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Uniform Commercial Code -- Checks -- Cash Deduction from Check Prior to Deposit as Final Payment under Article Four

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The decision in *James* will no doubt be subjected to much criticism, but in view of the dual nature of a public caseworker's duties, the court, in requiring warrants for all home visits, reached a very practical solution.

> To attempt to draw a distinction regarding the applicability of the [Fourth] Amendment dependent upon whether the caseworker intends to counsel the recipient as to how best to utilize his limited resources or to look for evidence of fraud would invite a trial of every official's purpose—a task which would undoubtedly pervert the intent of the Amendment.[45]

Although intrusion into a welfare recipient's home is motivated by the highest public purpose, "[e]xperience should teach us to be most on our guard to protect liberty when the Government's purposes are beneficent."[46]

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Uniform Commercial Code—Checks—Cash Deduction from Check Prior to Deposit as Final Payment under Article Four

The Supreme Court of Appeals of Virginia in *Kirby v. First & Merchants National Bank*[1] recently applied Article Four of the UNIFORM COMMERCIAL CODE[2] to reach a result that may be surprising to bankers in the states that have adopted the U.C.C.[3] The court held that the bank had made a final cash payment under section 4-213(1)(a)[4] of the U.C.C. when it permitted a customer to make a cash deduction from a check that was being deposited.[5]

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[45] 303 F. Supp. at 942.

[46] Olmstead v. United States, 277 U.S. 438, 479 (1928) (dissenting opinion of Justice Brandeis).

[1] 210 Va. 88, 168 S.E.2d 273 (1969).

[2] The UNIFORM COMMERCIAL CODE [hereinafter cited as U.C.C.] has been codified in VA. CODE ANN. §§ 8.1-.10 (1965). References *infra* will be to the Code as adopted in Virginia, but the number 8 will be omitted.

[3] Every state except Louisiana has now adopted the U.C.C. The U.C.C. is found in N.C. GEN. STAT. ch. 25 (1965). For a basic study of Article 4 as adopted in North Carolina, see Davis, *Article Four: Bank Deposits and Collections*, 44 N.C.L. REV. 627 (1966).

[4] § 4-213(1)(a) provides:

> (1) 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;

[5] 210 Va. at —, 168 S.E.2d at 276.

The transaction involved in *Kirby* is a common one. Mrs. Kirby, the defendant-payee, handed to plaintiff's teller a check made out to and endorsed by her for 2500 dollars. The check had been drawn on the First and Merchants National Bank by a local engineering firm. The defendant, who had an account at First and Merchants, gave the teller a deposit slip on which 2300 dollars had been entered in the "currency" column. The teller then gave Mrs. Kirby 200 dollars in cash, and on January 3, the next business day, the bank credited the defendant's account with 2300 dollars. On January 4 the bank discovered that the check was drawn against insufficient funds and a day later telephoned the defendant to inform her that the check had been dishonored and to request reimbursement.[6] The defendant failed to cover the check, and on January 10 the bank charged her account with 2500 dollars. This action created an overdraft of 543.47 dollars. The bank instituted suit to recover the amount of the overdraft.

In reversing a decision in favor of the bank, the supreme court held that the transaction was a final payment in cash of the entire check and rejected the bank's contention that "under the terms of its contract with Mrs. Kirby, the settlement was provisional and therefore subject to revocation whether or not the check was paid in cash on December 30."[7] The court further found that even if payment had not been in cash, the bank had no right to charge the item back to Mrs. Kirby's account[8] since the bank neither returned the item nor sent written notice of dishonor before the midnight deadline.[9]

In concluding that final payment in cash had been made, the court relied heavily on the testimony of a bank officer who stated that the bank "cashed" the check for 2500 dollars.[10] Documentary evidence of the manner in which the deposit slip had been made out and of the procedures employed to record the transaction was also examined by the court:

> The deposit of cash is evidenced by the word "currency" before 2,300.00 on the deposit ticket and by the words "Cash for Dep." on the back of the check. The Bank's ledger, which shows a credit of $2300 to Mrs. Kirby's account rather than a credit of $2500 and a debit

[6] *Id.* at —, 168 S.E.2d at 274-75.
[7] *Id.* at —, 168 S.E.2d at 277.
[8] *Id.*
[9] U.C.C. § 4-104(h) defines "midnight deadline" as "midnight on its next 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."
[10] 210 Va. at —, 168 S.E.2d 275.

