

1991

## Effectuating the Customer's Right to Stop Payment of a Check: The Forgotten Section 4-401

D. Benjamin Beard

Follow this and additional works at: [https://digitalcommons.law.uidaho.edu/faculty\\_scholarship](https://digitalcommons.law.uidaho.edu/faculty_scholarship)

 Part of the [Banking and Finance Law Commons](#), and the [Commercial Law Commons](#)

---

# EFFECTUATING THE CUSTOMER'S RIGHT TO STOP PAYMENT OF A CHECK: THE FORGOTTEN SECTION 4-401

D. BENJAMIN BEARD†

## I. INTRODUCTION

The provisions of Article 4 of the Uniform Commercial Code<sup>1</sup> relating to a customer's right to stop payment<sup>2</sup> of an item appear, at first blush, to be clear and straightforward. In fact, these provisions have generated confusion<sup>3</sup> and left the customer at the tender mercies of his bank. When the bank properly honors a stop payment order, the mechanism of the Code works splendidly. The bank returns the item unpaid,<sup>4</sup> and has no liability to its customer<sup>5</sup> or the holder.<sup>6</sup> Ultimate liability in the underlying transaction is resolved between the drawer and holder.<sup>7</sup>

---

† Associate Professor of Law, University of Idaho College of Law.

The author wishes to thank Professors Monique C. Lillard and Dennis C. Colson of the University of Idaho College of Law for their very helpful comments on earlier drafts of this article, and Karl Beus, University of Idaho, College of Law, Class of 1992, for his helpful research assistance. The author also wishes to acknowledge the helpful comments of Professor John F. Dolan, Wayne State University, notwithstanding his disagreement with the thesis of this article.

1. Unless otherwise noted, all references to the "Uniform Commercial Code," "U.C.C.," or "Code" are to the 1989 Official Text. References to "Article 4" are to Article 4 of the Code.

2. Principally U.C.C. §§ 4-403 and 4-407, but also § 4-401.

3. As one court has noted, "the current provisions of the Uniform Commercial Code [relating to the customer's right to stop payment] create ambiguity, inconsistency, conflict and confusion. As a result no clear-cut judicial determination has yet been made to harmonize the provisions, the statutory design and the realities of the practical commercial world." *Thomas v. Marine Midland Tinkers Nat'l Bank*, 86 Misc. 2d 284, 288, 381 N.Y.S.2d 797, 800 (Civ. Ct. 1976).

4. U.C.C. §§ 4-301, 4-302 (1989).

5. Dishonor is not wrongful in such a case because the item is not properly payable. U.C.C. § 4-402; *see infra* notes 92-95 and accompanying text.

6. The item does not act as an assignment of the drawer's funds, and the bank has no liability prior to acceptance. U.C.C. § 3-409 (1989).

7. *Id.* § 3-802.

Serious problems arise, however, when the bank fails to honor a valid and effective stop payment order.<sup>8</sup> Upon payment of the item, the bank will inevitably charge the customer's account.<sup>9</sup> As a result of this charge, the customer loses the use of the funds until the bank recredits the account.<sup>10</sup> The customer's belief in the effectiveness of the stop order exacerbates the situation because the customer is likely to continue drawing checks against funds he assumes are available, with the distinct possibility that these checks will be dishonored for insufficient funds.

Current constructions of the Code frustrate the customer's ability to obtain an immediate recredit to his account. The Code imposes no explicit obligation on the bank to recredit the customer's account,<sup>11</sup> and expressly places the burden of proving the

---

8. This article addresses the customer's right to obtain immediate recredit following payment of an item by a bank over a valid and timely stop order. It proceeds on the assumption that the stop payment order given by the customer to the bank is complete, accurate, and timely. With the proliferation of computerized check processing, however, the question of the efficacy of the stop payment order has been litigated frequently. See Norwood, *Bank Liability for Failure to Stop Payment*, 106 *BANKING L.J.* 527 (1989); Graziano, *Computerized Stop Payment Orders Under the U.C.C.: Reasonable Care or Customer Beware?*, 90 *COM. L. J.* 550 (1985); Lakin, *Stop Payment Orders: What Hath the Uniform Commercial Code Wrought?*, 63 *KY. L.J.* 299, 303-16 (1975). To eliminate the issue of the efficacy of the stop order itself, the terms "stop," "stop order," and "direction to stop," as used in this article, mean a valid, timely, and effective order to stop payment as contemplated by U.C.C. § 4-403(1) (1989).

It should be noted that there are many, particularly in the banking community, that view the customer's right to stop payment as pernicious and abusive. Whether, as a matter of policy, the right to stop payment should be eliminated is beyond the scope of this article. Certainly, reasonable minds may differ about whether a right arising in a simpler, slower era of bank collections is appropriate in today's high volume, automated, check-collection process.

This article, however, takes as a given the decision of the drafters to include the right to stop payment, and the recent decision to continue this right. U.C.C. § 4-403 (1990). Given that the right to stop payment is granted by the Code, it is the position of this article that such a right should be made truly effective, to the extent possible consistent with the structure and policy of the Code, to protect the rights of the customer, his bank, and third parties.

9. This results from the highly automated process of check clearing. U.C.C. § 4-103 comments 1 & 3 (1989); see *infra* note 82 and accompanying text.

10. See *infra* note 111 and accompanying text.

11. U.C.C. § 4-401(1) provides that "[a]s against its customer, a bank may charge against his account any item which is otherwise properly payable from that account even though the charge creates an overdraft." U.C.C. § 4-401 (1989)

fact and amount of loss on the customer.<sup>12</sup> Accordingly, the bank can maintain the charge against the customer's account and force the customer to bear the burden of commencing litigation to recover.<sup>13</sup> This state of affairs unfairly penalizes the customer and runs contrary to the Code policies underlying the right to stop payment.<sup>14</sup>

Although recent decisions have attempted to ease the customer's burden of proving loss once litigation has commenced,<sup>15</sup> the benefits of such analyses remain unavailable to the customer who does not or cannot litigate. To fully effectuate the right to stop payment, the customer must have the ability to force the bank to recredit his account without the necessity of litigation. Professor Alces has noted:

The average check, according to a 1982 report, is drawn for \$570. This amount may be significant to individual consumers, but is not likely to justify economically the drawer's initiation and prosecution of a lawsuit against the drawee that has paid over a stop order. In many instances, the amount of a wrongfully paid check might exceed the

---

(emphasis added). Although the section makes no express provision for the bank's right to charge an account with respect to an item which is *not* properly payable, the negative inference is that no such right exists.

12. U.C.C. § 4-403(3) provides that "[t]he burden of establishing the fact and amount of loss resulting from the payment of an item contrary to a binding stop payment order is on the customer." *Id.* § 4-403(3). Under current "accepted wisdom," the construction of this provision operates to make a bank's payment of an item contrary to a binding stop order somehow "properly payable." *See infra* Part III. Therefore, the bank's charge to the customer's account is valid until the customer satisfies this burden of proof. *See infra* notes 89-92 and accompanying text.

13. *See infra* notes 81-92 and accompanying text.

14. U.C.C. § 4-403 comment 2 (1989) sets forth the clear policy to protect the customer's right to stop payment as follows:

The position taken by this section is that stopping payment is a service which depositors expect *and are entitled to receive* from banks notwithstanding its difficulty, inconvenience and expense. The inevitable occasional losses through failure to stop *should be borne by the banks as a cost of the business of banking* (emphasis added).

This policy continues the historical protections accorded the customer's right to stop payment, *see infra* Part III, and is further supported by the fact that payment of an item over a valid stop order is an improper, wrongful payment. *Id.* §§ 4-403 comment 8, 4-407 comment 1.

15. *See infra* notes 37-55 and accompanying text.

state's small claims court jurisdictional limit and yet be insufficient to justify the litigation expense and delays inherent in a standard tort or contract case. Certainly, were the litigation postures reversed, it is unlikely that a payor bank would initiate an action to recover its wrongful payment of the average check.<sup>16</sup>

Under prevailing interpretations of section 4-403, the customer confronted with a payment over a valid stop order faces two, interrelated problems. First, the customer has lost the use of funds debited from his account following payment of the stopped item. This results from the lack of an express duty on the part of the bank to recredit the account when presented with evidence by the customer of the bank's failure to honor the valid stop order.

This inability to obtain a pre-litigation recredit leads to the customer's second problem. If the bank's payment discharged a valid obligation of the customer, prevailing interpretations of section 4-403(3) indicate that the customer will be unable to prove the requisite "loss" under that subsection in order to recover from the bank. Such a narrow interpretation of "loss" under section 4-403(3) fails to recognize the bank's breach of the bank-depositor contract, and forecloses recovery of "secondary losses," such as loss of credit or subsequent check dishonors resulting from the bank's initial wrongful payment of the stopped item.

By recognizing and giving effect to the forgotten section 4-401, the bank's initial wrong is corrected through recredit. If the bank does not recredit voluntarily, the bank's breach continues to afford the customer the ability to recover all damages flowing therefrom.

