

July 2015

# Section 542(c) of the Bankruptcy Reform Act of 1978 and Section 4-303 of the UCC: A Less Than Perfect Fit?

John P. Finan

Please take a moment to share how this work helps you [through this survey](#). Your feedback will be important as we plan further development of our repository.

Follow this and additional works at: <http://ideaexchange.uakron.edu/akronlawreview>

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

---

## Recommended Citation

Finan, John P. (1987) "Section 542(c) of the Bankruptcy Reform Act of 1978 and Section 4-303 of the UCC: A Less Than Perfect Fit?" *Akron Law Review*: Vol. 20 : Iss. 2 , Article 5.

Available at: <http://ideaexchange.uakron.edu/akronlawreview/vol20/iss2/5>

This Article is brought to you for free and open access by Akron Law Journals at IdeaExchange@Uakron, the institutional repository of The University of Akron in Akron, Ohio, USA. It has been accepted for inclusion in Akron Law Review by an authorized administrator of IdeaExchange@Uakron. For more information, please contact [mjon@uakron.edu](mailto:mjon@uakron.edu), [uapress@uakron.edu](mailto:uapress@uakron.edu).

## SECTION 542(c) OF THE BANKRUPTCY REFORM ACT OF 1978 AND SECTION 4-303 OF THE UCC: A LESS THAN PERFECT FIT?

by

JOHN P. FINAN\*

The Uniform Commercial Code (UCC) 4-303 addresses two areas where the UCC and the Bankruptcy Code intersect. The first relates to the vulnerability of drawee banks that honor checks after their customer has taken bankruptcy (has filed a voluntary petition or is the defendant in an involuntary case); the second relates to the timing of transfers made by check under 547 of the Bankruptcy Code (the preference section). In both areas there is a less than perfect fit between the Bankruptcy Code and UCC 4-303. The first area poses problems for practitioners whose clients have received notice of bankruptcy in situations where UCC 4-303 clearly provides protection but where Bankruptcy Code 542(c), at least arguably, does not. The second area involves the timing of a transfer by check. The majority of courts equate transfer with honor which is generally correct since honor generally is the time after which a creditor of the depositor cannot garnishee funds in the depositor's account. However sometimes, as explained below, priority contests between holders who present checks and garnishing creditors are not determined at the time of honor under UCC 4-303. A minority of courts simply ignore the priority rules of UCC 4-303 and hold that the transfer takes place when the check is honored. (Note: 547(e) of the Bankruptcy Reform Act of 1978 makes the priority rules of applicable non-bankruptcy law determinative of the issue of timing.) A compromise position equates transfer and issue if, but only if, honor is within ten days of issuance.

### VULNERABILITY OF DRAWEE BANKS

The first problem involves Bankruptcy Code 542(c) which, according to its legislative history, has codified *Bank of Marin v. England*. Section 542(c) of the Bankruptcy Code reads:

except as provided in 362 (a) (7) of this title, an entity that has neither actual notice nor actual knowledge of the commencement of the case concerning the debtor<sup>1</sup> may transfer property of the estate, or pay a debt owing to the debtor, in good faith and other than in the manner specified in subsection (d) of this section, to an entity other than the trustee, with the same effect as the entity making such a transfer or payment as if the case under this title concerning the debtor had been commenced.

---

\*Professor of Law, The University of Akron School of Law, Akron, Ohio.

<sup>1</sup>11 U.S.C. 547 (1982). "Debtor means person . . . concerning which a case under this title has been commenced"; the term "bankrupt" is not used in the Bankruptcy Code to describe a debtor.

UCC 4-303 provides in part:

[A] . . . notice [of bankruptcy] . . . comes too late to . . . terminate, suspend or modify [the bank's right or duty to pay an item or to charge it's customer's account for the item] if the . . . notice . . . is received or served and a reasonable time for the bank to act thereon expires . . . after the bank has done any of the following:

- (a) accepted or certified the item (UCC 4-303(1) (a));
- (b) paid the item in cash (UCC 4-303(1) (b));
- (c) become accountable for the item under subsections 1(b), 1(c), or 1(d) of UCC 4-213 or 4-302 dealing with the payor bank's responsibility for late return of items (UCC 4-303(1) (c), (d) clause one, and (e) clause one);
- (d) "otherwise has evidenced by examination of such indicated account and by action its decision to pay the item" (UCC) 4-303(1) (d) clause two).

Cursory examination of sections of the UCC and Bankruptcy Code reveals that each addresses an act<sup>2</sup> by the drawee bank, notice to the drawee bank of bankruptcy, and a legal detriment to the bank if it does not act prior to notice (or with respect to UCC 4-303 within a reasonable time after receipt of notice of bankruptcy). Complete harmony requires that the act by the bank, the notice, and the legal detriment described in one statute be the same as those described in the other. Such is not the case. To be sure, there is a great deal of overlap without which one could not compare, or even contrast, the two sections. The overlap is not complete however and, to the extent of difference, there is an imperfect fit. The apparent harmony and parallelism, seen in the highly abstract description above, vanishes when one descends to the concrete in all three instances: act, notice and legal detriment. Since the *Bank of Marin* case, was, according to the legislative history, codified in 542(c) of the Bankruptcy Code, a brief summary of the *Marin* case is a necessary step in understanding the contrast between Bankruptcy Code 542(c) and UCC 4-303.

