? Pre-Code theories could be found supporting an affirmative answer to each of these questions. The U.C.C. in section 4-303(2) simply states a rule of convenience, "any order convenient to the bank." Again a good rule not applicable unless the thrift is considered a bank for the purpose of the U.C.C., or sufficiently like a bank so that the rule should be applied by analogy. Otherwise, perhaps, there might be another sentence in the contract with the customer making such extensive use of his share draft account that the problem could arise.

On net balance it appears that thrift institutions, considering the rules applicable to the drawer-drawee relationship, will fare better if Article 4 of the U.C.C. were applicable than if the governing rules have to be established by contract. Yet the advantages are, on the whole, not substantial enough in themselves to deter any thrift institution from embarking on a share draft program even if Article 4 of the U.C.C. is not applicable.

II. THE PROCESSING AND PAYMENT OF DRAFTS

The function of the draft on a thrift institution from the customer's point of view is to pay debts or transfer funds. The drawer, however, under U.C.C. section 3-413(2) contracts to pay if the drawee does not, but conditioned upon "dishonor" (which includes making any necessary presentment) and the making of any necessary protest. Equally U.C.C. section 3-

48. See the cases on when a check is paid pre-Code in F. BEUTEL, BRANNAN NEGOTIABLE INSTRUMENTS LAW (7th ed. 1971).
414(1) on the indorser's contract provides the same conditional guaranty of payment. In both cases, the use of the words "without recourse" or the like serves, by virtue of express words in the statute,\(^49\) to disclaim this contractual warranty. It may be questioned whether anyone would take a draft drawn without recourse, although indorsing without recourse is not uncommon, as where a draft or check is made payable to several payees: the home owners, the mortgagee, and an adjustment company to protect the latter's commission. But if the commission has been paid and the mortgagee is satisfied with the owner's plans to rebuild, both the adjustment company and the mortgagee could, and perhaps should, indorse without recourse. Or, the case may be that a customer is paying for some work done on the home by a contractor using two subcontractors. The share draft is made payable to all three, but one subcontractor is not entitled to any money at the time and would sign off without recourse.

What are presentment and notice of dishonor and protest? How are they worked in the share draft program where the original share draft never is delivered to the drawee credit union for payment? The answers are found in Part 5 of Article 3 of the Code. Presentment is defined as "a demand for . . . payment made upon the . . . drawee . . . by or on behalf of the holder."\(^50\) Holder is defined as a "person who is in possession of . . . an instrument . . . drawn, issued, or indorsed to him or to his order or to bearer or in blank."\(^51\) The payable-through bank receives the draft indorsed, usually, "pay any bank" and being itself a bank is a holder. Thus, presentment under the Code is merely a "demand" for payment. The Comment buttresses the literal reading of the words by saying that the intent is "to make it clear that any demand upon the party to pay is a presentment no matter where or how."\(^52\) As Professor Prosser used to explain, if the proper officer of a payor is found in a rest room of a hotel and demand for payment is there asserted, a proper presentment has been made. It is true that U.C.C. section 3-504 does specify three ways in which "presentment may be made" and section 4-210 specifies ways in which a collecting bank may safely make a presentment to a nonbank drawee. However, these ways are permissive, not mandatory. Hence, the author is of the opinion that the electronic transmission by the payable-through bank to the credit union of the MICR line on the bottom of the share draft, including the encoded amount, is a proper presentment.

The Code does provide certain actions which the party to pay, in this

\(^{49}\) See U.C.C. §§ 3-414(1), 3-417(3).
\(^{50}\) Id. § 3-504(1).
\(^{51}\) Id. § 1-201(20).
\(^{52}\) Id. § 3-504 (Official Comment 1).
case the credit union, may require of the presenter without dishonor.\textsuperscript{53} These are four in number: (1) exhibition of the instrument, (2) reasonable identification of the person making the presentment and evidence of authority to make it, if made for another, (3) that the instrument be produced for payment at a place specified in it or, if there be none, at any place reasonable in the circumstances, and (4) a signed receipt on the instrument for any payment. Since it is optional with any payor whether to require these, they can be waived in advance by agreement. In fact, there is need to waive only three of the four because the electronic transmission identifies the transmitter, who by the words “payable through” has been designated by the drawer and indorser, as a person to make presentment. The instrument for which payment is being asked is identified by drawer account number and draft serial number, and the drawee will receive the benefit of the presentment warranties of U.C.C. section 3-417(1) in any event.

By agreeing to this method of presentment and waiving the right to an exhibition of the instrument is the credit union exposed to any liability not covered by the presentment warranties? One is obliged to say yes, but not any liability that commercial banks do not routinely assume, namely the risk of forgery of a drawer's signature. There will be a warranty of good title which covers forged or otherwise unauthorized indorsements where the person whose signature is not valid is not precluded from asserting the lack of authority.\textsuperscript{54} But as to the drawer's signature there is no warranty by a holder in due course presenting in good faith, and nonholders in due course only warrant a lack of knowledge. As a routine matter, most banks do not check drawer's signatures before payment of items below a certain amount. Losses due to forgery do not warrant the expense. It can be assumed that forgery losses on share draft and other individual accounts would not be significant in any event as the account balances may not be large enough to satisfy the forger's appetite. Can such losses be covered by insurance? In commercial banks the “deductible” in the Bankers Blanket Bond is usually higher than the amount of the nonexamined checks. However, insurance with a low deductible is available to credit unions and, it is believed, to saving and loans.

But the risk is there; for a payment by a drawee is final and may not be recovered on any theory from either a holder in due course or a person who has in good faith changed position in reliance on the payment.\textsuperscript{55}

\textsuperscript{53} See \textit{id}. \S 3-505.
\textsuperscript{54} \textit{id}. \S\S 417(1), 4-207(1).
\textsuperscript{55} \textit{id}. \S 3-418.
There is an implication that recovery is not barred against one who fits neither of the above categories, and the statute itself in section 3-418 specifically excepts two, and only two, types of recoveries. These are recovery of bank payments under Article 4 and recovery for breach of a presentment warranty.

