

# Uniform Commercial Code - Articles 3 and 4 - Bank Required to Disburse Funds After Final Payment. *Northwestern National Insurance Co. v. Midland National Bank*, 96 Wis. 2d 155, 292 N.W.2d 591 (1980)

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its use of quasi in rem jurisdiction to proceed directly against a tortfeasor's insurer. However, it remains to be seen whether a state can exercise jurisdiction in *Seider*-type situations through the enactment of a direct action statute.<sup>193</sup> The possibility that such a statute might be permissible reveals that the legitimate governmental interest test of *Watson* needs to be re-evaluated and better coordinated with *International Shoe's* minimum contacts test. Clearly, traditional notions of fair play and substantial justice are offended when the standard of due process is applied to two identical factual situations, but produces two distinct results simply because in one situation the tortfeasor is the named defendant, and in the other, the tortfeasor's insurer is the named defendant.

JOHN R. ORTON

**UNIFORM COMMERCIAL CODE — Articles 3 and 4  
— Bank Required to Disburse Funds After Final Payment. *Northwestern National Insurance Co. v. Midland National Bank*, 96 Wis. 2d 155, 292 N.W.2d 591 (1980).**

I. INTRODUCTION

The check collection procedure,<sup>1</sup> followed by banks in Wisconsin, is controlled by Article 4 of the Uniform Commercial Code,<sup>2</sup> which applies to items<sup>3</sup> in the course of bank collec-

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193. See Rosenberg, *One Procedural Genie Too Many OR Putting Seider Back Into Its Bottle*, 71 COLUM. L. REV. 660 (1971), where the author discusses a proposed direct action statute for New York which has since been rejected.

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1. For a detailed description of the check collection process, see Leary, *Check Handling under Article 4 of the Uniform Commercial Code*, 49 MARQ. L. REV. 331 (1965); and, Malcolm, *How Bank Collection Works — Article 4 of the Uniform Commercial Code*, 11 HOW. L. J. 71 (1965).

2. WIS. STAT. §§ 404.101 to 404.504 (1971). WIS. STAT. §§ 404.101 to 404.504, and §§ 403.101 to 403.806, correspond to Uniform Commercial Code §§ 4-101 to 4-504, and 3-101 to 3-806, respectively. Hereinafter, citations will be made to the U.C.C. section. Note, however, that the requirements of Article 4 may be superseded or modified by agreement, Federal Reserve Regulations, or clearinghouse rules. U.C.C. § 4-103.

3. U.C.C. § 4-104(1)(g) defines "item" as "any instrument for payment of money even though it is not negotiable but does not include money."

tion. Many items, including checks,<sup>4</sup> are also negotiable instruments,<sup>5</sup> and are thereby subject to the provisions of Article 3<sup>6</sup> as well.<sup>7</sup> In *Northwestern National Insurance Company v. Midland National Bank*,<sup>8</sup> the Wisconsin Supreme Court was asked to determine the circumstances, if any, which would excuse the duty of a payor bank<sup>9</sup> to disburse the funds on a check after final payment has been made on that check under Article 4.<sup>10</sup> Courts in other jurisdictions have resorted to various provisions within Article 3 and Article 4 as well as to the common law to resolve this issue. These decisions have produced a conflicting and contradictory body of caselaw.

In *Midland National Bank*, the Wisconsin Supreme Court seems to reject any justification for a payor bank's refusal to disburse not grounded in Article 4. In so doing, the court appears to rely upon a policy of the Code to end a transaction upon an instrument when it is paid. However, the court's refusal to decide whether the concept of good faith can be used to excuse a payor bank's duty to disburse seems to leave open the possibility that other conflicting Code policies may also be recognized by the Wisconsin Supreme Court in the future.

## II. BACKGROUND

### A. Overview of the Collection Process

When a check is presented to a payor bank for payment, the bank must decide whether to pay or dishonor it.<sup>11</sup> In making this decision, the bank must first determine whether the check is properly payable, since the bank may charge its cus-

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4. U.C.C. § 3-104(2)(b) defines "checks" as "a draft drawn on a bank and payable on demand."

5. U.C.C. § 3-104(1) establishes the criteria which a writing must meet to be a negotiable instrument.

6. U.C.C. §§ 3-101 to 3-805.

7. The provisions of Article 3 supplement those of Article 4, and in the event of a conflict, the provisions of Article 4 govern. U.C.C. §§ 3-103(2) and 4-102(1).

8. 96 Wis. 2d 155, 292 N.W.2d 591 (1980) [hereinafter cited as *Midland National Bank*].