The simplest solution to the customer's plight is to amend the Code to provide for an explicit duty on the part of the bank to recredit the customer's account following payment over a valid stop order. Unfortunately, the recently proposed revisions to Articles 3 and 4 do not include such a provision.<sup>17</sup> Accordingly, this

---

16. Alces, *Toward a Jurisprudence of Bank-Customer Relations*, 32 WAYNE L. REV. 1279, 1285-86 (1986) (citing ARTHUR D. LITTLE, INC., ISSUES AND NEEDS IN THE NATION'S PAYMENT SYSTEM 12, table 1 (1982)). See also *infra* note 116 and accompanying text.

17. Uniform Commercial Code Revised Article 3—Negotiable Instruments (With Conforming and Miscellaneous Amendments to Articles 1 and 4), 1990 official text with comments. U.C.C. §§ 4-401, 4-403 and 4-407 (1990); see *infra* Part V.B.

article will provide an analytical pathway through the maze of apparently conflicting Code provisions which impact a customer's right to stop payment. The text of the Code provides the customer with a right to have his account immediately recredited following payment over a valid stop order without the burden of litigation, while protecting the rights of the bank to recover the amount paid in order to avoid unjust enrichment of the customer or other parties. Such application of the Code protects the rights of both the customer and the bank, simultaneously preserving and advancing the policies of the Code.

Part II of this article will discuss the currently accepted wisdom regarding the proper construction of the customer's right to stop payment under section 4-403. Part III will review briefly the history of a customer's right to stop payment and his recourse against the bank for failure to stop. Part IV will proceed to an analysis of the "forgotten" section 4-401, and will show that this section provides an answer to the customer's dilemma regarding recredit following an improper payment. In Part V, a holistic analysis of sections 4-403, 4-407, and 4-401 will demonstrate that the customer's right to stop payment can be effectuated without the loss of legitimate protections of the bank.

## II. THE "ACCEPTED WISDOM"

The dilemma for the customer whose stop order has not been honored lies in the operation of the text of section 4-403,<sup>18</sup> as construed by courts and commentators. "The U.C.C. takes the position that the drawer of a check is entitled to stop payment thereon," and further provides that "[t]o mitigate the severity of that rule on banks, . . . the customer has the burden of proving any loss resulting from the payment of a check contrary to a stop

---

18. U.C.C. § 4-403 (1989) provides:

(1) A customer may by order to his bank stop payment of any item payable for his account but the order must be received at such time and in such manner as to afford the bank a reasonable opportunity to act on it prior to any action by the bank with respect to the item described in Section 4-303.

(2) An oral order is binding upon the bank only for fourteen calendar days unless confirmed in writing within that period. A written order is effective for only six months unless renewed in writing.

(3) The burden of establishing the fact and amount of loss resulting from the payment of an item contrary to a binding stop payment order is on the customer.

payment order.”<sup>19</sup> This is the generally accepted wisdom concerning the approach to the provisions of section 4-403.<sup>20</sup> This approach leaves the customer with the initial burden to litigate the issue of a recredit, because the bank can rely on the provisions of section 4-403(3) and require the customer to prove the loss. More importantly, if taken to its logical conclusion, this analysis forecloses the customer from recovering ancillary losses resulting from the improper payment, such as the wrongful dishonor of subsequent checks or the loss of credit, unless the customer establishes some defense to the stopped item or the transaction out of which it arose.<sup>21</sup> In the absence of such a “real loss,”<sup>22</sup> any other damages<sup>23</sup> will not be recoverable.<sup>24</sup>

---

19. H. BAILEY, *BRADY ON BANK CHECKS* (P) 23.21 at 23-44 (6th ed. 1987).

20. *Id.* at 23-46.

21. *See, e.g., Thomas*, 96 Misc. 2d at 289, 381 N.Y.S.2d at 800-01 (customer's liability on the item continues because the payee is a holder in due course; also, bank can assert the contractual rights of the payee or holder on the underlying transaction as a set-off to customer's claim). *See also infra* notes 83-92 and accompanying text.

22. *Id.* at 289, 381 N.Y.S.2d at 800.

23. For purposes of this article, losses sustained by the customer relating to the stopped item and the transaction out of which the stopped item arose will be referred to as “primary losses.” Other damages, such as those resulting from the wrongful dishonor of subsequent checks, loss of credit or, generally, the loss of the use of the funds by the customer, will be referred to as “secondary losses.” These labels are used solely for clarity and should not be considered as indicative of any substantive distinction between the types of loss. Indeed, it is the premise of this article that no distinction should be made between the types of loss or damage flowing from the bank's wrongful payment over a stop order.

24. *See infra* notes 84-92 and accompanying text. Professors White, Summers, and Clark adopt this view. J. WHITE & R. SUMMERS, *UNIFORM COMMERCIAL CODE 797-98* (3d ed. 1988); B. CLARK, *THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS* (P) 2.06(2) (3d ed. 1990). Certainly, for a customer to recover damages for payment over a valid stop order, the customer, like any aggrieved party, must prove its loss. The “accepted wisdom” regarding the proper construction of Section 4-403(3), however, improperly restricts, to primary losses, the “loss” which must be shown. This construction (1) fails to recognize the wrongfulness of the bank's action in paying over the stop order, U.C.C. § 4-401; and (2) eliminates any incentive for the bank to voluntarily recredit the customer's account to avoid potential liability for secondary losses, because this construction effectively limits the bank's potential liability to an amount not exceeding the amount of the item. *See NICKLES, MATHESON AND DOLAN, MATERIALS FOR UNDERSTANDING CREDIT AND PAYMENT SYSTEMS, Teacher's Manual* 312-13 (West 1987). The construction proposed herein avoids this result, but does not eliminate the need for the customer to prove his losses, primary and secondary, under section 4-403(3).

An early New York decision, *Cicci v. Lincoln National Bank & Trust Co.*,<sup>25</sup> involved an action by a customer under section 4-403 following her bank's wrongful payment over a stop order. The court denied the customer's motion for summary judgment. The court summarized its analysis as follows:

*Prior to the adoption of the Uniform Commercial Code in New York . . . there was no question that a depositor who issued to his bank a timely stop payment order could recover against the bank for a breach of the depositor's order by payment of the check in absence of any ratification of the bank's payment by the depositor. . . . [A] bank after breaching its depositor's instructions to stop payment on a check could not involve him against his will in litigation with a third party in order that the bank could recoup a potential loss resulting from its own error . . . . [Prior to adoption of the Code,] it appears to have been well settled law . . . that a prima facie case was made out by the depositor against the bank for breach of a timely stop payment order on a check, in the absence of ratification, without any allegation of damage. The plaintiff's complaint and the moving papers herein do not even allege . . . any damage by virtue of the bank's breach other than the fact that the plaintiff's account with the defendant bank has been reduced by \$3,000.00 [the amount of the wrongfully paid check].*

[The Court quotes Section 4-403(3).] The plaintiff urges that he is damaged by reason of the fact his bank account has been reduced by \$3,000.00. This contention is without merit because if it were adopted there would be no reason or purpose for the enactment of subdivision (3) of section 4-403 of the Uniform Commercial Code.<sup>26</sup>

In conclusion, the court held that:

[W]here a depositor and maker [sic] of a check moves for summary judgment pursuant to Section 4-403 of the Uniform Commercial Code it is part of the plaintiff's prima facie case to allege and thereafter, of course, to prove that

---

25. 46 Misc. 2d 465, 260 N.Y.S.2d 100 (Syracuse City Ct. 1965).

26. *Id.* at 468, 260 N.Y.S.2d at 102-03 (emphasis added).



he has been damaged by reason of the bank's wrongful payment of a check after receipt of a timely and proper stop payment order. . . .<sup>27</sup>

While the court in *Cicci* construed section 4-403(3) technically, the court did not address the question of what type of damages constitutes a loss which the customer must allege and prove under section 4-403(3). In a pre-Code case that relied on the imminent Code for support, the court suggested that the loss must be a primary loss, i.e., must relate to the instrument stopped, and/or the underlying transaction. In *Universal C.I.T. Credit Corp. v. Guaranty Bank & Trust Co.*,<sup>28</sup> customer sued payor bank for recredit following payment over a valid stop order. Although the court acknowledged the customer's absolute right to stop payment, the court analyzed the status of the depository-presenting bank as a holder in due course (HIDC). Because the presenting bank qualified as an HIDC and the court recognized the right of the payor to be subrogated to the rights of the HIDC,<sup>29</sup> the court held that "C.I.T [customer] is not allowed to recover because it has not borne its burden of showing that it suffered loss from [payor bank's] disregard of the stop payment order; C.I.T suffered no loss because it would have been liable to [depository-presenting bank] as a holder in due course in any event."<sup>30</sup> The court's reasoning indicates that the loss which must be established under section 4-403(3) is a primary loss on the stopped instrument or related transaction.

The reasoning of these early decisions has been adopted in more recent cases. Such decisions construe section 4-403(3) to place the burden on the customer to prove his loss before recovering against the payor bank for wrongful payment. Further, these decisions suggest that the loss must be a primary loss relating directly to the stopped item or to the transaction underlying the stopped item. In *Mitchell v. Republic Bank & Trust Co.*,<sup>31</sup> the court stated:

There is no case law in this state, and nothing in the Official or North Carolina Comments, which defines "loss"

---

27. *Id.* at 468, 260 N.Y.S.2d at 104.

28. 161 F. Supp. 790 (D. Mass. 1958).