In *Marin*, the bank paid checks of a depositor drawn before bankruptcy but presented after a voluntary petition had been filed. The question was whether the drawee bank was liable to the trustee for the amount of the checks paid although the bank had neither knowledge nor notice of the bankruptcy proceeding. The court held that the drawee bank was not liable, although the literal language of the Act yielded victory to the bankruptcy trustee. According to the court, "it would be inequitable to hold liable a drawee who pays checks of the bankrupt duly drawn but presented after bankruptcy, where no actual revocation of its authority has been made and it has no notice or knowl-

<sup>2</sup>"Act" as used herein includes a "non act" that occurs upon the expiration of the time limits of UCC § 4-302 or the failure to revoke a provisional settlement in a timely manner under UCC 4-213(1)(d).

edge of the bankruptcy.”<sup>3</sup> The court stated that “the kind of notice required is one reasonably calculated under all the circumstances to apprise the interested party of the pendency of the action.<sup>4</sup> According to the court, prior to such notice the trustee acquires no rights in the checking account greater than the bankrupt himself. *Marin* states, “absent revocation by the drawer or his trustee or absent knowledge or notice of the bankruptcy by the bank, the contract between the bank and the drawer remains unaffected by the bankruptcy, and the right and duty of the bank to pay duly presented checks remain as before.”<sup>5</sup>

Although *Marin* has been codified in 542(c) of the Bankruptcy Code, the protection afforded by that case may not be limited to the protection afforded by 542(c) of the Bankruptcy Code. In *In re Smith Corset Shops*,<sup>6</sup> the court states “whether or not Section 542(c) is technically applicable, it is a powerful indication of congressional acceptance of the principle set out in *Bank of Marin*.” Collier on Bankruptcy states: “It remains to be seen whether legislation alone can counteract the possible far-reaching effects of the *Bank of Marin* decision.”<sup>7</sup> Thus, one can argue that in determining the scope of 542(c) the rationale of *Marin*, the equitable principle of not holding a person liable who acts with neither notice nor knowledge of bankruptcy, is an important indicia of legislative intent. The argument may cut both ways just as a court may expand the scope of 542(c) to do equity, it may contract it when equitable principles are absent.

A drawee bank in circumstances such as *Marin* (a very common circumstance) is protected by UCC 4-303 if it does an act (pays, certifies, becomes accountable, or sight posts<sup>8</sup>) prior to the expiration of a reasonable time for the bank to act on the notice of bankruptcy. The Bankruptcy Code speaks of different acts. It protects the following: “Transferring property of the estate or paying a debt owing to the debtor.”<sup>9</sup> The question is, do the acts, as specified in the Bankruptcy Code,<sup>10</sup> encompass all of the acts listed in UCC 4-303? These acts will be considered in the following order: payment in cash, certification, accountability, and sight posting.

### *Payment in Cash*

This presents the easiest situation. The property of the estate to which the

<sup>3</sup>Bank of Marin v. England, 385 U.S. 99, (1966); H.R. REP. NO. 95-989, 95th Cong. 2d. Sess. 84 (1978).

<sup>4</sup>*Id.* The Court cited Mullane v. Central Hanover Bank & Trust Co., 389 U.S. 306, 314 (1950).

<sup>5</sup>*Id.* at 102.

<sup>6</sup>696 F. 2d 971, 977 (1st Cir. 1982)

<sup>7</sup>4 COLLIER ON BANKRUPTCY § 542.05 (1979).

<sup>8</sup>Sight post is a shortened form of the act more fully described by the language “or otherwise has evidenced by examination of such indicated account and by action its decision to pay the item.” UCC § 4-303(1)(d) (1978).

<sup>9</sup>11 U.S.C. § 546(c) (1982).

<sup>10</sup>*Marin*, 385 U.S. at 103.

bankruptcy trustee succeeds under 541 is a chose in action: namely, the depositor-debtor's claim against the drawee bank. Technically, a bank which pays an item in cash pays with its own funds and has not transferred property of the estate; technically, the trustee's claim is not that the bank has transferred property of the estate but rather that the bank has not, by paying the holder, discharged its obligation to the trustee, i.e., the obligation which became part of the estate when the petition in bankruptcy was filed. This argument is foreclosed by *Marin*, in that the bank is discharged if it pays the holder prior to receipt of notice. But how is *Marin* codified by 546(c)? The bank does not transfer property of the estate when it pays the holder in cash; rather, the bankruptcy estate is diminished when the bank successfully pleads discharge of its obligation to the trustee because of such payment. The successful plea is neither the transfer of property of the estate nor the payment of the debt owing to the debtor.<sup>11</sup> Nevertheless, the legislative history makes it clear that the bank is protected,<sup>12</sup> although the language used in 542(c) of the Bankruptcy Code is less than perfect in achieving that result.