If a credit union is not considered a bank for U.C.C. purposes, then only the breach of warranty and the implication as to the nonfinal type party, requiring the equitable action for recovery of money paid under mistake, are available to the credit union or other thrift institution.56

One issue is when is final payment made in the credit union share draft or other thrift institution situation? If neither a credit union nor a savings and loan is a bank, then the time for payment is the expiration of the time for “a reasonable examination to determine whether it is properly payable, but payment must be made in any event before the close of business on the day of presentment.”57 The day of presentment is the day of receipt of the transmission from the payable-through bank. The determination of properly payable is made by examining the state of the account at the time of receipt of the transmission, checking for any active stop orders, and the making of an official judgment to pay after any account review to determine whether to exercise any set-off by calling a loan or whether to advance funds to pay under the conditions of any overdraft protection plan giving the credit union an option not to make the advance.

Due, probably, to a mistake in the drafting of the Code, Article 4’s definition of “properly payable” in section 4-104(1)(i) was not carried over into Article 3 by section 3-102(3) which did carry back to Article 3 many of the Article 4 definitions. The definition laconically states that the term “includes the availability of funds.”58

If a credit union or savings and loan is not a bank, then the definition of “process of posting” does not apply,59 and neither do the provisions as to provisional payment and recovery thereof,60 nor do the provisions as to

56. The extra day provided by the permitted payor bank under U.C.C. § 4-301 would not be available unless the near-banks are within the Code definition of bank, or there is an appropriate clearing house rule or Federal Reserve Board Regulation. Drawee liability under § 3-419(1)(c), (2) could be avoided, however, by one interpretation of the “demand” per return in the presentment as including the full period of the midnight deadline of § 4-104(1)(b) and a right of revocation of the “provisional” same day settlements.
57. U.C.C. § 3-506(2).
58. It obviously includes a proper drawer’s signature and one “effective” or genuine indorsement.
60. Id. §§ 4-301, 4-302(a).
when any one of the four legals comes too late.\textsuperscript{61} The four legals are: first, any legal process seizing the account; second, the exercise of a right of setoff; third, the receipt of a stop order from the customer; and, fourth, the receipt of any knowledge or notice that the Code or local law suspends or terminates a drawer's right to make disbursements from the account balance. If it is determined that a credit union or a savings and loan is not a bank for U.C.C. purposes, then a court will be faced with the choice of going back to its pre-Code precedents, if any, as to nonbank draweres, or returning to the pre-Code jungle of the law of bank payments, or of using the sections of Article 4 by analogy as invited to do by the Comments to section 1-102, as the spirit and purpose of those sections do apply to share demand drafts on thrift institutions.

As a word of caution against just such an adoption by analogy, or a ruling that the arrangements between the payable-through bank and the credit union for sorting and processing by the bank in fact make the bank a remote processing agent for the credit union so that the "close of business on the day of presentment" beyond which a nonbank drawer may not defer payment is the day of presentment to the payable-through bank,\textsuperscript{62} the arrangements should be carefully reviewed by counsel and the credit union should draw up a written "determination" of its "process of posting." The "process of posting" for any institution is exactly what that institution has determined it to be, neither more nor less. The preamble to section 4-109 stresses the "usual procedure" followed "in determining to pay an item and in recording the payment including one or more of the following or other steps as determined by the bank: . . . ." Having a written procedure prepared before a transaction winds up in litigation is extremely helpful. This was proven in the famous, or infamous, \textit{West Side Bank} case.\textsuperscript{63} The relevant passages from the summary judgment papers in the lower Wisconsin court set forth the posting procedure used by West Side and show that in that case the process of posting by the payor bank had not been completed.\textsuperscript{64} Although some disagree with this approach,\textsuperscript{65} the case stands, in the opinion of this author, for no more than three propositions. First, a question of fact existed as to whether the process of posting had been completed, hence summary judgment could not be granted. Sec-

\begin{itemize}
  \item \textsuperscript{61} \textit{Id.} § 4-303.
  \item \textsuperscript{62} \textit{See id.} § 3-504.
  \item \textsuperscript{63} 37 Wis. 2d 661, 155 N.W.2d 587 (1968).
  \item \textsuperscript{64} \textit{See Leary \\& Tarlow, Reflections on Articles 3 and 4 for a Review Committee, 48 Temp. L.Q., 919, 928, n.25.}
  \item \textsuperscript{65} \textit{See J. White \\& R. Summers, The Uniform Commercial Code 701-02 (2d ed. 1980).}
\end{itemize}
ond, a bank could have a process of posting that provided for the reversal of entries that were correct when made if, under its process, the time for making a judgmental decision had not expired and a judgmental decision required reversal when the correctly made entry was reversed. Third, a clearing house rule could extend the time for returns until 10:00 a.m. on the day after the midnight deadline had expired.

But, in the vast majority of cases, it makes no difference in the time to act whether the payable-through institution is a bank designated to make presentment or the draft is payable at or by a bank. The MICR routing symbols will result in the draft being delivered at the designated bank. The Federal Reserve System's Regulation J, governing the time allowed for proper return and giving notice of dishonor, places the same constraints on a payable-through bank as apply to a paying bank: namely midnight of the next banking day following the day of receipt, defined as the midnight deadline.

But suppose the credit union is not treated as a bank, and the payable-through organization is not a bank but is treated as a place where the credit union has, in advance, issued a requirement to have the draft presented. Then the time for payment expires with the close of business on the day of presentment to the designated payable through organization. Suppose further the credit union and the processing organization do not complete the payment by that close of business. What then? Will the processing unit, which presumptively has made a conditional settlement for the drafts delivered to it, be able to revoke that payment and recover for the amount of the returned items?

The solution lies in the "or else" provided in the U.C.C. for failure to pay on time. There is no provision in Part 5 of Article 3 of the Code bearing on the issue. Clearly, if the presenter has the draft, the penalty, if it was properly payable, is liability for wrongful dishonor. But the liability to the member depositor is hopefully only for the actual damages proved. However, the Code may come into play and impose a liability to the holder in conversion.