29. U.C.C. § 4-407(a) (1989).

30. 161 F. Supp. at 794-95.

31. 35 N.C. App. 101, 239 S.E.2d 867 (1978).

as used in [section 4-403(3)]. We conclude that, where the bank pleads non-loss by the bank customer, a bank customer, in order to recover for damages caused by the bank's payment of a check contrary to a valid stop payment order, must show some loss other than the mere debiting of his bank account in the amount of the check. Otherwise there would appear to be no reason for the enactment of [section 4-403(3)].<sup>32</sup>

If the "mere debiting" of the account is insufficient to support an action under section 4-403(3), the question becomes whether any losses flowing from that "mere debiting," e.g., wrongful dishonor of subsequent checks, constitute sufficient loss under section 4-403(3) to support the customer's right to recover.

In another recent case, *Southeast First National Bank of Satellite Beach v. Atlantic Telec, Inc.*,<sup>33</sup> the court outlined the structure of the customer's case and the bank's response as follows:

Simply because a bank pays a check over a stop payment order does not entitle the customer to recover damages against the bank, but it does establish a *prima facie* case for the customer. The bank must present evidence to show absence of loss, or the right of the payee of the check to receive payment. Then *the customer must sustain the ultimate burden to show why there was a defense to payment of the item.*<sup>34</sup>

This statement makes clear that the loss which the customer must prove under section 4-403(3) relates to the stopped item. That is, the customer must show a defense to payment to prove that he has suffered a "loss" under section 4-403(3).<sup>35</sup>

Although the foregoing analysis of the customer's burden of proof appears to be supported by the language of section 4-403(3),

---

32. *Id.* at 103, 239 S.E.2d at 869. The court adopted the procedural structure relating to burdens of proof under *Thomas v. Marine Midland Tinkers Nat'l Bank*, 86 Misc. 2d 284, 381 N.Y.S.2d 797 (Civ. Ct. 1976); see *infra* notes 38-45 and accompanying text.

33. 389 So. 2d 1032 (Fla. Dist. Ct. App. 1980), *petition denied*, 397 So. 2d 779 (Fla. 1981).

34. *Id.* at 1033 (emphasis added).

35. See also *Kunkel v. First Nat'l Bank of Devil's Lake*, 393 N.W.2d 265, 267 (N.D. 1986) (customer must show some loss other than the "mere debiting of his bank account" resulting from payment over stop).

the harshness of the requirement that the customer show some loss relating to the item or the underlying transaction has led to a softening of this burden by some courts. As Professor Rubin has noted, "In several cases, the courts have focused on the somewhat scholastic distinctions between the burden of going forward and the burden of proof. . . ."<sup>36</sup> While adopting a plain-reading interpretation of section 4-403(3), the *Mitchell* and *Telec* decisions<sup>37</sup> followed the seminal case of *Thomas v. Marine Midland Tinkers National Bank*<sup>38</sup> regarding the allocation of burdens of proof to soften the effect on the customer. In *Thomas*, following a trial in which the customer proved payment by the bank over a valid stop order, the bank "virtually rested on [the customer's] case,"<sup>39</sup> neither asserting a defense nor adducing any real evidence whatsoever. The court recognized that:

The burden imposed upon the customer by . . . Section 4-403(3) . . . would appear to be inconsistent with the overall policy expressed in subdivision (1) of this section of the Code that the depositor's right to stop payment is a service to which he is entitled without regard to any inconvenience or occasional loss to the bank, and such right need not be predicated on proof of sound legal grounds.<sup>40</sup>

To effectuate this policy underlying the right to stop payment, the court established the following analytical framework regarding the burden of proof placed on the customer by section 4-403(3), and the bank's right of subrogation under section 4-407. First, the customer must establish the validity of the stop order and the fact of payment by the bank with a corresponding charge to the customer's account.<sup>41</sup> Such a showing establishes the customer's prima facie case for recovery.<sup>42</sup> The bank must then come forward with evidence demonstrating a non-loss by the customer.<sup>43</sup> Upon

---

36. Rubin, *Policies and Issues in the Proposed Revision of Articles 3 and 4 of the U.C.C.*, 43 BUS. LAW. 621, 659 (1988).

37. See *supra* notes 31-36 and accompanying text.

38. 86 Misc. 2d 284, 381 N.Y.S.2d 797 (Civ. Ct. 1976).

39. *Id.* at 287, 381 N.Y.S.2d at 799.

40. *Id.* at 288-89, 381 N.Y.S.2d at 800; see *infra* note 112 and accompanying text.

41. 86 Misc. 2d at 290, 381 N.Y.S.2d at 801-02.

42. *Id.* at 291, 381 N.Y.S.2d at 801-02.

43. *Id.*

the entry of such evidence by the bank, "the customer must sustain the ultimate burden of proof on the issue of loss."<sup>44</sup>

Such an analysis arguably strengthens the customer's ability to obtain a recredit; however, two problems remain. First, such a benefit only arises in the litigation context. The bank remains in a position to assert that because the customer cannot sustain his ultimate burden, he is not entitled to a recredit. More to the point, the nature of the loss which the customer must establish remains unclear. The immediate loss to the customer and the focus of the customer's action under section 4-403 relate to obtaining a recredit to his account. The propriety of a recredit per se involves the customer's rights in relation to the item itself and the underlying transaction. Yet this focus leads to the myopic view that fails to take into account further losses resulting from the charge. To properly analyze the competing rights and obligations of the customer and his bank, the issues relating to the bank's right to make and maintain the charge to the customer's account must be separated from the customer's right to recover damages caused by the wrongful payment, which may or may not include the amount of the item improperly paid.<sup>45</sup>

It is remarkable that in none of the cases so far discussed did the court even mention section 4-401. In *Siegel v. New England Merchants National Bank*,<sup>46</sup> the Supreme Judicial Court of Massachusetts considered the interplay of section 4-401 with sections 4-403 and 4-407. In *Siegel*, the bank prematurely paid a post-dated check of its customer, the drawer-depositor. In a suit brought by the customer's executrix for improper payment, the court analogized to the rights of the parties following payment over a valid stop. The court held that the customer had a valid claim for

---

44. *Id.*, 381 N.Y.S.2d at 802.

45. *See supra* note 23. Without a clear delineation between the bank's culpability in paying over a valid stop order and the customer's damage, both primary and secondary, flowing from the payment, the "accepted wisdom" regarding the operation of § 4-403(3) precludes the customer from recovering all losses and damages flowing from the bank's breach of contract. *See Phillips, The Commercial Culpability Scale*, 92 YALE L.J. 228 (1982). When a bank pays over a valid stop order, and the customer's valid obligation is discharged *and* no other secondary losses result from the payment, the customer cannot recover damages. Under current constructions of 4-403(3), however, the customer cannot recover *any* losses resulting from the payment, if payment of the item by the bank either satisfied or discharged a valid obligation of the customer. This result ignores the customer's right to stop payment and precludes recovery of valid losses flowing from the bank's breach of this right. *See infra* Part V.

46. 386 Mass. 672, 437 N.E.2d 218 (1982).

wrongful payment, but that the bank was entitled to be subrogated to the rights of the payee and any other holder on the item.<sup>47</sup> The court held that "the bank must recredit the depositor's account, but *may then* assert against the depositor any rights acquired by prior holders on either the instrument or the transaction from which it arose."<sup>48</sup>

The court explained the issue as a question of loss to the customer. The bank, although not entitled to debit the account for an item that is not "properly payable," asserted by way of defense that because the payment discharged a legal obligation of the customer, there had been no loss which the customer was entitled to recover.<sup>49</sup> To resolve this dispute, the court stated:

[T]he code fixes the rights of the bank and the depositor by a *two part adjustment*. The depositor has a claim against the bank for the amount improperly debited from its account, and the bank has a claim against the depositor based on subrogation to the rights of the payee and other holders. The bank may assert its subrogation rights defensively when its depositor brings an action for wrongful debit.<sup>50</sup>

The *Siegel* decision is somewhat inconsistent. In analyzing section 4-403(3), the court reasoned that between the bank and the customer, the customer is in the best position to prove losses resulting from payment over the stop: "The depositor, who participated in the initial transaction, knows whether the payee was entitled to eventual payment and whether any defenses arose. Therefore section 4-403(3) requires that he, rather than the bank, prove these matters."<sup>51</sup> If this is the meaning of 4-403(3), then it appears that until such a defense on the underlying transaction is established, the customer will not have satisfied its burden under section 4-403(3), and the debit to the account can stand.<sup>52</sup>

In its summary of the interplay between sections 4-401, 4-403, and 4-407, the court stated, however, that "[t]his view of the three relevant sections of the code suggests a fair allocation of the burden of proof. *The bank, which has departed from authorized*

---

47. *Id.* at 681, 437 N.E.2d at 224.

48. *Id.* at 673, 437 N.E.2d at 220 (emphasis added).

49. *Id.* at 675, 437 N.E.2d at 221.

50. *Id.* at 676, 437 N.E.2d at 221-22 (emphasis added).

51. *Id.* at 678, 437 N.E.2d at 222.

