

3-1-1986

MICR Fraud: A Systems Approach to Foiling The Felon's Fun

Fairfax Leary Jr.

Patricia B. Fry

Follow this and additional works at: <http://repository.law.miami.edu/umlr>

Recommended Citation

Fairfax Leary Jr. and Patricia B. Fry, *MICR Fraud: A Systems Approach to Foiling The Felon's Fun*, 40 U. Miami L. Rev. 737 (1986)
Available at: <http://repository.law.miami.edu/umlr/vol40/iss3/3>

This Article is brought to you for free and open access by Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized administrator of Institutional Repository. For more information, please contact library@law.miami.edu.

MICR Fraud: A Systems Approach to Foiling The Felon's Fun

FAIRFAX LEARY, JR.*

AND

PATRICIA B. FRY**

| | |
|--|-----|
| I. INTRODUCTION | 737 |
| A. <i>The American Check Collection System</i> | 739 |
| B. <i>Introduction to MICR Fraud</i> | 747 |
| II. A SYSTEM-ORIENTED ANALYSIS OF MICR FRAUD | 759 |
| A. <i>Notice of Delay in Transit of Checks</i> | 759 |
| B. <i>Defenses to Liability for Failure to Give Notice</i> | 765 |
| C. <i>The Demand for Prompt Funds Availability</i> | 768 |
| III. IS AMENDMENT THE ONLY CURE? | 773 |
| A. <i>U.C.C. Section 4-202(1)(e)</i> | 773 |
| B. <i>Regulation J</i> | 781 |
| C. <i>U.C.C. Section 4-103(5)</i> | 781 |
| D. <i>Other Provisions</i> | 783 |
| IV. CONCLUSION | 788 |

I. INTRODUCTION

In *The Pirates of Penzance*, the sergeant of police sings:

When a felon's not engaged in his employment
Or maturing his felonious little plans
His capacity for innocent enjoyment
Is just as great as any honest man's¹

With each new method of transferring value from one person's control to another's, "felonious little plans" are devised to enable the felon to obtain someone else's lucre the better to fund the felon's "capacity for innocent enjoyment." As each new scheme appears, defensive measures are developed to discourage the felonies. The first gold or silver coins were "pared," reducing their intrinsic value, until

* J.D., 1935, Harvard; Formerly Reporter for Article 4 of the U.C.C. in its earlier drafts; Public Member National Commission on Electronic Fund Transfers; Distinguished Senior Professor of Law, The Delaware Law School of Widener University.

** J.D., 1971, Southwestern; M.A., 1980, California State University; Associate Professor of Law, University of North Dakota Law School.

The authors acknowledge the research assistance of Amy Sassler, Stephen J. Kelly, and Robert Lanes, 3-Ls, and Kevin Vitelli, 2-L, all of Delaware Law School, in the preparation of this article.

1. W. GILBERT & A. SULLIVAN, *The Policeman's Song* in *THE PIRATES OF PENZANCE*, Act II (1880) (chorus omitted).

the use of the milled edge put a stop to this fraud.² When paper money came to be used, the counterfeiting art was developed. This crime has been reduced, but not eliminated.³ One successful criminal ploy involved the production in Country A of a second issue of the banknotes of Country B from the original plates. The same officials who had placed the first order persuaded the private engraver to reproduce the notes. The trouble was the officials had just become ex-officials.⁴

When private parties started transferring value through drafts, felons forged signatures to transfer the wealth to themselves.⁵ Today's check collection system discourages this scheme by forcing the party considered best able to avoid or insure against the loss to do so. If the forged signature is that of the drawer, the loss rests on the drawee, which is charged, under present laws, with knowing its customer's signature.⁶ If the forgery is the signature of an indorser, the

2. 15 ENCYCLOPEDIA BRITANNICA 579 (1960). The milled edge and, in some cases, inscriptions thereon "were intended to put a stop to the practice of clipping and filing coins, which was prevalent in the 16th and 17th centuries." *Id.* The accuracy and sharpness of the milling separated genuine from counterfeit coins.

3. From 1933 to 1936, counterfeiters caused average yearly losses totalling \$771,000. In fiscal year 1937, losses were reduced to just over \$519,000, and in fiscal year 1938, they fell to \$407,000. By the end of fiscal year 1939, losses were reduced to about \$295,000. 6 ENCYCLOPEDIA BRITANNICA 592 (1980).

Fifteen years later, during the fiscal year ended June 30, 1957, U.S. secret service agents captured \$1,548,167 in counterfeit bills. Of that total, however, more than \$100,000 was successfully passed [to] storekeepers and cashiers; the balance was seized before it could be put into circulation. In 1957 agents arrested over 300 persons for violating U.S. counterfeiting laws.

Id. at 593.

4. *Banco do Portugal v. Waterlow & Sons, Ltd.*, 1932 L.R. 452, 461 (1932).

5. In 1762, the landmark decision in *Price v. Neal* stated the rule that a drawee who paid the draft cannot recover the payment from an innocent holder of forged drafts. 97 Eng. Rep. 871 (K.B. 1762). Lord Mansfield said that any negligence lay with the drawee. We suspect Lord Mansfield based his negligence comment on the fact that there was no proof that the drawer had received the then customary letter of advice of a drawing. The forger was discovered and hanged for his crime.

Some American jurisdictions made exceptions to the above-stated rule before the Uniform Commercial Code was drafted. The English courts appear to distinguish between instruments bearing some authentic signatures and instruments which are total forgeries, and to permit the payor to recover funds paid on complete forgeries under the doctrine of mistake. See *National Westminster Bank Ltd. v. Barclay Bank Int'l Ltd.*, [1974] 3 All E.R. 834 (Q.B.).

6. U.C.C. § 3-418 (1978). One justification for this rule is that the drawee is charged with knowing its customers' signatures and has the power to verify those signatures. Another proposed justification is that the banks are in the best position to prevent losses due to forgeries through the development of methods to authenticate customers' orders which will be more secure than signatures.

The rule of *Price v. Neal* is restated in U.C.C. section 3-418, with limited exceptions. First, the section does not bar recovery of payment from one who is not a holder in due course. Second, it does not prohibit recovery from a person who has not changed position in reliance

loss rests on the person first dealing with the forger.⁷ To ensure that drawers and others will take care when preparing or handling drafts or checks, the risk of the loss is shifted if it is proved that negligence in the drawer's check issuance or reconciliation operations enabled the forgery to occur.⁸

A. *The American Check Collection System*

As the check collection system has evolved in this country, further opportunities for felons have arisen. The defensive measures used to combat any new felonious little plans, if they are to be successful, must integrate with existing systems of check collection. Solutions that fail to do so will be impractical primarily because they will not be cost-effective. Thus, before the authors analyze the most recent felonious ploy, magnetic ink character recognition fraud, referred to herein as MICR fraud, it is necessary to describe the existing check collection system in the United States.

The American check collection system uses a series of debits and credits to transfer depository institution credit from debtor to creditor. At each step in the journey of a check, the sender (the depositor or a collecting bank) is credited with the amount of the check and its recipient (the next collecting bank or payor/drawee) is debited for that sum. To permit processing cost savings, these debits and credits are provisional and reversible until the payor/drawee has received the item and has had an opportunity to decide whether to honor or dishonor it.⁹ In order to preserve their ability to reverse the provisional credits, depository institutions have the right to place a "hold" on the credit, preventing the customer from using the funds until the item has had time to clear.¹⁰

The "hold" or "delayed funds availability" policy of depository institutions discourages counterfeit checks. Also, lack of knowledge

on the payment. The U.C.C. also permits recovery from one who has presented the instrument with knowledge of the forged signature. U.C.C. §§ 3-417(1)(b), 4-207(1)(b) (1978).

7. See U.C.C. §§ 3-417(1)(a), 4-207(1)(a), 3-417(2)(a), 4-207(2)(a) (warranty of title sections). *But see infra* note 8.

8. U.C.C. sections 3-406 and 4-406 state general principles applicable to drawer negligence. Section 3-405, which does not require proof of drawer negligence, makes certain forged indorsements effective in the case of checks issued to imposters and in the case of embezzling check signers or "name suppliers." While the justification for section 3-405 is that the drawer, rather than the banking system, should control and insure against such employee embezzlements, the Code contains no provision applicable to similar misconduct by employees of a payee. One court has developed a common law negligence rule to deal with the misconduct of a payee's employee. *See Cooper v. Union Bank*, 9 Cal. 3d 371, 507 P.2d 609, 107 Cal. Rptr. 1 (1973).

9. U.C.C. § 4-201(1).

10. U.C.C. § 4-213(4).

of just how large a check one can forge in a given situation with assurance that it will not be dishonored by the payor has reduced the targets used by many forgers. Yet losses continue, and the forgery insurers continue to require larger and larger deductibles on their bankers blanket bonds.¹¹ The definitive and cost effective counter to forged drawer's signatures has not yet been devised.

When the check collection process became automated by the introduction of computerized record keeping and the use of the "MICR line" to enable automatic "reader-sorters"¹² to work in harness with an institution's main frame computer banks began to "pay" most checks without any human ocular examination.¹³ By omitting

11. Insurers have been known to set the size of the deductibles. Conversations between bankers and Professor Fairfax Leary, Jr. In *United States Fidelity & Guar. Co. v. Federal Reserve Bank of N.Y.*, the deductible per loss was \$100,000. 590 F. Supp. 486, 490 (S.D.N.Y. 1984).

12. See *infra* notes 39-41 and accompanying text.

13. The practice varies from bank to bank. Some banks make no examination of signatures. Signature inspection occurs in some banks for all items in excess of a predetermined undisclosed amount. Some banks also inspect all items in randomly selected accounts.

A survey made under Federal Reserve auspices indicated that the percentage of checks handled rapidly declines as the amount of the check increases. Nevertheless, comparison of the relative volume of checks with the amount of dollars represented by such checks discloses why limited visual inspections can prevent untoward forgery losses. The following table, excerpted from a Federal Reserve Bank of Atlanta publication, illustrates the point:

| Check Amount Up to | % Cumulative Volume | % Cumulative Dollars |
|-----------------------|------------------------|-------------------------|
| | from 0.00 to | |
| \$ 32 | 47.46% | 1.40% |
| 64 | 63.33 | 2.87 |
| ... | ... | ... |
| 1,024 | 96.19 | 18.12 |
| 2,048 | 97.72 | 22.63 |
| 4,096 | 98.66 | 28.07 |
| ... | ... | ... |
| 16,384 | 99.63 | 43.19 |
| ... | ... | ... |
| 65,536 | 99.92 | 60.80 |
| 131,072 | 99.96 | 68.89 |

FEDERAL RESERVE BANK OF ATLANTA, A QUANTITATIVE DESCRIPTION OF THE CHECK COLLECTION SYSTEM (1980).

According to the table, checks written for amounts up to \$32 account for almost 48% of all checks written, but only represent 1.4% of all dollars passing through the check system. Checks written for amounts up to \$2,048 account for about 98% of all checks written, and they represent only about 23% of all dollars passing through the system.

Accordingly, if a bank were to inspect all checks written for amounts in excess of \$32, then approximately half of all checks written would be subject to inspection. A manual inspection of this size, however, say 19 billion inspections, would be far too costly. If a bank were to inspect all checks in amounts in excess of \$2,048, then only slightly more than 2% of the checks written would be subject to inspection. In a bank paying 1 million checks per day,

any visual comparison of the drawer's signature with the exemplar in its records, the drawee runs the risk that a forgery will not be detected. Signatures are often routinely checked, however, on large items¹⁴ in all accounts, and less frequently on all items in randomly selected accounts. In this manner, the resultant losses from occasional forgeries are kept within cost-effective limits. The net effect is a cost savings, although occasional and nonrepetitive forgeries remain a liability of the payor bank.¹⁵

Long before the drafting of the Uniform Commercial Code's ("the Code") article four on bank collections began, banks had noted that about 99 1/2% by number, and 99 3/4% by value, of all checks were paid.¹⁶ To save costs, a system evolved which called for the payor to give notice of its treatment of an item only upon nonpayment.¹⁷ Savings in message costs alone were very large. With this system, collecting banks assume that an item has been honored once sufficient time has elapsed to permit the item to be presented to the payor and notice of dishonor to be received from the payor. No news is taken as good news.

Thus, the collection system operates upon the basis of non-inspection, notice of nonpayment, and delayed funds availability. During the era of manual bookkeeping, banks devised "availability

however, the total number of checks to be inspected would still total approximately 20,000. At a rate of 1,000 checks per hour, this would require 20 hours of staff time, and at 500 per hour, 40 employee hours would be required. Even at the slower rate, the inspection would only permit about seven seconds per item. Considering employee restlessness, and other factors, probably only five to six seconds would be spent per item. Only the crudest forgeries could be detected if the clerk checked for anything beyond the existence of a signature rather than a blank.

14. To avoid aiding some felonious little plans, no bank publicly discloses the amount which will trigger a signature viewing. Even so, due to volume and time per item spent in verifying, well-executed forgeries are often not detected.

15. The cost savings are based, in each bank, on a history of bank-absorbed forgery losses. If the loss is shifted to the drawer under U.C.C. section 3-406 or 4-406, however, so that the charge initially made to the drawer's account is not required to be reversed, no amount is entered into the loss figures. This "preclusion" of the drawer should not be lost by any ruling that the failure to examine all signatures on all items by the bank constitutes a failure to exercise ordinary care, or is not in accordance with reasonable commercial standards, or constitutes a lack of good faith. U.C.C. section 4-103(4) specifically provides that "[t]he specification or approval of certain procedures by [Article four] does not constitute disapproval of other procedures which may be reasonable under the circumstances." U.C.C. § 4-103(4) (1978). The comments to section 4-103 make the drafters' concern with the practical needs of mass volume check clearing abundantly clear. *Contra* Medford Irrigation Dist. v. Western Bank, 66 Ore. App. 589, 676 P.2d 329 (1984) (ruling that the failure of a bank to examine all signatures prevented the shifting of losses which resulted from forged checks from bank to its negligent customer under Oregon's version of section 4-406).

16. See Leary, *Deferred Posting and Delayed Returns—The Current Check Collection Problem*, 62 HARV. L. REV. 905, 912 (1949).

17. This system is embodied in U.C.C. section 4-301.

schedules" for use by bookkeepers. These schedules governed the duration of the hold which could be placed on deposited items in order to permit notices of nonpayment to be received.¹⁸ The holds assumed that presentment would be made to only one payor and that a prompt return would occur in the event of nonpayment. As the schedules developed, the holds tended to be based on three time levels only. The shortest hold period was for checks involving payor institutions in the same city. The second, or intermediate holding period, included payor institutions in the same state, and the third was for all others. When the system was computerized, the programmers often retained the same hold periods.¹⁹ The treatment of items drawn on institutions in foreign countries varied, as their payment and credit procedures were not necessarily the same as those adopted by domes-

18. For a description of the check collection process prior to automation, see Leary, *supra* note 16, at 909-15.

19. The usual practice, adopted by state regulation under funds-availability laws in California and New York, is a three-stage hold: same city, same state, and other. The way checks are handled, presentation and return occurs more rapidly between big cities throughout the country than it does between a city bank and a rural bank. For example, a check deposited with a Los Angeles, California bank will be presented and any notice of nonpayment will be received more rapidly if the check is drawn on a New York City bank than if it is drawn on a rural bank in remote northern California. A computer program based on actual experience would have saved much grief.

The following tables, borrowed in part from an article by Professor Jordan, report recent hold periods in Philadelphia and San Francisco:

| Type of Bank | DAYS OF HOLD | | |
|------------------------|--------------|-----------------|-----------------|
| | Philadelphia | San Francisco | |
| | | <i>Survey A</i> | <i>Survey B</i> |
| <i>Commerical Bank</i> | | | |
| Local Payor | 1-5 | 2-7 | 1-7 |
| Outside | 3-10 | 2-15 | 1-15 |
| <i>Savings Bank</i> | | | |
| Local Payor | 1-3 | 3-12 | 2-10 |
| Outside | 3-10 | 5-30 | 4-20 |
| <i>Credit Unions</i> | | | |
| Local Payor | N/A | N/A | 5-10 |
| Outside | N/A | N/A | 5-14 |

tic banks.²⁰

To comprehend the present automated system of check collection, it is necessary to understand the numbering system used on checks. The availability schedules, of course, assume prompt transmittal of items from depository institutions to payor institutions and of return items back to the depository.²¹ Each item and each notice of nonpayment is physically transmitted. To facilitate this daily physical transmission of millions of checks, depository institutions utilize correspondent or collecting banks, which receive the items, sort, and for-

The state regulations adopted in New York and California follow the three stage approach as follows:

| | DAYS OF HOLD | | |
|---------------------------------------|--------------|------------|--------------|
| | Local | Same State | Out of State |
| <i>New York Regulations</i> | | | |
| Banks | 2 | 3 | 6 |
| Savings Inst. | 3 | 4 | 8 |
| <i>California Regulations*</i> | | | |
| <i>Dept. of Banking</i> | | | |
| Banks | 2 | 3-4 | 8-9 |
| Savings Inst. | 4-5 | 4-5 | 9-10 |
| <i>Dept. of Savings & Ls.</i> | | | |
| Any Institution | 4 | 4 | 10 |
| <i>Dept. Corps. for Credit Unions</i> | | | |
| Any Institution | 5 | 5 | 9 |

*California bases its regulations on the status of the payor institutions.