66. The Comments to both U.C.C. §§ 4-109 and 4-213 recognize that paying a check is a "process," and the process consists of two major elements, one mechanical and the other judgmental. Nothing requires that the judgmental precede the mechanical. Indeed, in modern check processing it is usually the other way around as the judgmental decisions are made on the basis of computer print-outs generated by the mechanical process, and hence available in readable hard copy only upon completion of the mechanical.
68. U.C.C. § 4-104(1)(b).
69. See id. § 3-505.
70. See id. § 3-419(1)(b), (2) imposing on a drawee are absolute liability for the face
instrument" but in conversion, where a drawee to whom an instrument has been delivered "refuses on demand" either to pay or return it. The liability of the drawee is the face amount of the instrument. The Comment says the "demand" required may be made at the time of delivery, or it may be implied from the circumstances or understood as a matter of custom. The Comment also states that the word "refuses" is meant to cover any intentional failure to return the instrument, and failure to return through negligence is not included, although negligence might support a cause of action for damages caused by any delay or destruction. But it would be difficult to avoid the classification of action taken as a standard procedure as anything but an intentional act. Thus, with a clearing house or Regulation J requirement for returns, the demand has been made. A standard program extending the processing procedure beyond the close of business on the day of presentment is a "refusal" to return with resultant liability on the drawee for the amount of the item.

The rule of the U.C.C. that a bank may not disclaim liability for its own negligence or lack of good faith is not a hardship for credit unions or other thrifts. It is true the share-draft contract states that a credit union is not liable for any action it takes with respect to payment or nonpayment of a share draft except for negligence. This author, however, is very firmly of the opinion that all courts will read that clause of the contract as meaning "Except for negligence or any grosser misconduct such as willful, wanton, reckless or intentional disregard of the protection of its customer." Equally, the clause will not excuse a credit union from liability under U.C.C. Article 3 for paying a share draft with either or both of a forged drawer's signature or a forged indorsement no matter how genuine they appear. Even the savings bank passbook rule does not protect unless there is no negligence, the forgery is of high quality, and the withdrawal order is accompanied by the passbook which is regarded as a muniment of title. The rule arose in an era of mostly personal withdrawals where negligence in not identifying the person was easy to show, except where the withdrawal was by correspondence. The rule has not been adopted in all states and has been repealed for New York by its legislature.

But the time in which to make payment is subject to variation by agree-

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71. See id. § 4-103(1).
72. See ICUSC Statement, supra note 7.
ment. At least as to credit union and member, thrift and depositor, the agreement could provide that the credit union is authorized to take any action in the payment and return of drafts that could properly be taken by a bank in the collection of checks. Action by banks handling the share draft for collection would also be covered by agreement among banks, or even an agreement resulting from Federal Reserve Bank Operating Letters, which have the force of agreements by all involved parties, whether or not assented to by all parties interested in the item.\textsuperscript{75} There is, however, some division in the cases to date as to whether such agreements by Federal Reserve fiat apply to drafts and other items which are not collected through the Federal Reserve Banks.\textsuperscript{76} If sued for failure to return on demand under U.C.C. section 3-419(1) and (2) the credit union or other thrift should argue that, under custom and practice in the handling of share drafts, unless same-day action was explicitly stated, the demand was to return on the next banking day following delivery and that therefore no “refusal” had occurred when no return was made on the day of presentment. The argument should be based on deposition testimony or other evidence.

Aside from the possible liability for the face amount of items neither timely paid nor timely returned where the demand to pay or return accompanies the delivery of the item and specifies or implies same day action, are there other problems?

If a credit union is not treated as a bank for U.C.C. purposes it actually gets one more day than a bank to give notice of dishonor. A bank must give notice before its midnight deadline, but any other person has until midnight of the third business day following dishonor.\textsuperscript{77} If neither the payor nor the presenter is involved, the time limits run from receipt of notice of dishonor from some prior party.

What is the effect of unexcused delay or failure in any necessary presentment or in giving notice of dishonor? The Code provides that indorsers are discharged, but drawers are only discharged if supervening insolvency of the drawee deprives the drawer of funds on deposit maintained with the drawee to cover the instrument.\textsuperscript{78} Fortunately, the section does not limit

\textsuperscript{75} See U.C.C. § 4-103(2).


\textsuperscript{77} See U.C.C. § 3-508(2).

\textsuperscript{78} See id. § 3-502(1)(b).
this to bank failures. The wording covers "drawee or payor bank" and so the limited or, due to current deposit insurance procedures, the nonexistent deprivation is for practical purposes no discharge of drawers at all.

Yet viewing what we have discussed about the processing and payment of items, on net balance credit unions and other thrifts would be more certain of the applicable legal rules if both Articles 3 and 4 of the Code applied to the processing and payment of share drafts.

One final processing matter. If a credit union or a savings and loan association is not treated as a bank for U.C.C. purposes, it may not be protected in authorizing payment of share drafts bearing restrictive indorsements which have not been handled in accordance with the restrictive indorsement. The Code provision on effect of restrictive indorsements only immunizes intermediary and payor banks, not commercial drawees. But of course the credit union or other thrift has the presentment warranty of the person seeking payment and of the depositary bank.

III. Allocation of Loss from Wrongful Intrusions into the Payments System

Risks of loss from wrongful intrusions into the payment system are all, or almost all, risks that can be placed in two major categories: either they are external to all legitimate actors in the system or else they are internal to the operation of one of the legitimate actors in the system. The intrusions are either wrongful, careless, or accidental. The intrusions may occur at any one of seven stages which an instrument passes through in carrying out its basic function of causing the transfer of depositary credit from one party to another. In the paper message system—and share drafts and other thrift drafts are paper originated—some of the intrusions and loss allocations will not apply to drafts. But they will apply to checks and other items that customers of thrift institutions will deposit to the credit of their thrift-draft accounts. A brief overview of the risks may thus be of some benefit someday. The stages at which intrusion can occur are these:

1. The Origination Stage
2. Non-Depositary Institution Transmission Stage
3. Payee Processing Stage
4. Deposit Taking Stage

79. See id. § 3-206.
80. Of course if a credit union or a thrift disregards a prior restrictive indorsement on an item deposited with it, liability to the true owner will be imposed. See Underpinning and Foundation Constructors, Inc. v. Chase Manhattan Bank, 46 N.Y.2d 459, 386 N.E.2d 1319, 414 N.Y.S.2d 298 (1979).
5. Interdepositary Institution Transmission Stage
6. Process of Payment Stage
7. Post-Payment Risk Shifting Stage

Depending on the stage at which the intrusion occurs, or if the risk shifting rule applies, the result of the intrusion, whether wrongful, careless, or accidental, will be one of three—either delay in the accomplishment of the task, or a diversion of the depositary institution credit and its withdrawal by a party not intended to acquire the credit, or a shift away from the payor of certain normal payor risks. Since time is money, delay can be costly. And, of course, a total or partial diversion is also costly. Let us discuss each stage separately.