52. See *infra* notes 90-92 and accompanying text.

*bookkeeping, must acknowledge a credit to the depositor's account.*"<sup>53</sup> The bank must then carry the burden to establish its subrogation rights, including "the status of the parties in whose place it claims."<sup>54</sup> Finally, "the [customer] must then prove any facts that might demonstrate a loss."<sup>55</sup> This procedural framework suggests that the bank's wrongful debit constitutes the initial wrong, and any losses flowing from that debit would be sufficient to demonstrate loss under section 4-403(3). Yet it remains unclear whether the bank has any obligation to its customer to recredit the account prior to the joinder of all issues in litigation.

The technical reading of the requisite loss that must be proven under section 4-403(3) found in the foregoing analyses fails to address two interrelated issues. First is the issue of the propriety of the bank's charge of the customer's account following payment over a valid stop order. Proper analysis of the first issue then reveals the necessity to address the scope of the term "loss" as used in section 4-403(3). If it is concluded that the charge was improper in the first instance, then any secondary losses flowing from the wrongful act must be recoverable regardless of the lack of any primary loss on the stopped item and the underlying transaction.

### III. THE CUSTOMER'S RIGHT TO STOP PAYMENT—HISTORY

#### A. *Pre-Code Theory and Rules Regarding the Right to Stop*

Prior to the Code, the courts had developed clear, logical rules regarding the customer's right to stop payment. The contract

---

53. 386 Mass. at 678, 437 N.E.2d at 222-23 (emphasis added).

54. *Id.*, 437 N.E.2d at 223. It may be suggested that *Siegel* places the bank in the untenable position of having to prove facts of which it has no knowledge, e.g., the existence and rights of the payee or other holder or holder in due course to which it seeks subrogation. However, this is a burden borne by any party seeking rights of subrogation. As a subrogee under section 4-407, the bank must establish the existence and rights of its subrogor. Further, this is not unwarranted because the bank has no less knowledge of the existence of such parties than does the customer.

The customer must carry the burden of proving his damages, both primary and secondary, because he is in the best position to have access to such evidence. As to the rights of other parties to which the bank may claim subrogation, however, the customer is in no better position than the bank to establish such facts. Section 4-407 properly places the burden on the bank to establish its rights of subrogation.

55. *Id.* at 679, 437 N.E.2d at 223.

between the customer and the bank was defined as a debtor-creditor relationship.<sup>56</sup> This contract required the bank to honor all valid and proper orders of the customer to pay amounts from his account with the bank, for as long as funds remained available in the customer's account. The customer's order, however, remained executory and could be rescinded until the bank made payment.<sup>57</sup> Upon receipt of a timely stop payment order, the bank ceased to have authority to pay the item.<sup>58</sup> Because the bank-customer contract permitted the bank to pay only authorized orders, payment over the stop payment order constituted a breach of contract.<sup>59</sup>

The customer established the bank's breach by proving the timeliness and validity of the stop order.<sup>60</sup> Prior to the Code and upon such a showing, the bank was strictly liable for the amount paid out over the stop order.<sup>61</sup> The bank's negligence, or lack thereof, was irrelevant to the fact that a breach occurred and the customer had lost the funds paid out.<sup>62</sup> Consequently, the bank was obligated to recredit the customer's account in the amount paid out over the stop. Further, because any debit to the account was a breach of contract, damages for subsequent items dishonored as a result of the wrongful debit were recoverable. This result logically follows from the foreseeability of such damages by the bank, if its wrongful payment and debit reduced the account balance and resulted in insufficient funds returns of subsequent items.

As holder of the funds, the bank retained the ability to force the customer to litigate to recover. Yet, the existence of a clear rule imposing initial liability on the bank exposed the bank to potential liability over and above the amount of the item debited.

---

56. 6 C. ZOLLMANN, *BANKS AND BANKING* §§ 3701, 3710 (1936); TIFFANY ON *BANKS AND BANKING* §§ 41, 42 (1912); Hawkland, *Stop Payment Orders Under the Uniform Commercial Code*, 75 *COM. L.J.* 53, 59 (1970); Horner, *The Stop Payment Order*, 2 *BAYLOR L. REV.* 275, 286-87 (1950); Comment, *Stop Payment: An Ailing Service to the Business Community*, 20 *U. CHI. L. REV.* 667, 668 (1953); Note, *Stop Payment and The Uniform Commercial Code*, 28 *IND. L.J.* 95 (1952); Symons, *The Bank-Customer Relation: Part I—The Relevance of Contract Doctrine*, 100 *BANK. L.J.* 220, 222-23 (1983).

57. See *supra* note 56; see also *U.C.C.* § 4-303 (1989).

58. C. ZOLLMANN, *supra* note 56, § 3701, at 108.

59. See *supra* note 56.

60. C. ZOLLMANN, *supra* note 56, § 3710.

61. *Id.*

62. *Id.*

Such potential liability provided strong incentives to the bank to recredit the customer's account and to pursue litigation to recoup losses at a later time.<sup>63</sup>

Banks responded to such potential liability by attempting to disclaim liability for failing to honor stop orders through exculpatory clauses. Such clauses were generally unenforceable prior to the Code,<sup>64</sup> and remain unenforceable under the Code.<sup>65</sup> Banks further claimed a right to maintain the charge following payment over a valid stop on the grounds that by retaining the benefits of the underlying transaction, the customer had ratified the bank's payment over the stop order.<sup>66</sup>

Banks were able to obtain some relief in a few jurisdictions under the theory of equitable subrogation.<sup>67</sup> Although in the absence of ratification, the bank was strictly liable for payment over a valid stop order, some courts recognized that such a result could operate to unjustly enrich the customer by leaving the customer with both the consideration in the underlying transaction and the price paid. Consequently, a minority of courts allowed the bank to assert a claim against its customer or the merchant-payee by way of a separate action for equitable subrogation. The bank's assertion of this right was wholly separate from the issue of the bank's right, in the first instance, to charge the customer's account. The bank simply did not have the authority to charge the account.<sup>68</sup>

Accordingly, on the eve of the drafting of the Code, the customer's right to stop payment was absolute. In the absence of ratification, the bank had no right to charge the customer's account and could only obtain relief in a minority of jurisdictions by way of a separate, independent claim of subrogation.

### B. *The Early Drafts of the Code*

The Code drafters initially proceeded to codify the absolute liability of the bank for payment over a valid stop order.<sup>69</sup> They

---

63. For example, the bank may have been entitled to recover from its customer under the theory of ratification. See *Chase Nat'l Bank v. Battat*, 297 N.Y. 185, 78 N.E.2d 465 (1948). Also, the bank was accorded certain rights to be subrogated to the rights of the customer, payee, or other holder to prevent unjust enrichment. Horner, *supra* note 56, at 286-87.

64. 1 N.Y. Law Revision Comm'n. 1954 Report at 463 (1954); see also Comment, *The Stop Payment Order—A Potential Pandora's Box for the Drawer*, 39 ALB. L. REV. 252 (1975); Note, *supra* note 56; Horner, *supra* note 56, at 275.

65. See *supra* note 64; U.C.C. § 4-103(1).

66. See *supra* notes 56, 63. This defense is maintained under U.C.C. § 4-403 comment 8.

67. See *supra* notes 56-66.

68. See Horner, *supra* note 56, at 286-87.

69. "A payment in violation of an effective direction to stop payment is



also codified the bank's right of subrogation to avoid the potential for unjust enrichment.<sup>70</sup> The drafters, however, specifically prohibited the bank from charging a wrongful payment to the customer's account.<sup>71</sup> At this point, the Code retained the significant distinction between the bank's ability to charge the customer's account and the bank's ability to recoup potential losses through subrogation.<sup>72</sup>

The basic structure of the provisions relating to the bank-customer relationship took form in the September 1950 revisions to Article 4.<sup>73</sup> Section 4-501 specifically permitted the bank to charge items which were "properly payable" to the account of its customer.<sup>74</sup> Section 4-503 codified the customer's absolute right to stop payment, and section 4-507 codified the bank's rights of

an improper payment, even though it is made by mistake or inadvertence, *and it may not be charged to the drawer's account. . .*" U.C.C. § 4-203 comment 8 (Proposed Final Draft, Spring 1950), *reprinted in* 10 E. KELLY, *UNIFORM COMMERCIAL CODE DRAFTS 494-95* (1984) [hereinafter U.C.C. DRAFTS] (emphasis added).

70. *Id.* § 4-402(4), *reprinted in* 10 U.C.C. DRAFTS at 533. That section provided in relevant part:

(4) To prevent unjust enrichment a payor bank which has paid an item drawn or made by a customer and which it may not charge to his account may *in an action*

(a) against the holder who has received payment recover any part of the payment due its customer or any prior party in respect of the transaction in which the customer of the depository bank acquired the item; and

(b) against its customer recover any amount which would have been due from him on the item if payment had been refused.

*The bank has no right to charge the customer's account in respect of such cause of action.*

*Id.* (emphasis added).

Comment 5 to that section stated:

Subsection (4) gives a bank a right to recover *by action* where it has paid a validly drawn item over a stop-order or in other circumstances not permitting a charge to the account. . . . The section *does not permit a charge to the account* requiring the bank's rights to be established in an action or other proceeding.

*Id.* § 4-402 comment 5, *reprinted in* 10 U.C.C. DRAFTS at 534-35 (emphasis added).

71. *See supra* note 69.

