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# The Bank-Depositor Relationship--A Comparison of the Present Tennessee Law and the Uniform Commercial Code

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# The Bank-Depositor Relationship— A Comparison of the Present Tennessee Law and the Uniform Commercial Code

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*The author examines the relationship of the bank and its depositor under existing Tennessee law and then points out changes and modifications which would arise under the Uniform Commercial Code. Professor Spanogle notes that many of the problems discussed are not governed by statute in Tennessee and that the case law is unclear in certain areas. This is one of his reasons for recommending the adoption of the Uniform Commercial Code by the Tennessee legislature.***

It has been said many times that a bank is a debtor of its depositor, or that a bank is an agent of its depositor in paying out money from his account. Both of these descriptions are too general, however, to be very helpful in solving specific problems arising from concrete situations.[1] Instead, it is much more helpful to examine the various rights and duties of the two parties which are created by their relationship, without reference to the use of similar theories in other fields.

The depositor expects, in general, to have four rights concerning the money he places in an account with a bank: (1) the right to order that money be paid out to discharge any of his checks or other orders drawn against sufficient funds, (2) the right that his money be paid out only to discharge valid orders from him, (3) the right to revoke any of his orders before they have been paid by the bank, and (4) the right to have checks deposited to his account collected by the bank and credited to his account. In return, the bank expects the depositor to take reasonable care to prevent abuses of his rights under the deposit contract, and to attempt to discover any such abuses so as to prevent their repetition. This in-

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**As this issue goes to press, the Uniform Commercial Code has just been introduced in the General Assembly.

1. The general principles of agency law are not always applicable to the bank-depositor relationship, which has developed many speeific rules contrary to those applicable to other agency relationships. The same is true as to general principles from other fields of law. See, *e.g.*, RESTATEMENT (SECOND), AGENCY § 173 (1958); Note, 23 U. PITT. L. REV. 198 (1961); and Glennan v. Rochester Trust & Safe Deposit Co., 209 N.Y. 12, 102 N.E. 537 (1913).

volves such duties of the depositor as: (1) maintaining a sufficient balance in his account to cover his checks when they are presented, (2) signing his checks in a recognizable form, (3) issuing checks in a manner which will prevent defalcations by others, and (4) examining returned checks and statements for such defalcations.

Each of the rights of the depositor creates a corresponding duty on the bank, a violation of which may make it liable for losses caused by the violation. Thus, a bank may be liable if it: (1) refuses to pay a valid order of the depositor, (2) pays out the depositor's funds without a valid order from him authorizing such a payment,[2] (3) pays an order which the depositor has previously revoked, or (4) fails to collect the proceeds of checks deposited by the depositor.[3] On the other hand, failure of the depositor to perform his duties may relieve the bank of liability. Thus, the bank may defend against liability by showing that: (1) the depositor's balance was insufficient to cover his check, (2) his signature was unrecognizable, (3) he was careless in issuing the check, or (4) he failed to examine his returned statement or report discovered defalcations.

One purpose of this article is to examine these bases of a bank's liability and its defenses under the present Tennessee law.[4] It is useless to consider only the present law in this area, however, for the Uniform Commercial Code [hereinafter cited as U.C.C. or the Code] will affect substantial portions of it. The U.C.C. has now been adopted in eighteen states, including most of the commercially important states[5] and the neighboring states of Arkansas, Kentucky, and Georgia. More states may be expected to join this list in the near future.[6] As more states adopt the Code, lawyers in the remaining states will need to know its provisions for two reasons. An understanding of the Code will be necessary for lawyers in order to advise clients on interstate commercial transactions,[7] and also to predict the

2. Discussion of this field involves two separate problems:
a) Was the order received by the bank valid? and b) Has the bank paid out the depositor's funds without even a purported order from him?

3. An exhaustive study of check collection problems is in itself a sufficient subject for a complete article. Therefore, this article will examine such problems only insofar as they affect the first three sources of a bank's liability. See Part V *infra*. For a more thorough discussion of collection problems, see the authorities cited in note 202 *infra*.

4. Many of the problems in this area have not been brought before the Tennessee courts or acted upon by the Tennessee legislature. Where these problems have well-settled solutions, it will be assumed that Tennessee would follow that law, and treatises or cases from other jurisdictions will be cited. Where there is no settled answer or a substantial split of authority in other jurisdictions, this fact will be noted.