Jordan, *Ending the Floating Check Game: The Policy Arguments for Delayed Availability Reform*, 36 HASTINGS L.J. 515, 555-56 (1985). The San Francisco survey, Survey A, was prepared by the San Francisco Consumer Action group. Survey B was prepared by the California Public Research Group. We have combined the nonlocal in-state and the out-of-state holds since the distinction was not made in the Philadelphia survey. For the source of the Philadelphia material, see the Philadelphia Inquirer, Aug. 25, 1985, § IV, at 1. The California out-of-state hold shorter periods were from one to five days longer than the non-local in-state holds. See CAL. ADMIN. CODE tit. 10, R. 10.190406(a)(1)-(2) (1984). The New York regulations can be found in N.Y. Gen'l Regs. of the Banking Board §§ 34.1-34.5 (1983).

Professor Jordan sees an advantage in providing definite periods in order to treat certain items, such as government checks, categorically; but felons can forge these too. See Jordan, *supra*, at 553-54.

20. If checks are routed through a Federal Reserve Bank, the provisional credit becomes usable in two days. Some banks, now that interest is paid on demand accounts, do pay interest from "day of deposit." On the other hand, compare the 5% and 7% rates for such interest with, for example, bank prime rates of 10% or so. This spread in interest rates is beneficial to banks with long hold periods.

21. Prompt transmittal of items for payment by each bank is encouraged by the midnight deadlines contained in the U.C.C. See § 4-202(2) (1978) (collecting banks) and § 4-302 (1978) (payor banks). On the other hand, return items are handled manually and frequently travel through less speedy means, such as the United States postal system.

ward them on their journey from bank to bank until each reaches its respective payor institution.²² As the use of checks increased with the growth of business and commerce, and after the decision in *Veazie Bank v. Fenno*²³ stimulated banks to stress the advantages of using checks, the problem of sorting the growing number of checks into groups that were payable in the area served by each correspondent of the depository institution also increased in complexity. The banks found that the boxes or cubby-holes used for manual check sorting could be numbered and the sorting would be speeded if the checks themselves bore the same number, rather than asking the clerks to remember or to look up the name of each institution in the area of each correspondent.²⁴ As the *Key to Routing Numbers* states, however:

Prior to 1910 no uniform system existed to identify and route the growing number of drafts, checks and other payment documents passing among the nation's banks. It was not unusual to have several individual numbering schemes, each devised by a major correspondent or money center bank—serving the same small region.²⁵

Of course, to be effective, these numbers had to be printed on the checks when the check books were printed.

After 1899, a presentment section of the Uniform Negotiable Instruments Law ("U.N.I.L."), in the states which adopted it, pressed for speed in collections. Section 71 required presentment of demand instruments "within a reasonable time after issue," or, in the case of bills of exchange, "within a reasonable time after the last negotiation."²⁶ A same city/same day rule and a same day/deposit in the mail rule for out of town banks developed, perhaps out of the rules for notice of dishonor found in sections 103 and 104 of the U.N.I.L.²⁷

22. The occasionally cumbersome nature of this massive paper shuffling is described in M. MAYER, *THE BANKERS*, chs. 6, 7 (1981).

23. 75 U.S. 533 (8 Wall.) (1869) (ruling that federal tax on issue of bank notes could constitutionally be imposed on state chartered banks).

24. The discussion of routing numbers is, in substantial part, taken from the preface to the *KEY TO ROUTING NUMBERS* (1983) (the "KEY"). The American Bankers Association selected Rand McNally, the publisher, to assign routing numbers and publish the KEY.

25. *KEY TO ROUTING NUMBERS*, *supra* note 24, at v.

26. Section 71 of the Uniform Negotiable Instruments Law (U.N.I.L.) reads:

Where the instrument is not payable on demand, presentment must be made on the day it falls due. Where it is payable on demand, presentment must be made within a reasonable time after its issue, except that in the case of a bill of exchange, presentment for payment will be sufficient if made within a reasonable time after the last negotiation thereof.

A check is one form of bill of exchange. UNIF. NEGOT. INSTR. LAW § 71, *reprinted in* F. BEUTEL, *BRANNAN'S NEGOTIABLE INSTRUMENTS LAW* 151 (1948).

27. *KEY TO ROUTING NUMBERS*, *supra* note 24, at v-viii. U.N.I.L. sections 103 and 104 read:

As business became increasingly national in scope, a uniform national plan was needed. The American Bankers Association approved such a plan in 1911.²⁸ It originally consisted of two numbers separated by a dash. The numbers were printed following or near the date line on the check in the upper right hand quadrant, such as "3-1" or perhaps "16-4." The numbers to the left of the dash identified the city or state of the payor. The numbers to the right identified specific institutions within the designated geographical area.²⁹

The Federal Reserve System was created during Woodrow Wilson's administration.³⁰ One of its tasks was to eliminate the deductions that some banks took when paying checks presented by mail (the non-par banks). The Federal Reserve Banks were also instructed to expedite the collection of checks. By the late 1930's and early 1940's, the volume of checks was overwhelming the banking system. Then two developments occurred. One was a system of payor bank processing called "deferred posting and delayed returns."³¹ Items

Section 103. Where the person giving and the person to receive notice reside in the same place, notice must be given within the following times:

1. If given at the place of business of the person to receive notice, it must be given before the close of business hours on the day following;
2. If given at his residence, it must be given before the usual hours of rest on the day following;
3. If sent by mail, it must be deposited in the post office in time to reach him in usual course on the day following.

Section 104. Where the person giving and the person to receive notice reside in different places, the notice must be given within the following times:

1. If sent by mail it must be deposited in the post office in time to go by mail the day following the day of dishonor, or if there be no mail at a convenient hour on that day, by the next mail thereafter;
2. If given otherwise than through the post office, then within the time that notice would have been received in due course of mail, if it had been deposited in the post office within the time specified in the last subdivision.

F. BEUTEL, *supra* note 26, at 166-67.

28. *Id.*

29. Numbers one to forty-nine represented the network of reserve cities then in existence, and were assigned in the order of their population. Thus New York City was one, Chicago was two, and Philadelphia was three. Albany, New York was 29. Numbers 50-99 designated the 48 states and the District of Columbia. The numbers ending in zero (i.e., 50, 60, 70, 80 and 90) were assigned to the states which contained the principal collection centers in 1911, in the following order: New York (50); Pennsylvania (60); Illinois (70); Missouri (80), and California (90). The rise of the Sun Belt in the south and southwest came later with the development of air conditioning and, in the deserts, water systems.

The numbers to the right of the dash represent individual institutions. Each received an identifier having one to four digits. Because there were some 14,500 banking institutions in existence at this time (and at an earlier time there were more), some overlapping was, and still is, inevitable; but the duplication of numbers has been avoided in the same state or reserve city and only rarely occurs within the same Federal Reserve district.

30. Federal Reserve Act of Dec. 23, 1913, ch. 6, 38 Stat. 251 (1913).

31. *See* Leary, *supra* note 16, at 912 n.12.

received on Monday were "sorted" on that day, but the posting to the account and the final decision to pay or not were deferred until Tuesday.³² Clearing house rules were amended to permit items received in the morning clearings of one day to be returned at the return item clearing of the following banking day.³³ By 1949, seventeen states had adopted statutes authorizing this deferred posting,³⁴ and by the time the Code was promulgated in 1952, such statutes were in force in almost all of the states.³⁵ The Code, in section 4-301, adopted a similar rule.³⁶

The second development, implemented in 1945, changed the routing symbol to a fraction. The numerator was the old American Banker's Association identifier. The denominator was either three or four digits, depending upon which of the twelve Federal Reserve districts covered the location of the payor bank.³⁷

The fractions were used when the sorting was done visually and manually, as it was in the period between 1947 and 1952 when article four was being drafted. But the volume of checks to be processed daily and the cost of physical sorting continued to rise. In 1956, the automatic reader-sorters now in use appeared. These machines are capable of reading magnetic ink print at a speed far faster than the human eye and brain.³⁸ The new system called for a different method of placing the numerical routing symbols on checks. The symbols had to be printed in magnetic ink character recognition (MICR) form to permit the automatic reader-sorters to process the items. The

32. At the same time, a provisional settlement was made on Monday, subject to recovery on Tuesday, for unpaid items returned.

33. See Leary, *supra* note 16, at 912 n.12.

34. *Id.* at 906.

35. See U.C.C. § 4-301 comment 1 (1978).

36. U.C.C. section 4-301(1) permits settlements "made before midnight of the banking day of receipt" for demand items other than documentary drafts, to be revoked and recovered 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 is otherwise unavailable for return." U.C.C. § 4-301(1) (1978). The procedure is to supply a voucher for the repayment and to return the item to the bank refunding the payment.

37. The second digit in the three digit denominator, and the third digit where Federal Reserve districts 10, 11, and 12 were signalled, represented, in the case of numbers one through five, the Federal Reserve Bank or branch closest to the payor bank. Sometimes numbers six through nine were used to show special collection arrangements in the designated district.

The last digit in the denominator formerly signified when funds would be available after the check or other item reached the indicated Reserve Bank or branch. Now each Federal Reserve district has its own meaning for the final digit, but it must still be used in the routing symbols. KEY TO ROUTING NUMBERS, *supra* note 24, at v.

38. See Leary, *Check Handling Under Article 4 of the Uniform Commercial Code*, 49 MARQ. L. REV. 331, 334 n.8 (1965).

space at the bottom of the check was selected for the MICR line. As had occurred with availability schedules, the existing practice was rigidly followed with little or no space left for additional developments.³⁹ Three "fields" for the MICR numbers were set up with two alternative formats, one of which had to be rigidly followed in order for the reader-sorters to operate successfully. In one alternative, largely used for personal accounts, the first field was the routing symbol, the second was the so-called "on us" field, where the payor bank's own sorting information was encoded, and the third was for encoding the amount of the check. The "on us," or middle field, contained the drawer's account number and check number. In the second alternative, usable only on checks longer than six inches, the drawer's check number came first, followed by the routing symbol, the drawer's account number, and finally, the amount.⁴⁰

The routing symbol now consists of thirteen symbols; two "openers," two "closers," and nine digits. The digits consist of an adjusted denominator of the fraction, always consisting of four digits, immediately followed by the four digits of the institution identifier, and then a final check digit to ensure that the preceding digits have been correctly printed or electronically transmitted, as the case may be.⁴¹

B. MICR Fraud

With the introduction of the MICR line and automated processing, the stage was set for a brand new felonious little plan, only it is not necessarily so little. By forcing the item to go to two different locations, the felon could prolong the total time the item and the notice of nonpayment would take to get through the banking system so that the ultimate notice of nonpayment would be delayed beyond the established hold period. The felon could withdraw the funds and effect a getaway before the scheme was exposed. Other causes of "innocent enjoyment" would be served. It would no longer be neces-

39. The development of the standards for encoding checks with the MICR line is described in Clarke, *Mechanized Check Collection*, 14 BUS. LAW. 989, 990-91 (1959).

40. *Id.*

41. Whenever either the denominator or the institution identifier does not have four digits, the spaces preceding the actual digits are shown by zeroes on the MICR line. Thus 310, the denominator representing the third Federal Reserve district, Federal Reserve Bank of Philadelphia, will show as 0310 on the MICR line. Bank number one in that district will be 0001 and the ninth, or check digit, will be determined by a formula applied to 03100001, which in this case will be "1", so that the MICR routing symbol will be ".:031000011:."

The check digit is determined by multiplying each digit of the routing symbol by the digit falling under it when 371 371 37 is written below. Then the resulting $0+21+1+0+0+0+0+0+7$ is added, which here equals 29. The check digit will be the number necessary to raise the last digit to a "0"; in this case the check digit is "1."

sary for the felon to "case" the account on which the check was drawn to see how large a check could safely be written before the payor bank would return it for lack of sufficient available funds. It would no longer be necessary that the item be drawn on an actual account. Also, it would no longer be necessary to effect a "good" forgery so that payment would be made even if the check was one selected for signature verification.⁴² It would only be necessary to create an item that would continue traveling through the system long enough for the hold period to expire a full day or two before a notice of nonpayment would arrive.

This felonious little plan could be effective if the bank to which the item was presented could be tricked into believing it was a genuine item which had, through error, been "missent" to a bank other than the bank on which it was "properly" drawn. On that assumption, the first payor bank, or one of the intermediate banks, would divert the bogus item to a distant bank rather than return it to the depository institution, thus preventing a return within the hold period. This is the practice in the case of nonfelonious "missent" items. Indeed, the second payor bank need not actually exist; it need only appear to exist.⁴³ As a practical matter, no processing clerk would take the time to look in the most recent edition of the *Key to Routing Numbers*,⁴⁴ even if the item was one selected for visual inspection. Therefore, the felon would only need a superficial knowledge of routing numbers and a gullible or felonious check printer. The scheme called "MICR fraud" could thus come into being.

Northpark National Bank v. Bankers Trust Co. (Northpark),⁴⁵ was the first civil MICR fraud case. The MICR line on the check signalled Bankers Trust Company in New York (Bankers Trust), the fraction on the check signalled Detroit, and the printed name was "Bank of Detroit."⁴⁶ The MICR line was not printed in magnetic ink and therefore not machine readable. One of the first banks handling the \$62,500 item, however, placed it in a "carrier"⁴⁷ and encoded the

42. See *supra* text accompanying note 14. It still would be necessary for the felon to "case" his or her own account to determine the time span in which his bank would refuse to honor a draft drawn against a provisional credit for "uncollected funds."

43. See, e.g., *Northpark Nat'l Bank v. Bankers Trust Co.*, 572 F. Supp. 524, 526 n.4 (S.D.N.Y. 1983). In *Northpark*, the printed name on the check was "Bank of Detroit," which was not the name of any bank in existence in Detroit. This fact was not discovered until the item reached the Detroit branch of the Federal Reserve Bank of Chicago.

44. KEY TO ROUTING NUMBERS, *supra* note 24.

45. 572 F. Supp. 524 (S.D.N.Y. 1983).

46. This information was acquired by viewing a photocopy of the check, which was furnished to Professor Leary by counsel.

47. A "carrier" is a transparent glassine envelope which contains a lower edge of non-

MICR line thereon in magnetic ink. A look at the *Key to Routing Numbers* to verify the fraction or name would have shown that no Bank of Detroit existed, but no one did so until after the check had visited Bankers Trust via the Federal Reserve Bank of New York and had been sent to the Federal Reserve Bank of Chicago or directly to its Detroit branch.⁴⁸ There it was discovered that there was no Bank of Detroit. The check was then returned through channels to the Federal Reserve Bank of New York, which returned the check unpaid to the Federal Reserve Bank of Dallas. The Federal Reserve Bank of Dallas returned it through correspondents to the Northpark Bank of Dallas. The check was, of course, returned unpaid after the expiration of the "out of state" hold, and after the felon had successfully withdrawn \$62,500 from the account.⁴⁹ Judge Whitman Knapp, sitting in the Southern District of New York, ruled that the complaint stated a cause of action in negligence and denied the Federal Reserve Bank of New York's motion to dismiss.

The earliest case involving erroneous routing symbols involved a printer's error. In *Citizens State Bank v. Martin*,⁵⁰ the Supreme Court of Kansas determined, without discussion, that a bank designated solely by an erroneous MICR line was not a payor bank, nor was it a collecting bank, and that it owed no duty to give notice of a delay in transit.⁵¹ As we suggest later, the court correctly held that the bank was not accountable for the item, but erroneously concluded that it was not a payor bank.

In *Martin*, the bank delivered a book of checks with an erroneous MICR routing designation to a customer. On discovery of the error, the bank delivered a new book of checks and told the customer not to use the prior book. All went well for about six months, until the customer used some of the misprinted checks.⁵² As a result, the customer was convicted of felony theft. The *Martin* court ruled that the bank receiving the item due to the faulty MICR line designation had

transparent white paper on which a MICR line can be encoded. The current cost is 1.2 cents per carrier if purchased in quantity. In the alternative, banks may attach an adhesive white strip to the bottom of an instrument, upon which the MICR line may be printed. The current cost of the adhesive strip, if purchased in quantity, is 0.9 cents.