A. The Origination Stage

Intrusions here will far more often be found in items deposited with credit unions and other thrifts than in drafts drawn on credit unions or savings and loans. But we can suppose a customer becomes indisposed and gives someone a power of attorney which is misused, or drafts from the back of the book are stolen and used by a forger. In either case we may have a payee’s name placed on the draft which is either that of a nonexistant person or of a real person. The forger or the faithless attorney, as the case may be, does not intend the name used as payee ever to receive the proceeds. The forger wants it for personal purposes. In either case, do we have a forged indorsement? The Code says no. It provides that in these circumstances any indorsement by anyone in the name of the named payee is effective. In the case of the faithless person with the power of attorney, all subsequent takers are protected. They took with an authorized drawer’s signature and an effective indorsement. Payment to the presenter

81. U.C.C. § 3-405(1)(b) makes the indorsement by any person in the name of the named payee “effective” where an authorized signer does not intend the named payee to have any interest in the instrument. This is the pre-Code “fictitious payee” rule. Pre-Code, the paper was considered bearer paper. The Code requires a regular chain of indorsements. The rule does not apply if there is no indorsement in the name of the payee at all. Wright v. Bank of Cal., 276 Cal. App. 2d 485, 81 Cal. Rptr. 11 (1969). The requirement of a chain of indorsements gives rise to a means of defeating the effective indorsement if it is not precisely in the name of the named payee. See Percini Corp. v. First Nat. Bank of Hasersham County, 533 F.2d 398 (5th Cir. 1977); Travco Corp. v. Citizens Fed. Sav. & Loan Ass’n of Port Huron, 42 Mich. App. 291, 201 N.W.2d 675 (1972); Twellman v. Lindell Trust Co., 534 S.W.2d 83 (Mo. App. 1976). It may also introduce a concept of lack of good faith in accepting deposits with illegal indorsements, Kraftsman Container Corp. v. United Counties Trust Co., 169 N.J. Super. 488, 404 A.2d 1288 (Law Div. 1979), or from dealing with a known employee on a continuous basis with respect to the employer's checks payable to others. Brighton, Inc. v. Colonial FirstNat'l Bank, 176 N.J. Super. 101, 422 A.2d 433 (App. Div. 1980); Board of Higher Educ. v. Bankers Trust Co., 86 Misc. 2d 560, 383 N.Y.S. 508 (Sup. Ct. 1976).
was in fact payment to a holder. The Code goes further in recognizing a fake indorsement as effective in the case of an impostor—someone pretending to be someone else—who secures the issuance of a share draft in the name of the person impersonated. For example, a man sells furniture or an automobile, boat, or house owned by him and his wife. He is accompanied by a woman posing as the wife. A draft in the correct names of the husband and wife is issued to them. The indorsement in the wife's name by any person is "effective." This is so whether the imposture is created through the mails, face to face, or otherwise.83

There is a third situation. We can suppose, in our power of attorney case, the attorney in fact comes to the home to sign papers only periodically and a servant produces bills to be paid, some of which are fake. The attorney in fact signs drafts for each of the submitted bills and tells the servant to mail them off. The Code again makes the indorsement in the name of the named payee by any person effective if the agent or employee of the drawer supplying the name does not intend the named payee to have any interest in the instrument.84 The intent in these cases must have been formed when the name was supplied and not afterwards when checks were given to be delivered.85 Whether the name supplied is that of a person to whom no debt is owed or is that of a real creditor is immaterial except as it may bear on the time the intent of the agent or employee to embezzle the funds was formed. Thus, the Code allocates these risks, absent bad faith in the person taking the check from the wrongdoer, to the drawer who is the person placing confidence in the signer and the name supplier.

The thrift institution paying these share drafts is protected, but the customer is not left in all cases with recourse only against the faithless and usually worthless embezzlers. If they were so stupid as to use the names of organizations as payees, place a code-made-effective indorsement thereon, and then indorse as an individual, the drawer, under a growing number of decisions, will have a cause of action against the institution accepting the


83. One of the better pre-Code discussions of the impostor rule suggests that the difference between face to face, where the check issuer bore the loss, and the mail, where usually the second person duped bore the loss, was really a weighing of a comparative degree of fault to determine who bore the loss. See Abel, The Impostor Payee: Or, Rhode Island Was Right, 1940 Wisc. L. REV. 161 & 362.

84. U.C.C. § 3-405(1)(c).

draft for deposit. The basis is that the institution taking such paper is not observing the reasonable commercial standards of banking. It is, of course, advisable to police incoming deposits to the thrift institution for the same defect; namely, a payee which is a business or nonprofit enterprise indorsing a check or draft payable to it to an individual instead of depositing the draft in its own account.

There is a division of authority as to whether the effectiveness of an U.C.C. section 3-405 type indorsement is subject to a general rule of care in accepting deposits, but the policy requiring corporate payees to deposit and banks to observe restrictive indorsements seems to outweigh, in the courts, the policy underlying section 3-405.