9. The payor bank is "a bank by which an item is payable as drawn or accepted." U.C.C. § 4-105(b).

10. The supreme court's primary focus was on the issue enumerated above, and it is to that issue that this article is addressed. The court did, however, also deal with the issue of whether the original payor was an indispensable party to the litigation under Wis. STAT. § 260.12 (1978). The court held that it was not.

11. U.C.C. § 3-507(1) governs the determination of when a check is dishonored.

tomer's account only if the check is properly payable.<sup>12</sup> A check is not properly payable which bears either a forged endorsement or a forged drawer's signature.<sup>13</sup> A check is also not properly payable if the customer has given the bank a timely order to stop payment.<sup>14</sup> Finally, a check which has been materially altered is properly payable only to the extent of the original amount.<sup>15</sup>

If the bank decides to dishonor the check, it must do so in the manner and within the time periods specified in Article 4.<sup>16</sup> One particular method of dishonor is set out in U.C.C. section 4-301(1),<sup>17</sup> which allows a payor bank in any case where it is not also the depository bank to revoke a provisional settlement if such revocation is made before the payor bank's midnight deadline.<sup>18</sup> If the bank revokes in the manner and within the time periods specified in Article 4, its right to dishonor, at least as regards the person presenting the check for payment, is unqualified.

The payor bank's right to dishonor is terminated if and when the bank chooses to pay the check.<sup>19</sup> Such payment is referred to as "final payment" under Article 4.<sup>20</sup> The manner and time in which a check is to be finally paid are set out in

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12. U.C.C. § 4-401(1).

13. U.C.C. § 3-404(1) provides:

Any unauthorized signature is wholly inoperative as that of the person whose name is signed unless he ratifies it or is precluded from denying it; but it operates as the signature of the unauthorized signor in favor of any person who in good faith pays the instrument or takes it for value.

14. See U.C.C. § 4-403.

15. U.C.C. § 4-401(2)(a). This may also be regulated by Federal Reserve regulations.

16. See U.C.C. sections cited in note 2, *supra*.

17. U.C.C. § 4-301(1) provides:

Where an authorized settlement for a demand item . . . received by a payor bank otherwise than for immediate payment over the counter has been made before midnight of the banking day of receipt the payor bank may revoke the settlement and recover any payment if before it has made final payment [sec. 4-213(1)] and before its midnight deadline it

(a) returns the item; or

(b) sends written notice of dishonor or nonpayment if the item is held for protest or otherwise unavailable for return.

18. U.C.C. § 4-104(b) defines "midnight deadline" as midnight on its (the bank's) next banking day following the banking day on which it receives the relevant item or notice or from which the time for taking action commences to run, whichever is later.

19. U.C.C. § 4-301, Comment 5.

20. See, e.g., U.C.C. § 4-213.

section 4-213(1).<sup>21</sup> Under section 4-213(1), a check is finally paid if the bank has paid it in cash, settled for it without a right to revoke the settlement, completed the process of posting, or failed to properly revoke a provisional settlement. Upon final payment under the latter three methods, the bank becomes accountable for the amount of the item.<sup>22</sup>

Typically, the payor bank will either make final payment under section 4-213(1) or dishonor the check under section 4-301. The bank may, however, retain the check beyond its midnight deadline while taking no action on it.<sup>23</sup> In this case, section 4-302(a) applies to make the payor bank accountable, in the absence of a valid defense, for the amount of the item.<sup>24</sup>

As used in sections 4-213 and 4-302, the term "accountable" imposes a duty to account.<sup>25</sup> This duty has been generally interpreted to require the payor bank, in the absence of a

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21. U.C.C. § 4-213(1) provides:

An item is finally paid by a payor bank when the bank has done any of the following, whichever happens first:

- (a) paid the item in cash; or
- (b) settled for the item without reserving a right to revoke the settlement and without having such right under statute, clearing-house rule or agreement; or
- (c) completed the process of posting the item to the indicated account of the drawer, maker or other person to be charged therewith; or
- (d) made a provisional settlement for the item and failed to revoke the settlement in the time and manner permitted by statute, clearing-house rule or agreement."

Upon a final payment under subparagraphs (b), (c) or (d) the payor bank shall be accountable for the amount of the item.

22. The payor bank does not become accountable under § 4-213(1)(a) because it has already disbursed the funds by paying in cash.

23. Edwards, *Recovery of Final Payments Under the Uniform Commercial Code*, 6 Ohio N.U.L. Rev. 345 (1979) [hereinafter cited as Edwards].

24. U.C.C. § 4-302 provides:

In the absence of a valid defense such as breach of a presentment warranty [subsection (1) of Section 4-207], settlement effected or the like if an item is presented on and received by a payor bank is accountable for the amount of

- (a) a demand item other than a documentary draft whether properly payable or not if the bank, in any case where it is not also the depository bank, retains the item beyond midnight of the banking day of receipt without settling for it or, regardless of whether it is also the depository bank, does not pay or return the item or send notice of dishonor until after its midnight deadline; or
- (b) any other properly payable item unless within the time allowed for acceptance or payment of that time the bank either accepts or pays the item or returns it and accompanying documents.