5. New York, Pennsylvania, Illinois, Ohio, Michigan, Massachusetts, and New Jersey.

6. See, *e.g.*, the report of a California State Bar Committee urging that California adopt the U.C.C. 37 J. STATE BAR CAL. 117 (1962).

7. The U.C.C. contains its own conflict of laws provisions (see § 1-105) and the provisions give very broad jurisdiction to use the Code in the courts of any state which has enacted it.

answers which their own courts will formulate to solve new and developing problems in the commercial law field.[8] Further, any state not adopting the U.C.C. will be handicapped in commercial transactions by operating under two sets of laws in interstate transactions and by operating under more restrictive financing methods.[9] It is, therefore, quite likely that Tennessee will adopt the U.C.C., and probably in the near future. Thus, a second purpose of this article is to ascertain the rules regulating a bank's liability and defenses under the U.C.C., and to compare these rules to the present Tennessee law.

## I. Refusal To Pay

The depositor's primary purpose in opening a checking account is to draw checks against it. He expects the bank to pay these checks. When a bank refuses to pay a depositor's check, it may thereby become liable to him under what is popularly known as a "slander of credit suit."[10] A bank, however, is not liable for all refusals to pay depositors' checks, but only for wrongful refusals to pay. The problem thus becomes one of defining "wrongful," which can best be done by determining what refusals to pay are not wrongful. No element of malice or deliberateness is required by the term, for wrongful refusals to pay may be either willful or inadvertant.[11] All that is required is a refusal, for any reason, to pay a recognizably valid order drawn on sufficient funds.

It is obvious that a bank may refuse to pay checks drawn on insufficient funds. A bank may pay overdrafts, but it is under no

8. See, *e.g.*, Fairbanks, Morse & Co. v. Consolidated Fisheries Co., 190 F.2d 817, 822 n.9 (3d Cir. 1951). "We think provisions of the Uniform Commercial Code which do not conflict with statute or settled case law are entitled to as much respect and weight as courts have been inclined to give the various Restatements. It, like the Restatements, has the stamp of approval of a large body of American scholarship." *Ibid.* See also Gresham State Bank v. O & K Constr. Co., 370 P.2d 726 (Ore. 1962).

9. For an explanation of the advantages of the Code's financing devices, see Spivak, Secured Transactions (1960); Coogan, *Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien,"* 72 Harv. L. Rev. 838 (1959); Coogan, *Operating Under Article 9 of the Uniform Commercial Code Without Help or Hindrance of the "Floating Lien,"* 15 Bus. Law. 373 (1960); and Bunn, *Financing Dealers: Existing Wisconsin Law and the Uniform Code,* 37 Marq. L. Rev. 197 (1953).

10. This action may be based either in tort or in contract. The theoretical basis used may make a difference in the way damages are measured, or in the statute of limitations used. In Tennessee, both theories are available, J. M. James Co. v. Bank, 105 Tenn. 1, 58 S.W. 261 (1900), but the measure of damages is controlled in part by statute. Tenn. Code Ann. §§ 45-419, -420 (1956). See text accompanying note 20 *infra.*

11. Tenn. Code Ann. §§ 45-419, -420 (1956) provide liability where the refusal is inadvertant. In either tort or contract, all that is required is a breach of a duty. Intent therefore is not relevant.

obligation to do so.[12] A refusal to pay on grounds of insufficient funds is therefore not wrongful. Such an insufficiency must have been caused by previous valid orders from the depositor, however. A refusal to pay because of insufficient funds is wrongful, if the depletion of the depositor's account was due to a wrongful payment for which the bank is liable.[13]

The bank may also refuse to pay a check having a signature which is not recognizably the depositor's genuine signature.[14] There are two facets to this problem: (1) the handwriting may not be recognizable as the depositor's handwriting; and (2) the name, as used in the signature, may not be in the same form as it appears on the signature card. (J. A. Spanogle vs. John A. Spanogle.) The first issue poses an issue of fact to be decided by the jury. And in at least one Tennessee case, a signature not recognizable to the bank was recognizable to the jury.[15] On the second issue, the Tennessee law seems to be that form differences do not invalidate a check. At least, it has been held that a bank may pay such a check,[16] so that such a payment is authorized; and a refusal to make any authorized payment is arguably wrongful.[17]

The U.C.C. would not change any of the above rules. Section 4-402 reaffirms the basic rule that wrongful dishonor includes both inadvertant and willful refusals to pay valid orders. The Code does not attempt to define the term "wrongful" further. This would mean that the more detailed Tennessee rules would remain unchanged.