> of $200, is consistent with a cashing of the Neuse check and a depositing of part of the proceeds.[11]

Section 4-213(1) of the U.C.C. deals with those events that will make final the payment of an item by a payor bank.

> The concept of final payment is central to the scheme of Article 4 because the time of final payment of a check or similar item is the starting point for determining the rights and obligations of a number of parties in relation to an item.[12]

Subsection (1)(a) is at least one provision within section 4-213 in which there seems to be little room for confusion. An actual over-the-counter payment of an overdraft relieves the payee of any liability to the bank despite subsequent dishonor.[13]

The transaction in *Kirby* did not, however, readily conform to this provision since only a fraction of the face amount of the check was cashed and paid directly to the customer. Concededly, an argument can be made that there is a sound rational basis to the court's decision to treat the transaction as if the entire check had been cashed and then a portion of the proceeds deposited. Since the depository bank was also the payor bank,[14] little time would have been required for it to ascertain whether the check had been drawn against sufficient funds.[15] Furthermore, in light of the large number of checks handled daily by banks[16] and the need for prompt finalization of such transactions, it may not be surprising that a court

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[11] *Id.* at —, 168 S.E.2d at 275-76.

[12] Comment, *Bank Procedures and the U.C.C.—When is a Check Finally Paid?* 9 B.C. IND. & COM. L. REV. 957 (1968). See also Love, *How the Adoption of the Uniform Commercial Code Would Affect the Law of Bank Deposits and Collections in Oregon*, 32 ORE. L. REV. 288, 295-96 (1953).

[13] This provision conforms to prior case law. See, *e.g.*, National Bank v. Bank of Magdalena, 21 N.M. 653, 157 P. 498 (1916); Cherokee Nat'l Bank v. Union Trust Co., 33 Okla. 342, 125 P. 464 (1912); Fidelity & Cas. Co. v. Planenscheck, 200 Wis. 304, 227 N.W. 387 (1929). See also Morris, *The Law of Overdrafts*, 16 CLEV.-MAR. L. REV. 574, 579 (1967).

[14] U.C.C. § 4-105 provides in part:

(a) "Depository bank" means the first bank to which an item is transferred for collection even though it is also the payor bank;

(b) "Payor bank" means a bank by which an item is payable as drawn or accepted;

[15] U.C.C. § 3-506(2) permits deferred payment without dishonor so long as payment is made "before the close of business on the day of presentment."

[16] Malcolm, *How Bank Collection Works—Article 4 of the Uniform Commercial Code*, 11 How. L.J. 71, 74 (1965) (stating that fifty-million items are handled every day by banks).

should be inclined to declare a payment final at the earliest reasonable time. However, the court in deciding *Kirby* did not give adequate consideration to the probability that the bank allowed the customer to deduct cash from her deposit solely as a convenience to her.

After deciding the issue of whether there had been a cash payment in favor of the customer, the court considered arguendo the bank's contention that its contract with Mrs. Kirby made settlement of the check provisional. The relevant portions of the contract provided:

> All items are credited subject to final payment and to receipt of proceeds of final payment in cash or solvent credits by this bank at its own office . . . . This bank may charge back, at any time prior to midnight on its business day next following the day of receipt, any item drawn on this bank which is ascertained to be drawn against insufficient funds or otherwise not good or payable. An item received after this bank's regular closing hour shall be deemed received the next business day.[17]

That transactions are provisional until final payment is expressly recognized by the U.C.C.[18] The charge-back provision included in the contract is not in derogation of the applicable Code provisions. Section 4-212(3) provides that:

> [A] depository bank which is also the payor bank may charge back the amount of an item to its customer's account or obtain refund in accordance with the section governing return of an item received by a payor bank for credit on its books (Section 4-301).

Section 4-301(2) provides:

> If a demand item is received by a payor for credit on its books it may return such item or send notice of dishonor and may revoke any credit given or recover the amount thereof withdrawn by its customer, if it acts within the time limit and in the manner specified . . . .[19]

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[17] 210 Va. at —, 168 S.E.2d at 277 n.6.

[18] *See, e.g.*, U.C.C. § 4-212, Comment 1. "Deferred posting" has been in use for many years. See Leary, *Deferred Posting and Delayed Returns—The Current Check Collection Problem*, 62 HARV. L. REV. 905 (1949).