25. U.C.C. § 4-312, Comment 7.

valid defense, to disburse the amount of the check to the one presenting it for payment.<sup>26</sup> This rule of disbursal — or accountability — holds the payor bank strictly liable for the amount of the check,<sup>27</sup> regardless of whether actual damages were sustained<sup>28</sup> or whether the check was properly payable.<sup>29</sup>

In the great majority of cases, once final payment occurs and the duty to account arises, the bank will disburse the amount of the check to the one who presented it for payment and debit its customer's account.<sup>30</sup> The bank has only a limited time, however, in which to determine if the check is properly payable and decide whether or not to pay it before final payment occurs and the right to dishonor is lost. Thus, the bank will frequently not discover that it has mistakenly paid the check until after making final payment under either section 4-213 or section 4-302(a). The bank, having no recourse against its own customer, is then faced with the question of whether it must suffer the loss or whether it can either refuse to disburse the funds to the presentor or recover funds already paid. In attempting to resolve the question of disbursal, the courts have been unable to agree on which sections of Article 3 or Article 4 should govern.<sup>31</sup>

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26. See, e.g., *Engine Parts Inc. v. Citizen's Bank of Clovis*, 92 N.M. 37, 582 P.2d 809 (1978); *Blake v. Woodford Bank & Trust Co.*, 555 S.W. 589 (Ky. 1977); *Georgia R.R. Bank & Trust Co. v. First Nat'l Bank & Trust Co.*, 139 Ga. App. 683, 229 S.E.2d 482 (1976); *Appliance Buyer's Credit Corp. v. Park State Bank*, 121 Ill. App. 2d 444, 256 N.E.2d 666 (1970); *Rock Island Auction Sales, Inc. v. Empire Packing Co.*, 32 Ill. 2d 269, 204 N.E.2d 721 (1965).

27. *Western Air & Refrigeration v. Metro Bank of Dallas*, 599 F.2d 83, 85 (5th Cir. 1979); *Engine Parts, Inc. v. Citizen's Bank of Clovis*, 92 N.M. 37, 582 P.2d 809 (1978); *North Carolina Nat'l Bank v. South Carolina Nat'l Bank*, 449 F. Supp. 616 (D.S.C. 1976), *aff'd* 573 F.2d 1305; *Appliance Buyer's Credit Corp. v. Park State Bank*, 121 Ill. App. 683, 256 N.E.2d 666 (1970).

28. *Western Air & Refrigeration v. Metro Bank of Dallas*, 599 F.2d 83 (5th Cir. 1979); *Met Frozen Foods v. Nat'l Bank of No. Am.*, 89 Misc. 2d 1033, 393 N.Y.S.2d 643 (1977); *Rock Island Auction Sales v. Empire Packing Co.*, 32 Ill. 2d 269, 204 N.E.2d 721 (1965).

29. *Blake v. Woodford Bank & Trust Co.*, 555 S.W.2d 589 (Ky. 1977); *Georgia R.R. Bank & Trust Co. v. First Nat'l Bank and Trust Co.*, 139 Ga. App. 683, 229 S.E.2d 482 (1976); *Rock Island Auction Sales v. Empire Packing Co.*, 32 Ill. 2d 269, 204 N.E.2d 721 (1965).

30. *Edwards*, *supra* note 23, at 346.

31. *Id.*

### B. Article 4 Defense to Duty to Defend

Article 4 itself provides certain defenses to the duty to account. Section 4-302(a) provides that the bank becomes accountable for a check only "in the absence of a valid defense."<sup>32</sup> The section also specifically provides that breach of warranty constitutes a defense to the duty of accountability and refers to section 4-207(1), which sets forth specific warranties received by a payor who pays a check in good faith. Section 4-213 does not itself provide that any defense is available to avoid the duty to account imposed by that section,<sup>33</sup> but certain defenses based on breach of warranty are made available by reading the section together with section 4-302 or 4-207(1).<sup>34</sup> In addition, section 4-108(2) provides the bank with a defense to the duty to account when the bank has been unable to take action due to circumstances beyond its control.<sup>35</sup>

### C. Article 3 Defenses

Courts have also recognized various defenses outside Article 4. Examination of these defenses is supported by the introductory language to section 4-302, which states "[i]n the absence of a valid defense such as breach of a presentment warranty, settlement or the like . . . ." Although the section specifically mentions settlement and breach of warranty, the language implies that a number of defenses are available, and does not expressly limit defenses to those contained in Article 4.<sup>36</sup>

Within Article 3, courts have focused primarily on sections

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32. U.C.C. § 4-302; *see also* Engine Parts Inc. v. Citizen's Bank of Clovis, 92 N.M. 37, 582 P.2d 809 (1978).