A bank may be forced into delaying payment when a third party notifies it of an adverse claim to the account. Such delay, if pro-

12. The payment of a check causing an overdraft is considered a loan to the depositor, and may be recovered as such. This rule is incorporated in the U.C.C. § 4-401. If the depositor is a corporation, however, the signor of the checks causing the overdraft must have authority to procure loans as well as authority to sign checks. If the signor for the corporation does not have this authority, the bank may recover from the corporate depositor only the amount it benefitted from the overdrafts. Hennessey Bros. & Evans Co. v. Memphis Nat'l Bank, 129 Fed. 557 (6th Cir. 1904). This quasi-contractual measure of recovery means that the bank is liable for defalcations through unauthorized employee overdrafts, but may recover any funds properly put at the disposal of the company.

The bank may allow a custom to arise that it will honor the depositor's overdrafts. Such a privilege may be withdrawn by the bank at any time. First Nat'l Bank v. First Nat'l Bank, 127 Tenn. 205, 216-17, 154 S.W. 965, 968 (1912). Nor must the bank notify the depositor before it can withdraw the privilege, for the depositor's reliance seems irrelevant. If, however, the payee or holder knows of the custom and he relies thereon when accepting a check, the bank's ability to withdraw the privilege and dishonor that cheek seems limited. *Ibid.*

13. Citizens' Nat'l Bank v. Importers' & Traders' Bank, 119 N.Y. 195, 23 N.E. 540 (1890); American Exch. Nat'l Bank v. Gregg, 138 Ill. 596, 28 N.E. 839 (1891).

14. American Nat'l Bank v. Miles, 18 Tenn. App. 440, 79 S.W.2d 47 (M.S. 1934).

15. First Am. Nat'l Bank v. Ivey, Civil No. 9961-2, M.S., Tenn. App., Dec. 4, 1959.

16. American Nat'l Bank v. Miles, *supra* note 14.

17. RESTATEMENT (SECOND), AGENCY § 146, comment *f*; §§ 385(1), 400 (1958).

longed, may result in the dishonor, under the Deferred Posting Statute,[18] of checks presented for payment. If the third party fails to prove his claim, such dishonor would be wrongful. This problem will be discussed more fully under Wrongful Payment, Part III.[19]

The measure of damages for a wrongful refusal to pay a check is controlled partly by statute and partly by case law. The old Tennessee rule was that a jury could assess general damages, without specific proof, if the depositor was a merchant.[20] This is similar to the common law measure of damages in libel or slander per se.[21] Thus rule, however, has been abrogated in part by statute, so that proof of actual damages is now required in all cases where the refusal to pay was inadvertant, not malicious.[22] The statute's limitation on its applicability presumably means that the case-law rule is still applicable to malicious refusals to pay.

Actual damages, in order to be recoverable, must be proximately caused by the bank's refusal to pay. This raises the question of the foreseeability of indirect losses resulting from the refusal. This question in measuring damages is most dramatically presented when the depositor has been arrested under a Bad Check Law because of the bank's refusal to pay his check.[23] Such damage has been ruled foreseeable in Tennessee, and is therefore recoverable.[24] Whether this ruling may be extended to cover other indirect losses[25] is impossible to predict.

In ascertaining damages, the Code expressly codifies both Tennessee rules.[26] Actual damages must be proved where the refusal to pay is inadvertant, not malicious. Also, damages from an arrest or prosecution of the depositor may be recovered as being proximately caused. In other indirect loss situations,[27] the issue of proximate cause is question of fact for the jury.

18. TENN. CODE ANN. §§ 45-417, -418 (1956). The length of the delay required has not been specified in the cases, but it must be more than a few hours. Miller v. Bank of Wash., 176 N.C. 152, 96 S.E. 977 (1918). The delay is usually required to be a sufficient length of time to give the claimant an opportunity to assert his claim in court. See note 125 *infra*. This should be less than the two days allowed by the Deferred Posting Statute; however, checks presented for payment, but still unpaid at the time of the notification of the adverse claim, would still present the above problem.

19. See text accompanying note 125 *infra*.

20. J. M. James Co. v. Bank, *supra* note 10.

21. See PROSSER, TORTS 590-91 (2d ed. 1955).

22. TENN. CODE ANN. §§ 45-419, -420 (1956).

23. Other situations where proximate cause problems may arise involve the cancellation of insurance policies or the foreclosure of a mortgage or other lien due to the refusal to pay a check for a premium or an installment.