48. Despite much inspection of records, counsel could not establish either when the check left Bankers Trust Company or how it arrived at the branch of the Federal Reserve Bank of Chicago. Telephone conversation between Professor Leary and Thomas Baxter, counsel for the Federal Reserve Bank, after settlement of the case in 1985.

49. 572 F. Supp. at 527. The parties later settled after extensive and expensive discovery. Phone conversation between Professor Fairfax Leary, Jr. and Judge Whitman Knapp (1985).

50. 227 Kan. 580, 609 P.2d 670 (1980).

51. *Id.* at 587, 609 P.2d at 676.

52. *Id.* at 581-82, 609 P.2d at 672.

only those duties arising out of clearing house rules, and no violation of those duties had been asserted.⁵³ This case may well account for the selection of the Federal Reserve Bank of New York as the defendant in *Northpark* and other cases. The Kansas drawer had adopted the MICR line by using the misprinted check blanks,⁵⁴ thus the check, in fact, had alternate drawees.

The second successful MICR fraud scheme was described in an opinion denying motions to dismiss the complaint for failure to state a claim on which relief could be granted. The scheme in *United States Fidelity & Guaranty Company v. Federal Reserve Bank of New York (U.S.F. & G. I)*⁵⁵ involved a successful three-bank routing of a check for \$880,650 that worked despite flaws in the check production. The felon selected the Union Trust Company of Maryland, in Baltimore, as the depository bank. The counterfeit check had printed on it the name of a Philadelphia bank with an erroneous and misspelled street address and wrong zip code, a printed routing fraction for the State Bank of Albany, New York, and a MICR line routing symbol that started with the designation for the New York Federal Reserve District's Utica Processing Center. The balance of the MICR routing symbol indicated no known bank in that district. The check was first sent to Albany, which stamped it "Sent in Error" and returned it to Utica. The Utica Processing Center then forwarded the item to the

53. *Id.* at 584, 609 P.2d at 673.

54. Under U.C.C. section 3-102(1)(b), an "order" may be addressed to one or more drawees "jointly or in the alternative but not in succession." The Uniform Negotiable Instrument Law treated a draft drawn on a fictitious payee as a promissory note of the drawer. UNIF. NEGOT. INSTR. LAW § 130, reprinted in BEUTEL, *supra* note 26, at 80. The U.C.C. approach is different. Under the definition of "payor bank" contained in U.C.C. section 4-105(b), the designated drawee should qualify as a payor bank even if it has no prior relationship with the drawer, because the item is an order directed to it to pay. In the absence of some preexisting relationship between the drawer and the designated drawee/payor bank, however, the bank may dishonor the item with impunity. U.C.C. § 4-105(b) (1978). The drawer of a check engages that upon dishonor it will pay the amount of the draft to any holder or endorser. U.C.C. § 3-413(2). A drawee has no liability on the instrument until it accepts. U.C.C. § 3-409(1). The result is that the drawer is liable on the instrument, but a fictitious drawee will have no responsibility unless it accepts the item. See also, Federal Reserve Board, Regulation J, 12 C.F.R. § 210.6(a)(2) (1985) which provides:

A Reserve Bank may present or send an item based on the routing number or other designation of a paying bank or nonbank payor appearing in any form on the item when the Reserve Bank receives it. A Reserve Bank shall not be responsible for any delay resulting from its acting on any designation, whether inscribed by magnetic ink or by other means, and whether or not the designation acted on is consistent with any other designation appearing on the item.

Id.

55. 590 F. Supp. 486 (S.D.N.Y. 1984), *aff'd mem.* — F.2d — (2d Cir. Mar. 14, 1986) (referring to both 590 F. Supp. 468 and 620 F. Supp. 361, and stating that the result was correct).

Federal Reserve Bank of Philadelphia in a cash letter for payment, not as a return item. The Federal Reserve Bank of Philadelphia sent it to First Pennsylvania Bank which, two days later, refused to pay.⁵⁶

The depository bank had received the check from its customer on May 6, 1980. Having heard no adverse news on May 15, 1980, it permitted a \$755,000 withdrawal from an account having an "available" posted balance of \$881,615. To its horror, the depository bank received a telephone notice in the afternoon of May 16, 1980 that the check for \$880,650 was being returned unpaid. The true collected balance in the account was only \$965!⁵⁷

We can assume that Union Trust Company of Maryland rapidly informed its insurer of its potential loss of \$754,035 and that the insurer, with equal speed, reminded the bank that there was a \$100,000 deductible. They then, in an action which one can understand, made common cause to find some other bank to which to shift the loss. Counsel selected the Federal Reserve Bank of New York for a New York suit and also started a Pennsylvania action against two banks located there.⁵⁸ The New York complaint was filed in the District Court for the Southern District of New York. As it had in *Northpark*, the Federal Reserve Bank of New York moved to dismiss for failure to state a claim on which relief could be granted. On May 16, 1984, incidentally the fourth anniversary of that fateful day when notice of nonpayment was received, Judge Haight, sitting in the Southern District of New York, ruled that the complaint stated a claim for relief.⁵⁹

The district judges in *Northpark* and *U.S.F. & G. I* were both ini-

56. *Id.* at 490-91. Much of the factual material was obtained from materials filed with the Federal Reserve Bank of New York's motion for summary judgment made upon the close of discovery. It was supplied to Professor Leary by counsel for that bank. Additional facts have been obtained from the *U.S.F. & G.* opinions, and from conversations with various counsel in the case. See *United States Fidelity & Guar. Co. v. Federal Reserve Bank of N.Y.*, 620 F. Supp. 361 (S.D.N.Y. 1985), *aff'd mem.*, ___ F.2d ___ (2d Cir. Mar. 14, 1986) (*U.S.F. & G. II*); *U.S.F. & G.*, 590 F. Supp. 486 (*U.S.F. & G. I*) (prior ruling on complaint).

57. Although the felon's account had been opened at one branch, the large item was deposited at another branch. The teller handling the deposit failed to place a hold on the balance. The teller also failed to comply with a bank policy requiring tellers to notify the branch manager when checks over \$100,000 were received for deposit. 620 F. Supp. at 363-64. The motion papers contain a copy of a "Disciplinary Memorandum" placed in the teller's personnel file.

The felon, believed by the F.B.I. to have also obtained \$192,000 by a similar fraud against a Hartford, Connecticut bank (there was a "wanted" poster in the motion papers), apparently believed that a six banking day hold had been placed, or that an earlier withdrawal would arouse suspicion. A weekend intervened between May 6 and May 15.

58. Counsel sued the First Pennsylvania Bank and The Philadelphia National Bank. The two cases were later consolidated in the Southern District of New York.

59. *U.S.F. & G.*, 590 F. Supp. at 501. Subsequently, on October 19, 1985, Judge Haight

tially faced with motions to dismiss complaints in negligence based on a claimed failure of the Federal Reserve Bank, as a collecting bank, to exercise ordinary care in handling items on their return journey. In *Northpark*, Judge Knapp correctly found the governing rule in section 4-202 of the U.C.C.⁶⁰ He adopted a narrow and, we believe, erroneous view of U.C.C. section 4-202(1)(e) on delay in transit after reading the comments to earlier drafts of the subsection.⁶¹ He did not note the significant restructuring of the fundamental approach to the system of check collections embodied in subsequent drafts, as we shall subsequently explain, nor did he apply a broad reading of the word

granted motions for summary judgment submitted by the various defendants. 620 F. Supp. at 373.

60. 572 F. Supp. at 531. U.C.C. section 4-202 provides:

- (1) A collecting bank must use ordinary care in
 - (a) presenting an item or sending it for presentment; and
 - (b) sending notice of dishonor or non-payment or returning an item other than a documentary draft to the bank's transferor [or directly to the depository bank under subsection (2) of Section 4-212] . . . after learning that the item has not been paid or accepted, as the case may be; and
 - (c) settling for an item when the bank receives final settlement; and
 - (d) making or providing for any necessary protest; and
 - (e) notifying its transferor of any loss or delay in transit within a reasonable time after discovery thereof.
- (2) A collecting bank taking proper action before its midnight deadline following receipt of an item, notice or payment acts seasonably; taking proper action within a reasonably longer time may be seasonable but the bank has the burden of so establishing.
- (3) Subject to subsection (1)(a), a bank is not liable for the insolvency, neglect, misconduct, mistake or default of another bank or person or for loss or destruction of an item in transit or in the possession of others.

U.C.C. § 4-202.

61. The relevant portion of the decision states:

The history of U.C.C. § 4-202(1)(e) can be traced at least back to the Proposed Final Drafts Nos. 1 and 2 of Article III on commercial paper. The relevant section in Draft No. 1 was appropriately entitled "*Lost Items*," see § 715 (Draft No. 1, April 15, 1948) (emphasis added), and in Draft No. 2 it was called "*Loss of Cash Items in Transit*." See § 713 (Draft No. 2, July 30, 1948) (emphasis added). Their respective notes and comments leave no doubt that the "delays in transit" which the drafters contemplated were those occasioned by mishaps in the mails. See Notes and Comments to Draft No. 1 at 71 (April 15, 1948); Notes & Comments to Draft No. 2 at 17 (August 2, 1948). See also UCC § 3-611(2) (1948 Edition). We have found nothing in the subsequent legislative history to persuade us that the several stylistic mutations which eventually led to UCC § 4-202(1)(e) modified the above described legislative intent.

572 F. Supp. at 531.

Notwithstanding the judge's conclusion regarding subsequent drafts, the later drafts and the final draft were based on a different "system" which incorporates major changes. Among other things, this different system 1) eliminated the liability of correspondent banks for the conduct of their transferees, 2) eliminated different collection channels for cash items and noncash items, and 3) omitted any specific duty to trace. See *infra* text accompanying notes 63-67.

“transit,”⁶² necessitated by a systems approach to the MICR fraud problem. Nor did he analyze the careful structure of U.C.C. section 4-202.

As finally adopted, U.C.C. section 4-202(1) imposes on a collecting bank the duty to use ordinary care in performing the five general tasks of a collecting bank. Three of these refer to a collecting bank's own actions.⁶³ The other two tasks appear to have application to the MICR fraud situation, but each of these tasks is triggered by the requirement of “learning” or “discovering” an action by another bank. The first of these duties is found in U.C.C. section 4-202(1)(b), which requires ordinary care in “sending notice of dishonor or non-payment or returning an item other than a documentary draft to the bank's transferor . . . *after learning* that the item has not been paid”⁶⁴ The second subsection, U.C.C. section 4-202(1)(e), calls for ordinary care in “notifying its transferor of any loss or delay in transit within a reasonable time *after discovery* thereof.”⁶⁵

One point both judges overlooked in the recent cases was the use of the words “learning” and “discovery” in the two subsections as conditions precedent to the necessity to act. Research should have led to U.C.C. section 1-201(25)'s post-amble which explains that “[d]iscover’ or ‘learn’ or a word or phrase of similar import refers to knowledge rather than to reason to know.”⁶⁶ “Knowledge” means actual knowledge rather than reason to know.⁶⁷ Unfortunately, the definitional cross references following the comment to section 4-202 do not flag these words for researchers.

In *Northpark*, Judge Knapp ruled that the complaint stated a legally sufficient claim in negligence.⁶⁸ He also stated that, at trial,

62. Because the system of holds is implicit in U.C.C. section 4-213(4)'s proviso that “the bank has had a reasonable time to learn that the settlement is final,” the “transit” involved is the round-trip journey of the item to one payor bank and back unpaid. Also, it should be noted that a bank never has actual knowledge that an item has been paid. More appropriately, in any revision of the Code, the language should be “until the bank has had a reasonable time to receive a return of the item if it is not being paid.” U.C.C. § 4-213(4)(1978). On March 14, 1985, the decision was affirmed by the Second District Court of Appeals in a four page opinion at Docket No. 85-7912, ten days after oral arguments.

63. U.C.C. § 4-202(1).

64. U.C.C. § 4-202(1)(b) (emphasis added).

65. U.C.C. § 4-202(1)(e) (emphasis added).

66. U.C.C. § 1-201(25).

67. Thus, grammatically the duty of ordinary care applies only to a bank's own actions. Where actions by others are involved, the bank's affirmative duty to act is triggered only by actual knowledge. This is consistent with U.C.C. section 4-202(3), which provides that a bank is not responsible for the conduct of another bank or person or for another bank's insolvency except, of course, as prior knowledge may affect the propriety of the selected routing. U.C.C. § 4-202(3) (1978).

68. 572 F. Supp. at 535.

the plaintiff must prove that the differences in the MICR line and the printed drawee named on a check arise predominantly when the check is fraudulent, rather than through innocent error.⁶⁹ If this could be shown, a duty to notify the depository bank would arise out of the general duty of ordinary care. The judge's reasoning imposes a duty arising, at best, from a "reason to suspect" rather than the actual knowledge which is the basis of the duty to use ordinary care in sending notice "when learning" that the item has not been paid.⁷⁰

In *U.S.F.&G. I*, Judge Haight placed the burden on the plaintiff to convince the trier of fact of the foreseeability that returning the item to the Federal Reserve Bank of Philadelphia would result in that Federal Reserve Bank's failure to return the check to Union Trust Company without diversion. The plaintiff also had to prove that it was foreseeable that loss would result from the Federal Reserve Bank of Philadelphia's failure to return the item to Union Trust. Further, the plaintiff had to prove the foreseeability, given existing banking procedures, that the Federal Reserve Bank of New York would have detected the fraud, detected the risk, and taken curative action.⁷¹ This ruling ignored both the actual knowledge requirement of U.C.C. section 4-202, which applies when dealing with the actions of another bank, and the rule that a bank is not liable for the negligence of others in the collection chain.

Judge Haight imposed other burdens, requiring the trier of fact to determine whether this type of fraud was so common that the Federal Reserve Bank of New York should have taken exceptional precautions to detect it in carrying out an overall duty to exercise ordinary care. If the trier of fact determined that special precautions

69. *Id.* at 534-35. Judge Knapp stated:

If day-to-day banking experience should demonstrate that inconsistencies are usually the result of simple error, there would be no reason to assume that a conscientious banker should become alarmed at learning of an inconsistency or deem it his duty to notify anyone. On the other hand, if day-to-day banking experience should establish that such inconsistencies are usually an indication of fraud, then it might well be argued that a collecting bank, in satisfying its obligation of ordinary care, should take steps promptly to notify a prospective victim in the collection chain.

Id. (citations omitted). The court also stated that "[t]he plaintiff may, if it be so advised, amend its complaint to allege facts suggesting that routing code inconsistency should be regarded as indicating the probability of fraud; and may conduct appropriate discovery on that issue." *Id.* at 535.

70. See U.C.C. § 1-201(25). The two-pronged "own acts" and "actual knowledge" approach of U.C.C. section 4-202(1) is needed to enable banks to cope, cost-effectively to the holders of the 99% of the checks that are good, with an automated mass handling system in which there is no time for the protective reflection implicit in the concepts of "reason to know" or "foreseeability."

71. *U.S.F.&G. I*, 590 F. Supp. at 498.

were unwarranted, the trier of fact should then determine whether following standard banking procedures would have led to detection of the fraud and anticipation of Union Trust Company's loss.⁷² This last element involved two further decisions. First, whether it was reasonably foreseeable that a check bearing inconsistent routing designations would be rejected by the second payor. Second, if ordinarily such inconsistencies result from innocent printers' errors, then the trier of fact should consider whether the characteristics of the particular check were such that a bank exercising ordinary care would have recognized the check as bogus.⁷³

Quite apart from the extreme complexity of the trial evidence that would be required under the above tests, and the resulting probability that a jury would have difficulty handling such issues, this application of foreseeability tests ignores the drafting precision of the Code's bank collections material. There is no overall imposition of a duty of ordinary care in U.C.C. section 4-202. It specifies five discrete tasks to be performed with ordinary care.⁷⁴ These tasks were specified after lengthy consideration of the 1948-1952 mass production nature of check collections. Furthermore, they apply equally to non-cash items, and were carefully drafted in light of the nature of collections of such items. The duty of ordinary care is imposed in two of the tasks *only* after the condition precedent to the exercise of that task has been satisfied, namely a "discovery" or a "learning" (that is, actual knowledge). Section 4-202 recognizes that the duties of collecting banks are ministerial and largely mechanical, except when the bank presents an item to a nonbank payor. The duties were and are done routinely by clerks performing monotonous repetitive tasks. These jobs are now largely automated so that human inspection of checks and other cash items is avoided whenever possible. Therefore, in the case of sending notices or returning items, the Code required actual knowledge of a prior nonpayment and imposed a duty to use reasonable care in sending notice thereof to the transferor, or alternatively, in returning the item to the transferor in lieu of sending the notice.⁷⁵

The Code provisions express the policy that each participant may rely on the others to conduct themselves properly. U.C.C. section 4-202(3) provides that a bank complying with its duties under subsection (1) of that section is not liable for the acts of another bank except under subsection (1)(a). This exculpation includes the handling of the

72. *Id.* at 499.