33. North Carolina Nat'l Bank v. South Carolina Nat'l Bank, 449 F. Supp. 616 (D.S.C. 1976) *aff'd*, 573 F.2d 1305 (§ 4-213 imposes strict liability). *But cf.* Demos v. Lyons, 151 N.J. Super. 489, 376 A.2d 1352 (1977).

34. Edwards, *supra* note 23, at 351, n.62.

35. *See* U.C.C. § 4-108(2) and accompanying comments. It is unclear as to exactly what "circumstances beyond the control of the bank" give rise to a defense to the duty to account. *See, e.g.*, Port City State Bank v. American Nat'l Bank of Lawton, Oklahoma, 486 F.2d 196 (10th Cir. 1973), where a computer breakdown was found to be such a circumstance. *But see* Blake v. Woodford Bank & Trust Co., 555 S.W.2d 589 (Ky. 1977), where the court found just the opposite.

36. Edwards, *supra* note 23, at 352.

3-511 and 3-418. Use of section 3-511(2)(b)<sup>37</sup> has been examined by only a few courts outside of Wisconsin, and only one court has suggested that the section would support a defense to the duty to account imposed by section 4-302(a).<sup>38</sup> Courts which have rejected section 3-511(2)(b) have done so primarily because of their construction of the language of the section itself.<sup>39</sup>

The words "such party" used in section 3-511(2)(b) refers to the "party to be charged" in section 3-511(2)(a). The "party to be charged" is the party who promises to pay the instrument upon dishonor according to his drawer's or endorser's contract.<sup>40</sup> The party presenting the check for payment could not be charged on his endorser's contract because if the check is dishonored, it will be returned by the bank and it will be the presenting party who will initially seek to enforce payment. If the check is paid, it could not then be dishonored, and the presenting party's endorser's liability would never arise.<sup>41</sup>

Other courts have focused on section 3-418.<sup>42</sup> Section 3-418<sup>43</sup> establishes the general rule that a payor cannot recover a final payment whether or not the check was properly payable.<sup>44</sup> The section does, however, recognize certain exceptions

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37. U.C.C. § 3-511(2)(b) provides:

[Presentment or notice or protest as the case may be is entirely excused when

(b) such party has himself dishonored the instrument or has countermanded payment or otherwise has no reason to expect or right to require that the instrument be accepted or paid.

38. *American Nat'l Bank of Powell v. Food Basket*, 497 P.2d 546 (Wyo. 1972).

39. *Available Iron & Metal Co. v. First Nat'l Bank of Blue Island*, 56 Ill. App. 3d 516, 371 N.E.2d 1032(1977).

40. *See, e.g.*, U.C.C. §§ 3-413(2) and 3-414(1).

41. A few courts have looked to § 3-511(4), but that section's use in this context has been strongly criticized and has been accepted by only a small minority. *See, e.g.*, *Blake v. Woodford Bank & Trust Co.*, 555 S.W.2d 589 (Ky. 1977) (rejects § 3-511(4)); *contra*, *Leaderband v. Central State Bank*, 202 Kan. 450, 450 P.2d 1 (1969).

42. *See, e.g.*, *Lowe's of Sanford, Inc. v. Mid-South Bank & Trust Co.*, 44 N.C. App. 363, 260 S.E.2d 801 (N.C. App. 1979); *Aetna Life and Casualty Co. v. Hampton State Bank*, 497 S.W.2d 80 (Tex. Civ. App. 1973).

43. U.C.C. § 3-418 provides that:

Except for recovery of bank payments as provided in the article on Bank Collections and Deposits (Article 4) and except for liability for breach of warranty on presentment under the preceding section, payment or acceptance of any instrument is final in favor of a holder in due course or a person who has in good faith changed his position in reliance on payment.

44. *Edwards, supra* note 23, at 347.



to this rule. One exception arises from the language specifically excepting a breach of warranty on presentment from the final payment rule and allows a payor to recover even a final payment if such a breach of warranty has occurred.<sup>45</sup> Another exception is indicated by the language which makes payment final in favor of a holder in due course<sup>46</sup> or one who has in good faith changed his position in reliance on payment. This language implies that payment would not be final, and would thus be recoverable, if it were made to a person who was not a holder in due course or did not change position in good faith.<sup>47</sup> Thus, a payor bank could theoretically interpose section 3-418 to excuse its duty to disburse the funds to a holder who did not meet the requirements of that section.