24. First Am. Nat'l Bank v. Ivey, *supra* note 15.

25. See note 23 *supra*.

26. U.C.C. § 4-402.

27. See note 23 *supra*.

## II. WRONGFUL PAYMENT—DEFECTIVE CHECKS

A bank may incur liability not only by wrongfully refusing to pay a check, but also by wrongfully paying one. The depositor expects the bank to pay from his account only on orders from him, and only when those orders are valid. As to the validity of checks, the most common defect encountered is a forgery, either of the depositor's signature or of an indorsement. Other types of defects include material alterations and staleness. As to the requirement of an order from the depositor himself, a court or a third party may order the bank to pay out the depositor's funds; or the bank may seek to use his account to pay debts he owes to it. Under some circumstances, these claims may be paid and charged to the depositor's account without even a purported order from him.[28] The problems involving payment without any purported order from the depositor will be discussed in Part III.

In all situations involving wrongful payment, there are at least two parties to whom the drawee bank may look for possible reimbursement. It may attempt to charge the depositor himself, and it may also attempt to recover from the collector—the prior holder or collecting bank who was paid by the drawee bank. It may be able to recover from both, from only one, or from neither of these parties; but the liability of each party should be examined in every situation, and should be examined separately. Since these two avenues of recovery are interrelated, both must be examined in order to present a clear picture of the bank-depositor relationship. Thus, in considering the rules applicable to each type of defect, recovery possibilities both against the depositor and against the collector will be examined in this article.

### A. FORGED CHECKS

A bank may not charge to the depositor's account a check bearing either a forged drawer's signature[29] or a forged indorsement unless the depositor is, in the words of the Negotiable Instruments Law (N.I.L.), "precluded from setting up the forgery."[30] This means that the bank must show that the depositor was negligent in his handling of the check in order to shift the loss to him. Although the negligence of the depositor may preclude him from asserting a defect

28. See text accompanying note 109 *infra.*

29. As used herein, the term "forged signature" will include all unauthorized signatures, whether the forger purports to act as an agent or not. The rules applicable to all unauthorized signatures are almost identical, differing only in the applicability of the doctrine of ratification. On other issues the same rules apply, so that the inclusive term "forged signature" may be used. See UNIFORM NEGOTIABLE INSTRUMENTS LAW § 23 [hereinafter cited as N.I.L.]; BRITTON, BILLS & NOTES 362 (1961) [hereinafter cited as BRITTON].

30. N.I.L. § 23, TENN. CODE ANN. § 47-123 (1956).

in both forged drawer's signature and forged indorsement cases, the rules defining negligence in the two situations are quite different. In both types of cases the depositor may be negligent either in the execution of the check or in failing to discover and report the forgery after his statement is returned to him.

The U.C.C. would spell out the case-law rules on wrongful payment of defective checks, which are now implied from the N.I.L. or carried over from the common law. It would make few changes in the presently-settled rules, but it would decide most of the unresolved questions. The Code's rules on forged checks are divided into four sections. Section 4-401 sets up the basic rule that a defective check may not be automatically charged to the depositor's account.[31] Section 3-406 then provides an exception to this rule where the depositor is negligent in the execution of the check. Section 4-406 provides a like exception where the depositor is negligent in failing to discover and report the defect. Section 4-207 covers the bank's ability to recover from prior holders and collecting banks.[32]

Courts in Tennessee, and in other states, have found few instances of negligence by the depositor in the execution of checks bearing a forgery of his signature.[33] One reason for this is that merely placing an employee who later defalcates in a position of trust where he can forge[34] checks does not constitute such negligence. Giving him such a position may, however, clothe the employee with apparent authority, which will also preclude the depositor from relying upon forgery.[35]

On the other hand, the depositor is more likely to be held negligent in the execution of a check bearing a forged indorsement than in the execution of one bearing a forgery of his signature. Such negligence

31. Section 4-401 of the U.C.C. provides that the bank may charge the depositor's account with checks which are "properly payable." Checks are not properly payable if they bear a forged drawer's signature (§ 3-401), a forged indorsement (§ 3-404), or a material alteration (§ 3-407).

32. Section 3-417 provides similar remedies to those in § 4-207. The remedies in the latter section are expressly applicable to the check collection process, however.

33. The one Tennessee case on point involved a forged promissory note which was secured by a mortgage properly signed the same day. Denison-Gholson Dry Goods Co. v. Hill, 135 Tenn. 60, 185 S.W. 723 (1916). The court held that the maker's execution of the mortgage, which clearly referred to the forged note, precluded her from setting up the forgery of the note. *Id.* at 71. More common examples of such negligence from other states include negligent keeping of a signature stamp or of signed blank checks which are used without authorization by employees or strangers. See 2 PATON, DIGEST OF LEGAL OPINIONS 1797 (1942) [hereinafter cited as PATON].