73. *Id.*

74. *See supra* text accompanying notes 63-67.

75. *See infra* notes 101-03 and accompanying text.

item on its way to a payor bank and of the item or notices on the return journey.

Thus, considering only U.C.C. section 4-201(1)(b), while the Federal Reserve Bank of New York had actual knowledge of a non-payment by State Bank of Albany, if it had given notice of that fact by sending the item to its *de jure* transferor as a return item, it should not have been responsible for any losses caused by the action of its transferor.⁷⁶ The Code clearly intended to provide that each bank in the chain of collection is not its brother's keeper.

An item sent for collection through a Federal Reserve Bank is subject to the regulations of the Federal Reserve System.⁷⁷ Each Federal Reserve Bank deals only with banks in its own district. It carries the reserve accounts of those banks only, except as specifically arranged with other Federal Reserve Banks. Check collections operate by giving immediate provisional credit for cash items forwarded for collection, subject to refund on a return "with entry."⁷⁸ In view of the pressures to reduce the duration of bank holds, and to save a stop on the item's journey to the payor bank, a Federal Reserve Bank may give a bank in its district the privilege to send items directly to the Federal Reserve Banks and processing centers in other Federal Reserve cities, with the consent of each Federal Reserve Bank involved, if the usual volume of items justifies the practice.⁷⁹

Nevertheless, despite "direct send" privileges, the provisional credits are set up so that the direct sender's provisional credit is with the Federal Reserve Bank of its own district.⁸⁰ Since return items are

76. Note, however, on the basis of the extensive discovery conducted after denial of the motion to dismiss and the evidence submitted in connection with the motion for summary judgment in *U.S.F.&G. II*, Judge Haight found that when the item was received as a return item at Utica, it was "swapped" into a cash item letter and sent to the Federal Reserve Bank of Philadelphia. This action indicates that it was to be presented for payment to First Pennsylvania Bank, and treated as a normal "free" or "missent" item. See *U.S.F.&G I*, 590 F. Supp. at 490-91 (Judge Haight felt this might not be discoverable).

77. See 12 C.F.R. § 210 (1985) (the provisions of regulation J, which, in cases of conflict with the Uniform Commercial Code, constitute "agreements otherwise" varying the effect of Code provisions); U.C.C. § 4-103(2).

78. "With entry" or "without entry" are terms used to indicate whether or not the sender is calling for any immediate entry into a mutual account in connection with the return item.

79. 12 C.F.R. § 210.4 (1985).

80. See FEDERAL RESERVE BANK OF PHILADELPHIA, OPERATING CIRCULAR NO. 5, COLLECTION OF CASH ITEMS ¶ 18, at 5-2 (revised February, 1982). The Federal Reserve Bank of Philadelphia's circular provides:

A sender that maintains or uses an account with us and that has cash items payable in another District may send the items directly to the Reserve Office of the District under procedures we prescribe. Under Section 210.4 of Regulation J, items sent direct are deemed to have been handled by us. Senders that by arrangement deliver cash items payable in other Districts to us or to another

few in number and expensive to handle, the extra expense of a direct return with a separate sending to reverse the provisional credits is avoided by sending return items to the Federal Reserve Bank in whose district the physical transferor was located. Thus, Judge Haight decided that for purposes of U.C.C. section 4-202, the Federal Reserve Bank of Philadelphia was the *de jure* transferor of the Federal Reserve Bank of New York in *U.S.F. & G.*

Judge Haight correctly recognized this practice and concluded in *U.S.F. & G. I* that the return of the item to the Federal Reserve Bank of Philadelphia did not constitute a lack of ordinary care. Since this additional stop on the return journey is standard procedure, the depository hold periods should have been and probably were calculated with this in mind. Thus, in *U.S.F. & G.*, the check deposited in Baltimore on May 6th was sent back from State Bank of Albany on May 9th and reached the Federal Reserve Bank of Philadelphia, via the Federal Reserve Bank of New York, in time to be sent forward by the Federal Reserve Bank of Philadelphia on May 14th, the weekend of the 10th and 11th having intervened. Had the check been returned to Philadelphia National Bank instead of being diverted by cash letter to First Pennsylvania Bank, it is possible that Union Trust Company would have received wire notice of the return in time to prevent the May 15th withdrawal. No wire notice of nonpayment was required as neither the Federal Reserve Bank of Philadelphia nor Philadelphia National Bank were originally alleged to have received a wire notice of nonpayment.⁸¹ On the other hand, if the correspondent relationship between Philadelphia National and Union Trust Company involved a custom of wiring notice of nonpayment, regardless of whether a wire had been received, then Union Trust Company might

designated location for consolidated shipment should give us prior notice of any deviation from that agreement.

Id. The Federal Reserve Bank of New York's operating circular provides:

We may permit or require a sender that maintains or uses an account with us and that has a substantial volume or dollar amount of cash items payable in another District, or in the territory of another office of this bank, to send the items directly to the Reserve Office of that District or territory. We will give additional instructions to a sender authorized to send direct. If we authorize a sender to send items direct, we may refuse to accept these items from the sender. Under section 210.4 of Regulation J, items sent direct under our authority are deemed to have been handled by us.

FEDERAL RESERVE BANK OF NEW YORK, OPERATING CIRCULAR NO. 4, COLLECTION OF CASH ITEMS ¶ 7, at 6 (revised Nov. 13, 1980).

81. 590 F. Supp. at 490-91. It is not clear whether State Bank of Albany sent wire notice to the Federal Reserve Bank of New York. Under Regulation J and the relevant Operating Circulars at that time, a Federal Reserve Bank not receiving a wire notice was under no obligation to give one.

have received notice on May 14th and could have blocked the account.

After the motion to dismiss was denied, the parties conducted extensive discovery. Based on this discovery, the Federal Reserve Bank and other defendants filed motions for summary judgment. They asserted that the actions of Union Trust, as it handled the deposit of the check and permitted the withdrawal of the funds without further investigation, despite having previously been told that the check was drawn on a nonexistent account, barred any recovery. In granting these motions, Judge Haight described Union Trust's conduct as "more than mere negligence, for it entailed acting in the face of a known and obvious risk. Viewed in its entirety, Union Trust's conduct was breathtakingly foolhardy; nay, commercially suicidal."⁸²

Judge Haight declined to assign liability to the depository bank, the first bank to refuse payment, or the "purported payor," on the basis of who was best able to detect the fraud. Rather, the judge turned to U.C.C. section 3-406, stating that he was "persuaded that it [was] appropriate to apply its spirit by analogy to apportionment of loss due to MICR fraud."⁸³ He ruled that the record disclosed that "the recklessness of Union Trust played a substantial—nay, indispensable—role in the success of this fraud."⁸⁴ He granted summary judgment to the Federal Reserve Bank of New York, State Bank of Albany, and Philadelphia National Bank.

Despite facts indicating that First Pennsylvania Bank had failed to return the item within its midnight deadline, Judge Haight also granted its motion for summary judgment. He ruled that U.C.C. section 4-302 did not "shift the burden of loss to a payor bank which misses its deadline if the payee was already aware when presenting the check that it would not be accepted or paid except by mistake."⁸⁵ While the decision does not explicitly so state, this ruling must rest on the preamble of U.C.C. section 4-302, which states that accountability will exist only "[i]n the absence of a valid defense such as breach of a presentment warranty (subsection 1 of section 4-207), settlement effected or the like."⁸⁶ Although Judge Haight is correct, the rule he adopted is unfortunately not as well established as it should be. Judge Haight implicitly ruled that learning that First Pennsylvania Bank carried no account on which the check was drawn was analogous to

82. 620 F. Supp. at 368.

83. *Id.* at 372.

84. *Id.* at 373.

85. *Id.*

86. U.C.C. § 4-302.

the other exceptions to the accountability rule under the phrase "or the like."

Such defenses are beyond the scope of this article. We discuss the allocation of loss in the case where the banks involved are not reckless or "commercially suicidal." Judge Haight notes the problem in his opinion in *U.S.F.&G.*, stating: "If such fraud is carried out with more sophistication than demonstrated by Goldstein [the depositor] the deposit and collection of funds may escape the notice of even a careful bank."⁸⁷

II. A SYSTEM-ORIENTED ANALYSIS OF MICR FRAUD

The purpose of this article is to show that if one takes an approach to the issues in such cases which views the entire system of bank collections as a superior biologist would view an ecological system,⁸⁸ one could and should reach a result somewhat different from the one reached in the recent MICR fraud cases. There are protective measures available to prevent losses in situations involving what are essentially diversions from the customary and reasonably anticipated physical journey traversed by the vast majority of checks. These protective measures should be applied whether the situation involves fraud or an honest error in check production because the purpose of the hold procedure is to protect the system against the normal risk of nonpayment of ordinary checks. In either case, the risk of a non-recoverable withdrawal is present. If the situation involves a counterfeit check, then the nonrecoverable withdrawal risk is practically a certainty. If an honest error is involved, the bulk of the risks are still present, but the diversion extends those risks for an unexpected longer period of time.⁸⁹ The issue is whether the U.C.C. or Regulation J of

87. 620 F. Supp. at 371. In a telephone conversation with Professor Leary shortly after the opinion in *Northpark* was published, Judge Knapp stated that, in addition to this case, in criminal court settings he had tried five cases involving the same fraud.

88. This point was made by John Cairns, Jr., Distinguished Professor of Biology, Virginia Polytechnic Institute, in an oral tribute delivered in Philadelphia to the distinguished biologist Ruth Patrick Hodge. Professor Cairns stated, "Scientists capable of 'thinking systems' are exceedingly rare. Most biologists both think and work at the species level and, although they may talk about systems, rarely incorporate that level of biological organization into their research." Leary & Fry, *A "Systems" Approach to Payment Modes: Moving Toward A New Payments Code*, 16 U.C.C. L.J. 283 (1984) (citing Professor Cairns). Lawyers rarely do so either. The authors suggest, however, that thinking "systems" is essential when dealing with any rule of law relating to bank collections.

89. Usually only payor banks use the full midnight deadline. See U.C.C. § 4-104(1)(h) (encompassing the balance of the day of receipt plus 24 hours of the next following banking day). Assume a six day "out of state hold" and actual time in transit to a payor bank and back of six days. A diversion to another bank for payment would add at least two more night-time travels, plus another midnight deadline. The return would then arrive on day eight in the

the Board of Governors of the Federal Reserve System now provides for an appropriate warning, and if the answer is no, whether an amendment is needed?

The authors believe that the underlying philosophy of the bank collections provisions of the U.C.C. rest on several principles basic to the system, all of which must be considered to determine, first, where any new forms of loss should fall, and second, when the initial liability should be shifted because preventive steps have not been taken.

A. *Notice of Delay in Transit of Checks*

The first principle is that each participant in the chain of collection must operate on the assumption that every other participant will act properly. Statistically, due to the automated collection of checks in bulk, all but a miniscule percentage of checks in the process of collection are properly handled. In view of the desired speed in check handling, this assumption should only be defeated by actual knowledge to the contrary, either as to practices or procedures.

Whether an organization⁹⁰ has knowledge should be determined in accordance with the Code's rules for determining notice to an organization. Section 1-201(27) provides that the key for organizational knowledge is the knowledge of "the individual conducting the transaction."⁹¹ In today's world this must be taken to mean the person in charge of the machine that performs the transaction, and having the organizational power to direct the manner in which it operates. In the case of notice, a failure to act or to communicate data can, in certain circumstances, result in liability.⁹² Similarly, depending on like circumstances, a failure to reprogram where a potential for harm exists should result in liability. Preventive measures requiring visual examinations, which would give knowledge and thus trigger a duty to give notice, should only be required at a point

afternoon, rather than day six. The "system" would have permitted withdrawal on day seven by the successful felon, who could thus serve his capacity for innocent enjoyment.

90. U.C.C. section 1-201(28) provides that "organization" includes a corporation, government or governmental subdivision or agency, business trust, estate, trust, partnership or association, two or more persons having a joint or common interest, or any other legal or commercial entity. U.C.C. § 1-201(28).

91. U.C.C. § 1-201(27).

92. U.C.C. section 1-201(27) brings foreseeability of harm into play by making notice effective not only when brought to the attention of the person conducting the transaction, but also in any event when it should have been brought to his or her attention, by an organization exercising due diligence. The second sentence provides guidelines for the determination of "due diligence." These guidelines include a duty to communicate when the one having the information has "reason to know" of both the transaction and that "the transaction would be materially affected by the information." U.C.C. § 1-201(27).

where the least number of checks would need to be examined; yet it should be a point where an appropriately effective degree of prevention could be obtained with any remaining losses affordably absorbed. We suggest that only two points in the collection process should be considered in MICR fraud cases.

The first point at which a visual examination might be required is where the high speed reader-sorters reject the item as not machine processable and the item itself cannot be made machine processable.⁹³ Rejections constitute a small percentage of the total. In both of the reported cases of MICR fraud, the entire MICR line was not printed in magnetic ink and the item was rejected by the machines. The figures were proper in *Northpark* but not machine readable. The rejection was cured by placing the item in a "carrier" and encoding figures in magnetic ink on the carrier's lower band.⁹⁴ Had this been attempted in the *U.S.F. & G.* case, the court might have held that the encoding bank had knowledge that the routing symbol was short one digit and that the named bank was located in Philadelphia, the Third Federal Reserve District's Reserve City, not in the Second Federal Reserve District, as indicated by both the first four digits of the second field and the routing fraction—particularly in light of the proximity of Baltimore and Philadelphia.

The other point at which a visual examination might be required is in the return item process. But where in that process? A visual inspection of the face of an item is necessary in order to divert it from its return journey to the depository bank, thus giving us the second point. The visual inspection could occur at the first bank to which the item was sent for payment. That bank might forward the item in a low speed cash letter to the other possible payor bank, rather than returning it to its transferor.⁹⁵ The Code should classify this action as causing a "delay in transit." This classification would be within the spirit of U.C.C. section 4-202(1)(e), if not its letter. Under U.C.C. section 4-202(1)(e), notice of such a delay would then be required.⁹⁶

If, however, as in *U.S.F. & G.*, the first bank receiving the item for

93. Ways to make the item machine processable include placing the item in a carrier or adding an adhesive strip at the bottom. *See supra* note 47.

94. *See supra* text accompanying note 47.

95. The receiving bank might divert the item if it perceived the item to be a "missent item." The term "missent item" refers to an item with a name and numbers pointing to Bank B which somehow became part of a cash letter delivered for payment to Bank A. Clearing houses have rules for "missent items." They are often routinely forwarded to another bank without notice to the depository bank.

96. *See* U.C.C. § 4-202(1)(e). As presently worded, the section appears to require the notice to go to the bank's transferor. U.C.C. section 4-202(1)(b) provides for direct returns to the depository bank. Subsection (e) should do the same.

payment returns the item to its transferor and that transferor, or another intermediary bank, extends the return journey by sending the item to another potential payor, that action constitutes a delay of the return journey. The diverting bank has knowledge of the delay obtained from its own action. The negative notice of payment in the cash item collection ecosystem requires that a notice of the delay be given to the depository bank. The reason for this is not that there is a badge of fraud or the like. The reason is that the funds-availability system is based on a failure to receive notice of dishonor or nonpayment within a time frame measured by a transit period to one bank and back. Even if the item is properly drawn on the second bank, the time during which the depository bank is subject to risks of nonpayment has been extended without its knowledge.

Of the two points—initial rejection by high speed processors, and what we may call the diversion point—we believe the diversion point should be, and on a systems approach must be, selected as the place where notice of delay in transit should be initiated. Reasons for this will be set forth at a later point. But how should the notice be given?

The wire notice provisions of the Federal Reserve System, as presently drafted, do not suffice. They apply only to payor banks. As set forth in the operating letters or circulars of the several Federal Reserve Banks, these rules did not, prior to October 1, 1985, require the Reserve Banks to do more than forward by wire any notices received by wire.⁹⁷

As to whether U.C.C. section 4-202(1)(b) required the Federal Reserve Bank of New York to do more than return the item to the Federal Reserve Bank of Philadelphia, Judge Haight stated in *U.S.F. & G. I.*: “Section 4-202(1) of the U.C.C., which requires ordinary care in notifying downstream banks of dishonor, is best interpreted as requiring a bank to send notice of dishonor reasonably calculated to reach the depository bank in time to prevent a withdrawal against a dishonored check.”⁹⁸ He then said that if it was reasonably foreseeable that the check would be diverted from its return to the depository and rejected by another bank, “New York Fed failed to use ordinary care in routing the check to Philadelphia Fed without taking some precaution to avoid the foreseeable risks. Because it apparently sent no other notice of dishonor to Union Trust, it would

97. *U.S.F. & G.*, 590 F. Supp. at 493. See also FEDERAL RESERVE BANK OF NEW YORK, OPERATING CIRCULARS NOS. 4 & 6, ¶¶ 20 & 23 (revised Sept. 18, 1979).