[19] U.C.C. § 4-301(2) applies the rules of deferred posting to situations in which the depository bank is also the payor bank and thus is a departure from prior case law. *See, e.g.*, Cohen v. First Nat'l Bank, 22 Ariz. 394, 198 P. 122 (1921); W.A. White Brokerage Co. v. Cooperman, 207 Minn. 239, 290 N.W. 790 (1940). For an excellent discussion of § 4-301, see Love, *How the Adoption of the Uniform Commercial Code Would Affect the Law of Bank Deposits and Collections in Oregon*, 32 ORE. L. REV. 288, 314-16 (1953).

The "time limit" is "midnight of the banking day of receipt" and the "manner specified" is either returning the item or sending written notice of dishonor or nonpayment.[20] Thus under the U.C.C. the settlement remains provisional until the expiration of the midnight deadline or the prior occurrence of one of the two specified events.

Applying these provisions to the action taken by First and Merchants, it is obvious that the bank's procedure did not comply with the Code. The court stated that "even if the Bank's settlement for the Neuse check had been provisional, the Bank had the right to charge that item back to Mrs. Kirby's account only if it complied with U.C.C. §§ 4-212(3) and 4-301."[21] The failure of a bank to send timely and proper notice would result in the loss of the provisional status of the payment of checks, the court said.

Many banks in North Carolina employ a different method of recording the type of deposit made in *Kirby*. Insisting that they will not accept a deposit slip made out in the form Mrs. Kirby used, they require that the total amount of the check be entered in the "checks" column and that cash deductions be indicated within the column by the words "less cash."[22] These banks operate under the theory that allowing such simultaneous withdrawals is a service to the customer to save him the time and effort of having to deposit the full amount and then draw a check for the cash needed.[23] This practice may be preferable to the one permitted by First and Merchants in *Kirby*, but, arguably, even the type of transaction commonly used in North Carolina could be construed as a final cash payment because the end result is the same regardless of the manner in which the deposit is recorded. Courts should, however, treat the split-deposit transactions that are common in North Carolina as though the bank had provisionally accepted the check and then granted immediate right of withdrawal. Since the bank requires the total amount of the check to be entered in the "checks" column and allows the practice to prevent inconvenience to its customers, the intention of the bank to provisionally accept the item should be recognized.[24]

The court in *Kirby* made no reference to sections that allow alteration

[20] U.C.C. § 4-301(1)(a)-(b).

[21] 210 Va. at —, 168 S.E.2d at 277.

[22] This type of deposit will be hereinafter referred to as a "split-deposit."

[23] 210 Va. at —, 168 S.E.2d at 278 (dissenting opinion giving other means by which a cash withdrawal can be effected).

[24] For a decision reaching a result contrary to *Kirby*, see Citizens State Bank v. Pritchett, 123 Colo. 497, 231 P.2d 462 (1951). The result was based in part on the theory that the transaction was a service to the customer.

of the U.C.C. by agreement.[25] While its drafters recognized the need for some degree of flexibility in the future use of Article 4 of the U.C.C., they were faced at the outset with the basic problem of

> whether the Article should consist of a set of rules cast in a rigid form in order to protect customers of the banks, with only limited variation of the provisions thereof by agreement or action permitted, or whether the Article should consist of basic mechanical bank collection rules, a statement of permissive bank collection practices and, in addition, a section or sections permitting liberal variation of the provisions of the Article by agreement . . . .[26]

The decision was in favor of flexible rules, and, in light of the ever changing nature of bank-collection practices, this policy seems wise.[27] The central provision to achieve flexibility is subsection 4-103(1), which states that "the effect of the provisions of this Article may be varied by agreement except that no agreement can disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care . . . ."[28]

Section 4-103 provides three methods by which the Code provisions may be varied. The first is the "ordinary" agreement,[29] which is frequently contained on the signature card signed by the customer when opening an account in a bank. The second method is through general banking usage, provided for in subsection (3). The third is the provision for novel banking procedures found in subsection (4), which states that "[t]he specification or approval of certain procedures by the Article does not constitute disapproval of other procedures which may be reasonable under the circumstances."