34. Including checks executed without authority. See note 29 *supra*.

35. RESTATEMENT (SECOND), AGENCY § 173 (1958). The bank may be liable for conversion, however, if it has notice that the employer's checks are issued for the signing employee's personal use. Federal Sav. & Loan Ins. Corp. v. Third Nat'l Bank, 173 F.2d 192 (6th Cir. 1949). *Cf.* United States Guar. Co. v. Hamilton Nat'l Bank, 189 Tenn. 143, 223 S.W.2d 519 (1949).

is best illustrated by the "fictitious payee" situation. In this situation, an employee who has no authority in himself to sign checks, or who needs a co-signor to issue valid checks, makes out checks payable to other employees for work they have not done, or to suppliers for materials they have not provided. He has these checks signed by the authorized corporate signor, but does not deliver them to the named payees. Instead, the dishonest employee forges the payee's signatures thereon and cashes them. The Tennessee courts have ruled that the depositor may be negligent in the execution of such checks, if they are issued without first checking his records of hours worked and good received.[36] If the records to be checked are those of a sub-contractor, however, the depositor has no duty to check such records before signing checks.[37] Even if the depositor does not check his own records, the bank must show that this negligence "substantially contributed" to the dishonest employee's scheme before the depositor is precluded from asserting the forgery.[38] Thus, if the scheme has been perpetrated by the depositor's own employee, and the depositor has not set up an accounting system reasonably calculated to prevent such defalcations, the loss will fall on the depositor. If the scheme has been perpetrated by a sub-contractor, or the depositor has used a reasonable accounting system, the loss will fall on the bank.[39]

In Tennessee, the preclusion due to negligent conduct has heretofore been based upon equitable estoppel theory.[40] Thus, to preclude the depositor from asserting the forgery, the bank must show that the depositor's conduct misled the bank and caused it to change its position justifiably in reliance upon the misrepresentation.[41] The bank must show that it has not been negligent;[41a] but, even though it

36. United States Guar. Co. v. Hamilton Nat'l Bank, *supra* note 35.

37. McCann Steel Co. v. Third Nat'l Bank, 47 Tenn. App. 287, 337 S.W.2d 886 (M.S. 1960). The distinction is probably based on the relative accessibility of the different sets of records.

38. *Ibid.*

39. The bank may also argue that the use of a fictitious payee made the check payable to bearer, so that proper indorsements are not required. N.I.L. § 9(3). TENN. CODE ANN. § 47-109(3) (1956). This argument fails in this state because the Tennessee courts have ruled that such checks do not become bearer paper unless every signer of the check knew that the payee would have no interest in the check. McCann Steel Co. v. Third Nat'l Bank, *supra* note 37. See Spanogle, *Bills and Notes —1961 Tenn. Survey*, 14 VAND. L. REV. 1135 (1961). The U.C.C. would change this rule. U.C.C. § 3-405. See note 47 *infra*.

40. Denison-Gholson Dry Goods Co. v. Hill, *supra* note 33. According to Britton, an estoppel theory will never protcet the bank from a one-time forgery. BRITTON 368. This is quite correct where the payment precedes the depositor's negligence. See note 51 *infra*. It is not necessarily true, however, where the depositor's negligence precedes the bank's payment, as in the negligent execution situation. In the latter case, the negligence may well mislead the bank and cause the payment: thus providing the requirements for an estoppel in pais.

41. Furnish v. Burge, 54 S.W. 90 (Tenn. Ch. App. 1899).

41a. McCann Steel Co. v. Third Nat'l Bank, *supra* note 37.

may seem to have been negligent in paying the check, it may still be protected if it can produce evidence that its course of conduct, which would ordinarily be classified as negligent, was both justified and caused by the depositor.[42] Such conduct is not in fact negligent, but is reasonable under the circumstances. Such justification might be shown by evidence of use of standard banking procedures. On the other hand, the bank might be required to show affirmatively that it has not been negligent in any way not related to its reliance on the customer's misrepresentation.[43]

The U.C.C. does not alter the present rule that a bank may not charge a defective check to the depositor's account unless the depositor is precluded from setting up the defect.[44] Nor does it change the present rule that a depositor's negligence in executing a check may so preclude him, even against a holder in due course or the bank.[45] Further, it does not attempt to define what conduct will be considered negligent.[46] Thus, the present Tennessee rules concerning the depositor's negligence in executing a check would not be changed by the U.C.C., nor would the further development of such rules by the Tennessee courts be affected.[47] The Code does state that

42. McCann Steel Co. v. Third Nat'l Bank, *supra* note 37, at 298, 337 S.W. 2d at 891.

43. *Id.* at 301, 337 S.W.2d at 892. "The Bank cannot shift its primary responsibility . . . unless it can point to some act on the part of the Steel Company which caused the Bank to act as it did."