72. *Id.*

73. U.C.C. Article 4, Part 5 (Revisions, Sept. 1950), *reprinted in* 11 U.C.C. DRAFTS at 381-85.

74. *Id.* § 4-501, *reprinted in* 11 U.C.C. DRAFTS at 381. This is the first time the drafters included an explicit provision regulating the right of the payor bank to charge the customer's account.

subrogation.<sup>75</sup> Section 4-507 continued the bank's right to recover as subrogee of the holder or the customer, but only by way of a separate action.<sup>76</sup> The September 1950 revisions continued the premise that payment over a valid stop could not be charged to the customer's account, although the bank may have had a cause of action, as subrogee, to recoup amounts necessary to prevent unjust enrichment.

The stop payment provisions of Article 4 took a dramatic turn between the September 3, 1951 draft and the November 1951 Final Text Edition.<sup>77</sup> In an effort to placate banking interests, which had been unsuccessful in obtaining validation of exculpatory clauses or limiting the efficacy of oral stop payment orders,<sup>78</sup> the drafters for the first time incorporated section 4-403(3). In the November 1951 Draft, the burden of establishing loss was placed on the customer under section 4-403(3),<sup>79</sup> and the bank's right of subrogation was not limited to realization via a separate cause of action.<sup>80</sup>

---

75. *Id.* §§ 4-503, 4-507, 11 U.C.C. DRAFTS at 381, 383-84.

76. *Id.* § 4-507, 11 U.C.C. DRAFTS at 383-84.

77. Compare Uniform Commercial Code Article 4: Bank Deposits and Collections, Superseding August 1951 Revision, Text Edition (September 3, 1951), reprinted in 12 U.C.C. DRAFTS at 360-64, and Uniform Commercial Code: Final Text Edition (November 1951), reprinted in 12 U.C.C. DRAFTS at 554-57.

78. See N.Y. Law Revision Comm'n, *Study of Uniform Commercial Code: Memoranda Presented to the Commission and Stenographic Report of Public Hearing on Articles 3 and 4 of the Code*, Legis. Doc. 65(C), 1 N.Y. Law Revision Comm'n 1954 Report 187-548, particularly testimony of Walter D. Malcolm at 467-68 (1954).

79. Section 4-403(3) provided, "The burden of establishing the fact and amount of loss resulting from the payment of an item contrary to a binding stop payment order is on the customer." U.C.C. § 4-403(3) (Final Text Edition, November, 1951), reprinted in 12 U.C.C. DRAFTS at 555.

80. Section 4-407 provided,

If a payor bank has paid an item over the stop payment order of the drawer or maker or otherwise under circumstances *giving a basis for objection by the drawer or maker*, to prevent unjust enrichment and only to the extent necessary to prevent loss to the bank by reason of its payment of the item, the payor bank *shall be subrogated* to the rights

(a) of any holder in due course on the item against the drawer or maker; and

(b) of the payee or any other holder of the item against the drawer or maker either on the item or under the transaction out of which the item arose; and

(c) of the drawer or maker against the payee or any other holder

The 1952 draft of the Code<sup>81</sup> provided commentary explaining this drastic change. Comment 9 to section 4-403 noted that, upon payment of an item over a valid stop, banks make a charge against the customer's account in the ordinary course.<sup>82</sup> Because the customer bears the burden of establishing the loss resulting from payment over a stop order, the bank is not obligated to recredit the customer's account until the customer satisfies this burden.<sup>83</sup> These provisions placed the burden of litigating on the customer in the absence of an ability to obtain a voluntary recredit by "satisfying" the bank that a loss resulted from the bank's error.

The significance of the change wrought by the November 1951 draft lies in the manner in which the customer obtained recourse for a wrongful payment over a valid stop order. Under the common law rule and the initial drafts of the Code, the customer's right to obtain recredit was absolute; the bank lacked the right to charge the customer's account, and any damages flowing from the wrongful charge were recoverable, regardless of the rights or obligations of the customer on the item or the underlying transaction. Placing the burden of establishing loss on the customer created an anomalous situation in which the customer could not recover for damages flowing from the charge to its account unless he first

---

of the item with respect to the transaction out of which the item arose. U.C.C. § 4-407, *reprinted in* 12 U.C.C. DRAFTS at 557 (emphasis added).

This provision is identical to the current section 4-407. Note that the provision no longer refers to a payment which the bank may not charge to the account of the customer. Moreover, there is no language limiting the bank's right of subrogation. The right is simply granted to the bank. *Cf.* U.C.C. § 4-402(4) (Proposed Final Draft, Spring, 1950), *reprinted in* 10 U.C.C. DRAFTS at 533. *See supra* note 69.

81. Uniform Commercial Code (Official Draft, 1952), contained in volumes 14 & 15 of Kelly's U.C.C. DRAFTS.

82. Comment 9 provided:

When a bank pays an item over a stop payment order, such payment automatically involves a charge to the customer's account. Subsection (3) imposes upon the customer the burden of establishing the fact and amount of loss resulting from the payment. Consequently until such burden is maintained either in a court action or to the satisfaction of the bank, the bank is not obligated to recredit the amount of the item to the customer's account and, therefore, is not liable for the dishonor of other items due to insufficient funds caused by the payment contrary to the stop payment order.

*Id.* § 4-403 comment 9, *reprinted in* 14 U.C.C. DRAFTS at 534.

83. *Id.*

established a primary loss on the item in a judicial proceeding.<sup>84</sup>

Comment 9, however, was deleted from the Code without explanation in the 1957 draft of the Code.<sup>85</sup> Both the author of comment 9, Walter D. Malcolm, and the Editorial Board of the 1955 draft of the Code considered comment 9 merely a "logical extension" of the rule set forth in section 4-403.<sup>86</sup> On the other hand, the New York Law Revision Commission, in its study of Article 4, was not convinced of the propriety of comment 9. The Commission stated,

Subrogation to a right to enforce [an item under section 4-407] is not the same thing as a right to charge the customer's account. . . . Comment 9 [to section 4-403] states that until [the customer satisfies its burden under section 4-403(3)] the bank is not obligated to recredit the customer's account. It is not clear that the rule indicated in this Comment 9 does result from the text of Section 4-403(3).<sup>87</sup>

These disparate interpretations of the impact of section 4-403(3) on the bank's liability for subsequent losses following a debit after payment over a valid stop order provide little instruction on the current effect of section 4-403(3). On the one hand, the deletion of comment 9 may indicate the drafters' ultimate agreement with the Law Revision Commission. Yet, deletion of comment 9 may have been a means by which to avoid conflict with the New York Commissioners and allow the courts to interpret section 4-403(3) to its "logical conclusion." Based on current analyses by the courts,<sup>88</sup> it appears that the view of the Editorial Board in 1955 has prevailed.

---

84. See Lakin, *supra* note 8, at 320 (loss which must be established by the customer under section 4-403(3) is tied to the drawer's "rights against the payee or other holder").

85. U.C.C. § 4-403 Official Draft with Comments 1957, *reprinted in* 19 U.C.C. DRAFTS at 448-50.

86. See testimony of Walter D. Malcolm, 1 N.Y. Law Revision Commission 1954 Report at 467-8 (1954); see also Supplement No. 1 to the 1952 Official Draft 145 (1955), *reprinted in* 17 U.C.C. DRAFTS at 463.

87. 2 N.Y. Law Revision Commission 1955 Report at 339 (1955).

88. See *supra* Part II.

Indeed, Professor Clark characterizes the effect of section 4-403(3) in a manner consistent with former comment 9:

This completely mysterious § 4-403(3) means that the drawee bank would not be liable for wrongful dishonor of subsequent checks, checks that would have been honored if the stop order had been followed. Until the customer satisfies his burden of proof in a court under § 4-403(3), the item is presumably properly payable.<sup>89</sup>

Apparently Professors White and Summers agree with such an analysis. They posit a hypothetical in which a customer sues his bank for payment over a valid stop order and the wrongful dishonor of subsequent checks.<sup>90</sup> Where "the court finds that the payee had no good cause of action," the court will order a recredit and also rule in favor of the customer regarding his action for wrongful dishonor.<sup>91</sup> However:

If the bank-customer litigation [under 4-403(3)] comes out the other way (by subrogation under 4-407 bank shows that its subrogee—payee or other holder—had a good cause of action against customer), . . . . The bank as subrogor *sustains its right to debit the account notwithstanding the stop order*. Having sustained this right with respect to the first check, *it follows that the bank may dishonor checks subsequently presented against insufficient funds*.<sup>92</sup>

#### IV. THE FORGOTTEN SECTION 4-401

Conspicuous by its absence in the foregoing analysis is any reference to section 4-401.<sup>93</sup> The analyses of both Professor Clark

---

89. B. CLARK, *supra* note 24, (P) 2.06(2) at 2-100.

90. J. WHITE & R. SUMMERS, *supra* note 24, at 797.

91. *Id.*

92. *Id.* at 797-98 (emphasis added).

93. Section 4-401(1) provides that "[a]s against its customer, a bank *may charge against his account* any item which *is otherwise properly payable* from that account even though the charge creates an overdraft." U.C.C. § 4-401(1) (1989) (emphasis added).