The Code does cover negligence “substantially contributing” to alteration or forgery, and precludes the negligent contributor from asserting the forgery as against a holder in due course or a good faith payor observing reasonable commercial standards. A recent case involving drawer preclusion as to a forged indorsement may have application to some drafting practices. In United States Fidelity & Guaranty Co. v. Merchant's Bank & Trust Co., a savings bank honored a forged withdrawal order accompanied by the passbook and a direction to issue a check on its commercial bank account payable to the person in front of them who represented herself as the housekeeper of the customer's daughter who was too busy to appear this time but had made withdrawals several times in the past. The lower court found against the savings bank drawer on two grounds, only one of which was affirmed. Affirmed was the ruling that the drawer's negligence in honoring the withdrawal order substantially contributed to the forged indorsement on the check drawn on the commercial bank because the savings bank's personnel had never before seen or heard of the house-

86. See note 81 supra. See also the special case of a check made payable to a bank, which must be taken at the risk of the bank as to the title and authority of the depositor unless applied to a debt of the drawer or deposited in one of its accounts. Federal Sav. & Loan Ins. Corp. v. Kearney Trust Co., 151 F.2d 720 (8th Cir. 1945); Sun 'N Sand, Inc. v. United Cal. Bank, 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978); Arrow Builders Supply Corp. v. Royal Nat'l Bank, 21 N.Y.2d 428, 235 N.E.2d 756 (1968). The cases stem from Sims v. United States Trust Co., 103 N.Y. 472, 9 N.E. 605 (1886), a case taking an attitude contra to the policy of the Uniform Fiduciaries Act and U.C.C. § 3-304(2), (4)(e), requiring actual knowledge of a breach of fiduciary duty, not notice.


88. U.C.C. § 3-406. Note the protected classes are specified. This is not the case under § 3-405. The difference was deliberate so long as a regular chain of indorsements was present.

keeper and made no effort to verify her authority by a telephone call. Nor did they compare signatures.

The case is interesting because the lower court used the impostor rule we have just discussed, but used it erroneously. The general rule is that a misrepresentation of agency does not fall under the impostor rule. Yet cases such as this one, holding that negligence in not verifying an agent's authority substantially contributes to the forgery of the principal's indorsement on an instrument so obtained, are, in fact, undermining the agency exception. The only difference between the two results is that when U.C.C. section 3-406 is used the person purchasing from the wrongdoer must be a holder in due course to prevail. The drawer or other payor must pay in accordance with the reasonable commercial standards of the drawer's or other payor's business to be protected, whereas, as we've discussed, the prior section just says any indorsement in the name of the payee is effective with no limitation as to the persons who can assert the effectiveness.

In the Connecticut case there was no indorsement. The alleged housekeeper opened an account in another bank in the housekeeper's name and deposited the check in that account without any indorsement. The depositary bank placed a stamp on it reading "Credited to the Account of the within named payee lack of indorsement guaranteed." Referring to U.C.C. section 4-205(1), entitling a bank to supply its customer's missing indorsement, the court said the stamp had the same effect as if the depositing customer had written the payee's name. Thus, there was a forged indorsement which the savings bank was precluded from denying, and the preclusion applied to its subrogated insurance company. This is one of the cases on one side of the split of authority under the Code as to whether section 3-406 retains the pre-Code requirement that the negligence must directly and proximately induce the taking of the item on the forgery, or whether the section has broadened the scope of the doctrine by using "substantially contributes." Holding for no change are decisions in Ohio, Alabama, and the Eighth Circuit.91 For broadening the scope are holdings in...

90. See U.C.C. § 3-405 (Official Comment 2). "Impostor refers to impersonation and does not extend to a false representation that the party is the authorized agent of the payee. A maker or drawer who takes the precaution of making the instrument payable to the principal is entitled to have his indorsement." See Fidelity & Deposit Co. of Md. v. Chemical Bank N.Y. Trust Co., 65 Misc. 2d 619, 318 N.Y.S.2d 957 (Sup. Ct. 1970), aff'd, 333 N.Y.S.2d 726 (App. Div. 1972); Annot., 81 A.L.R.2d 1365, 1398 (1962).

Oregon, Connecticut, Indiana, Maryland, and New York.\textsuperscript{92} A Pennsylvania Superior Court case, much cited for the broadening view, has been recently questioned by the Pennsylvania Supreme Court with a complimentary reference to the Eighth Circuit case espousing the narrower view.\textsuperscript{93}

\subsection*{B. Non-Depository Institution Transmission Stage}

The drawer must get the check to the payee. Intrusion by mail intercept is usually an external intrusion. The Code scheme is to place the loss on the person to whom the wrongdoer passes the check, whether by suit upstream on the transfer warranties of sections 3-417(2) and 4-207(2) or with the drawee suing on the presentment warranties.\textsuperscript{94} Some states permit a drawer suit upstream as a warranty suit by-passing the drawee and any intermediary banks. This is allowed either on a third party beneficiary theory\textsuperscript{95} or on a theory that the drawer is really "paying" the check in ordinary understanding and hence the presentment warranties run directly to the drawer as an "other payor."\textsuperscript{96}

\subsection*{C. Payee Processing Stage}

There are many cases where intrusion is internal to a payee's operations, and the rules here will affect the thrift draft program as thrift customers will issue many checks to business payees. Here we have employees of the payee abstracting incoming checks or depositing checks with a "cash out" deposit slip.\textsuperscript{97} This can occur with "mail-openers," or accounts receivable

\begin{itemize}
\item \textsuperscript{94} See, e.g., U.C.C. §§ 3-417, 4-207(1).
\item \textsuperscript{97} For examples of cases involving forged endorsements on incoming checks by employees of the payee see Hermetic Refrigeration Co. v. Central Valley Nat'l Bank, 493 F.2d
posting personnel, or bookkeepers, or those taking the payee's deposits to its depository institution. The Code treats all of these as forged indorsements with the rules of warranty and conversion allocating the risk of loss ultimately to the first solvent handler after the forger.98 There is no exception for internal employee forgery or other intrusion at the payee processing stage unless a court can be persuaded that negligent supervision of the wrongdoing employee "substantially contributed" to the forgery so that the rule of U.C.C. section 3-406 can apply. In a now well-known case, Cooper v. Union Bank,99 the court found that drawer negligence in not auditing or otherwise checking up on a lawyer's secretary's repetitive forgery of the lawyer payee's indorsement on incoming checks barred the lawyer from asserting forgery on checks coming in after six months of successful embezzlement. A Michigan court of first instance, however, in Greishaber v. Michigan National Bank of Detroit,100 accepted an accountant's testimony that the supervision exercised there was the same as that exercised by eighty to eighty-five percent of other dentists. On this testimony, the court found no negligence in the payee dentist. Hence, the bank sued bore any loss it could not recoup from its transferor.