44. U.C.C. §§ 4-401, 3-404.

45. U.C.C. § 3-406. The preclusion is based upon an estoppel theory, as it is under present Tennessee law. See note 40 *supra*, and U.C.C. § 3-406, comment 5.

46. "No attempt is made to define negligence which will contribute to an alteration. The question is left to the court or the jury upon the circumstances of the particular cases. Negligence usually has been found where spaces are left in the body of the instrument in which words or figures may be inserted. No unusual precautions are required, and the section is not intended to change decisions holding that the drawer of a bill is under no duty to use sensitized paper, indelible ink or a protectograph; or that it is not negligence to leave spaces between the lines or at the end of the instrument in which a provision for interest or the like can be written." U.C.C. § 3-406, comment 3.

"The section applies the same rule to negligence which contributes to a forgery or other unauthorized signature, as defined in this Act (Section 1-201). The most obvious case is that of the drawer who makes use of a signature stamp or other automatic signing device and is negligent in looking after it. The section extends, however, to cases where the party has notice that forgeries of his signature have occurred and is negligent in failing to prevent further forgeries by the same person. It extends to negligence which contributes to a forgery of the signature of another, as in the case where a check is negligently mailed to the wrong person having the same name as the payee. As in the case of alteration, no attempt is made to specify what is negligence, and the question is one for the court or the jury on the facts of the particular case." *Id.*, comment 7.

47. The negligence rules concerning the fictitious payee situation would not be changed. The bearer paper rules of that situation would be changed, however, where the defalcating employee is a co-signer of the checks. § 3-405. See note 39 *supra*. The present Tennessee law is a minority view. See Morris, *Fictitious Payees on Checks Requiring Dual Signatures*, 1961 WIS. L. REV. 439.

the negligence must "substantially contribute" to the alteration or forgery in order to preclude the depositor from asserting the defect, which is also true under present Tennessee law.[48] Moreover, the bank's payment must be in accordance with "reasonable commercial standards." This means that negligence of the bank in failing to discover the defect will prevent it from taking advantage of the estoppel.[49] It also means that the justifiable reliance principle of estoppel law would be retained, and that the burden of proof placed on the bank in this situation is spelled out.

Where the drawer's signature has been forged, negligence in discovering the forgery is a much more common ground for preclusion than is negligence in the check's execution. This preclusion is based on an estoppel theory in Tennessee.[50] As in the negligent execution situation, the bank must show that the depositor's conduct misled the bank and caused it to change its position in reliance thereon.[51] Failure to discover a forged drawer's signature on a check will therefore not estop the depositor if there is but one such forgery;[52] the bank has already paid the check before the depositor's failure to discover, so that no misrepresentational act of the depositor led the bank to pay the check. If there is a series of such forgeries, however, the bank may argue that it was misled by the failure to discover and that this omission caused the losses on all checks paid after the failure. Thus, the bank would be liable for the first checks in a series of forgeries, but not for later defalcations.[53] A separate problem arises where there is but one forgery, and the forger remained in the jurisdiction for some time after the forgery should have been discovered. Here, the depositor's failure has cost the bank an opportunity to recover from the forger, but the loss is not due to misrepresentation. Estoppel theory will therefore not protect the bank, but a breach of contract theory would.[54] This theory of recovery has never been

48. U.C.C. § 3-406. As to the present law, see note 37 *supra*.

49. U.C.C. § 3-406, comment 6.

50. Furnisb v. Burge, *supra* note 41. A forged check may not be ratified in Tennessee, although an unauthorized signature by one who purports to act as the drawer's agent may be. Boone v. Citizens Bank & Trust Co., 154 Tenn. 241, 290 S.W. 39 (1927). Ratification of the unauthorized signature would permit the drawee bank to recover on each check so ratified, without proof that it had been misled. BRITTON 367.