It may be argued that the general provisions of § 4-401 have been superseded by the specific provisions of § 4-403(3). Section 4-401, however, addresses *the bank's right* to charge its customer's account. Section 4-403 says nothing about the bank's right to charge an account, but rather addresses the *customer's rights* and obligations concerning a stop order.

and Professors White and Summers indicate that the initial wrongful charge to the account following a payment over a valid stop can somehow be validated retroactively if the customer fails to show some "right" to stop the item in question. The difficulty, however, with such analyses derives from two factors. First, the bank has no authority to charge an item to the customer's account which is not properly payable to the customer's account.<sup>94</sup> Second, payment over a valid stop is wrongful.<sup>95</sup>

Nothing in the Code changes the basic relationship between the customer and the bank. The bank is permitted to pay and charge only authorized orders of its customer.<sup>96</sup> A check is an executory order of the customer until payment or acceptance by the bank.<sup>97</sup> In the event a timely and effective stop order is received by the bank, any authority to pay the item and charge the account is revoked.<sup>98</sup> Accordingly, regardless of the customer's rights vis-à-vis the payee or holder, the bank lacks the authority to pay the item or, more importantly, to charge the customer's account. To prevent unjust enrichment to the customer, the bank is given rights of subrogation to recover the amount of the item paid.<sup>99</sup>

Moreover, the Code does not displace other common law defenses and rights developed to equitably allocate losses on the item and underlying transaction.<sup>100</sup> None of these rights and defenses, however, negates the initial wrongful nature of the bank's payment and charge of the customer's account. To rectify this problem, the bank must be obligated to recredit the customer's account without the need for litigation and before any secondary losses result from the charge. Further, the bank must be answerable for such secondary damages regardless of its rights relating to the payment of the item itself.

The Supreme Court of Ohio established a duty to recredit a

---

94. *Id.* § 4-401 (1989).

95. Comment 8 to § 4-403 states that "[a] payment in violation of an effective direction to stop payment is an improper payment, even though it is made by mistake or inadvertence." *Id.* § 4-403 comment 8. Comment 1 to § 4-407 reaffirms this position: "Section 4-403 states that a stop payment order is binding on a bank. If a bank pays an item over such a stop order it is prima facie liable . . ." *Id.* § 4-407 comment 1.

96. *Id.* §§ 4-401-402; see *supra* notes 57-59 and accompanying text.

97. U.C.C. §§ 3-409, 4-303 (1989).

98. *Id.* § 4-303.

99. *Id.* § 4-407.

100. *Id.* §§ 1-103, 4-407 comment 5, 4-403 comment 8.

customer's account when a bank pays items that are not "properly payable." In *Cincinnati Insurance Co. v. First National Bank of Akron*,<sup>101</sup> the bank paid items lacking necessary indorsements. In a broad holding, the court decided for the customer and held that "[w]hen a bank charges an item, which is not 'properly payable' pursuant to R.C. 1304.24 [U.C.C. § 4-401], against a customer's account, the bank is required to recredit the customer's account in the amount of the item."<sup>102</sup> Although this holding was rendered in a case involving payment over an invalid indorsement, the court's analysis proceeded entirely under section 4-401:

[I]f [the bank] had examined the checks to verify that each of the named payees had appropriately endorsed the checks, the banks would have known that the checks were not "properly payable" under [4-401]. Since [the bank] failed in this regard, they breached the contract with their customer. Thus, by the clear implication of [4-401], if the item is not "properly payable," the bank is required to recredit the customer's account.<sup>103</sup>

Given that a payment over a valid stop is an improper payment,<sup>104</sup> under the rationale of the Ohio Supreme Court, the bank must recredit the customer's account. Because this duty is imposed on the bank, any failure to recredit will make subsequent dishonors wrongful. By placing a duty to recredit on the bank from the beginning, it is clear that any subsequent dishonors, loss of credit, or other losses flowing from the wrongful debit will constitute losses within the meaning of section 4-403(3).

An early case recognizing many of the policies protecting the customer's right to an immediate recredit is *Sunshine v. Bankers Trust Co.*<sup>105</sup> *Sunshine* addressed the bank's subrogation rights under section 4-407. In *Sunshine*, the payee-depositor of a check drawn on the depository bank sued to recover for an improper charge-back to the customer's account following a stop order from the drawer.<sup>106</sup> Though the facts involved a charge-back to the account of the depositor of an "on-us" item, rather than a debit to the account of the drawer of the item, the court's reasoning

---

101. 63 Ohio St. 2d 220, 407 N.E.2d 519 (1980).

102. *Id.* at 220, 407 N.E.2d at 520.

103. *Id.* at 224, 407 N.E.2d at 522.

104. U.C.C. § 4-403 comment 8 (1989).

105. 34 N.Y.2d 404, 314 N.E.2d 860, 358 N.Y.S.2d 113 (1974).

106. *Id.* at 407-08, 314 N.E.2d at 862, 358 N.Y.S.2d at 116.

concerning the bank's rights as to crediting and debiting the depositor's account are apropos. The court held that the bank's charge-back of the item following receipt of a stop order was untimely and hence improper.<sup>107</sup> The bank, however, claimed the right of subrogation to the position of the drawer as against the plaintiff-depositor.<sup>108</sup> In this context, the court set forth reasoning which indicates that a drawer, whose account has been charged following a valid stop, should be entitled to an immediate recredit, with the burden being placed on the bank to proceed by way of subrogation to recoup any resultant loss.

The depositor asserted that the bank had no right of subrogation because no debit to the drawer account had been made,<sup>109</sup> and accordingly, the drawer had suffered no loss to which the bank could be subrogated.<sup>110</sup> In holding that the bank need not go through a mere formality of debiting and recrediting the drawer's account in order to be entitled to subrogation the court stated:

When a stop-payment order has been timely given, *the party issuing the order should not lose the use of its funds.* Yet, if we were to accept the [depositor's] argument, the bank would be compelled to debit the account of the party issuing the stop payment as a precondition for suing as a subrogee of that party. *The "innocent" party who issued the timely stop-payment order would then lose the use of the funds for some time.* Certainly, the court should not compel a bank to, in effect, *wrongfully convert* a customer's fund in order to vindicate its subrogation rights.<sup>111</sup>

The court also addressed the bank's argument regarding its ability to avoid loss following payment over a valid stop. Although it did address the issue of the bank's rights of subrogation against the drawer, the court noted:

Usually, the code provides the Bank with a means of recouping any loss it has suffered, but this is by no means always the case. The Official Comment to section 4-403 of

---

107. *Id.* at 410, 314 N.E.2d at 863, 358 N.Y.S.2d at 118.

108. *Id.* at 411, 314 N.E.2d at 864, 358 N.Y.S.2d at 120.

109. *Id.* at 412, 314 N.E.2d at 864, 358 N.Y.S.2d at 120.

110. *Id.*, 314 N.E.2d at 865, 358 N.Y.S.2d at 120.

111. *Id.* at 412-13, 314 N.E. 2d at 865, 359 N.Y.S.2d at 121 (emphasis added).



the Code makes clear that a stop-payment order need not be supported by a sound legal basis; it is, instead, a service that must be provided by the banking industry. [The court quotes comment 2.]<sup>112</sup>

The court held that the depositor was entitled to summary judgment on the issue of the bank's charge-back of the item to her account,<sup>113</sup> and that "the money is now hers subject to recovery by the Bank qua subrogee of [drawer]."<sup>114</sup> Although the bank was entitled to have the judgment stayed pending resolution of the dispute over its subrogation rights, the stay must be accomplished through the judicial process and not by the bank's unilateral action of charge-back.<sup>115</sup>

The policy behind keeping separate the charging of the account and the bank's rights of subrogation was stated as follows:

Banks are in the unique position of holding the very stakes for which they are contending. Respondent asserts that if we send this case back for trial, we would in effect, allow the Bank to be the arbiter of a dispute between two outside parties. We are not unmindful that banks may, perhaps even under a colorable claim of right, charge back a depositor's account when no such right exists. The burden on a depositor of then going forward to bring a suit is a heavy one, and, indeed, an impossible one to bear where the amount involved is small. Our decision should not be interpreted to permit this result. . . . [O]nce the Bank loses its right to charge back, the item becomes commingled with the general funds of the depositor. When the Bank is suing as subrogee, it may not at the same time make a preliminary determination of the merits of the case by charging back on the customer's account. So that in this case the Bank has no more or less right to take away or freeze [depositor's] account than would the Bank's subrogor, [drawer].

---

112. *Id.* at 413 n.5, 314 N.E.2d at 865-66 n.5, 358 N.Y.S.2d at 121 n.5 (citation omitted). See also *Opin. Atty Gen. Mich.*, No. 5947, 30 U.C.C. REP. SERV. 1445 (1981).

113. 34 N.Y.S.2d at 414, 314 N.E.2d at 866, 358 N.Y.S.2d at 122.

114. *Id.*

115. *Id.* at 415 n.8, 314 N.E.2d at 867 n.8, 358 N.Y.S.2d at 123 n.8, where the court states: "This, of course, should in no way prevent a bank from obtaining an attachment of the funds or otherwise freezing them *in any manner available to it under the law.*" (emphasis added).