98. 590 F. Supp. at 497-98. We note that the Second Circuit in its memorandum affirmance (*supra* note 55) referred with approval to *U.S.F. & G. I.* This is unfortunate as the discussion of foreseeability is not applicable.

have failed in its duty of ordinary care under § 4-202.”⁹⁹

Judge Haight’s statements are supported by an extensive footnote which displays a fundamental misconception as to the coverage of the Code. The footnote contains the statement:

As New York Federal points out, returning the check does provide notice, since the check is generally stamped “unpaid” by the dishonoring bank. However, because returning the dishonored check is a nearly universal practice within the industry, a fact which must have been known to the drafting committee, New York Fed’s argument raises the question of why the alternative requirement of sending notice was included at all. Plainly the drafting committee did not intend both notice and return in all cases, since it made the provision disjunctive. However, by including the separate provisions for notice it seemed to indicate recognition that the standard practice of returning a check, which does provide notice, would not always suffice. The reference to notice is otherwise essentially redundant.¹⁰⁰

With respect, the footnote indicates that the learned judge overlooked the fact that, in its final form, U.C.C. section 4-202 covered all types of items, including “cash items” as well as “collection items.” It also covered notice of dishonor, notice of nonpayment, and returning the item.¹⁰¹ Placing the three actions in the alternative, as the Code did, indicates that only one need be done. Despite the sensitivity to the needs of the collection system elsewhere reflected in his rulings, we submit that in this case the judge overlooked the need to consider that system, in which the provisional credit had to be reversed, and that a return of the item itself was required as a voucher to do this.¹⁰² If, on the other hand, the item was a demand item being held for protest by a payor bank, as section 4-301(1)(b) provides, only

99. *Id.* at 498.

100. *Id.* at n.20.

101. *See supra* note 61. The judge overlooked the fact that these were all permissible alternatives for the sender, often a payor bank of a noncash item. U.C.C. section 4-301(1)(b) lists only one limited alternative to returning the item, if it is a cash item. Section 4-202 must cover a collecting bank which presents a noncash item to a nonbank payor, as well as cash items. Even if the noncash item is something other than a documentary draft, common sense would dictate that the item might be retained to see if ultimate payment could be secured. The drafting decision that rules must cover both cash items and noncash items mandated a listing of what might be required in the alternative. *See* U.C.C. § 4-202.

102. The use of the second alternative in U.C.C. section 4-301(1)(b) is indeed limited. The payor bank must return the item itself, or may send written notice if “the item is held for protest or is otherwise unavailable for return.” U.C.C. § 4-301(1)(b). The term “otherwise unavailable for return” has not yet received judicial interpretation. *Cf.* *United States v. Loskocinski*, 403 F. Supp. 75 (E.D.N.Y. 1975) (grand jury subpoena vacated because penalty for not returning item too severe to force bank to assume risk that New York courts might not consider subpoena sufficient to make item “otherwise unavailable”).

a notice could be sent in respect of a "cash item." Since section 4-301(1)(b) is in part three of article four, the part relating to payor banks, the drafters did not feel it was necessary to state fully, in the exception in section 4-202, what collecting banks should do about returning notices or items where "demand items other than documentary drafts are concerned." The demand documentary draft was excepted from the return requirement since part five of article four, relating to documentary drafts, requires retention by the last presenting bank where a nonbank payor is involved.¹⁰³ Section 4-202 also covers time items and other items not customarily returned.

The learned judge's approach would have the drafters write into each section where alternative actions are listed additional words indicating that any alternative suffices for all others named. That was not the drafting style, which was, rather, to indicate when alternatives were not co-equal, as in U.C.C. section 4-301(1). Further, a systems approach would not require this. In the case of cash items, this approach is contrary to the principle that in the absence of actual knowledge a bank is entitled to assume that other banks have performed correctly.

The court's approach in *U.S.F. & G.* also overlooks the fact that grammatically the duty to use ordinary care governs the "sending" and not what is to be sent. The "[s]ubject to subsection (1)(a)" language in subsection three indicates when "ordinary care" relates to the actions, or foreseeable actions, of the person to whom something is sent. The continued use of "foreseeable" in Judge Haight's formulations also overlooks the actual knowledge content of the conditions precedent in U.C.C. section 4-202(1)(b) as well as in U.C.C. section 4-202(1)(e). Furthermore, the hold periods differ from depositary bank to depositary bank, so that there is no way, for example, that the Federal Reserve Bank of New York could have had any knowledge of the actual length of Union Bank's hold period for any particular item. Finally, Judge Haight's requirement of some form of notice in addition to the required return of the item itself would apply to every collecting bank in every chain of collection, unduly enlarging the number of notices and the costs of operating the system.

If the penalty for not giving a notice of the extension of the total transit time from the start of the collection process to its finish back at the depositary bank is to be the damage caused by the failure to send the notice, and the principle of placing liability for misdeeds upon the wrongful actor is to be used, then the onus should be placed on the

103. U.C.C. § 4-503. Note that the presenting bank must also originate and send a notice of dishonor in the case of all "on arrival" drafts. U.C.C. § 4-502.

bank initiating the diversion from the customary return journey.¹⁰⁴ Collecting banks should not be required to make a detailed examination of all return items under a foreseeability test.

By considering every dispatch in the "return item" channel as a return to the depository bank, we avoid two awkward decisions. The first is determining the status of a bank, as payor or collecting bank, to which an item is missent for payment by reason of the numerals on the item. The second is that we avoid Judge Haight's worry in *U.S.F. & G. I* about how to prove the intent with which, for example, New York Fed returned the item to the Federal Reserve Bank of Philadelphia.¹⁰⁵ The intent should not be relevant. Return to a transferor, or directly to the depository bank, should be a proper action in all circumstances. The issue should be resolved by considering all such returns as proper in the absence of proof of specific instructions directing, or specific action creating a diversion from the journey to one bank and back.

By a proper interpretation of U.C.C. section 4-202(1)(e), liability would be placed on the bank diverting the return from the normal route back to the depository bank. The diverting bank, by its own actions, will have actual knowledge that the transit from depository bank to one bank, thought to be a payor bank, and back has been delayed¹⁰⁶ by the transit to the second bank for payment and back. This places the burden for giving notice of delay on the first bank to have actual knowledge of the delay. No jury or other trier of fact has to speculate on the foreseeability of a future diversion by a bank to which a return item is routinely sent. The basic principle of placing

104. See *supra* text accompanying notes 93-95.

105. 590 F. Supp. at 497. Of course, if the item is "swapped" from a return item letter to a forwarding cash item letter (see *supra* note 76), the purpose of the return is clearly stated. The knowledge thus acquired is that any ultimate return for nonpayment is delayed.

106. Under this principle, the bank with actual knowledge that it is making a diversion bears the burden of initiating and forwarding a notice. Unlike a payor bank simply returning an item, it takes deliberate action to send the item on a journey different from the one it would normally follow. If that bank is a collecting bank, it also knows that the item has already been presented to one bank for payment.

A problem arises in the case of items innocently missent but having a single payor. In this case, possibly the resulting loss should be placed on the sending bank that misdirected the item. In any revision of the language of U.C.C. section 4-202, it might be advisable to attempt a distinction between diversions and "missends." Any distinction, however, would require a human inspection of the item; but this would occur only after the missending is discovered. We conclude that the notice requirement should apply to missent items as well as diverted items, as the same risks exist and, in both situations, the duration of the risks is extended.

Banks capable of distinguishing between MICR fraud and missending might prefer, due to the percentage of checks that are ultimately honored, to omit the notice of delay in the case of missent items and absorb any losses not recoverable from the missending bank. If negligence on the part of the missending bank is shown, the losses should fall on that bank.

liability on a bank only for its own actions, not for the actions of another bank, is preserved.

A bank sending an item on a diversion from the standard journey to one payor bank and back should divert at its peril, unless it gives the depositary bank due notice of the diversion to enable the depositary bank to extend its hold pending the expiration of an additional time period.

B. *Defenses to Liability for Failure to Give Notice*

We have suggested that a notice of diversion given by any bank diverting an unpaid item from its return journey to the depositary bank is one way to prevent MICR fraud. There is another point in the system where clumsy MICR frauds could be checked. This point is at the depositary bank, either when the item is first deposited or when the item is rejected by its MICR sorters. The items in both of the recently reported cases were not printed in magnetic ink on the so-called MICR line. In *Northpark*, the MICR line was otherwise in order, except that it indicated Bankers Trust Company of New York as the payor bank, while the printed name and fractional routing number indicated a different Federal Reserve District. Where clerks handle rejected items, it should not unduly delay processing operations to train them to note whether the denominator of the routing fraction and the first four digits of the routing numbers in the first field of the MICR line indicate the same district,¹⁰⁷ and to refer the item to supervisors when they do not. Similarly, it would not consume much time to have clerks note whether the routing symbol contains nine digits.¹⁰⁸ It would not take long, however, for those planning a MICR fraud to be sure not to be caught by these tests. These tests, therefore, do not satisfy our requirements for a systems-oriented, cost-effective device to discourage losses through MICR fraud. Mandating action by the depositary bank would be ineffective and therefore such action should not be required.

The better solution is to require notice of diversion, and to give any bank that fails to give such notice a defense of gross contributory negligence, where such negligence can be shown.¹⁰⁹ This defense was

107. See *supra* note 41.

108. *Id.*

109. Because the policy underlying our proposal is that the bank which diverts the item is in the best and most cost-effective position to prevent the loss, liability for the loss should be shifted away from that bank when it can be shown that, in fact, another bank had and failed to take advantage of an opportunity to prevent the loss. See Leary & Fry, *A "Systems" Approach to Payment Modes: Moving Toward a New Payments Code*, 16 U.C.C. L.J. 283, 289-91 (1984). As Judge Haight noted in his ruling on summary judgment, section 3-406, in a similar fashion,

raised in *U.S.F. & G. II* after discovery was completed and was successful. As Judge Haight found in the order granting summary judgment, no hold was placed on withdrawals despite the size of the check, which had been deposited in a branch that was not the branch at which the account was domiciled. Curiously, when the "home" branch noticed the large deposit, its employees determined that the item was drawn on the First Pennsylvania Bank by having a microfilm copy put on a screen and read to them. They made a telephone inquiry to First Pennsylvania prior to any withdrawal. The inquiry elicited the fact that First Pennsylvania had no account for the drawee named on the check.¹¹⁰

Nothing was done with this information. When the malefactor requested a wire transfer of \$660,000 and a cash withdrawal of \$95,000, the computer showed the full \$881,000 plus as available funds. Both requests were honored shortly after they were made, despite the apparently unresolved "suspicion." Shortly thereafter the telephone notice of nonpayment was received. The conduct of the depository bank seems, at the least, to have been negligent.¹¹¹ An additional defense would be that the failure to give notice, or delay in giving the notice, did not cause the loss because the notice, even if timely given, could not have reached the depository bank prior to the time the bank allowed the withdrawals.¹¹²

U.C.C. section 4-103(5), however, presents a bit of a problem. It specifies that the measure of damages "for failure to exercise ordinary care . . . is the amount of the item reduced by an amount which could not have been realized by the use of ordinary care."¹¹³ In MICR fraud cases, this would result in no recovery at all because even with

shifts forgery losses from the bank to the customer when the customer's negligence enables the forgery to occur. 620 F. Supp. at 371-73. See *infra* note 113 for a discussion of missent but honest items.

110. 620 F. Supp. at 364. In addition, the branch manager requested credit reports on the business which Goldstein, the depositor, stated he represented. Both of the services contacted reported they had no record of such a business.

111. The depository bank's negligence formed the basis for Judge Haight's decision to grant summary judgment to the various defendants. 620 F. Supp. at 371-73.

112. U.C.C. section 4-103(5) reduces damages by the "amount which could not have been realized by the use of ordinary care." *Cf.* *Wells Fargo Bank v. Hartford Nat'l Bank*, 484 F. Supp. 817 (D. Conn. 1980).

113. U.C.C. § 4-103(5). Section 4-103(5) provides that "[t]he measure of damages for failure to exercise ordinary care in handling an item is the amount of the item reduced by an amount which could not have been realized by the use of ordinary care . . ." *Id.*

If the diverted item is genuine and was either missent or contained a printer's error, and is ultimately honored by a payor, the losses caused by any failure to give notice of diversion would be minor. In fact, they would only amount to the value of the use of the funds for the period of any extended hold that would have been imposed—reduced, of course, by any interest payable to the customer for that period. Where large items are involved, a revised

ordinary care, no funds would have been received on a completely bogus check. This section must be treated as placing the amount of the item as a top limit, and permitting recovery, in conjunction with U.C.C. section 1-103 and the final sentence of comment six to U.C.C. section 4-103, of loss caused by a complete failure to perform the designated duty as well as loss caused by any negligence in the performance of that duty. This is consistent with the result reached in certain cases¹¹⁴ where a bank failed to wire notice of nonpayment under Federal Reserve rules in existence before the recent amendment imposing sanctions. Those cases held that the depository bank was entitled to recover the amount of disbursements that would not have been made had the wire notice been timely given.

When the drafters of the Code adopted the negative notice of payment approach and eliminated any duty to trace,¹¹⁵ they could not have knowingly intended to rule that all losses caused by completely bogus checks should fall on the depository bank even though it received no notice of a diversion of the return journey or of a delay in any aspect of the journey. A system based on funds availability requires that banks that rely without negligence on the system be reimbursed for losses, up to the face amount of the item, whether bogus or merely uncollectible. They should be reimbursed whenever the negligence or failure of an intermediary or payor bank causes the depository bank to act as if payment had been received after no notice was received in a normal time.

These protections are not needed where the collection is not in the cash item-provisional credit channel. That channel is the only collection channel where payment is, by lapse of time, finalized. Where items are sent for remittance, as is paper that bankers call either "collection items" or "non-cash items," the issue does not arise. Failure to receive a remittance indicates nonpayment and tracing does occur.¹¹⁶

article four could provide for a notice of diversion to protect against the extension of the normal risks of nonpayment.

114. See, e.g., *Empire Nat'l Bank v. Chester Nat'l Bank*, 66 Misc. 2d 422, 320 N.Y.S.2d 705 (Sup. Ct. 1971). But see Mulford, *The Federal Reserve's "Wire Advice of Nonpayment,"* 100 BANKING L.J. 622, 629-31 (1983) (collection of cases).

115. See U.C.C. § 4-212 & comment 1.

116. The "collection item" process, as distinguished from the "cash item" process, usually involves a "discount" of the item by the depository bank, often with a reserve amount withheld to cover "bad" items. The depository bank sends the item in a "collection letter" requesting a remittance. Absent a special request, for example, for New York, Chicago, or Atlanta funds, or perhaps "federal funds," the remittance is by a cashier's check of the presenting or payor bank. This is sent after that bank ascertains the desires of the customer (i.e., drawer or account party) as to payment, and ascertains the adequacy of funds in the account. Often, if there are not sufficient funds, the bank at the end of the collection chain will hold the item for

C. *The Demand for Prompt Funds Availability*

In a systems view, one must consider another force with which the system must contend: pressure from many sources for earlier availability of funds. While shortening the total journey might have a dampening effect on a felon's ability to commit MICR fraud, any availability statutes not keyed to normal journeys could increase the incidence of such frauds.

Delayed availability can result from several causes. The first is the *actual* journey time to payor bank and back, including processing times at depository, intermediary, and payor banks.¹¹⁷ The second is a *theoretical* journey time, which assumes each bank will use the full midnight deadline period before forwarding the item to the next bank but physical transport time will occur only during the night.¹¹⁸ The

several days. See *Memphis Aero Corp. v. First Am. Nat'l Bank*, 647 S.W.2d 219 (Tenn. 1983).

The collection letters are usually multicarbon forms, kept in a dated "tickler file." One of the carbons is a "tracer" letter. Nonpayment is signalled by the failure to receive a remittance check, and, after a few days, the tracer will be dispatched. Since "payment" is signalled by receipt of the remittance instrument, there is no need for a U.C.C. section 4-302(a) accountability rule, except where the item is "properly payable" and a remittance is not sent. If the customer has directed nonpayment, the item becomes one that is not "properly payable."

Article 4 incorrectly fails to distinguish between the "clean draft" sent by a collection letter, and the check or other cash item moving with a simultaneous flow of provisional credits. "Demand item other than documentary draft" is not felicitous language.