51. Furnish v. Burge, *supra* note 41.

52. BRITTON 367; 2 PATON 1881.

53. Critten v. Chemical Nat'l Bank, 171 N.Y. 219, 63 N.E. 969 (1902); BRITTON 370; 9 C.J.S. *Banks & Banking* § 356, at 744 (1938).

54. The theory is that the depositor's negligence has breached the contract of deposit. The theory allows the bank to preclude the assertion of the forgery whenever the depositor's negligence has caused a loss, whether that negligence led the bank to pay the check or not. The forger's delayed escape or insolvency is sufficient to establish that the loss is due to the depositor's failure. BRITTON 368.

considered by the Tennessee courts, so its availability is undetermined.[55]

The depositor has no duty, however, to examine returned checks for forged indorsements, because he cannot compare the indorsements to the genuine signature of others.[56] Although one case indicated that there may be an exception to this rule where the depositor possesses the payee's signature, the exception has never been applied by the Tennessee courts.[57] Thus, there will be few instances of depositor negligence in the discovery of forged indorsements after payment of the check.[58] There is, however, a statutory provision in the nature of a statute of limitations which bars assertion of any defect unless it is discovered and asserted within six years of the return of a statement.[59]

Unlike the present Tennessee case law, the U.C.C. would provide specific rules on the extent of the duty of the depositor to discover defects in checks returned to him by the bank. Section 4-406 recognizes a difference between defects which may be discovered by the use of reasonable care and those which are so artfully done that detection by ordinary means is impossible. The Code does not attempt to define the amount of investigation required to comply with the "reasonable care" standard. The entire concept seems new to Tennessee law, but this is primarily because there are no cases in the area.[60]

Only forged drawer's signatures are forgeries which may be discovered by the use of reasonable care.[61] Thus, the depositor would still have no duty to examine his returned checks for forged indorse-

55. Furnish v. Burge, *supra* note 41, considers only estoppel and ratification theories, but does not expressly reject others. Foutch v. Alexandria Bank & Trust Co., 177 Tenn. 348, 149 S.W.2d 76 (1940) permits use of both estoppel and breach of contract theories to prevent the depositor's recovery on an untimely discovered raised check. See note 90 *infra*. This preclusion is not based upon N.I.L. § 23, however. See note 89 *infra*.

56. United States Guar. Co. v. Hamilton Nat'l Bank, *supra* note 35; Darling Stores, Inc. v. Fidelity-Bankers Trust Co., 178 Tenn. 165, 156 S.W.2d 419 (1941).

57. Prudential Ins. Co. v. National Bank of Commerce, 227 N.Y. 510, 125 N.E. 824 (1920), cited with approval in *Darling Stores*, note 56 *supra*, at 171, held that, if the depositor has the payee's signatures, the rationale of the rule is not valid, so that whether the depositor has a duty to examine becomes a question of fact for the jury. This rule has been ignored in cases where it would have been applicable, including *Darling Stores*, therefore weakening its value.

58. Presumably, a failure to notify the bank after receiving actual knowledge of the forged indorsement could estop the depositor from asserting later forgeries of the same indorser's signature. The U.C.C. would not change this rule. § 4-406, comment 6.

59. TENN. CODE ANN. § 45-432 (1956).

60. Although Furnish v. Burge, *supra* note 41, involved failure to discover a forgery, it did not involve a check returned by the bank to its depositor after payment and cancellation.

61. U.C.C. § 4-406(1).

ments, as is true under the present Tennessee law.[62] If the depositor is negligent in not discovering a discoverable defect and his negligence causes the bank a loss, he is precluded from later setting up the defect.[63] The negligence of the depositor, therefore, will not protect the bank from the one-time forger who immediately leaves the state or becomes insolvent. If, however, a series of forgeries perpetrated over a period of time[64] is involved, the depositor's negligence seems conclusively presumed by the Code to have caused the bank a loss, and liability will fall on the depositor. Also, if the forger remains in the jurisdiction for "a reasonable time" after the items are returned by the bank, the depositor's negligence will place the loss on him. The former rule conforms to present Tennessee law, and the latter decides a question presently open in this state.[65] On the other hand, if the depositor can establish lack of ordinary care by the bank in paying the defective checks, the bank may not assert the depositor's later negligence in failing to discover the defect.[66]

If the defects are not discoverable, the preclusion rules do not apply. The Code does, however, provide rules in the nature of statutes of limitations to cut off the assertion of these defects.[67] These rules are similar to Tennessee Code Annotated section 45-432, but with shorter time limits. Instead of six years to object to defects, the depositor would have one year to discover and object to forgeries of his own signature and alterations, and three years for forged indorsements. These rules would not be affected by any negligence of the bank.