### *Certification.*

UCC 4-303 provides that notice of bankruptcy is untimely unless the bank has had a reasonable time to act thereon prior to acceptance or certification.<sup>13</sup> No further reference will be made to acceptance since "certification of a check is acceptance."<sup>14</sup> Certification of a check is the act which grants protection if performed within a reasonable time after receipt of notice.<sup>15</sup> Is certification an act which offers protection under 542(c)?; i.e., is it the transfer of property of the estate or paying a debt owing to the debtor? It surely is not the latter and, unless it is the former, the policy of the *Marin* case to protect drawee banks from double liability will be frustrated. Consequently, to harmonize the rationale of 542(c) with its language, one must conclude that certifying a check of a drawee who has taken bankruptcy is the transfer of property of the estate by the drawee bank. The term "transfer" is defined broadly in 101-48 of the Bankruptcy Code as follows: "transfer means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing or parting with property or with an interest in property including retention of title as a security interest and foreclosure of the debt as equity of redemption."<sup>16</sup> Despite the breadth of the quoted definition, it is difficult to find a transfer of the property

<sup>11</sup>11 U.S.C. § 546(c). *But see* 4 COLLIER ON BANKRUPTCY § 542.04 (1979) "A drawee bank obviously fell within the express language of clause (2) of former 70(d) when it honored a check of its insolvent depositor because it was paying an undebtedness (bank and depositor are debtor and creditor) and delivering property of the debtor upon the order of the debtor (his check).

<sup>12</sup>Otherwise *Marin*, would not be codified.

<sup>13</sup>UCC § 3-410(1) (1978). Acceptance is the drawee's signed engagement to honor the draft as presented.

<sup>14</sup>UCC § 3-411 (1978).

<sup>15</sup>UCC § 4-303(1)(a) (1978).

<sup>16</sup>11 U.S.C.A. § 101-48 (West Supp. 1986).

Fall, 1986]

of the estate in the drawee's certification of a check.<sup>17</sup> Nevertheless, that difficulty must be surmounted if double liability is to be avoided; otherwise, the drawee bank becomes liable to the holder by certifying a check and, unless protected by Bankruptcy Code 542(c), is also liable to the bankruptcy trustee.<sup>18</sup>

### *Accountability.*

There are two types of accountability referenced in UCC 4-303. The first is accountability based on final payment of an item under UCC 4-213(1). That section reads in part:

- (1) An item is finally paid by a payor bank when the bank has done any of the following, whichever happens first: . . .
- (b) settled for the item without reserving a right to revoke the settlement and without having such right under statute, clearing house rule or agreement; or
- (c) completed the process of posting the item to the indicated account of the drawer, maker or other person to be charged therewith; or
- (d) made a provisional settlement for the item and failed to revoke the settlement in the time and manner permitted by statute, clearing house rule or agreement.

Upon a final payment under subparagraphs (b), (c) or (d) the payor bank shall be accountable for the amount of the item.<sup>19</sup>

According to UCC 4-303, final payment by accountability constitutes an act protecting the bank.<sup>20</sup>

The second type of accountability is referenced in UCC 4-303, namely accountability under 4-302 dealing with the payor bank's responsibility for late return of items.<sup>21</sup>

Does either type of accountability — accountability upon final payment under UCC 4-213(1) or accountability for tardiness under UCC 4-302 — amount to a transfer of property of the estate or the paying of a debt owing to the debtor within the meaning of 542(c)? Taking final payment first, it should be noted that payment may not be equated with remittance. Comment 2 to UCC 4-213 reads:

If an item being collected moves through several states, e.g., is deposited for collection in California, moves through two or three California banks

---

<sup>17</sup>The certification obtained by the payee completes the transfer from the drawer to the payee but the completed transfer is the transfer of the drawer's claim against the drawee bank, not a transfer by the bank. May one conclude that an act by the bank which completes the transfer of the drawer's claim, is a transfer of the property of the estate by the bank? If so, then *Marin* is codified and the difficulty is surmounted.

<sup>18</sup>UCC § 3-413 (1978).

<sup>19</sup>UCC § 4-213(1) (1978).

<sup>20</sup>UCC § 4-303, subsection (1)(b), (1)(c) clause 1, and (1)(e) clause 1.

<sup>21</sup>UCC § 4-303(1)(e).

to the Federal Reserve Bank or San Francisco to the Federal Reserve Bank of Boston, to a payor bank in Maine, the collection process involves the eastward journey of the item from California to Maine and the westward journey of the proceeds from Maine to California. Subsection (1) adopts the basic policy that final payment occurs at some point in the processing of the item by the payor bank. This policy recognizes that final payment does not take place, in such hypothetical case, on the journey of the item eastward. It also adopts view that neither does final payment occur on the journey westward because what in fact is journeying westward is the proceeds of the item. Because the true tests of final payment are the same in all cases and to avoid the confusion resulting from variable standards, the rule basing final payment exclusively on action of the payor bank is not affected by whether payment is made by a remittance draft or whether such draft is itself paid. Consequently, subsection (1) rejects those cases which base time of payment of the item in remittance cases on whether the remittance draft was accepted by the presenting bank.<sup>22</sup>

The language of UCC 4-213(1) and the just-quoted comment thereto establish that payment by becoming accountable involves not the discharge of a bank's obligation by remittance, but imposition of an obligation (accountability) on the bank. Yet, unless such imposition is equated either with the transfer of property of the estate or with the payment of a debt owing to the debtor, the policy of 542(c) to avoid double liability will be frustrated. It is submitted that, despite the infelicity of language, such accountability by payment involves a transfer of property of the estate or the payment of a debt owing to the estate within the meaning of 542(c) of the Bankruptcy Code;<sup>23</sup> otherwise there would be double liability, the result foreclosed by *Marin*. The same argument applies with equal force to accountability based upon late return of items under UCC 4-303. However, the policy of 542(c) is based upon notions of fairness enunciated in *Marin*.<sup>24</sup> It is arguable that a bank which becomes accountable, not because of its act in honoring a check but because of its failure to act in a timely fashion, does not come within the scope of the protection provided by *Marin* and codified in 542(c) of the Bankruptcy Code. *Marin* is based on equitable principles of fairness; might not a court hold that the equities do not extend to one who lacks clean hands because of delay?