In practice, however, section 3-418 has been given a more restricted application. There is an apparent though unexplained trend among some courts to use section 4-302 or 4-213 rather than section 3-418 in actions based on a payor bank's refusal to disburse funds on a check after final payment.<sup>48</sup> Courts, on the other hand, appear to favor the use of section 3-418 over its Article 4 counterparts where the funds have already been disbursed, and the issue is one of reimbursement of the payor bank.<sup>49</sup>

#### D. Good Faith and the Duty to Disburse

Finally, an exception to the duty to disburse based on the concept of good faith was recognized by the Supreme Court of Virginia in *Bartlett v. Bank of Carroll*.<sup>50</sup> The payor bank, which was also the depository bank, revoked the credit given to the plaintiffs for several checks which had been made payable to the plaintiffs by a third party in an effort to circumvent the effect of an adverse probate ruling. The plaintiffs then sued the bank for actual and punitive damages for the alleged wrongful dishonor of certain checks which the plain-

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45. *Id.*

46. U.C.C. § 3-301(1) sets out the criteria for holder in due course status.

47. Edwards, *supra* note 23, at 349.

48. *Id.* at 351.

49. See, e.g., *Demos v. Lyons*, 151 N.J. Super. 489, 376 A.2d 1352 (1977); *Maplewood Bank & Trust Co. v. F.I.B., Inc.*, 142 N.J. Super. 480, 362 A.2d 44 (1976); *First Nat'l City Bank v. Altman*, 277 N.Y.S.2d 813 (1966).

50. 218 Va. 240, 237 S.E.2d 115 (1977).

tiffs had drawn on the now revoked credit, alleging that final payment had occurred under section 4-213(1).

The Virginia Supreme Court, after finding that final payment had occurred,<sup>51</sup> nonetheless ruled that the bank could escape liability if the plaintiffs had acted in bad faith in their dealings with the bank. The court first noted that the drafters of the Uniform Commercial Code had been much concerned with the concept of good faith,<sup>52</sup> and held that only a party not acting in bad faith could claim the protection of section 4-302 or of section 4-213.<sup>53</sup> The court also noted that even if the general Code provisions of good faith did not apply, the common law concept could still be used to supplement the requirements of sections 4-302 and 4-213<sup>54</sup> through section 1-103.<sup>55</sup>

### III. NORTHWESTERN NATIONAL INSURANCE COMPANY V. MIDLAND NATIONAL BANK

In 1974, the drawer of the disputed checks was engaged as a prime contractor for a government construction project. Certain parts of the project had been subcontracted to Larry Smith, Inc., for which Northwestern National Insurance Company (Northwestern) had been acting as a surety. The drawer issued two checks to Larry Smith, Inc. and Northwestern as joint payees. These checks were drawn on Midland National Bank (Midland).

Upon receipt of the two checks, the subcontractor pulled out of the project. The drawer of the two checks thereupon sent to Midland a timely and proper stop payment order. The checks were presented to Midland shortly thereafter by an intermediary bank,<sup>56</sup> and Midland extended provisional credit. Due to a succession of errors by Midland employees, the checks were not returned until five days after their present-

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51. *Id.* at \_\_, 237 S.E.2d at 118.

52. *E.g.*, U.C.C. §§ 1-203 and 3-418.

53. 218 Va. 240, \_\_, 237 S.E.2d 115, 119 (1977).

54. *Id.*

55. U.C.C. § 1-103 provides in part that "[u]nless displaced by the particular provisions of this act, the principles of law and equity . . . estoppel, fraud, misrepresentation, . . . mistake . . . or other validating or invalidating cause shall supplement its provisions."

56. An intermediary bank is any bank to which the check is transferred in the course of collection except the depository or payor bank. U.C.C. § 4-105(c).

ment. Upon the return of the checks, Northwestern instituted an action to recover the value of the two checks from Midland, the payor bank, alleging that Midland had failed to revoke its provisional settlement within its midnight deadline. Thus, Northwestern argued, Midland became liable for the amount of the checks under section 4-302.

The trial court found that Midland had indeed missed the midnight deadline and would have been liable for the checks in the absence of a valid defense.<sup>57</sup> The trial court also found, however, that the stop payment order had been the direct result of the termination of performance by the subcontractor. In addition, the trial court found that both the subcontractor and Northwestern were aware that the two checks would probably not be paid. Based on these findings, the circuit court held that Midland did have a valid defense under section 3-511(2)(b) since Northwestern had no reason "to expect or right to require that the instrument be paid or accepted."<sup>58</sup>

Reversing the decision of the trial court, the Wisconsin Supreme Court dealt first with the applicability of section 3-511(2)(b). The court rejected section 3-511(2)(b) as a defense to the duty to account arising under section 4-302 for several reasons.