98. This is liability for breach of the "presentment warranty" of good title, U.C.C. §§ 3-417(1)(a) and 4-207(1)(a), whereby the drawee recovers from the presenting bank. The presenting bank and other banks collect reimbursement upstream by virtue of the "transfer warranty" of good title, §§ 3-417(2)(a) and 4-207(2)(a). The chain is broken if one transferee did not "receive consideration," as such a transferee makes no warranty. The "triggering" language in the subsection stating the transfer warranty is "any person who transfers an instrument and receives consideration. . . ." (emphasis supplied) Multiplicity of action up the collective chain can be eliminated by the use of the "vouching in" process in U.C.C. § 3-803. The Code, unfortunately, follows the common law privity concept of Hartford Accident & Indem. Co. v. First Nat'l Bank & Trust Co., 281 N.Y. 162, 22 N.E.2d 324 (1939) so that the vouching notice can go only to a bank's immediate transferor. But this concept is totally inconsistent with the California courts' rulings allowing direct suit by a drawer against a remote depository bank. The term "answerable over" found in U.C.C. § 3-803 should be interpreted as coequal in scope with the direct action allowed the notice giver. The occasional case of an intermediate set-off should not prevent this result. The loss of the amount set-off would be the basis of a further upstream warranty claim in any event. Direct "vouching" to the person of ultimate liability should be permitted.


D. Deposit Taking Stage

The rules here will apply to thrift institutions accepting checks and other items for deposit, as well as to claims for refund of payments made on a customer's drafts.

First, it is expected that checks will be examined for a regular chain of indorsements, although, as we have seen, under U.C.C. section 4-205(1) a depositary bank can supply "its customer's indorsement." But where there are copayees and the indorsement of one is missing or is forged, the loss falls on the depositary institution, which, of course, has the warranty of its depositor. So, too, where a corporate check signed by an authorized signer is taken for that signer's personal debt, whether in payment or as security, and its use for that purpose is not proper. This is because section 3-304(2) prevents holding in due course as there is notice that a fiduciary is using corporate funds for the fiduciary's own obligations. The trouble is worse when a third party's check payable to the bank is deposited, without inquiry, into an individual's account or applied towards an indebtedness of anyone except the drawer. The rule is that the depositary bank is liable if the individual's action was proper. Of course, if the item is payable to the bank "for account of" or with an account number added to the name of the bank on the payee line, the rule is otherwise. The drawer has told the bank what to do. Also applicable here is the rule that a check payable to a corporation and indorsed by it to another is, in the words of section 3-304(1)(a) "so irregular as to call into question its validity, terms, or ownership," as discussed above under the "effective" indorsement rules of section 3-405.

A thrift institution is also heading for trouble if an indorsement prior to that of one of its members is a restrictive one of the "for deposit" or "for collection" type, even if the institution is considered as a bank. A recent New York Court of Appeals case illustrates this. In Underpriming and Foundation Constructors, Inc. v. Chase Manhattan Bank, there was a phony "invoice-insertion-scam" using the name of a real customer of the

104. See notes 81-87 and accompanying text supra.
drawer so that any indorsement in the name of the named payee was "effective" under U.C.C. section 3-405(1)(c). Unfortunately for the banks, the crooks copied the indorsement of the named payee too literally and the rubber stamp said "For deposit only." Below that was the indorsement of the depositor selected by the crooks to collect and distribute the proceeds. The New York court permitted a direct suit by the drawer against the depositary bank stating, in effect, that its failure to police the prior restrictive indorsement was the cause of the successful depletion of the drawer's account at the payor bank, and that, since the named payee had no interest, someone had to be able to sue.

Finally, payable-through drafts issued by insurance companies can cause trouble if disbursed against before being paid by the drawee. In Montgomery v. First National Bank,106 such a practice was ruled a failure to deal with the draft in accordance with reasonable commercial standards of the banking business. The court was aided by the bank's own tellers' manual stating that such drafts should not be cashed over the counter. Courts should see the difference between insurance company payable-through drafts and those of credit unions or other thrifts—where a different function is served by making the draft payable through—as there is no checking by the drawee to see if releases are received, or are in order, or the like, before authorizing payment. The function is to obtain the data processing services of the designated bank by using its transit routing numbers. The Montgomery rule should not apply to share drafts.

E. Interdepositary Institution Transmission Stage

At this fifth stage, the losses to be allocated arise from physical destruction of the paper message, from misencoding by the first encoding institution, and from loss or delay in transit. In general, the scheme of the U.C.C. is to allocate any loss or delay damages to the creditor, taking in conditional payment the nonbank-issued instrument involved—unless of course a specific agreement between debtor and creditor reallocates the risk. The Code provides that the taking of an instrument suspends the underlying obligation and any discharge of an obligor on the instrument is a discharge on the underlying obligation.107 If there is no discharge, and if

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106. 265 Or. 55, 508 P.2d 428 (1973) (employees ignored provision in bank's tellers' manual).
107. U.C.C. § 3-802(1)(b). As to bank obligations, U.C.C. § 3-802(1)(a) gives a discharge. There is no reason why this latter rule of discharge should not apply, as well to
the instrument is dishonored, the creditor may sue either on the instrument or on the underlying obligation.

Case law says that if the instrument is paid, the payment relates back to the day the creditor voluntarily accepted the instrument.\textsuperscript{108} Delay costs, in the case of ultimate payment, thus fall on the creditor. In the case of ultimate dishonor, they fall on the debtor.

But there is no U.C.C. rule fixing a time limit on transmission between banks. The limits are only on processing time within banks. The only section on transmission time merely requires the bank to use ordinary care to send the item on to the next bank by a reasonably prompt method considering relevant instructions, the nature of the item, the number thereof on hand, the costs involved in different types of sending, and the method generally used by the bank “or others” to present such items.\textsuperscript{109} The sending bank must notify its transferor only when it has actual knowledge of the delay. In any event, the measure of damages prescribed for a bank’s failure to use ordinary care, if that can be proved, is “the amount of the item reduced by” an amount that could not have been realized had ordinary care been used.\textsuperscript{110} “Bad faith” must be shown to recover damages based on a loss of use of funds.