Any attempt of a bank to alter Section 4-213(1)(a) by adopting the policy that items paid in cash are provisionally accepted would fall within subsection (4) since such a position would probably be regarded as novel in any region of the country. It is improbable that the courts would countenance this sort of procedure since the result would be a sub-

[25] For a general discussion of alteration by agreement, see J. CLARKE, H. BAILEY & R. YOUNG, JR., BANK DEPOSITS AND COLLECTIONS 28-46 (1963) [hereinafter cited as CLARKE]; Leary, *Check Handling Under Article Four of the Uniform Commercial Code*, 49 MARQ. L. REV. 331, 341-49 (1965).

[26] CLARKE at 28-29.

[27] *See* Malcolm, *Article 4—A Battle With Complexity*, 1952 WIS. L. REV. 265, 276.

[28] At least one author has serious doubts as to whether freedom to vary by agreement is effective as a "preservative of flexibility." *Id.* at 269-70.

[29] CLARKE at 31.

stantial loss of protection to the customer as well as a reduction in the speed and efficiency of the banking process.[30]

In regard to split-deposits, however, banks should be able to stipulate in a contract with its customers that such items are accepted provisionally, at least with repect to those not drawn on the contracting bank. In order to avoid the classification of split-deposits as final cash payments, they should be deemed deposits of checks with immediate right of withdrawal. Thus banks contracting for provisional acceptance of split-deposits to provide greater convenience for customers would be protected by the U.C.C.'s rules governing provisional settlement. Assuming that a bank does make such a specific contract, it may still be desirable to include in the agreement a term modifying the U.C.C.'s requirements for notice.[31] Under the Code, notice must be sent to the customer before the midnight deadline. According to Professor Clarke, there is little doubt that agreements reasonably extending the time limitation are permissible.[32] There would seem to be no reason under the Code why methods for sending notice could not also be reasonably varied.

Officials of three banks in North Carolina who were interviewed said that none of the banks have made any effort through "ordinary agreement" to vary any of the U.C.C.'s requirements for notice. One official stated that in the event of dishonor of a deposited check, his policy is to telephone the depositor-payee, as was done in *Kirby*. According to this official, if the customer fails to resolve the matter quickly, a more formal written notice is given. The official of the second bank stated that upon dishonor of a check, written notice is sent in every case. The third bank apparently sends written notice only when the item dishonored is unusually large; for smaller items, the only notice given the depositor is provided on the regular monthly statement.

Clearly the methods employed by the first and third banks do not fulfill the strict requirements of section 4-301(1) of the U.C.C. For either bank to overcome a depositor's claim that insufficient notice was given, it would be forced to show alteration of the requirements either by general banking usage or novel banking procedure since no use has been made of a contract modifying the U.C.C. In order to establish the existence of general banking usage, the burden "would be on the party seeking the

[30] *Id.* at 40.

[31] For a comparison of requirements for notice under the traditional negotiable instruments law and the U.C.C., see, C. FUNK, BANKS AND THE UNIFORM COMMERCIAL CODE, 169-76 (1964).

[32] CLARKE at 44.

benefit thereof."[33] Comment 4 to section 4-103 sets forth general guidelines and suggestions for defining the term "general banking usage":

> The term "general banking usage" . . . should be taken to mean a general usage common to banks in the area concerned . . . . Where the adjective "general" is used, the intention is to require a usage broader than a mere practice between two or three banks but it is not intended to require anything as broad as a country-wide usage.

It would seem easier and perhaps more effective for a bank to argue that the Code's provisions for notice had been validly altered by novel banking procedure, defined by subsection 4-103(4). As long as the depositor received actual notice of the dishonor within a reasonable time, neither banking efficiency nor protection for the customer would be adversely affected.

In order to avoid the necessity of making arguments based on general banking usage or novel banking procedure during litigation, banks should consider revision of their contracts with customers. An agreement extending the time and method of sending notice would have to fall within the boundaries of reasonableness and good faith; arguably a term that specifically provides for some form of actual notice within a reasonable time would meet this test.[34] The contract should also specifically provide that split-deposits (or deposits that are split in substance, if not in form, as in *Kirby*) are only accepted subject to provisional settlement to increase the likelihood that courts will not interpret such deposits as final cash payments.

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[33] *Id.* at 39.

[34] On the question of what courts would likely uphold as a reasonable time, notice of a dishonored item made by regular bank statement, which might take thirty days or more to reach the customer, undoubtedly will not prove acceptable. Actual notice of dishonor—either orally or in writing—within five days probably is reasonable.