When the Bank is acting as subrogee, it has the burden of going forward.<sup>116</sup>

This analysis applies to the bank's rights against its customer after paying over a valid stop. The bank holds the stakes for which the parties to the underlying transaction contend. The bank has received the valid stop order of its customer, the drawer, and by its error has paid amounts improperly. The bank's right to recoup any loss suffered as a result is by way of subrogation under section 4-407. The reasoning of the Court of Appeals of New York requires that the bank recredit its customer's account upon demonstration that a valid stop was given and a debit wrongfully made. The bank would then be entitled to proceed by way of subrogation under 4-407. This would place the burden of litigation on the bank. Of course, attachment of any funds in the account by proper judicial process is available to the bank. The charge to the customer's account, however, would need to be reversed.<sup>117</sup>

One court has recognized the separate nature of the customer's claim for recredit and the bank's rights to recoup losses as subrogee under section 4-407, although it does so without reference to, or reliance on, section 4-401.<sup>118</sup> In *Hughes v. Marine Midland Bank, N.A.*, Judge Regan held that "the plaintiffs [customer] meet their burden to prove loss both under the common law, and under the code, if they show that the bank has paid out from the depositor's account a sum of money over a valid stop order, and the loss, both *prima facie*, and at trial, is that sum so paid out."<sup>119</sup> The court supported its holding by analogy to insurance subrogation:

---

116. *Id.*, 314 N.E.2d at 866-67, 358 N.Y.S.2d at 122-23 (citations omitted).

117. The parallel is apt because in *Sunshine* the depositor would have to demonstrate the impropriety of the charge-back. Under section 4-403(3) the customer carries the burden to establish the loss and the validity of the stop order. In each case, when the bank acts unilaterally to charge-back or to charge the account, the customer has no notice that he has lost the use of the funds. This is more problematic for the customer whose account is charged following a valid stop. The customer making a deposit generally assumes payment but is not entitled to rely on final payment. U.C.C. § 4-212 (1989). The customer issuing a valid stop assumes his order will be followed, and he is in a stronger position to claim he is entitled to rely on the presence of the funds. Requiring the bank to proceed by legal process before freezing the account provides notice to the customer which he does not otherwise have.

118. *Hughes v. Marine Midland Bank, N.A.*, 127 Misc. 2d 209, 484 N.Y.S.2d 1000 (Roch. City Ct. 1985).

119. *Id.* at 215, 484 N.Y.S.2d at 1004-05.

[W]here the carrier must pay the insured upon the event of loss . . . . The carrier can sue the guilty party . . . ; but that option bears no relationship to the carrier's duty to pay its insured under its insurance contract on a proper proof of loss. Here the debtor-creditor contract between the [customer] and the bank governs the bank's liability.<sup>120</sup>

The court's rationale for its construction of the Code is summed up as follows:

[T]he cases contain two persuasive reasons for recognizing this sequential separateness of these causes of action: (1) The "innocent" party who has issued a timely stop payment order is entitled to the use of his funds pending the determination of his legal obligations in the underlying transaction; and (2) the cost of prosecuting the suit on the underlying transaction may exceed the maximum possible recovery, and it may never be brought. In such event, the bank must bear the loss as a cost of doing business.

This Court understands that this holding allows the depositor-plaintiff possibly to become a third-party defendant in his own § 4-403 action. . . . But that possible procedural posture should not, and does not, affect or alter

---

120. *Id.* at 216, 484 N.Y.S.2d at 1005. This analysis is critical. It may be asserted that our system of vindication of rights requires that the aggrieved party prosecute his claim before he is entitled to recovery. That is, a debtor is entitled to retain funds allegedly owing to a creditor, until the creditor establishes his rights via a judgment. In the present context, the purported debtor is the bank, which is entitled to retain funds (maintain a debit to an account) until the creditor-customer establishes his entitlement to those funds.

Yet, in the insurance context, the creditor-insured is entitled to immediate payment on a claim without the necessity of litigating its rights under the insurance contract. Indeed, insurers have been held liable for breach of a covenant of fair dealing for failure to pay an apparently valid claim. Following payment, the insurer must proceed by way of subrogation to recover from other parties which may be liable. Indeed, one author has asserted that banks paying over valid stop orders, when presented with evidence of a valid stop order by the customer, should be liable in tort for breach of a covenant of fair dealing if the bank refuses to recredit. Tabac, *Countermanded Checks and Fair Dealing Under the Uniform Commercial Code*, 10 ANN. REV. OF BANK L. 251 (1991).

It is the position of this article that such tort recovery is unnecessary and confuses the proper functioning of the Code. Yet the insurance subrogation analogy demonstrates that there are circumstances in which the law requires payment to an aggrieved party when a breach of contract is demonstrated, without the precondition of suing for judgment.

*the substantive legal relationships among all these parties, nor ought it to confuse and merge the sequential separate-ness of the causes of action each of these statutes has created.*<sup>121</sup>

By recognizing the separate actions available to the customer and the bank in the circumstance of a wrongful payment over a valid stop order, Judge Regan has provided meaningful recourse to the customer. The effect of the decision is to make clear that charging the customer's account is wrongful. Accordingly, regardless of the bank's separate right and action to recoup losses, the customer's right to recover for secondary losses is preserved. Indeed, the court noted that one purpose of recognizing the loss to the customer was to limit the potential damages that might accrue to the customer and for which the bank might ultimately be held liable.<sup>122</sup>

## V. A COMPLETE ANALYSIS

### A. *The Current Code*

Factoring section 4-401 into an analysis of the rights of the customer and bank following payment over a valid stop order in no way derogates from the proper scope and operation of sections 4-403 and 4-407. Recognition of a properly stopped item as not "properly payable," removes any authority in the bank to charge the customer's account. Clarifying the customer's right to an immediate recredit provides incentive to the bank to do so. In turn, the policy behind the right to stop payment, to cast the occasional loss on the bank as a cost of doing business, is fulfilled. Further, granting a recredit eliminates the potential for greater secondary damages, thereby restricting the amount of overall damages.<sup>123</sup>

Yet the bank is not left without its remedies. Section 4-407 gives the bank the ability to recoup losses on items paid over a valid stop order by way of subrogation to avoid unjust enrichment. When the bank proceeds by way of subrogation under section 4-407, the loss from payment over the stop—either in terms of the

---

121. 127 Misc. 2d at 217, 484 N.Y.S.2d at 1006 (citations omitted and emphasis added).

122. *Id.* at 215-16 n.6, 484 N.Y.S.2d at 1005 n.6.

123. *Id.*

amount of the item itself or relating to the cost of litigation—is placed on the bank as a cost of doing business. The procedural framework outlined in cases such as *Thomas*<sup>124</sup> and *Telec*<sup>125</sup> then comes into play. In its subrogation suit, the bank can point to section 4-403(3) to reverse the normal burden of proof placed on a plaintiff to prove each of the elements of its case. Under *Thomas*, the customer would have the initial burden to establish the validity of the stop order. The bank then would have the burden to produce evidence demonstrating its right of subrogation and the substantive right of its subrogee. Upon production of such evidence, the customer would have the ultimate burden of persuading the trier of fact that a primary loss had been suffered. In each of these circumstances, the customer is required to prove his rights and defenses with respect to the underlying transaction. The bank's action for subrogation provides the appropriate forum for deciding such issues.

On the other hand, should the bank refuse to recredit the account, the customer's action for recredit would be brought under section 4-403. With regard to the customer's loss on the item, the customer only has to show the existence of a valid stop order, the bank's payment, and the charge to his account. To the extent that secondary losses are also claimed, the customer carries the burden under section 4-403(3) to prove the amount of such losses. Recognition of the bank's lack of authority to charge the account under section 4-401 allows the customer to recover these secondary losses without regard to the underlying transaction that gave rise to the stopped item. In the event the bank seeks to recover the amount of the item by way of subrogation under section 4-407, the cause of action remains independent of the customer's right to recover secondary losses under section 4-403.

The result is a crisp delineation between the coverages of sections 4-403 and 4-407. Section 4-403, coupled with section 4-401, pertains to the relationship between the customer and his bank in the stop order transaction. Section 4-407 brings in the issues relating to the substantive rights and obligations of the parties to the transaction underlying the stopped check.

#### *B. The Revised Articles 3 and 4*

The simplest method of vindicating the customer's right to stop payment is to amend the Code to impose a duty on the bank

---

124. 86 Misc. 2d 284, 381 N.Y.S.2d 797. *See supra* note 32.

125. 389 So. 2d 1032. *See supra* note 33.

to recredit the customer's account following a wrongful payment over a stop order. The Revised Articles 3 and 4 contained in the 1990 Official Text of the U.C.C.,<sup>126</sup> however, do not go so far. Nonetheless, the revisions to Part 4 of Article 4 do add support for the construction of sections 4-401, 4-403, and 4-407 set forth above.

Revised section 4-403(c) explicitly recognizes the implied ability to recover for wrongful dishonors following payment over a valid stop order. The section provides:

(c) The burden of establishing the fact and amount of loss resulting from payment of an item contrary to a stop payment order or order to close an account is on the customer. The loss from payment of an item contrary to a stop payment order *may* include damages for dishonor of subsequent items under section 4-402.<sup>127</sup>

The first sentence of the subsection essentially restates the present section 4-403(3); the second sentence is new. The problem with the addition involves its failure to indicate *when* wrongful dishonor losses may be recovered. Current case law suggests that the customer must first prove a primary loss *on the item stopped* or the underlying transaction.<sup>128</sup> If such a loss is proven, other secondary losses may be recovered because the customer has carried his burden to show that the charge was wrongful. The difficulty remains, however, as expressed by Professor Clark, that until the customer carries his burden the item is "presumably properly payable"<sup>129</sup> and therefore chargeable to the customer's account. Because the revision only indicates a possibility that section 4-402 damages may be recoverable, exactly what the customer's burden is as to the loss suffered remains unclear.