### *Sight Posting.*

The argument that it strains language to treat payment in cash, certification of a check, or accountability, as a transfer of property of the estate is perhaps a quibble. Under section 70 of the Bankruptcy Act, the predecessor of

<sup>22</sup>UCC § 4-213, Comment 2 (1978).

<sup>23</sup>Accountability serves the same function as certification as far as the problem being discussed is concerned in that it completes the transfer of the drawer's claim against the bank to the payee. See footnote 15 *supra* and accompanying text for a suggested reconciliation of the policy of 542(c) and its language.

section 541, trustees were vested by operation of law with the title of the bankrupt as of the date of filing of the petition initiating a proceeding. Technically, the trustee was vested with title to a claim against the drawee bank, not with title to any funds therein. Nevertheless, a transfer by the bank to a holder who subsequently sought discharge of the debt owing to the trustee was not only treated as a transfer of property, it was treated as a transfer that was not protected by 70(d) of the Bankruptcy Act.<sup>25</sup> Section 542(c) of the Bankruptcy Code merely uses the terminology of the Act in treating a transfer of the bank's own funds as a transfer of property of the estate whenever the bank successfully claims discharge of its obligation to the estate because of the transfer.<sup>26</sup> Thus, despite infelicitous drafting, there is little doubt that a bank is protected if 1) it pays a check in cash, 2) certifies the check, or 3) becomes accountable under either UCC 4-213(1) or UCC 4-303. More than a quibble is involved, however, with respect to sight posting, a phenomenon described in the Comments to UCC 4-303 as follows:

The sixth event conferring priority is stated by the language "or otherwise has evidenced by examination of such indicated account and by action its decision to pay the item." This general 'omnibus' language is necessary to pick up other possible types of action impossible to specify particularly but where the bank has examined the account to see if there are sufficient funds and has taken some action indicating an intention to pay. An example is what has sometimes been called 'sight posting' where the bookkeeper examines the account and makes a decision to pay but postpones posting.<sup>27</sup>

The effect of posting under the "omnibus" language was addressed in the *Yandell* case.<sup>28</sup> On July 29 a drawee bank received checks. The bookkeeper examined them and the drawer's account and made a penciled note to indicate a commitment to pay. The bookkeeper also stamped and initialed the checks.

<sup>25</sup>*Id.* In *Marin*, both the majority and the dissenting opinion are in agreement on that score as far as the plain meaning of the Act is concerned. The majority avoided the plain meaning in order to do equity. See also, KING & COOK, CREDITORS RIGHTS, DEBTORS' PROTECTION (1980); BANKRUPTCY, CASES AND MATERIALS, MATHEW BENDER (1985), wherein the authors comment on the *Marin* case state, "that a literal reading of the Act could have led to the opposite conclusion."

<sup>26</sup>*Marin*, 385 U.S. at 102-03. The *Marin* case states "it is therefore argued with force that payment by the drawee of a drawer bankrupt's checks after the date of filing is a 'transfer' within the meaning of § 70(d)(5). Yet we do not read the statutory words with ease of a computer. There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction." If the Court did not regard honor as a transfer of property of the bankrupt, there would have been no need to resort to equitable principles to avoid the literal meaning of § 70(d)(5). Subsequently, the Court suggests that equity can be achieved and the policy of the Act can be served by treating the transfer to the payee as a voidable preference. The Court states, "The payee is a creditor of the bankrupt, and to make him reimburse the trustee is only to deprive him of preferential treatment and to restore him to the category of a general creditor. To permit the trustee under these circumstances to obtain recovery only against the party that benefitted from the transaction is to do equity." Presumably the transfer of property which constitutes the preference is the transfer of the chose in action, the drawer's claim against the drawee bank, not the transfer of the bank's property to the payee.

<sup>27</sup>UCC § 4-303 Comment 3.

<sup>28</sup>*Yandell v. White City Amusement Park, Inc.*, 232 F. Supp. 582, (D. Mass. 1964).  
Published by IdeaExchange@UAKron, 1987



However, they were not machine posted until August 2. On August 1, a writ of garnishment was served on the bank. The court held the writ untimely under 4-303(1) (d), (the omnibus provision). A writ of garnishment is one of the "four legals" and is treated by UCC 4-303 in a manner parallel to a notice of bankruptcy thereunder.