First, the court noted that section 4-302 required the payor bank to pay or return the item or to send notice of its dishonor. Since the section is phrased in the alternative, the court reasoned that a defense which might excuse the obligation to send notice of dishonor would not necessarily excuse the duty to pay or return the item in a timely manner.<sup>59</sup> The court held that, even assuming section 3-511(2)(b) could be applied to excuse Midland's duty to send a timely notice of dishonor, it would not necessarily provide a complete defense to the duty to account under section 4-302.<sup>60</sup>

The court's second reason for rejecting section 3-511(2)(b) rested on its analysis of section 4-301.<sup>61</sup> The court noted that

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57. 96 Wis. 2d at 156; 292 N.W.2d at 593.

58. *Id.*

59. *Id.* at 165; 292 N.W.2d at 597.

60. *Id.* at 164; 292 N.W.2d at 596.

61. U.C.C. § 4-301(1) provides:

Where an authorized settlement for a demand item . . . received by a payor bank otherwise than for immediate payment over the counter has been made

under section 4-301, a payor bank may only send notice of dishonor if the check is held for protest or otherwise unavailable for return. The court reasoned that, since the check was available for return, Midland was under an obligation to return the check in a timely manner and was not statutorily permitted to send notice of dishonor. This being the case, the court found that section 3-511(2)(b) would thus "have no bearing on Midland's accountability under section 4-302."<sup>62</sup>

The Wisconsin court's final reason for rejecting section 3-511(2)(b) rested on its analysis of the language in the section itself. The court noted that the term "such party" in section 3-511(2)(b) referred to "the party to be charged" in section 3-511(2)(a). The language thus referred to drawers and endorsers, or those parties which would be held liable on the instrument itself. Since Northwestern was seeking to recover from the bank, the court found that it could not be a party to be charged with liability.<sup>63</sup> Therefore, the court held that section 3-511(2)(b) would not excuse the payor bank from liability under section 4-302.<sup>64</sup>

The court dealt next with the question of whether section 3-418 could be used to prevent disbursement of funds after final payment under section 4-302. In analyzing section 3-418, the court found that the introductory language of the section<sup>65</sup> and certain comments accompanying the section<sup>66</sup> indicated that the applicability of section 3-418 to situations within the banking system was limited by the provisions of Article 4. The court then rejected the use of section 3-418 as a defense to section 4-302, holding that the above indications demonstrated "an intent on the part of the drafters of the Code to exclude the payor bank's liability provision under section 4-

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before midnight of the banking day of receipt, the payor bank may revoke the settlement and recover the payment if before it has made final payment . . . and before its midnight deadline it

- (a) returns the item; or
- (b) sends written notice of dishonor or nonpayment if the item is held for protest or otherwise unavailable for return.

62. 96 Wis. 2d at 169, 292 N.W.2d at 599.

63. *Id.* at 167, 292 N.W.2d at 598.

64. *Id.*

65. See § 3-418, *supra* note 43.

66. U.C.C. § 3-418, Comment 5.

302 from the operation of section 3-418."<sup>67</sup>

The court finally turned to the question of whether either the common law principles or the general Uniform Commercial Code provisions on good faith constituted a possible defense to the payor bank's duty to account under section 4-302. Citing the lack of a finding of bad faith at the trial court level, the Wisconsin Supreme Court declined to express an opinion as to the applicability of such a defense.<sup>68</sup>

#### IV. CRITIQUE AND EFFECT OF *Midland National Bank*

##### A. *Use of Section 3-511 as a Defense to Final Payment*

Prior to *Midland National Bank*, very few courts had been called upon to deal with the issue of applicability of section 3-511 as a defense to the duty to account under section 4-302.<sup>69</sup> The chief focus of the *Midland* court was on this issue, and in rejecting the use of section 3-511, the court seems to have followed the best reasoned of the prior decisions, *Available Iron and Metal Co. v. First Nat'l Bank of Blue Island*.<sup>70</sup>

It would seem to be the better reasoning to reject the use of section 3-511 as a defense to section 4-302. It is doubtful, based on the language of the section, that the drafters intended to provide a payor bank with such a defense to the duty to account. Further, the one court<sup>71</sup> accepting the section as such a defense based its holding primarily on principles of agency from which it could impute the knowledge of the drawer-employee that there were insufficient funds to pay the check to the payee-employer.<sup>72</sup> Finally, even if such a defense were accepted by the court, it would appear to be of only limited use, since it would be available only if the bank is entitled to give notice of dishonor and has failed to do so.<sup>73</sup>

##### B. *Availability of Section 3-418*

Less fortunate are the implications arising from the Wisconsin court's treatment of section 3-418. The apparent result

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67. 96 Wis. 2d at 169, 292 N.W.2d at 599.