Perhaps it was felt that the force majeure clause in Article 4\textsuperscript{111} would excuse most if not all interinstitutional delays. But delays in meeting intrabank midnight deadlines caused by an armored car breakdown\textsuperscript{112} and a computer breakdown after the Christmas holiday\textsuperscript{113} have been held to be no excuse, while a delay caused by the malfunction of a new computer, plus assurances which proved to be false that the “down time” would be only a short while, has been held to be an excuse.\textsuperscript{114}

That normal collections can have considerable delays within the United States is illustrated by \textit{Wells Fargo Bank v. Hartford National Bank & Trust} checks issued by thrifts on their commercial banks and to their own items drawn on themselves (assuming corporate power to issue).

\textsuperscript{108} Kirby v. First & Merchants Nat’l Bank, 210 Va. 88, 168 S.E.2d 273 (1969) (On a check deposited with deposit slip deducting “cash out” from amount of check and the remainder entered as total deposit, court said check was paid in full, no right of charge back. A deposit agreement could well change the result.)

\textsuperscript{109} U.C.C. § 4-204(1).

\textsuperscript{110} \textit{Id.} § 4-103(5).

\textsuperscript{111} \textit{Id.} § 4-108(2).


Co., where a check deposited in Connecticut on November 22, 1977, was not presented to the Reno, Nevada Branch of the payor bank until December 10. The return did not reach Connecticut until December 27, yet each bank involved acted within what it thought was its midnight deadline. The holding was, of course, that one collecting bank was wrong in the calculation of its midnight deadline by four days and so bore the $25,000 loss.

Misencoding and error in the transmission of the MICR line, if these errors happen, and they will, are not covered by the U.C.C. in any specific way. What little litigation that has occurred seems to allocate the loss to the one making the misencoding and to hold that the amount written by the drawer controls. Thus, where an underencoded item had been charged to the account, the drawer nevertheless had lost the ability to place a stop order against the corrective charge. Clearing house rules, if they exist, will, of course, govern if they speak to the misencoding issue—as many in fact do.

F. Process of Payment Stage

We have already discussed the problems arising in determining when payment is made and the priority of the four legals under the problems of the drawer-drawee relationship. If the thrift institution is a bank for U.C.C. purposes when items are returned to it, it can assert a right of charge back despite any claim by its customer that it or another bank failed to use ordinary care. The section is clearly one which, in reason and policy, should be applied even if thrift institutions are not banks for all U.C.C. purposes. They should be treated as banks in all instances where


118. U.C.C. § 4-212.
the collection of drafts necessarily must smoothly interface with the collection system of banks for the proper serving of the public convenience.

Care must be taken in the drafting of the agreement with the payable-through bank that the entire payment function is not delegated to it, but only the processing function. Regulation J of the Federal Reserve System includes a payable-through bank in its definition of paying bank. This definition need not be fully equated with the Code’s “payor bank” for all purposes, but it must be so equated for the time allowed to complete the entire process of payment as the functions of making payment are allocated between the thrift institution and its designated payable-through bank.

G. Post-Payment Risk-Shifting Stage

May a suit by a thrift institution for breach of a presentment warranty be lost if there is delay in bringing the suit? If the institution is treated as a bank, as it should be, then Article 4 Code rules would apply. The warranty section in the Article provides that a claim for breach of warranty must be made within a reasonable time after the person claiming learns of the breach. Failure to do so discharges the person liable “to the extent of any loss caused by the delay.” Probably a court would, and it should, apply the same rule to a case where only the Article 3 rules apply even though Article 3 has no express counterpart of the Article 4 language. Comment 1 to the Article 3 warranty section states:

Warranty terms, which are not limited to sales transactions, are used with the intention of bringing in all the usual rules pertaining to warranties, and in particular the necessity of reliance in good faith, and the availability of all the remedies for breach of warranty, such as rescission of the transaction or an action for damages. The necessity for prompt notice is one of “all the usual rules” and the discharge to the extent of the loss caused by the delay seems better than the “forever barred from any remedy” imposed by Article 2 for failure to give notice of a breach of a sales warranty.

As between drawer and payor bank, both the common law and the

119. See note 67 and accompanying text supra.
120. U.C.C. § 4-207(4).
121. Id. § 3-417 (Official Comment 1).
122. Id. § 2-607(3)(a).
123. The argument that the expression of a rule of prompt notice in the Article 4 warranties means no notice requirement where only Article 3 applies fails because the language in Article 4 cuts down the usual warranty rule, rather than stating a rule where none existed.
U.C.C. change certain loss allocations if the drawer fails to use reasonable care to examine the periodic statement and report unauthorized drawer's signatures and alterations. The thrust of the rule is that in the case of the first statement all unauthorized drawer's signatures or alterations are the responsibility of the good faith drawee, unless it can show that a prompt report would have enabled it to effect some recovery. That is, the failure to report or delay in reporting caused a loss and the bank had paid in good faith. The late reporting drawer can nevertheless avoid picking up the loss if it can be shown that the bank failed to exercise ordinary care in paying the item.

A further rule applies to repetitive unauthorized signatures or alterations committed by the same person. The examination of the statement and report must be completed in a reasonable time not to exceed fourteen days, and the customer reporting late is precluded as to subsequent forgeries paid after the fourteen-day period and before actual notification, so long as payment continued to be made in good faith. Again, of course, if the customer can show lack of ordinary care in making the payment, the preclusion does not apply.

Finally, without regard to care or lack of it by drawer or payor, there is a three-year notice bar for unauthorized indorsements. These are the time limits in the official text. Many states have made changes, so the applicable state law must be consulted.

Repetitive forgeries of the signature of a thrift institution's customer on drafts will be extremely rare except in one situation: where one spouse takes the drafts and signs them for the other spouse either on the separate account of the other spouse or on a two signature joint account where both signatures are required. Then comes the marital dissolution and the suit to recredit the account. A clear defense to repetitive forgeries would be helpful to thrifts. It is there if courts will apply Article 4 to the thrifts.