Consider a case where, instead of a writ of garnishment, a notice of bankruptcy is received between the time that a bank has sight posted and the time that it has completed the process of posting or has otherwise become accountable. Assume further that prior to accountability the bank had a reasonable time to act on the notice of bankruptcy. Here the UCC, by its plain language and under the authority of *Yandell*,<sup>29</sup> protects a bank which pays the holder. Does the Bankruptcy Code also protect the bank from liability to the estate? Remember that, once a petition in bankruptcy is filed, the chose in action, the debtor's claim against the bank, becomes part of the estate created by section 541 of the Bankruptcy Code. Has the bank discharged its liability to the estate if, after sight posting but before accountability, it receives a notice of bankruptcy? The rationale of the *Marin* case<sup>30</sup> suggests a negative answer since the bank is not subject to double liability if it pays the trustee and dishonors the check presented by the holder. Since 542(c) of the Bankruptcy Code, according to its legislative history, codifies the *Marin* case and *Marin* in turn is based on the equitable principle of preventing double liability to the holder whenever notice of bankruptcy comes after accountability, it seems to follow that 542(c) affords no protection whatsoever to a bank which honors a check presented by a holder under the circumstances being discussed. The language of 542(c) supports this conclusion for; whatever may be said for the proposition that payment in cash, certification of a check, or accountability, amounts to a transfer of property of the estate, it seems clear that sight posting does not amount to such a transfer.<sup>31</sup> Sight posting certainly does not amount to the paying of a debt owing to the debtor. Consequently there is a disparity between the protection provided by UCC 4-303 and that provided by 542(c) which could be a trap for the unwary bank which consults only the Uniform Commercial Code and not the Bankruptcy Code.

### *The Notice Requirements Compared*

As noted above, 542(c) of the Bankruptcy Code requires that the bank act prior to actual notice in order to gain protection. The UCC protection has a similar requirement; however, there is not complete harmony. The UCC protects the bank if the notice is "received or served" and a reasonable time for the bank to act thereon expires after the bank has done any of the acts catalogued

<sup>29</sup>*Id.*

<sup>30</sup>See *Supra* note 3.

<sup>31</sup>It does not fit the rationale offered in footnote 15, *supra*, because it does not complete the transfer of the drawer's claim against the bank to the trustee.

above. 542(c) of the Bankruptcy Code does not expressly afford a bank a reasonable time to act on a notice received or served. Whether courts will read a reasonable time period into the language used in 542(c) remains to be seen.

Apart from the discrepancy just noted, there is a possible discrepancy between the definition of "notice" as used in the UCC and "actual notice" as used in 542(c) of the Bankruptcy Code. (The Bankruptcy Code is arguably redundant in referring to both actual notice and actual knowledge for, presumably, whenever there is actual knowledge there is actual notice. In the interest of brevity, only actual notice will be referred to hereafter with the understanding that actual notice refers, *inter alia*, to actual knowledge). What is the relationship between "actual notice," as used in 542(c), and notice as used in UCC 4-303? The UCC provides that a person has notice of a fact when he has received a notice or notification of it.<sup>32</sup> Person is defined to include an organization.<sup>33</sup> However, under UCC 1-201(27) notice received by an organization is not immediately effective. UCC 1-201(27) reads:

(27) Notice, knowledge or a notice of notification received by an organization is effective for a particular transaction from the time when it is brought to the attention of the individual conducting that transaction, and in any event from the time when it would have been brought to his attention if the organization had exercised due diligence. An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.<sup>34</sup>

UCC 4-303(1) speaks of the time a notice is received and a reasonable time for the bank to act thereon expires. Presumably, however, the bank has a reasonable time, not from the receipt of notice, but from its effectiveness under UCC 1-201(27). Because of the flexibility of the term "reasonable" this is a construction easily reached and seems to accord with the policy of UCC 4-303(1).

In order to compare the time at which a reasonable time expires with actual notice under the Bankruptcy Code 542(c), it is necessary to consider the meaning of the term "actual notice" as used in that subsection. According to *Osborn on Mortgages*, "[w]hen it comes to determining what constitutes 'notice,' there has been a great confusion and disagreement both as to analysis and terminology of the subject."<sup>35</sup> He describes the clear areas, *i.e.* constructive

---

<sup>32</sup>UCC § 1-201 (25) (1978).

<sup>33</sup>UCC § 1-201 (30) (1978).

<sup>34</sup>UCC § 1-201 (27) (1978).

<sup>35</sup>G. OSBORN, *OSBORN ON MORTGAGES* 519 (1951).

notice — the knowledge with which one is charged by reason of recordation — and the other extreme, full actual knowledge of the ultimate fact of a hostile conveyance. According to him, between these two extremes there is inquiry notice and ratiocination notice. One has inquiry notice if he “does not know a fact affecting his legal position [but] nevertheless [is] conscious of other facts so strongly indicating the existence of the ultimate fact that a man of ordinary prudence would inquire concerning it or conduct his business as though it existed.”<sup>36</sup> As for actual notice, he states, “some courts, when faced with this question, have held that actual notice and actual knowledge mean the same thing.”<sup>37</sup> Clearly that cannot be the case under 542(c) of the Bankruptcy Code since it uses both terms, obviously indicating that there is a difference between them. Osborn continues,