68. *Id.*

69. See notes 37-43 and accompanying text, *supra*.

70. 56 Ill. App. 3d 576, 371 N.E.2d 1032 (1977).

71. *American Nat'l Bank v. Food Basket*, 497 P.2d 546 (Wyo. 1972).

72. *Id.* at 548.

73. Edwards, *supra* note 23, at 353.

of *Midland National Bank* is to make section 3-418 inapplicable to determinations regarding final payment within the banking system. This result would be unfortunate for several reasons.

In rejecting section 3-418, the court relied heavily on what it perceived to be the intent of the drafters that the section be excluded from determinations involving a payor bank's liability under section 4-302. This intent was gleaned primarily from the introductory language of section 3-418 together with language from the Official Comments to that section. Analysis of section 4-302 and section 3-418 and the accompanying comments indicates that this intent is by no means clear and suggests that a contrary intent may also be present.

The introductory language to section 4-302 states that the bank is accountable "[i]n the absence of a defense such as breach of warranty." The above language implies that there are a number of defenses available to the rule of accountability expressed in that section. In addition, the language does not expressly limit these available defenses to those contained in Article 4.<sup>74</sup> It could thus be argued that the drafters did not intend to exclude defenses such as 3-418 which are not expressly provided for in Article 4.<sup>75</sup>

Also, the court's rejection of section 3-418 implicitly rejects an important and fundamental Code policy. Use of that section is consistent with the policy of taking equities between the parties into consideration.<sup>76</sup> While the relevant provisions of Article 4 are in harmony with another important Code policy, that of ending the transaction on an instrument when it is paid,<sup>77</sup> they do not by themselves take into account the equities between the parties. Section 3-418 is in accord with both of these fundamental policies<sup>78</sup> and cannot be said to expressly conflict with the actual Article 4 provisions on final payment.

A final criticism of the court's rejection of section 3-418 is

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74. *Id.* at 352.

75. It should be noted in this regard, however, that in the event a conflict does arise between the provisions of Article 3 and those of Article 4, the provisions of Article 4 are to govern. U.C.C. §§ 3-103(2) and 4-102(1).

76. U.C.C. § 3-418, Comment 3.

77. Edwards, *supra* note 23, at 352.

78. Edwards, *supra* note 23, at 349, and U.C.C. § 3-418, Comment 1.

that it appears to limit defenses only to those in Article 4. The court thus seems to favor the policy embodied in that article of ending the transaction on an instrument when it is paid. This policy makes the bank strictly liable for the amount of a check upon final payment.<sup>79</sup> As one court noted, such a provision for strict liability, which could not take equities into account, would allow "a payee . . . [to] . . . coerce or defraud the bank into making payment, yet be permitted to keep the money so obtained."<sup>80</sup> This policy of strict liability, implicit in the *Midland* court's rejection of section 3-418, runs the added risk of producing judicially correct decisions but inequitable results.

Due to the rather sweeping nature of the court's rejection of section 3-418, the continued availability of the section as a defense to final payment accountability is unclear. In *Midland National Bank*, for example, the payor bank had not yet disbursed the funds to the presenting party.<sup>81</sup> There is an unexplained though apparent trend among the various state courts to use section 4-302 or 4-213 rather than 3-418 in this situation.<sup>82</sup> These same courts, on the other hand, appear to favor the use of section 3-418 over its Article 4 counterparts if the funds have already been disbursed, and the issue is one of reimbursement for the payor bank.<sup>83</sup>

One possible explanation for this distinction may be that the Article 4 provisions, and sections 4-213(1)(b), (c) and (d) in particular, deal specifically with situations where the bank has not yet disbursed the funds, while section 3-418 is in part a restitution section<sup>84</sup> and would appear more applicable in the situation where the funds have been disbursed and the bank seeks their return. Given this as yet judicially unexplained distinction, *Midland National Bank* may not apply to a situation where the payor bank has disbursed the funds. In

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79. See note 27 *supra*.

80. *Demos v. Lyons*, 151 N.J. Super. 489, 376 A.2d 1352, 1357 (1977).

81. 96 Wis. 2d at 156, 292 N.W.2d at 592.

82. *Edwards*, *supra* note 23, at 351.

83. See, e.g., *Demos v. Lyons*, 151 N.J. Super. 489, 376 A.2d 1352 (1977); *Maplewood Bank & Trust Co. v. F.I.B., Inc.*, 142 N.J. Super. 480, 362 A.2d 44 (1976); *First Nat'l City Bank v. Altman*, 277 N.Y.S.2d 813 (1966).