117. The journey of the item in *U.S.F. & G.* serves as a useful model. That journey included the following steps:

1. Deposit on May 6, 1980.
2. Receipt by Philadelphia National Bank via Purolator Courier at 2:41 a.m., May 7, 1980.
3. The Utica Regional Processing Center received the item directly from Philadelphia National either late in the evening on May 7, 1980 or early May 8, 1980.
4. The item was sent to Albany State Bank on May 8, 1980 and arrived between 9:00 a.m. and 11:00 a.m. on Friday, May 9, 1980.
5. Saturday and Sunday (10th and 11th) intervening, State Bank of Albany returned the check, stamped "Sent in Error," to the Utica Regional Processing Center on the evening of May 12, 1980.
6. On May 13, 1980, Utica Regional Processing Center sent the check to the Federal Reserve Bank of Philadelphia.
7. Federal Reserve Bank of Philadelphia received the check and presented it to First Penn. on May 14th.

620 F. Supp. at 363-68; 590 F. Supp. at 490-91.

Had the item not been diverted to First Penn., it would have gone to Philadelphia National Bank from Philadelphia Fed. The Union Trust of Baltimore would have received it in the early morning of May 15, and might have known of the dishonor late on May 14, in time to charge back the provisional credit before the opening of business on May 16, the date of the withdrawal. If this had been done, in six or seven banking days or eight or ten calendar days the item would have been handled by eight banking locations on different days, but only one, State Bank of Albany, would have used the full midnight deadline.

118. See *supra* note 117. If each bank had used its full midnight deadline, seven more

third is a hold planned to be longer than necessary, which is placed, some claim, to permit use of the collected funds by the depository bank for a longer period than necessary but could be a "hedge" against delay in the mails.¹¹⁹

Some believe that many of the holds now in use are of the third type, namely, that they are placed to extend the "float" period. This belief has resulted in pressure for funds availability legislation, which has been passed, as a result, in Delaware, California, Illinois, and New York.¹²⁰ Because the banks use the negative notice system for checks, there is a need for holds on the provisional credits. Abuses only exist when the hold period exceeds the period necessary to learn of any nonpayment.

Over the years, there have been several efforts to reduce the necessary hold periods and the customers' lost opportunity costs resulting from long hold periods. The first effort is reflected in the U.C.C. as optional section 4-212(2).¹²¹ At the suggestion of James Kennedy, Operations Vice President of the Philadelphia National Bank, the concept of "direct returns" was incorporated in section 4-212(2) at a time when there was no MICR line or automation. Kennedy thought that the check being returned could be slipped into an envelope draft drawn on the depository bank by the returning payor bank and included in outgoing cash letters. The check would thus not have to retrace the precise journey that it travelled on the way from the depository bank to the payor bank. The payor's books would let the

banking days would have been consumed, and, due to two more intervening weekends, the item would not have been returned until May 25th, for a total of 15 banking days or 21 calendar days.

119. See *supra* notes 117-18. See also *Wells Fargo Bank v. Hartford Nat'l Bank & Trust Co.*, 484 F. Supp. 817 (D. Conn. 1980). In *Wells Fargo*, a check drawn on the Reno branch of a Nevada bank was deposited in New York on November 22. It reached Los Angeles on November 23, but, sending it by mail from there to Reno took sixteen days. The return item reached the depository bank on December 27, a total of thirty-five days; yet each bank handling the item acted in a timely fashion. *Id.* at 818-20. As between banks in major banking areas, presentment can occur on a next day basis through the use of courier services where there is a substantial volume of items to transfer. For a table of "hold" periods see *supra* note 19. The out of state holds can be criticized as too long where metropolitan areas are involved. Where rural or "up-state" payor banks are involved, however, they are perhaps not too long, particularly if placed on a worst case basis.

120. CAL. FIN. CODE § 866-866.9 (West Supp. 1985); DEL. CODE ANN. tit. 5, § 937 (Supp. 1984); N.Y. BANKING LAW § 14-d (McKinney Supp. 1984). A new Illinois statute, enrolled effective July 1, 1986, amends U.C.C. section 4-213 by adding a new subsection (5), which sets fixed numbers of days for funds availability. ILL. S.B. 525, § 4 (1986). See also *Jordan, supra* note 19. (proposals to amend Article IV of the U.C.C. to limit bank's wide discretion in determining when customers are permitted to withdraw deposited funds).

121. Subsection 4-212(2) has been adopted in all but a handful of jurisdictions, namely Nebraska, Nevada, New Jersey, Oregon, Wisconsin, and the District of Columbia. California adopted the subsection in 1983, effective January 1, 1984. See 1983 CAL. STAT. 1011.

provisional credit given for the item stand and be "washed to zero" by the credit received for the cash letter containing the return item. The depository bank's credit received for its sending would "wash" the payment for the envelope draft. The depository bank would then charge that sum back to its customer just as if its provisional credit had been revoked.¹²² This concept has not yet been implemented except in a pilot program in the Dallas Federal Reserve Region.¹²³ The only time-saving would be due to the use of the fast transit means used for cash letters, rather than the slower United States mails often used for return items. The item would still require manual processing, as do all return items today, unless placed in an envelope draft or carrier encoded for fast sorting.¹²⁴

A second effort to reduce hold periods focused on the use of a "wirefate" collection instruction for large items.¹²⁵ It was abandoned as too expensive. Presently, all Federal Reserve Operating Circulars

122. Some have argued against direct returns as requiring each bank to deal with 14,500 other banks. The fate of the fight over direct sending to a payor bank is instructive. See 2 PATON'S DIGEST §§ 17:21-17:24 (1942). As of 1941, 18 states had adopted the Bank Collection Code, which provided for direct sending in section six; 21 states had adopted the American Banker's Association's "Forwarding Direct to Payor Act," but four of these states later adopted the Bank Collection Code. Six other states had their own collection codes. Federal Reserve Regulations and Operating Circulars also so provided. The explanatory note to section six of the Bank Collection Code stated: "Custom has sanctioned the practice of forwarding direct to the drawee or payor bank, contrary to the judicial rule that such method of forwarding is negligence . . ." 2 PATON'S DIGEST 1377. No one in the states enacting the American Banker's Association's "Forwarding Check Direct to Payor Act" appears to have thought for a moment that a depository bank sending through correspondents was not protected by the Act. Any claim that direct returns cannot go through correspondents is equally incorrect.

123. Presentation by Governor Gramley, Board of Governors of the Federal Reserve System, Bank Administration Institute 1985 Check Processing Conference, Dearborn, Michigan (March 27, 1985)(photocopy on file in the office of the *University of Miami Law Review*).

124. The Dallas Direct Return Project uses the courier system of the Federal Reserve Bank, which greatly speeds returns. The sorting of return items for forwarding, however, continues to be manual.

The Federal Reserve Bank of Dallas describes the "Return Item Pilot Programs" as having four elements: (1) processing of all returns by the Fed even if the item did not go through the Fed for presentment; (2) sorting and delivering these items to the financial institutions of first deposit; (3) providing notification of nonpayment on all large returns to the financial institutions of first deposit; and (4) charging a fee to the payor institution. FEDERAL RESERVE BANK OF DALLAS, OPERATING CIRCULAR NO. 83-9 (Jan. 13, 1983).

125. See 2 PATON'S DIGEST 1278 (1942) ("An agent collecting bank is under a duty to follow all instructions in undertaking collection, and would be liable for any loss caused by its failure to wire advice of nonpayment as instructed."); see also *O'Neil v. First Nat'l Bank of Lovelock*, 15 F. Supp. 133, 138 (D. Nev. 1936) (involving bank's instruction to wire nonpayment of items for \$500.00 or over). In 1947, Professor Leary found that these instructions, and instructions stating "Wire Fate," were prevalent. Due to the current speed and to the standard "Wire Notice" instructions in all Federal Reserve Banks' Operating Circulars, their use seems to have declined.

contain uniform provisions requiring a wire notification of nonpayment of large items, now defined as \$2,500 and over.¹²⁶ Federal Reserve Banks forward notices received by them from payor banks by wire.¹²⁷ Studies show that the requirement of wire notice, defined to include a telephone call, was honored in the breach at least fifty-two percent of the time.¹²⁸ The Board of Governors of the Federal Reserve System has recently adopted an amendment to its Regulation J, which was designed to put some teeth into the requirement that payor banks wire notice of nonpayment. A failure to wire notice renders the bank liable for any loss incurred by the depository bank.¹²⁹

A third effort to reduce hold periods is reflected in the state legislation on funds availability. These state laws address two problems. First, customer (usually consumer customer) awareness of the length of holds; banks must issue descriptive statements of their hold policies. The Delaware statute goes no further.¹³⁰ Second, the state laws address the length of the holds that the bank may impose. New York and California provide for administrative statements of reasonable times for holds.¹³¹ The regulations, however, merely adopt a same city, same state, and other state approach, excluding out of country

126. See, e.g., 12 C.F.R. § 210.6(a) n.3 (1980) (current version 12 C.F.R. § 210.6(a)(2) (1986)).

127. *Id.*

128. Mulford, *The Federal Reserve's "Wire Advice of Nonpayment"*, 100 BANKING L.J. 622, 631 (1983). The author's conclusion is of interest:

Check law contains a number of ambiguities that seem to invite litigation. When does the midnight deadline run when a paying bank uses off-premises facilities for processing? Does the midnight deadline apply at all on second presentment? When is a paying bank excused from a failure to meet the midnight deadline? It is because of these uncertainties that the Federal Reserve Banks resolutely refuse to inspect checks for timeliness of return.

Id. at 632-33 (citations omitted).

129. 50 Fed. Reg. 5740-41 (1985) (revising 12 C.F.R. § 210.12). New subparagraph (c)(6), effective October 1, 1985, provides:

A paying bank that fails to exercise ordinary care in meeting the requirements of this paragraph shall be liable to the depository bank for losses incurred by the depository bank, up to the amount of the item, reduced by the amount of the loss that the depository bank would have incurred even if the paying bank had used ordinary care. A paying bank that fails to act in good faith in meeting the requirements of this paragraph may be liable for other damages, if any, suffered by the depository bank as a proximate consequence. If the paying bank or the depository bank prevail in litigation involving the requirements of this paragraph, it may recover its court costs and reasonable attorneys' fees. A paying bank shall not be liable for mistake, neglect, negligence, misconduct, insolvency or default of any other bank or other person in connection with providing notice under this paragraph.

Id. at 5740.

130. DEL. CODE ANN. tit. 5, § 937 (Supp. 1984).

131. CAL. FIN. CODE § 866; N.Y. BANKING LAW § 14-d.

items and make no provision for extending holds upon receipt of notice of delay in transit. The recent Illinois legislation goes into greater detail based on the type of drawer involved.¹³²

Check truncation, called by the bankers "check safe-keeping,"¹³³ would, if practiced by the bank of first deposit, collect funds by wiring the MICR line through the system of Automated Clearing Houses to the payor bank. This method would mitigate two problems: funds availability and MICR fraud. The procedure is as follows. The bank of deposit wires the three fields of the MICR line to the payor bank. Each sending has a trace number so that if the trace number of the first sender is included in the subsequent messages, a reply rejecting payment could use that trace number as a depositary bank identifier. Hence the problem of determining the depositary bank from endorsements on the reverse of the item is eliminated. Practically all of the time consumed in moving paper from one institution to another and in sorting for further sending would also be eliminated. For this method to be truly effective for mass processing, however, the information in the MICR line would have to control any words or numbers written on the item.¹³⁴

Another method, which has not been tried, would be to use U.C.C. section 4-206,¹³⁵ so that only the depositary bank's indorsement appears on the reverse side of the item. The cash letter could constitute the indorsement of the intermediary bank.¹³⁶ The depositary bank's indorsement stamp could then be enlarged to set forth its

132. CAL. ADMIN. CODE tit. 10, R. 10.190406(a)(1)-(2) (Supp. 1984); ILL. S.B. 525, *supra* note 120, N.Y. GEN'L REGS. OF THE BANKING BOARD, §§ 34.1-34.5 (1983).

133. See Leary & High, *The Place of EFT and Check Truncation in Corporate Payment Systems*, 5 DEL. J. CORP. L. 1, 2 n.7, 28 (1980). The first bank having the capacity transmits the MICR line electronically to the payor bank and maintains the item for 90 days subject to retrieval on request. A microfilm print is available thereafter. The payor bank gives provisional credit on the day of receipt, subject to cancellation by a wire notice sent within the midnight deadline. The bankers call this system "Check Safe Keeping."

134. U.C.C. section 3-118(c) (adopting the rule that words control figures, should be amended). Regulation J of the Board of Governors of the Federal Reserve System, which permits Federal Reserve Banks to "go by the numbers," is a step in the right direction. See 12 C.F.R. § 210.6(2)(a). Encoding machine operators always encode from the numbers. If these are misencoded, any loss must, of necessity, be borne by the misencoder.

135. U.C.C. section 4-206 provides that "any agreed method which identifies the transferor bank is sufficient for the item's further transfer to another bank." U.C.C. § 4-206.

136. This might run afoul of U.C.C. § 3-202(2) which provides that "[a]n indorsement must be written by or on behalf of the holder and on the instrument or on a paper so firmly affixed thereto as to become a part thereof." It would, however, alleviate the substantial problems presently experienced by the collection system as a result of illegible indorsements or indorsements obliterated by subsequent indorsement stamps superimposed by collecting banks later in the chain. For a discussion of the indorsement problem, see Supplementary Information to Amendment, 50 Fed. Reg. 5734 (codified at 12 C.F.R. § 210) (1985).

routing number. Return items could be placed either in carriers or have a full white strip attached along the bottom. In either case, the MICR line would show the amount of the check.¹³⁷ The depository bank could then determine the account to be charged, as it now does with return items.

III. IS AMENDMENT THE ONLY CURE?

We have analyzed the issues in MICR fraud that we feel are most significant. We have given our preferred solution in light of the operation of the system. We now address a third question: Can the desired result be achieved by interpretation or is amendment necessary?

A. *U.C.C. Section 4-202(1)(e)*

A requirement that the diverting bank give notice, if asserted other than in federal courts in the Second Circuit could be successful, especially if a systems approach to interpretation were taken. With respect, we again suggest that Judge Knapp erred in limiting the word "transit" to the several disparate physical movements of paper between banks without regard to any increase in the number of such movements.¹³⁸ Judge Haight's acceptance of Judge Knapp's reading can be taken as approved because *U.S.F. & G I* was cited by the Court of Appeals in its memorandum affirmance.¹³⁹ We believe that a person, package, or check should be considered "in transit" from start to finish of the intended journey, despite waiting periods at different places along the way. For example, when a person leaves a train and waits for a ferry to complete the journey, the person is still considered "in transit" to the ultimate destination.

Judge Knapp correctly summarized the check collection system, but failed to apply a systems approach to the delay in transit. He properly identified the two important features of the system. He wrote:

The first is that, notwithstanding the colloquial suggestion to the contrary, checks deposited for collection do not generally "clear."

. . . .

Thus the hallmark of the normal completion of collection—*i.e.* the

137. For criticism of the time-consuming and error-prone system presently used for return items, see Jordan, *supra* note 19, at 531-33; Mulford, *supra* note 128, at 623.

138. See *supra* note 62.

139. *U.S.F. & G.*, 590 F. Supp. 486, 494 (S.D.N.Y. 1984), *aff'd mem.* ___ F.2d ___ (2d Cir. Mar. 14, 1986) (stating that the result was correct). Any attempt at a different interpretation in a district court will have hard sledding.

check having been paid—is the receipt of *no notice* by the depository institution.

The second important feature is that the collection process has been, of course, automated by the use of check sorting computers.¹⁴⁰

The *Northpark* opinion recognizes that banks customarily place holds on the provisional credits automatically given for deposited items to allow time for the unpaid item or notice of its nonpayment to arrive, lest the bank make an unintended loan to its customer. An inference which arises from automation, of course, is that checks in the process of collection or return are visually examined for only three purposes, namely, for routing, to determine if a reason for nonpayment is stated, and for accounting purposes to determine the amount.

Trouble arrives when, as in *U.S.F. & G.*, the check is returned with the stamp "Sent in Error." In that case, a bank has two choices. One alternative is to continue the item on its return journey to the bank's transferor; the other is to send it to what it considers to be the proper payor bank. But where the second alternative is adopted, the bank which makes that choice should recognize that the system is *not* geared to handle the extended period of time caused by a diversion of the return journey to a second bank for payment. A system where no notice of payment is given should provide for some notice of the additional time required when items are sent to a second bank for payment.

Judge Knapp found it significant that both the April and July 1948 versions of the bank collection materials used the word "transit" in connection with a comment referring to delay in the mails.¹⁴¹ That comment was not included in the final Code. These drafts contained a provision imposing full liability on a collecting bank for "any loss caused by delay in transit or failure of such item to arrive."¹⁴² The comments pointed out that this result would effect a considerable change in prior law which had, by case law, the Bank Collection Code, and deposit agreement, placed the risk of loss due to the mail or other delay on the depositor.¹⁴³ The comment referred to the case law "duty to trace" and suggested that periodic reconciliation of mutual

140. *Northpark*, 572 F. Supp. at 525-26 (emphasis added).