[o]thers have extended it to include what *should* be known, either because a reasonable man would draw the inference that it did exist by logical deduction, or from general human experience, or from knowledge of other facts in his possession, or else, as a man of ordinary prudence, he would find out by additional inquiry or conduct his affairs on the assumption that it existed. It should be observed that while in such a case the knowledge of the facts upon which the duty of inquiry is based must actually be brought home, the knowledge of the ultimate fact is then attributed to him on a reasonable man standard of ratiocination and prudent conduct regardless of whether the particular individual actually so thought or would have acted. In other words, when knowledge of certain facts have been established the person will be treated, by a rule of substantive law, as though he had knowledge of the ultimate fact that affects his rights regardless of whether in fact, he did or did not have such knowledge. Since, however, actual knowledge of the inquiry stimulating fact must be brought home, there is justification for classifying such notice as actual, even though the ultimate knowledge is ascribed to him by operation of a rule of substantive law . . . still others, however, have called notice of this sort ‘constructive.’ If, in addition, knowledge of the facts upon which the duty is grounded is attributed to the individual because he, as a reasonable person, would, or should, have discovered them, without proof that in fact he had done so, it would be straining the natural meaning of the term ‘actual notice’ to say it covered such a case. Here the legal consequences of actual knowledge of the ultimate fact become operative upon establishing certain facts without showing that the person whose rights are affected actually knew the facts established or the ultimate facts.<sup>38</sup>

---

<sup>36</sup>*Id.* at 519.

<sup>37</sup>*Id.* at 520.

<sup>38</sup>*Id.* at 520-21.

He summarizes,

“[T]he law, by applying an artificial, reasonable man standard, first says that he is charged with knowing the existence of certain facts regardless of whether he does or does not know them; and then, by applying the same standard, charges him with further knowledge which he ought to have acquired in consequence of his attributed knowledge of the first fact. Such a situation certainly should not be classified as ‘actual notice.’”<sup>39</sup>

Applying Osborn’s terminology one might conclude that a person has actual notice, as the term is used in 542(c) of the Bankruptcy Code, if he has actual knowledge of the ultimate fact that a bankruptcy petition has been filed, or he has actual knowledge of some facts which lead to that conclusion, either by inquiry or ratiocination. Thus, the following would be excluded from the definition of “actual notice” in the Bankruptcy Act: 1) constructive notice such as record notice and 2) both inquiry and ratiocination notice when the basic fact is not actually known.<sup>40</sup>

The next question is whether or not inquiry notice is included within the term actual notice. The Uniform Commercial Code, 1-201(25), reads in part, “a person has notice of a fact when . . . (c) from all the facts and circumstances known<sup>41</sup> to him at the time in question he has reason to know that it exists.” The Uniform Commercial Code has adopted ratiocination notice, or what might be more aptly called inference notice, and has rejected inquiry notice as a standard.<sup>42</sup> Since even a reasonably prudent person can learn more by inquiry than by mere thinking or inferring, the inference notice standard charges one with much less notice than does the inquiry notice standard. Which does the Bankruptcy Code adopt? There is no definition of notice in section 101, the definitional section, or in any other section of the Bankruptcy Code. If one resorts to the general definitions enunciated by Osborn, the Bankruptcy Code has adopted both inquiry and inference notice. It remains to be seen whether courts will limit the definition of notice in the Bankruptcy Code to the definition found in UCC 1-201(25) (c). If they do not, the apparent harmony between UCC 4-303(1) and Bankruptcy Code 542(c) is at least, in part, illusory because situations will surely arise where one has inquiry notice of the commencement of the case concerning a debtor, but not inference notice. In such a case a drawee bank is protected by the Uniform Commercial Code but not by the Bankruptcy Code.<sup>43</sup>

The possible mismatch in the definition of notice under the Bankruptcy

<sup>39</sup>G. OSBORN, *supra* note 35, at 519-21.

<sup>40</sup>According to UCC 1-201(25), “A person ‘knows’ or has ‘knowledge’ of a fact when he has actual knowledge of it.”

<sup>41</sup>*Id.*

<sup>42</sup>See E. PETERS, A NEGOTIABLE INSTRUMENTS PRIMER, (2d Ed. 1974).

<sup>43</sup>It is assumed that if one lacks inference notice under UCC 1-201(25)(c) he or she has not received a notice or notification of it under UCC 1-201(25)(b), at least not a notification effective under UCC 1-201(27).

Code and the Uniform Commercial Code coupled with the reasonable time to act thereon standard of UCC 4-303(1) suggests that in cases where timing is close, there may be discrepancy between the Uniform Commercial Code and the Bankruptcy Code.

### *The Legal Detriment*

Thus far discussion has been about the act which must be performed prior to notice of bankruptcy or a reasonable time to act thereon in order to avoid a legal detriment. The third issue is, what is the legal detriment? Or, put another way, what is the legal benefit of timely action? According to Bankruptcy Code 542(c), if one acts timely, the effect of the transfer or payment is the same "as to the entity making such transfer or payment as if the case under this title concerning the debtor had not been commenced."<sup>44</sup> Thus, the drawee bank is not liable to the estate. What is the legal benefit of timely action under UCC 4-303(1)? According to that subsection, the benefit is this — if the notice of bankruptcy is untimely, it does not terminate, suspend or modify any rights the drawee has against the drawer, nor does it terminate, suspend or modify any duties of the bank owing to the drawer. Conversely, if the notice is timely, it does terminate, suspend or modify such rights or duties. Presumably, in the context of bankruptcy, if the notice of bankruptcy is timely the drawee bank has neither a right nor a duty owing to the drawer to pay the item to the holder. Since a check is not of itself an assignment,<sup>45</sup> it seems to follow that the bank is subject to an action by the bankruptcy trustee if, but only if, the notice of bankruptcy is timely,<sup>46</sup> and thus the legal detriment is identical under the Bankruptcy Code and under the Uniform Commercial Code. To be sure, the language used in the two Codes is not identical, but the legal effects at least seem to be.