There is one more trouble other than "are you a bank" in the application of section 4-406 of the Code to credit unions. The time periods start to run "when a bank sends to its customer a statement of account accompanied by items paid in good faith." This will not happen under an intercept

124. U.C.C. § 4-406.
125. Id. § 4-406(1), (2)(a).
126. Id. § 4-406(3).
127. Id. § 4-406(2)(b).
128. Id. § 4-406(4).
129. For example, the periods in Georgia are 60 days and 1 year respectively. GA. CODE ANN. § 109A-4—406(4) (1979). California and others use one year in both instances. See CAL. COM. CODE § 4406(4) (West 1964).
truncation at the payable-through bank, nor will the credit union, as the
section also provides, be holding the statement and items for the member
pursuant to request or instructions.

But section 4-406 mentions a third way that will start a customer's time
period for examination: namely, that the institution "or otherwise in a
reasonable manner makes the statement and the items available" to the
member. Does that apply to the situation? The institution will be sending
a statement and its specifications state that a print of the copy made by the
payable-through bank will be supplied to the customer on request.

But what are the specifications for the film and camera to be used to
make the copies? Will they be accurate enough to permit an examiner of
questioned documents to give an opinion on any but the most clumsy for-
gerries, as to which the Code makes the payor liable anyway for not using
ordinary care in examining signatures? Put another way: if the customer
claims a forgery, is the film good enough to permit a handwriting expert to
say, as a witness for the paying institution, that it is not a forgery or that it
is such a good forgery that careful signature examiners would not have
cought it? Discussion with one expert elicited his opinion that an expert
opinion cannot be given from the film copies now being made.

There is another problem with the program and that's because the paya-
ble-through bank is programing a destruction of the original drafts within
sixty days after the end of the month in which the drafts were paid.

Parenthetically, assuming that there is a retrieval capability for the origi-
inal if request is made before the routine destruction, if a draft is paid on
March 29th it will be destroyed on May 30th. But suppose the statement
cycle for the customer ends on the 20th of the month, so that the first list-
ing the member receives covering the payment will be sent, say April 27th
arriving April 28th. The proposed contracts to be used by credit unions
give the member sixty days to object, or until June 27th or twenty-eight
days after destruction of the draft. But if the Code sections just discussed
were applicable, the customer should have reported by May 12th when the
questioned draft had not yet been destroyed and could have been retrieved
for examination and preservation as evidence.

130. Conversation with David Purtell, Examiner of Questioned Documents in Chicago,
October 24, 1980.

131. The contract provision requires objections to be made in 60 days from receipt of the
statement. A 30-day time limit has been upheld as not unreasonable. New York Credit
Men's Adjustment Bureau, Inc. v. Manufacturers Hanover Trust Co., 41 A.D.2d 912, 343
N.Y.S.2d 538 (1973); Webster Schott Bldg., Inc. v. Manufacturers Hanover Trust Co., 32
Now suppose the particular thrift institution operated on a quarterly statement system cycling at, say, the 15th and 30th of each month. The particular customer is on a 15th of the month quarterly cycle. March 15 was the end of the preceding cycle. All other facts are the same except the statement is not even sent out until June 15th or two weeks after the original draft is routinely destroyed. In this scenario, the Code section would not have been of any help to either party.132

Suppose the claim is for a raised draft. If the original is available, an examiner of questioned documents can, by subjecting the original to different light rays, tell if the figures have been altered by the same or a different ink. This, it is believed, cannot be done from a photographic copy.

The point to be made here is that a better coordination between the routine destruction of the original drafts, the timing for reporting unauthorized signatures or alterations, and the credit union or thrift institution statement cycles, should be worked out. And in view of the fourteen-day rule in U.C.C. section 4-406, it could be done by specifying a shorter time for reporting forgery or alteration than the draft account contracts now specify.133

One can suggest that a court could be persuaded to rule that the statement with a legend that copies will be available on request would start the U.C.C. section 4-406 period running and that a request for a copy to determine whether there was an unauthorized signature or alteration in amount would be a sufficient “report.” One can also suggest that an institution could by contract with its customer specifically provide that a failure to make such a request would bar future claims as to alteration in amount or authorization of the draft. A change in the payee’s name, a rare form of alteration, would have to be excepted and the loss absorbed by the institutions as a cost of the processing savings.

IV. CONCLUSION

Our little trip with gun and camera through the wilderness of Articles 3 and 4 has really revealed, if it has indeed revealed anything at all, only the

132. Perhaps it was for similar timing reasons that the National Commission on Electric Fund Transfers recommended, Congress enacted, and Regulation E of the Board of Governors of the Federal Reserve System provides that a statement must be sent covering each month in which an electronic transaction in an account takes place. See, e.g., Fed. Res. Reg. E, 12 C.F.R. § 205.9 (1980)

tips of several icebergs. The author can only hope he has alerted readers to the need to prepare to steer between the icebergs. For every rule discussed there are exceptions based on ratification, estoppel, election of remedies, and the like, and the rules as to these must be examined before advising a client.

On net balance, the author believes, in each case, thrift institutions will be better off to urge the court to apply the Code either directly by interpreting the "business of banking" for Code purposes to be the handling of third party payment instruments by any properly organized and authorized depositary institution; or, if unsuccessful in that regard, to argue for the application of the Code by analogy as expressing the proper allocation of risks. The situation can be aided by including in the thrift draft account contracts two extra clauses. One would provide that the relations between the institution and its customer shall be governed by the rules of the Uniform Commercial Code applicable to a bank and its customer. The other, for all joint accounts, should be a grant by each signer on the account of a power of attorney to each other signer on the account to indorse for deposit to the account any check, draft, or other item payable to any two or more of the parties to the joint account. In this way the loss allocation rules will be identical with the rules applicable to checks. The simplicity of a single rule will prevent much confusion as NOWs and share drafts proliferate. Of course, much trouble will be eliminated if rapid adoption by legislatures of the suggested change in the definition of banking in the U.C.C. can be accomplished.