84. *Griffin, Final Payment and Warranties on Presentment Under the Uniform Commercial Code — Some Aspects*, 23 *DRAKE L. REV.* 34 (1973) [hereinafter cited as *Griffin*].

such a situation, section 3-418 may yet be applicable to determine the payor bank's right to recover funds disbursed after final payment.

Finally, if section 3-418 has been effectively read out of all final payment situations within the banking system, it is unclear as to whether the payor bank might still have a common law cause of action in restitution.<sup>85</sup> Since section 3-418 is implicitly, at least, a restitution section,<sup>86</sup> its rejection by the court in *Midland National Bank* raised the inference that the common law action would also be unavailable. Nothing in Article 4, however, directly displaces the common law in this area,<sup>87</sup> and section 1-103, which allows courts to supplement Code provisions with common law and equitable principles, might allow such a cause of action based on restitution principles.

### C. Defense of Good Faith

Since the supreme court expressed no opinion<sup>88</sup> as to the applicability of *Bartlett v. Bank of Carroll*,<sup>89</sup> the concept of good faith as discussed therein may yet be a defense in Wisconsin to the Article 4 provisions on final payment. As noted in *Bartlett*, the sources of this defense are twofold. The first is to apply a concept of good faith derived from the general provisions of the Uniform Commercial Code.<sup>90</sup> Article 4 is silent on the issue of good faith, but, as acknowledged by the *Bartlett* court, to read the requirement of good faith out of the article would run contrary to the manifest objectives of the Code itself.<sup>91</sup> In addition, the language and comments of section 1-203 indicate an intent on the part of the drafters that the general provisions of the Code on good faith apply to Article 4 in general and to sections 4-302 and 4-213 in particular.<sup>92</sup>

Secondly, even if the general Code provisions did not ap-

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85. See RESTATEMENT OF RESTITUTION, §§ 29-38 (1937).

86. Griffin, *supra* note 84, at 44.

87. See *Demos v. Lyons*, 151 N.J. Super. 489, 376 A.2d 1352 (1977).

88. 96 Wis. 2d at 169, 292 N.W.2d at 599.

89. 218 Va. 240, 237 S.E.2d 115 (1977).

90. U.C.C. § 1-203 provides that "[e]very contract or duty within this act imposes an obligation of good faith in its performance or enforcement."

91. *Bartlett v. Bank of Carroll*, 218 Va. 240, 237 S.E.2d 115, 119 (1977).

92. U.C.C. § 1-203 and accompanying Comments. See also U.C.C. § 1-103, Comment 1.



ply, common law principles of good faith could be used to supplement Article 4 through section 1-103. Since Article 4 is silent on the question of good faith, its provisions cannot be said to have displaced the principles of common law in this area.<sup>93</sup> Summers and White have pointed out that “[t]he synthesis . . . of pre-Code cases, statutory history, and post-Code cases is that any party *not acting in bad faith* can claim the protection of 4-302 and 4-213 . . . .”<sup>94</sup>

The acceptance of such a defense, however, implies an acceptance of the Code policy of taking the competing equities between the parties into consideration. This policy would conflict with the policy apparently favored by the court in *Midland* to end the transaction on an instrument when it is paid. The court’s failure to decide the applicability of a defense of good faith to this area leaves unanswered the question of priority between these two competing Code policies.

## V. CONCLUSION

Courts in other jurisdictions have applied various provisions within Articles 3 and 4 as well as the common law to determine the circumstances, if any, which would excuse a bank’s refusal to disburse funds on a check after final payment has occurred. Against this conflicting and contradictory judicial background, the Wisconsin Supreme Court sought to resolve the issue in *Northwestern National Insurance Co. v. Midland National Bank*. The Wisconsin court’s rejection of section 3-511(2)(b) follows the better reasoned cases in this area. The court’s rejection of section 3-418, however, raises several important questions.

One of these involves the future applicability of section 3-418 within the banking system. The language of the *Midland* decision appears to bar any application of the section to a situation within the banking system. There is, however, a trend among some courts to apply section 3-418 in certain instances. Though the factual situation in *Midland* is distinct from those situations where section 3-418 is applied, the broad language of the court’s rejection makes it unclear whether the Wiscon-

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93. *Bartlett v. Bank of Carroll*, 218 Va. 240, 237 S.E.2d at 119.

94. R. SUMMERS & J. WHITE, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* § 16-2 (1980) (emphasis added).

sin court will follow this trend.

The other important question arises from the court's apparent decision in favor of the Code policy which ends a transaction on an instrument when it is paid. This choice appears to rule out a conflicting Code policy of considering the equities of the competing parties. The court's refusal to determine the applicability of the concept of good faith to this area, however, leaves the door open to a later recognition of this conflicting policy. By leaving this door open, the court has left to the future the resolution of the inevitable priority conflict between the two policies.

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