### *Assignments*

The above discussion was based on the assumption that the check in question did not constitute an assignment. "A check or other draft does not of itself operate as an assignment,"<sup>47</sup> and usually drawers take no action making a check an assignment. However, checks do occasionally constitute assignments and in such cases, banks which honor them are protected, it is submitted, both by the language of the Bankruptcy Act and the policy underlying *Marin*, namely the avoidance of double liability. UCC 4-303, in its list of acts, does not mention assignments, but presumably that gap is filled by UCC 1-103, which is captioned "Supplementary General Principles of Law and Equity" and which reads: "Unless displaced by the particular provisions of this Act, the principles

<sup>44</sup>11 U.S.C. § 542(c) (1982).

<sup>45</sup>UCC § 3-409 (1978).

<sup>46</sup>When the term timely is used, it is assumed that not only has the notice been received on time, but the bank has had a reasonable time to act thereon.

<sup>47</sup>UCC § 3-409(1) (1978).

of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions."<sup>48</sup>

Assume the following hypothetical: A check which constitutes an assignment is drawn prior to bankruptcy but is honored after a petition in bankruptcy has been filed and after the bank has received actual notice of bankruptcy and has had a reasonable time to act thereon before it honored the check. Is the bank liable to the trustee for honoring the check? No, for the following reasons:

An assignment is effective between the parties at the time it is made, i.e., at the time the check constituting the assignment is delivered by the drawer to the payee. At that time, the chose in action, the claim of the drawer against the bank, ceases to be a claim of the drawer and becomes a claim of the payee. Thus, under the language of the Bankruptcy Act, property of the estate was transferred before the drawee bank received actual notice of the commencement of the case and thus the bank is protected by the literal language of 546(c).

What if the bank is not notified of the assignment before it receives notice of the bankruptcy of its customer/assignor? It is a general rule that, although an assignment is effective between the parties at the time it is made,<sup>49</sup> the obligor, i.e. the drawee bank, has the power to discharge itself by paying the assignor-obligee prior to the time it receives notice of the assignment.<sup>50</sup>

The obligee, of course, is the drawer to whose rights the trustee succeeds when an estate is created upon the filing of the petition in bankruptcy.<sup>51</sup> Presumably, when the drawer takes bankruptcy, this rule provides that, if the obligor, i.e., the drawee bank, pays the estate created by 541(a), prior to the time it receives notice of the assignment, it is discharged.<sup>52</sup> If so, then a bank which receives notice of bankruptcy prior to the time it receives notice of the assignment may pay the estate without incurring liability to the assignee-holder. The practice point is obvious. A payee, doubtful of the financial solvency of the drawer, should not only insist that the draft be an assignment, but should also give notice to the drawee bank at the earliest possible time. Enforc-

<sup>48</sup>UCC § 1-303 (1978).

<sup>49</sup>L. CORBIN, CORBIN ON CONTRACTS § 902, (1952).

<sup>50</sup>Continental Purchasing Co., Inc. v. Van Realte Co., 295 N.Y.S. 867 (N.Y. App. Div. 1937). See also RESTATEMENT (SECOND) OF CONTRACTS § 341 (1979).

<sup>51</sup>11 U.S.C. § 541 (1982).

<sup>52</sup>L. CORBIN, *supra* note 49. In such a case, the assignor holds the proceeds of the assigned rights in constructive trust for the assignee. RESTATEMENT (SECOND) OF CONTRACTS, § 341 Comment a. Presumably the bankruptcy estate, which is comprised of the property of the debtor under § 541 of the Bankruptcy Code, also holds the proceeds in constructive trust for the payee.

ing a constructive trust against the estate<sup>53</sup> is not an attractive alternative.

What if the bank pays a holder after being notified of bankruptcy but before it receives notice of the assignment? Here the bank is discharged from liability. To be sure it had the power to be discharged by paying the estate since it had not received notice but it is not obliged to exercise that power; its payment to the payee (or subsequent holder) is not a transfer of property of the estate. Consequently the bank is not liable.

Discussion of assignments may be largely academic since they are rare. However, assignments, when made, are generally made when there is doubt about the solvency of the drawer. Thus, assignments may be less rare in the bankruptcy context than they are in general. Furthermore, the law regarding assignment may become more important as lawyer, realizing the advantages listed above, use them to avoid the dangers of attacks based on the law of preferences.

#### TIMING OF CHECK TRANSFERS

The second area to be addressed in this paper is the timing of check transfers. Timing of such transfers is a difficult problem because it is uncertain when a check transfer takes place for purposes of section 547 of the Bankruptcy Code. Timing is determined by reading UCC 4-303 together with the timing formula of 547(e) of the Bankruptcy Code.