The bank's rights of subrogation under section 4-407 as amended remain substantively the same.<sup>130</sup> The comments to section 4-407 also remain substantively unchanged. Curiously, the revised comment 7 to section 4-403 includes a new, specific reference<sup>131</sup> to the

---

126. Uniform Commercial Code Revised Article 3—Negotiable Instruments (With Conforming and Miscellaneous Amendments to Articles 1 and 4), 1990 Official Text with Comments.

127. U.C.C. § 4-403(c) (1990 Official Text) (emphasis added).

128. See *supra* Part II.

129. B. CLARK, *supra* note 24, (P) 2.06(2) at 2-100.

130. See U.C.C. § 4-407 (1990 Official Text).

131. *Id.* § 4-403 comment 7.

comments of section 4-407 for clarification of the interplay between sections 4-403 and 4-407. However, no additional clarification is provided.

Revised section 4-401 provides additional support for this analysis in its expanded definition of "properly payable." According to revised section 4-401(a),

(a) A bank may charge against the account of a customer an item that is properly payable from that account even though the charge creates an overdraft. An item is properly payable if *it is authorized by the customer* and is in accordance with any agreement between the customer and bank.<sup>132</sup>

The revision, as in the case of revised section 4-403(c), merely makes explicit that which is already implicit under current law. The fact remains that an item for which a customer has issued a valid stop payment order, ceases to be an authorized item. The revision explicitly recognizes that an item for which authorization to pay has been withdrawn, is not properly payable. Accordingly, the bank's authority to charge the customer's account after payment of such an item cannot be upheld. By providing express recognition that a charge is valid only for authorized items, the revision supports the distinct analyses of the customer's right to obtain recredit for an improperly charged item, and the bank's possible rights to recoup losses via section 4-407 subrogation.

### C. *The Complete Analysis Applied*

Two hypotheticals demonstrate the propriety of this analysis. The basic facts are as follows:

Desktops, Inc. orders materials for the manufacture of office furniture from Parts, Inc. Upon receipt of the goods and the invoice from Parts, Desktops issues its check to the order of Parts for \$25,000 (the "Parts Check"), the contract price. The check is drawn on Desktops' account at First National Bank ("Bank").

Hypothetical No. 1: Upon inspection of the goods received from Parts, Desktops discovers certain defects which make 50 percent of the shipment unacceptable to Desktops. Desktops phones Bank and places a stop order on the Parts Check. The oral order is immediately confirmed in writing by Desktops, accurately setting

---

132. *Id.* § 4-401(a) (emphasis added).

forth all pertinent information: account number, payee, check number, date of check, and amount of check. Three days later, the Parts Check is presented to Bank for payment, and Bank inadvertently pays the check over the valid stop order. Upon receipt of its monthly statement from Bank, Desktops discovers the payment of the Parts Check and the dishonor of two subsequent checks for insufficiency of funds because of the debit to its account in the amount of the Parts Check.

Hypothetical No. 2: Suppose the same facts as in Hypothetical No. 1, except that the shipment from Parts conformed in all respects to the contract between Desktops and Parts. Desktops is experiencing cash flow problems, however, and decides to delay payment of the Parts invoice to a later date. Desktops' management knows that Parts' policy is to give its customers up to 6 months to pay before commencing any action to collect the account. Desktops issues its stop order to delay payment of the Parts invoice to a later date when its cash flow is stronger. As a result of Bank's payment of the Parts Check, Desktops is denied trade credit or a working capital loan because the balance in its account with Bank is suddenly too low.

Under the current construction of section 4-403(3), Desktops must establish a primary loss on the Parts Check in order to recover. Desktops will be able to establish such a loss in the first hypothetical. In that case, the most Parts could recover from Desktops is \$12,500, 50 percent of the price of the goods under their contract. By subrogation to the rights of Parts, Bank has a right to recover this \$12,500. Desktops, however, will be entitled to a recredit of at least \$12,500. In this case, the question then becomes how much of Desktops' secondary losses resulting from the dishonor of the subsequent checks will be recoverable. This will require proof that the checks were dishonored, proof of the time of their presentment, and proof of the damages flowing from the dishonor of checks which would not have been dishonored had the Bank only debited Desktops' account in the amount to which it is entitled by subrogation, \$12,500. Alternatively, Bank may argue that the debit was proper until Desktops establishes its primary loss. Therefore, no wrongful dishonors occurred, and Desktops' recovery is limited to \$12,500.

In the first case, the difficulty of proof is significant. Determining which checks were wrongfully dishonored and the losses flowing from those checks is difficult. Further, to avoid liability, the Bank, in the first instance, must make a determination of how much of a debit is justified. The Bank ought not to be placed in



this position,<sup>133</sup> nor allowed to be the arbiter of the rights of Parts and Desktops.

The alternative case does not comport with existing analyses. Once Desktops establishes some loss on the item, presumably the initial debit is at least partially wrongful, and the damages for the subsequent dishonors are recoverable. This result is now expressly provided in revised section 4-403(c).

By recognizing that the charge to Desktops' account was wrongful in the first instance, these difficulties can be avoided. The validity of the stop order revokes the Bank's authority to charge Desktops' account. Hence, Desktops retains the funds, and subsequent dishonors are wrongful. Yet the Bank is entitled to recover, as subrogee under section 4-407, the amount to which Parts was entitled. This result prevents Desktops from being unjustly enriched by retention of both the funds and the conforming goods. The Bank suffers only damages resulting from its own wrong, and Desktops receives the benefits of the right to stop payment provided by the Code.

The second hypothetical further distinguishes the existing views of section 4-403 from the position taken herein. In the second hypothetical, Desktops has no legal right to withhold payment from Parts. That is, Desktops has no loss relating to either the Parts Check or the underlying obligation because payment of the Parts Check has satisfied Desktops' legal obligation to Parts. Yet, the loss of credit to Desktops resulting from the low balance in its account at Bank would not have occurred but for the Bank's wrongful payment of the Parts Check and the concomitant debit of Desktops' account. Under the current analysis, Desktops cannot recover any losses resulting from the deprivation of credit because it cannot establish a primary loss related to the item. Revised section 4-403(c) does not help Desktops because secondary losses in this case do not result from wrongful dishonor of subsequent

---

133. See § 4-212, comment 5. When a collecting bank negligently handles an item and the result is the dishonor of the item, the collecting bank is still entitled to charge-back the item against the depositor's account, without liability beyond the amount of the check. The rationale for this is stated as follows: "Any other rule would result in litigation based upon a claim for wrongful dishonor of other checks of the customer, with potential damages far in excess of the amount of the item. *Any other rule would require bank to determine difficult questions of fact.*" *Id.* § 4-212 comment 5 (emphasis added). In the stop payment context there is no similar rule protecting the payor bank. Further, in this hypothetical, Bank must make difficult factual determinations to make the partial charge to Desktops' account.

items. Desktops effectively has been deprived of the right to stop payment granted under section 4-403.

In the context of Hypothetical No. 2, it is possible that the damage suffered by Desktops is significantly greater than the damage suffered in Hypothetical No. 1. Indeed, the loss of credit may be severe enough to drive Desktops into bankruptcy. However, such drastic consequences can be avoided. By recognizing the Bank's lack of authority to charge Desktops' account, Desktops is in a far stronger position to obtain recredit to its account upon establishing the validity of the stop order. Moreover, the Bank remains able to recover, as subrogee of Parts, the full amount of the Parts Check. In this way, the secondary losses suffered by Desktops are avoided, and all parties are placed in the position they would have occupied had the stop order been properly honored by Bank. Further, the policy of the Code is served by placing the occasional loss resulting from wrongful payments on the Bank.

#### V. CONCLUSION

By separating the analysis of (1) the bank's right to charge a customer's account following payment over a valid stop order and the customer's concomitant right to recredit, from (2) the bank's right to recover the amount of the item where unjust enrichment would occur, section 4-403 can be given full effect. Such a separation allows the customer to satisfy its burden under section 4-403(3) by establishing all losses, both primary and secondary, flowing from the wrongful payment and debit. The potential liability for secondary losses provides incentive to the bank to recredit the customer's account pending resolution of the issues relating to the loss on the instrument itself. As a result, the bank will bear the occasional loss arising from payments over stop orders as a cost of doing business as contemplated by comment 2 to section 4-403. However, the bank still retains the ability to recover losses from the payment of the item by way of subrogation in situations where unjust enrichment would otherwise occur. In such cases, the burden of litigation is initially cast on the bank, the party whose actions caused the problem in the first place. Further, the customer is not forced to litigate the merits of his underlying transaction when contesting the bank's charge to his account.

Keeping the customer's right of recourse following payment over a valid stop order separate from the bank's right of subrogation is consistent with the provisions of section 4-403. It also vindicates the rights and obligations of all parties under the code.