141. *Id.* at 531.

142. ALI-NCCUSL, U.C.C. § 3-713 (1948) (Proposed Final Draft No. 2, July 30, 1948).

143. ALI-NCCUSL, Notes and Comments to Part VII of U.C.C. Proposed Final Draft No. 2 (Aug. 2, 1948) [hereinafter cited as August Comments to Draft No. 2]; Commercial Code (Group No. 1) Notes and Comments to Part VII Proposed Final Draft No. 2 — Article III, August 2, 1948, p. 17. The relevant text reads:

Section 713. *Loss of Cash Item in Transit.* A collecting bank forwarding a cash item to another bank is liable to all prior parties for any loss caused by delay in

accounts between the sending and the destination bank would disclose the failure to arrive, or a delay in arrival.

The same drafts provided that each bank, in the case of cash items, was liable for the negligence of the immediate next correspondent selected by it, thus adopting the New York rule for such items. The general duties of collecting banks as to cash items were set forth in section 712 of the *April 1948 Draft Number One* and in section 708 of the *July 1948 Draft Number Two*. The latter draft reduced the duties to two: "Subject to subsection (2), a collecting bank taking a cash item must (a) forward the item for presentment by some proper method; and (b) if the item is not paid, return it or send notice of nonpayment to its transferor."¹⁴⁴ Subsection (2) required a collecting bank to act on an item or notice within a reasonable time after receipt but in any event before midnight of its next banking day.¹⁴⁵

The *April 1948 Draft* covered only cash items but noted that rules for non-cash items had not yet been drawn. Such provisions

transit or failure of such item to arrive, but not for any loss caused by delay of the depositor in furnishing a duplicate.

The August Comment to the August draft reads:

Section 713. *Loss of Cash Items in Transit*. It is very clear that this radically alters the present theory. The cases say, quite unanimously, that the risk of mail loss or delay is on the customer.

.....

Of course, as in other cases of bailments the plaintiff's prima facie case is made out when failure to re-deliver or credit the proceeds is shown, and the burden of explanation is on the bank.

.....

The cases also generally hold that a bank forwarding an item is under a duty to trace the item. The present system used in cash item transit departments, apparently, does not set up a specific tracing system, but when accounts are reconciled discrepancies caused by non-arrival of an entire cash letter are revealed. As a practical matter, however, banks may find it difficult to prove a mailing, other than through general practice, which may not convince a jury. One insurance company has intimated that many claims for items allegedly lost on bank premises may be really cases of a loss in the mails. The change made by the section may be more theoretical than real. . . .

.....

Basic to the present section is the assumption that, in view of the termination of general negotiability provided in Section 710 [indorsement by bank's limiting transfer; see U.C.C. § 4-201(2)], a cheap form of blanket insurance can be made available to banks. The point requires further exploration with representatives of the insurance companies.

Id. at Comment 1.

Note that the immediately preceding section of these drafts made a bank that forwarded an item to an intermediary bank liable to its transferor and to all prior parties for the conduct of any subsequent intermediary bank, but not for the conduct of the payor bank. There was, therefore, no need to provide specifically for any delays due to another bank's actions.

144. U.C.C. § 708(1) (Draft No. 2, July 1948).

145. U.C.C. § 708(2) (Draft No. 2, July 1948).

were included in the *July 1948 Draft*, which provided that the general duties of a collecting bank taking a non-cash item were:

[To] use diligence and good faith

(a) to have the item presented in the proper manner to the proper party at the proper time; and

(b) to complete the collection; and

(c) to notify its transferor of any non-completion; and

(d) upon dishonor of the item to take the action necessary to preserve the liability of any secondary parties.¹⁴⁶

The notes and comments to the *July 1948 Draft* were published on August 2, 1948 and stated that the purposes of the section under discussion were:

To adopt the Massachusetts rule for the responsibility of a collecting bank; the duty imposed is one of diligence and good faith and includes a duty to use due diligence to keep its transferor informed of any miscarriage in the mails or of any failure by a correspondent to take proper action on the item. To perform this duty, the bank will be obliged to trace non-cash items if a report is not received in a reasonable time

As there is no absolute duty to complete the collection, the bank is not responsible for loss in the mails or for negligence of its carefully chosen correspondents.¹⁴⁷

The distinction between handling cash items and noncash items was eliminated later at the insistence of the Committee of Counsel of the Federal Reserve Banks on the proposed Code.¹⁴⁸ The application of the New York rule for correspondents in the case of cash items was abandoned.¹⁴⁹ The present section 4-202 resulted from a consolidation of the separate rules in prior drafts for cash items and non-cash items.¹⁵⁰

Throughout the drafting process, the liability of collecting banks was "the amount of the item reduced by an amount which could not have been realized by the use of proper handling."¹⁵¹ This standard still applies under U.C.C. section 4-103(5) for "a failure to exercise ordinary care in handling an item."¹⁵² This presumably includes, in the case of cash items, both the forward journey and the return jour-

146. U.C.C. § 721 (Draft No. 2, July 1948).

147. August Comments to Draft No. 2, *supra* note 143, at 23-24.

148. A Committee of Counsel for the Federal Reserve Banks, headed by the late O. J. Schlijker, Esq., of the Federal Reserve Bank of Boston, was adamant that then-present practices should not be codified, as Professor Leary well remembers.

149. U.C.C. § 4-202 comment 4.

150. See *supra* notes 140-47 and accompanying text.

151. See, e.g., § 750(1) (Proposed Final Draft No. 2, July 1948).

152. U.C.C. § 4-103(5) (1978).

ney. The change from liability for improper handling to liability for lack of ordinary care, in a systems approach, should not be significant.

But what of a failure to warn of dangers resulting from an extension of the supposed overall transit time, which is the basis for bank holds on accounts? The depository bank is clearly relying upon its customer's credit, plus the percentage chances that deposited checks will clear, when it permits withdrawals before the normal transit time has elapsed. When the customer is new, or where the deposited item drastically inflates normal balances, the depository bank customarily places the hold.

Both Judge Knapp and Judge Haight felt that the system and an overriding duty to exercise ordinary care required that a notice of diversion be given in some manner. The result reached by each court is unsatisfactory insofar as it is dependent upon jury findings of foreseeability. The result thus lacks the precision needed in rules governing a bulk, rapidly moving, and automated paper sorting system. Further, no legislature examined anything but the final official draft approved just before legislative consideration. Hence, prior drafts, while historically interesting, are not evidence of the legislative intent of any legislature adopting the U.C.C.

In determining the meaning of "loss or delay in transit," it may be convenient to analogize the functions of intermediary banks to those of a railroad. Time spent in a railroad yard for switching and for train make-up is still time spent "in transit."¹⁵³ If a railroad car is diverted to a wrong destination and has to be returned to the yard to be sent to the proper destination, it would still be considered in transit during the diversion and return to the yard, as well as during the second journey out of the yard to the correct destination.

In the MICR fraud cases, the judges considered the comments to one subsection in the 1948 drafts, without considering the impact on the system of changes thereafter made in other sections. The 1948 cash item/noncash item structure was entirely removed in subsequent drafting. The 1948 drafts involved a system in which a bank handling

153. *Bush v. Florida ex rel. Dade County*, 140 Fla. 277, 191 So. 515 (1939) (property tax); *Davis v. A. F. Gossett & Sons*, 30 Ga. App. 576, 118 S.E. 773 (1923) (Interstate Commerce Commission Act); *Stein-McMurray Ins., Inc. v. Highlander Ins. Co.*, 95 Idaho 818, 821, 520 P.2d 865, 868 (1974) ("in transit" and "during transportation" within commercial property policy included time between leaving point of departure until safe arrival); *Den Gre Plastics Co. v. Travelers Indem. Co.*, 107 N.J. Super. 535, 540, 259 A.2d 485, 490 (Law Div. 1969) (" 'In transit' ordinarily means movement of goods on transporting conveyance from starting point to point of delivery, including stops along the way, incidental to carriage"); *Brown v. Western Union Tel. Co.*, 85 S.C. 495, 67 S.E. 146 (1910) (telegraph); *Pennsylvania Nat'l. Mutual Casualty Ins. Co. v. Murphy*, 579 S.W.2d 58, 61 (Tex. Civ. App. 1979) (rental van "in transit" while parked overnight in motel parking lot).

a cash item was subjected to the New York collection rule, which made the initial collecting bank liable for the actions of subsequent banks in the collection chain. Hence, there was no need to include consideration of anything but movement between banks in the phrase "loss or destruction in transit." The final drafts, however, adopted the Massachusetts rule throughout the collection process, and eliminated any cash item/collection item distinctions. We believe this change affected the meaning of the phrase "any loss or delay in transit" in U.C.C. section 4-202(1)(e).

A problem arises, however, by reason of the wording of U.C.C. section 4-202(3), which is the direct descendant of the subsection which used the phrase "in transit" in the 1948 drafts. Subsection (3) states that a bank "is not liable . . . for loss or destruction of an item in transit or in the possession of others." Does the reference to "others" require an interpretation of "in transit" to mean only mere physical movement time, without regard to the needs of a system based on no notice of implementation and with "funds availability" based on a lapse of time without notice of nonpayment? We think not. Besides, there is a difference between responsibility for what happens elsewhere, whether known or not, and the duty to give notice upon receipt of actual knowledge, specifically, knowledge that a depository bank's receipt of notice of nonpayment will be delayed.

Who, then, are the "others" referred to in U.C.C. section 4-202(3)? One group would be the payor banks, since under the railroad analogy they are the consignees. Hence the position under the redrafted Code that payor banks are "in possession" for processing for the entire period of a midnight deadline¹⁵⁴ should not preclude a court from determining that a diversion causes a delay in transit, when actual knowledge thereof is also required to trigger the duty to send a notice. In today's world, independent item processors would also fit under the words "in the possession of others."¹⁵⁵

We suggest that the different function of each of the two subsections should also be considered in determining the two interpretations. U.C.C. section 4-202(3) involves an exculpation where narrow interpretations are customarily made. The subsection deals with liability and changed an established common law rule in a number of

154. The provision for direct sending to a payor bank, U.C.C. section 4-202(1), and the deferred posting provision of U.C.C. section 4-301(1) necessarily assume possession by the payor bank.

155. There are at least three instances where the items will be in the possession of another: use of remote processing centers operated by payor banks, having other banks do part of the "pay-processing" of items, or, as is the case with Travelers Express Co., having credit union share drafts truncated.

states.¹⁵⁶ It also deals with "loss or destruction" only.

On the other hand, U.C.C. section 4-202(1)(e) deals with relaying actual knowledge about events which will defer the receipt of notice of nonpayment. Narrow interpretation of this section is inappropriate and, indeed, approaches the interpretations employed in the reading of common law pleadings long years ago, namely reading with a zeal fired to pervert. Such a reading would result in an interpretation of U.C.C. section 4-202(1)(e) and U.C.C. section 4-202(3) that no notice was required to be given under the former upon learning of a destruction of an item since the latter obviously treated destruction as something different from loss. Hence, destruction would not be covered by the word "loss" in subsection (1)(e) and no notice of destruction would thus be required.

Such narrow and picayune readings violate the basic principle that a statute is not to be interpreted in a manner that would treat the legislature as a body composed solely of the northerly portions of south-bound horses. As Grant Gilmore once said, courts should "read the Code cheerfully."¹⁵⁷ Courts should be fired with a cheerful zeal to make the Code work sensibly on the system it covers even if time has wrought more technological changes in the system than were dreamt of by the drafters.¹⁵⁸

The two MICR fraud decisions discussed in this article both agree in finding a duty to warn of the delayed receipt of a notice of nonpayment. Judge Knapp wanted evidence that discrepancies between the location of the named bank and the routing numbers in the MICR line indicated fraud more often than honest error. Judge Haight felt that several foreseeability tests should be put before a jury with full evidence of usual conduct. Neither considered the impact on automated processing of the uncertainties raised by their rulings. Neither appreciated the careful distinctions made in U.C.C. section 4-202(1) between a bank's duty with respect to its own actions and the actions of other banks where actual knowledge is a prerequisite to any duty to act. Nor did either judge recognize that a depository bank needs notice of the diversion of good checks, as well as fraudulent ones.

As we have shown, appropriate statutory construction under a

156. *See supra* note 143.

157. American Law Institute/American Bar Association Commission on Continuing Legal Education, meetings conducted during 1966-67 (Professor Leary was present).

158. U.C.C. § 4-101 comment 1 (1978) ("There is needed a uniform statement of the principal rules of the bank collection process with ample provision for flexibility to meet the needs of the large volume handled and the changing needs and conditions that are bound to come with the years."). *See also* U.C.C. § 1-102(2)(b).

systems approach leads to the result for which we contend, since it leads to proper results in other cases. Yet two excellent judges, otherwise quite sensitive to the system, have taken a different course. We cannot expect all other judges to interpret the Code with greater finesse. If changes in articles three and four are to be proposed,¹⁵⁹ such changes should make it crystal clear for all judges that the basis of U.C.C. section 4-202 is a duty of due care by a bank as to its own actions and that, except for transfers of what it receives to its transferor, action need only be taken to warn that transferor upon receipt of actual knowledge of facts showing that a collection or return journey will go or has gone awry. In MICR fraud cases, this places the burden of giving a notice of diversion upon one bank only, the diverting bank, be it an intermediary or one to whom the item was presented for payment. Recipients of such a notice have the duty to forward it.¹⁶⁰ If the pressures for funds availability force the adoption of reduced hold periods, the need for notice of diversions will be much greater than it is today, and these statutes must provide for extensions of holds on receipt of such notices.

B. Regulation J

The Board of Governors of the Federal Reserve System recently amended Regulation J to impose liability for the failure of a payor bank to comply with the requirement of an electronic advice of non-payment on items over \$2,500, and to provide that a bank failing to use ordinary care in doing so is liable for damages up to the amount of the item, less any sums which could not have been recovered by the

159. In 1977, the Permanent Editorial Board of the Uniform Commercial Code created the 3-4-8 Committee to study the need for revision of articles three and four, among other things. Following an invitational meeting at Williamsburg, Virginia in the spring of 1978, the Permanent Editorial Board instructed the 3-4-8 Committee to proceed with attempts to draft a statute that would embrace both the check collection system and other payment systems. See Memorandum to National Conference of Commissioners on Uniform State Laws from Hal S. Scott, Reporter to the 3-4-8 Committee, dated June 15, 1983. In the fall of 1983, a second conference was convened at Williamsburg to discuss the then most recent draft of the New Payments Code. This complex and comprehensive drafting effort drew intense criticism. It appeared that there was little support for the code in the form it then took.

In June 1984, the Permanent Editorial Board decided to continue its attempts to develop a comprehensive payments code, but without the consumer protection provisions. Thereafter, following discussions with various interest groups, the Permanent Editorial Board reformulated the project to include the drafting of a law governing wholesale wire transfers and the updating of the law applicable to paper transfers. As of the writing of this article, this has become the official position of the American Law Institute and National Conference of Commissioners on Uniform State Law. See Mooney, *Introduction to 1985 Annual Survey of the U.C.C.*, 41 BUS. LAW. — (Aug. 1986).

160. U.C.C. § 4-202(1); *U.S.F. & G.*, 590 F. Supp. at 492-94 (Judge Haight's discussion of the duty to transmit notices).

use of such care.¹⁶¹ One might consider adding to that a duty to wire notice on diverted items. The intermediary banks would forward such notices electronically. The volume and expense would not be great. The expense could be considered a trade-off in return for receipt of similar protective notices if that bank's deposited items were diverted.

On the other hand, the bank to which an item is missent has no prior connection with the item or its drawer, so why impose the expense on it if it merely returns the item to its transferor? On the whole, to us, placing the burden on the diverting bank, even if it had no other connection with the diverted item, seems a more appropriate choice. Factual determinations as to which bank had the duty to send the notice should not be dependent on jury findings as to foreseeability, but rather upon the diverting bank's own action.

C. U.C.C. Section 4-103(5)

Some tinkering with U.C.C. section 4-103(5) is perhaps also in order. In the case of the fraudulent check or even the ordinary bad check, where the failure to exercise ordinary care results in permitted withdrawals because no notice of nonpayment arrived, the loss is measurable, but may not be the face amount of the item. Section 4-103(5) presently bars any recovery in such cases because nothing would have been recovered had ordinary care been used.¹⁶² The damages should include recovery of any withdrawal permitted after the lapse of the "reasonable time" permitted by U.C.C. section 4-213(4), reduced by any recovery shown to be obtainable from the customer of the depository bank. The bank seeking recovery must prove that, had a notice been sent, it would have been received in time to prevent, and would in fact have prevented the withdrawal of some or all of the credit.¹⁶³ Since the liability is for a failure to exercise ordinary care, namely negligence, the defenses to such liability should also apply.