The timing formula of the Bankruptcy Code is understandable only if it is remembered that there are two types of perfection, perfection under 547 of the Bankruptcy Code (bankruptcy perfection) and perfection under Article 9 of the Uniform Commercial Code (UCC 9-303(1) (UCC perfection); and if it is also remembered that there are two types of transfer under 547(e)(2) of the Bankruptcy Code (bankruptcy transfer) and transfer under applicable non-bankruptcy law between the transferor and the transferee (actual transfer). A transfer is perfected within the meaning of the Bankruptcy Code<sup>54</sup> when a judicial lien creditor, on a simple contract, cannot acquire an interest which is superior to the interest of the transferee. This point in time will be hereafter referred to as parity. Under Bankruptcy Code 547(e)(2), if parity is achieved within ten days after the actual transfer, the bankruptcy transfer takes place at the time of the actual transfer; otherwise, it takes place at the time parity is achieved if parity is achieved before the commencement of the case. If parity is achieved after the commencement of the case, and after the expiration of the ten day period, then the bankruptcy transfer takes place "immediately before the date of the filing of the petition."<sup>55</sup>

The transferee is exposed to risk of avoidance whenever the transfer is

<sup>53</sup>*Id.*

<sup>54</sup>11 U.S.C. § 547(e)(1)(B) (1982).

<sup>55</sup>11 U.S.C. § 547(e)(2)(C) (1982). <https://doi.org/10.2307/2574747> <https://www.akronlawreview.com/vol20/iss2/5>

postponed to a time after the beginning of the reach-back period (ninety days for non-insiders; one year for insiders).<sup>56</sup> Frequently checks will be issued prior to the beginning of the reach-back period, but honored after the beginning of that period. The question then is, when did the bankruptcy transfer take place? At the time of issue? At the time of honor? Or at some other time? On this question the cases are in conflict. The majority holds the time of honor; the minority holds the time of issue; and a compromise position holds the time of issue provided honor is within ten days therefrom.<sup>57</sup> Under the language of UCC 4-303, the majority seems correct in rejecting the time of issuance whether or not honor is within ten days thereof because a lien creditor can obtain parity after the date of issuance even if honor is within ten days thereafter. The ten day grace period would only operate if the issuance of a check constituted an actual transfer of the drawer's claim against the drawee; it does not unless there is an assignment in which case the ten day period is unnecessary since transfers take place when the assignment is effective. However, it is not clear that honor is always the time of transfer. UCC 4-303 determines when a writ of garnishment comes too late. Since a garnishing creditor is a lien creditor, the appropriate test under the Bankruptcy Code provisions discussed above is, when does the transferee obtain parity with garnishing creditors? According to UCC 4-303, such parity is achieved no later than the time that the bank has done one of the following acts: paid the item in cash, certified the check, become accountable under UCC 4-213(1), or 4-303, or sight posted. Arguably parity is achieved slightly before such time for UCC 4-303(1) provides that "any . . . legal process served upon . . . a payor bank . . . comes too late . . . if the legal process is . . . served and a reasonable time for the bank to act thereon expires . . . after the bank has done any of the following"<sup>58</sup> acts enumerated just above. Since calculation of a hypothetical reasonable time poses practical difficulties in litigation, courts may ignore the reasonable time language. The following discussion assumes that they will; no case to date has considered such language.

A bank honors a check<sup>59</sup> when it pays it in cash, certifies it, or becomes accountable by finally paying the item under UCC 4-213(1); however, it is doubtful that a bank honors a check either by sight posting or by becoming accountable under 4-302 of the Uniform Commercial Code. The two acts mentioned in

---

<sup>56</sup>11 U.S.C. § 547(b)(4) (1982).

<sup>57</sup>Hall, *Preferences and Setoffs*, 2 BANKR. DEVELOPMENTS J. 49,61-62 (1985).

<sup>58</sup>After the reasonable time begins to run, it is no longer possible for a garnishing creditor to obtain parity.

<sup>59</sup>"Honor" is not defined. UCC 3-507(1)(a) provides that an instrument is dishonored when: 1) payment or acceptance is refused, or 2) payment cannot be obtained within the prescribed time, or 3) in case of bank collections, the instrument is seasonably returned by the midnight deadline. Assuming that honor and dishonor are contradictories, not contraries, it follows that honor occurs when an instrument is paid or accepted. In the case of a check, acceptance means certification, UCC 3-411(1); therefore, honor seems to occur when an instrument is paid in cash, certified, or there is accountability by final payment under 4-213(1) of the Uniform Commercial Code. It does not mean accountability because of a lapse of time under 4-302 or accountability when a check is sight posted.



the last sentence, however, make a writ of garnishment untimely and are almost always prior to the time of honor, however defined. Thus honor, although it is a convenient term to signify parity, is not always equivalent thereto.

It is believed that equating the time of honor with parity is a good rule of thumb. However, care must be taken to investigate whether some act prescribed by UCC 4-303 occurs before honor. If it does, then parity is achieved prior to honor. Given the importance of timing in preference litigation, an analysis which yields an earlier date may be dispositive and certainly is worth exploring by the transferee-defendant in a preference action.

#### CONCLUSION

A major task of lawyers involved in Bankruptcy practice is the task of integrating the Bankruptcy Code with applicable non-bankruptcy law. Frequently, such law is the UCC. Drafters of the Bankruptcy Code were aware of the need for harmonization and have been generally successful. However, as discussed in this article, there are fringe areas where the fit is less than perfect. This Article addresses one of those fringe areas.