In addition, uniformity is needed in the courts' treatment of the effect of contributory negligence. This necessity is illustrated by the *U.S.F. & G. II* case since Maryland, the place of the depository bank, adheres to a common law contributory negligence defense,¹⁶⁴ while New York, where defendants were located, applies a rule of compara-

161. 50 Fed. Reg. 5734 (1985). See *supra* note 129.

162. Thus, in *U.S.F. & G.*, the loss would literally have been \$880,650 minus zero, whereas only about \$754,000 had been withdrawn. The formula here should, if the face amount of the item is to be used, provide for the subtraction of any balance which is not withdrawn from the account.

163. Some cases have reached the proper result when dealing with a claim that a "wire notice," if sent, could have stopped a withdrawal. See *supra* note 114.

164. C. HEFT, *COMPARATIVE NEGLIGENCE MANUAL* app. II (1978).

tive negligence in tort cases.¹⁶⁵ Yet, as Judge Haight noted in his order granting summary judgment, tort concepts of fault are singularly inappropriate to the check collection system. This system "was designed to facilitate commerce primarily by guiding and making predictable the consequences of behavior."¹⁶⁶ The Code generally allocates losses on the basis of which party would ordinarily be in the best position to prevent the loss.¹⁶⁷ Judge Haight turned to the rules relating to forgeries under the Code in order to find the rule of decision. He reasoned that the loss allocation in the forgery rules was particularly well developed and sensitive to the system. Judge Haight refused to determine which of the parties should initially bear the loss in the case of MICR fraud, but did utilize U.C.C. section 3-406 as the basis for analogizing a rule of contributory negligence, shifting the loss to a negligent depositary bank.¹⁶⁸

A clear and country-wide uniform rule would promote settlement of disputes and furnish a firm basis for alternative dispute resolution procedures. It would encourage depositary banks to exercise reasonable care for their own safety, without requiring manual inspection of each deposited item. U.C.C. section 4-103(5) should, therefore, specify a negligence rule of defense. A proper rule, however, should only find this defensive negligence where a bank permits a withdrawal in the face of actual knowledge of facts or conduct of the customer which indicates the fraudulent nature of the item involved, or in the face of knowledge of such facts outside of the face of the check as would make the forwarding for collection of the item an act of bad faith.¹⁶⁹

165. N.Y. CIV. PRAC. R. § 1411 (McKinney 1975). Despite the rising popularity of comparative negligence, the authors suggest that the preferable rule in the check collection system should be one of contributory negligence. The weighing of relative fault which is required by a comparative negligence system is inconsistent with an automated processing system in which many tasks are performed mechanically and automatically. A comparative negligence system would require an examination of intentions and introduce the foreseeability factors of the *U.S.F. & G.* decision, which are so undesirable. See *supra* text accompanying note 106.

166. 620 F. Supp. at 21.

167. *Id.* at 22. It should be noted, however, that the shift of the loss in U.C.C. section 3-406 works only in favor of holders in due course and innocent payors. In MICR fraud cases, no one will have paid the instrument, and it is questionable if an intermediary bank losing its right of charge back by its diversion of the item qualifies as a holder in due course.

168. *Id.* at 370-73.

169. A failure to investigate for fear of what an investigation would show indicates a lack of good faith. See *Maley v. East Side Bank*, 361 F.2d 393 (7th Cir. 1966); *McCarthy v. Kasperak*, 3 Ohio App. 3d 206, 444 N.E.2d 472 (1981).

D. *Other Provisions*

A bank should be able to extend its hold period upon receipt of a notice of diversion because such notice provides knowledge that a longer than normal time may elapse before the bank receives a notice of dishonor or nonpayment. Equally, upon receipt of such notice, the depository bank should have the option of placing a hold, if it has not already done so. Language in any revision should specify that credit for deposited items is provisional even if no hold is placed, so that the customer may be subjected to an extension of the customary holds when the bank receives a notice of delayed returns.

The right of "charge-back" under U.C.C. section 4-212 would not seem to be triggered by a notice of delay. By the wording of the section, charge-back is conditional on the receipt of a final notice of nonpayment. An added phrase may be needed to cover extensions of a "hold" period. Indeed, in MICR fraud cases, a right of charge-back would be cold comfort except when exercised before any withdrawal, or in those very few instances where a solvent depositor may have accepted such a check. The basic protection must prevent a withdrawal.

Jurisdictions with funds availability statutes should amend them to ensure that, in the case of both MICR fraud and mistakenly mis-sent genuine items, provision is made to enable a bank receiving a notice of diversion to extend its hold period without incurring liability. Since, in some cases, these statutes may not be an integral part of the Code, the escape valve of U.C.C. section 1-103 would not be available, although it is doubtful that any court faced with a blatant MICR fraud case would permit a recovery against a bank that extends its hold period in such a situation. The problem could arise, however, in the context of a missent genuine check with a claim for wrongful dishonor due to the extended hold. Since the funds availability statutes also require disclosure, banks should disclose to their customers the circumstances in which they will extend holds.

Finally, revisers should consider whether the warranty rules of U.C.C. section 4-207(1) need adjustment or have an application that might be contrary to the solution adopted for the problems of MICR fraud and missent items. There is no warranty that an item is the genuine, nonfraudulent instrument it purports to be. The five warranties in U.C.C. section 4-207(2) plus the provisions of U.C.C. sections 3-405 and 3-406 do cover the known pre-MICR frauds. Unless the drawer is precluded, the normal breach of warranty result is to place the entire liability on the first person after the drawer who dealt directly with the malefactor. A similar result would normally be

reached in MICR fraud cases under a literal application of U.C.C. section 4-103(5) since, even if ordinary care had been used in such cases, no recovery could have been obtained on the instrument. Yet, in the case of MICR fraud, we urge a different rule. Both courts and the Board of Governors of the Federal Reserve System have felt that a different rule should apply in cases of failure to give wire notice of nonpayment on large items. Hence, we conclude that no change should be made in the warranty provisions. Depository banks will receive adequate protection by a rule requiring notice of diversion if they also have the ability to extend holds and thus to extend the right to cancel the provisional credit.

Due to the large number of checks to be processed and routed among more than 40,000 depository institutions, imposing a strict warranty liability on depository banks seems unwarranted. Felons can commit MICR fraud by using two distant banks in the same Federal Reserve District. Then there would be no discrepancy between the printed name on the item and the opening four digits of the routing symbol in the MICR line. Indeed, detection at the point of deposit violates the principle that liability should be placed on the bank able to abort a wrongful intrusion into the payments process at the least cost. In order to detect a MICR fraud, the depository bank personnel would have to make a thinking examination of every deposited item. Failure to do so should not be negligence except in exceptional circumstances. The bank diverting a return item to another bank, rather than sending it back to the depository bank, has made a choice as to that item only. It has chosen to take it out of the system on which depository banks base their hold periods. Hence, an obligation to notify is no great burden. It applies only to items that have potential to cause a banking loss due to an extension of the journey time. It does not require a thinking examination of every deposited item, nor of every return item, but requires sending a notice only after actual knowledge is acquired. If no notice of diversion is sent and yet the item is paid by the second bank, no loss would result from the failure to give notice of diversion, except for a small loss of interest arising from allowing withdrawals a couple of days earlier than would have been the case.

One final consideration. Should the accountability rules of U.C.C. section 4-302(a) apply to an item used in a MICR fraud? Since the use of the MICR line arose after the Code scheme was set, and became widespread only after 1956, we can postulate that the drafters did not consider MICR fraud in the determination of what defenses to list in the preamble to U.C.C. section 4-302.

Analysis must proceed through several stages. Do we want to impose liability for failing to revoke the provisional credit within the midnight deadline on a bank to which a fraudulent item has been sent? In MICR fraud cases where there was a discrepancy in the numbers and the name, the courts have struggled to determine which of the two banks is the payor bank or whether they are both subject to payor bank liability. If neither is a payor bank, then U.C.C. section 4-302 has no application. If either or both are payor banks, then can accountability be defeated under the present preamble using the words "or the like"?¹⁷⁰ If it cannot now be defeated, does proper policy require that accountability be defeated by amendment? If it can be defeated, does any strong policy require the imposition of accountability?

First, what is the rule of U.C.C. section 4-302(a) as to payor banks today? The preamble reads: "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" ¹⁷¹ The issue then becomes whether a cash item tainted with MICR fraud is "like" unto a cash item tainted by a breach of warranty.¹⁷² The two most analogous presentment warranties are the warranty of good title and absence of alteration. They cover the two most prevalent pre-Code check frauds—the forged endorsement and the artful alteration. Skillfully conducted MICR fraud is indeed a most artful alteration. It is usually a total creation of the depositing payee, as are some alterations. Hence, we conclude that a court could accept a defense of "or the like" as covering MICR fraud, as Judge Haight impliedly did in *U.S.F.&G.* Should a court do so?

The policy underlying the defense and the warranty seems to be one of risk allocation, based on notions of which bank can best protect the collection system when that system has two points of visual exam-

170. U.C.C. § 4-302 (1978).

171. *Id.*

172. Judge Haight treated First Pennsylvania Bank, the bank designated by the words on the check in *U.S.F. & G.*, as the payor bank. He ruled that the gross negligence of Union Trust barred its recovery under U.C.C. § 4-302(a). See 620 F. Supp. at 373.

Martin held, without discussion, that a bank solely indicated by the MICR routing line, when name and fraction indicated another drawee, was not a payor bank. 609 P.2d at 676, 679. In *Oneida Nat'l Bank & Trust Co. of Cent. N. Y. v. Union Bank of Cal.*, the trial judge ruled on motion for summary determination of issues that counterfeit official checks of the nonexistent "London Office, 95 Duke St., WI" of "Israel Discount Bank, Limited" did not designate Union Bank as a payor bank where there was no printed name of a bank drawee on the item. No. C 372, 643, slip op. at 2 (Sup. Ct. of Cal., County of Los Angeles Dec. 29, 1983). The American Bankers Association routing fraction, however, and the MICR line routing symbol were those of Union Bank of California, and thus would seem to designate it, under Federal Reserve Regulation J, with reasonable certainty. See *supra* note 54.

ination of items—at the point of deposit and at the point of payment as to alterations. The drafters selected the point of deposit. As to forgeries, the theory was that a payor bank could best protect against forgeries of its drawer's signature by signature comparisons, aided by the statement reconciliation duties of its customer. As to forged indorsements, the theory was that banks should not accept items for collection from those who were not credit-worthy. Whether these risk allocations are valid today is beyond the scope of this article.

We do feel, however, that MICR fraud is sufficiently analogous to a material alteration that it should be specifically treated in the Code's midnight deadline accountability rules for payor banks. Specifically, we suggest that the matter be treated in U.C.C. section 4-108, as a separate subsection providing that a bank to which an item has been sent with an encoded account number not compatible with that bank's account numbering system may obtain an extra day for processing simply by sending a notice to its transferor before its midnight deadline expires. The notice must describe the item so that it will be identifiable to the depository bank. The notice could only be given in the case of items where the account number in the MICR line does not designate an active account in the bank, and a name search of the bank's records is necessary to determine if the named drawer is a customer of the bank. The extra day would not be obtainable for other defects in the MICR line which are correctable by standard machine processing procedures, or clearly designate another bank in the printed words.

Furthermore, in such cases, the bank should not be accountable for the full amount of the item. Whether designated by the MICR line or by printed name, a payor bank not returning the item by its midnight deadline and not giving the notice in timely fashion nevertheless should not be liable for more than the amount of any withdrawals allowed after a normally returned item or a timely sent notice would have been received. A notice given to a presenting bank or other intermediary bank should of course be promptly forwarded, as is required for notices of dishonor by U.C.C. section 4-202(1)(b).

The extra time allowance is justified by the same policy underlying the inclusion of the phrase "taking proper action within a reasonably longer time may be seasonable . . ." in U.C.C. section 4-202(2). The midnight deadline limits are based on the assumption that the items fit the system. Digits in a MICR line that do not fit the system make the item one that does not fit the system, and thus an extension of the midnight deadline is justified, but only if notice of the extension

is given. In the bulk cash item process, obtaining the consent of the transferor is not practicable.

Why would we give the right to an extra day to possibly three banks: the MICR line designated bank, the fractionally designated bank, and the bank designated by the printed name? The reason is that, contrary to the rulings of the courts to date,¹⁷³ all three banks should be held to be designated payor banks in the alternative, since the definition of an order in U.C.C. section 3-102(1)(b) states, not that the drawee's name must be printed alphabetically, but only that the drawee must be reasonably identified. A numerical designation, understandable by the operators of the automated system, reasonably identifies the bank with that designation as a "person to pay."¹⁷⁴ Section 3-102(1)(b) continues that the order may be addressed to one or more persons jointly or in the alternative, but not in succession.¹⁷⁵ Hence, one can conclude that each bank so designated numerically or by printed name is a bank "by which the item is payable as drawn or accepted" since, in MICR fraud cases, the drawer or the fraudulent payee is the creator—drawer—of the instrument. Technically, when any designated bank refuses to pay the item, it has dishonored the item because section 3-504(3)(a) provides that presentment "may be made to any one of two or more . . . drawees . . ."¹⁷⁶ Thus, banks have a choice when a numerically designated bank does not pay an item sent to it for payment. They can return it as dishonored, or they can divert it from the return journey to another designated payor, but in such an event, to preserve the integrity of the system, the diverting bank must send the depositary bank a notice of the delay in transit.

The Board of Governors of the Federal Reserve System has recognized the effect on the system of automation's shift from words to figures. Regulation J now provides that no Federal Reserve Bank incurs liability to its sender, or anyone else, for routing an item in accordance with either the MICR line routing number or the routing

173. See *supra* note 172. The old rule of law that words control figures, in today's automated banking world, should be changed. See *supra* note 134.

174. U.C.C. § 3-102(1)(b).

175. From this analysis, one could conclude that the item, when returned by the first bank, was dishonored. Because drawees in succession are not permitted, the item could be returned to the depositary bank, when dishonored by any one of the joint or alternate drawees. See U.C.C. § 3-102(1)(b). Today, however, banks often present dishonored cash items again automatically. A diversion based on notice to the depositary bank should be treated as a second presentment. Where there are alternate drawees, a second presentment can be made to the other designated drawee. The prohibition against drawees in succession is merely designed to prevent a drawer from requiring several presentments before the drawer's liability ripens under the drawer's contract. U.C.C. § 3-413(2).

176. U.C.C. 3-504(3)(a).

fraction.¹⁷⁷ Since the duty is to send for presentment, the justification is that the system requires that any bank so designated is a bank by which the item is payable as drawn.

The existence in U.C.C. section 3-118(c) of the old saw that "words control figures" may require a special provision in the definition of payor bank in article four. When drafting article three, William Prosser, Reporter, told his Associate Reporter, Fairfax Leary, Jr., that the rule of U.C.C. section 3-118(c) was not supported by the empirical evidence he had seen. Revisers of article three would do well, in the computerized and increasingly digital world we live in, more than thirty years after the Code was drafted, to suggest the very change that Prosser felt was really not practicable in 1948-1950. In the routing of checks, figures govern words.

IV. CONCLUSION

We offer the solutions herein as suggestions to be considered for resolution of a complicated problem that has resulted from automation in the collection of cash items and the negative notice of payment character of the system. If we have done no more than emphasize the interrelation of numerous sections of article four and the necessity for judges and others working with problems to consider the impact on the system as a whole of any proposed ruling or amendment, then our effort will not have been wasted.

The true function of the Code is to keep the system operating smoothly when new technical improvements appear and are adopted for the benefit of those interested in the ninety nine percent of items that are good. If the words of the Code are read in the light of the needs of the system as it exists today, it becomes evident that the Code is a document suitable for its basic purpose of permitting "the continued expansion of commercial practices." This should be accomplished through interpretation as well as "through custom, usage, and agreement of the parties." Courts outside the domain of the Court of Appeals for the Second Circuit are free, as we have shown, to interpret existing law in a manner which will protect the system from successful MICR frauds. In view of the precedents being created, however, and the distinguished judges creating the precedents, amendments to the relevant statutes and regulations may well be the better solution.

As W. S. Gilbert wrote in another connection, we say to our readers

177. 12 C.F.R. § 210.6(a)(2) (1985).

[T]he night has been long —
Ditto ditto [our] song — and
Thank goodness they're both of them over!¹⁷⁸

178. W. GILBERT & A. SULLIVAN, *The Nightmare Song of the Lord Chancellor* in *IOLANTHE*, Act II (1882).