Against the collector—the holder or collecting bank paid by the depositor's drawee bank—the depositor's bank's right of recovery depends upon whether the forgery is of the drawer's signature or of an indorsement. Once the bank has paid a check bearing a forged drawer's signature, it may not subsequently charge the check back

62. A depositor having notice of a forged indorsement would be required by the Code to report this fact to his bank, if such is the present law. U.C.C. § 4-406, comment 6. As to the present law, see note 58 *supra*. *Cf.* note 57 *supra*.

63. U.C.C. § 4-406(2)(a).

64. The loss caused by the depositor's negligence includes only those checks paid fifteen days or more after the bank returns the first defective items to the depositor for inspection. § 4-406(2)(b).

65. The former rule is based upon an estoppel theory, and the courts have held that this theory is valid in Tennessee. Furnish v. Burge, *supra* note 41. The latter rule is based upon a breach of contract theory, which does not require a misrepresentation to the bank before it pays the defective check. See BRITTON 367. This theory has not yet been considered by the Tennessee courts, so its validity in this state is still an open question. See note 55 *supra*.

66. U.C.C. § 4-406(3). This procedure follows estoppel theory, but shifts the burden of proof to the party who is trying to establish another's negligence.

67. U.C.C. § 4-406(4).

to any prior holders for value who did not know of the forgery.[68] This is the old common law rule of *Price v. Neal*,[69] which has been followed in Tennessee since the adoption of the N.I.L.[70] The bank admits the genuineness of its depositor's signature by accepting or paying the check under N.I.L. section 62.[71] Any failure to recognize a forgery of that signature is deemed to be negligence by the bank, making it liable for the loss. If the collector knew of the forgery, the bank may charge the amount of the check back to him.[72] If the collector had no actual knowledge of the forgery, however, but was only negligent in not investigating the status of the person whom he paid, the bank may not recover from him.[73]

Where the bank has paid a check bearing a forged indorsement, it may subsequently recover the amount of that check from the collector, even if he purchased the check for value and in good faith.[74] The bank's recovery rights are different from those in the case of the forged drawer's signature because the bank does not have the payee's genuine signature to compare to the indorsements. Thus, the recovery is upon a quasi-contractual basis. Such recovery is not available against a collecting agent or bank after it has paid the proceeds to its principal.[75] Recovery is available against such agents only upon a warranty theory, but the warranties of the N.I.L. do not run to drawee banks under Tennessee law.[76] Drawee banks, therefore, must

68. Figuers v. Fly, 137 Tenn. 358, 378, 193 S.W. 117, 122 (1916). Thus the bank may recover from two classes of persons: 1) donees of the forger; and 2) persons obtaining payment in bad faith.

69. 3 Burr. 1354, 97 Eng. Rep. 871 (K.B. 1762).

70. Farmers' & Merchants' Bank v. Bank of Rutherford, 115 Tenn. 64, 88 S.W. 939 (1905).

71. TENN. CODE ANN. § 47-162 (1956).

72. Such knowledge would give the bank an action in fraud or deceit, in which the bank's mere negligence would not be relevant. This may mean that a holder in due course who obtained the instrument without knowledge of the forgery, or even one who later had the check certified without such knowledge, may be liable to the bank if he was notified of the forgery before receiving payment. There is no Tennessee law on this issue. For a discussion of the common law solution to the problem, see Ames, *The Doctrine of Price v. Neal*, 4 HARV. L. REV. 297, 301 (1891); Note, 23 U. PITT. L. REV. 198 (1961).

73. Figuers v. Fly, *supra* note 68, at 378, overruling a prior case, People's Bank v. Franklin Bank, 88 Tenn. 299, 12 S.W. 716 (1889), which had allowed recovery from a negligent collector.

74. Figuers v. Fly, *supra* note 68, at 375.

75. National Park Bank v. Eldred Bank, 90 Hun 285, 35 N.Y. Supp. 752 (Sup. Ct. 1895), *aff'd*, 154 N.Y. 769, 49 N.E. 1101 (1897); National Park Bank v. Seaboard Bank, 114 N.Y. 28, 20 N.E. 632 (1889).

76. Figuers v. Fly, *supra* note 68, at 377. The warranties of N.I.L. § 66, TENN. CODE ANN. § 47-166 (1956), are only negotiation warranties, not presentment warranties. They do not run to the drawee bank because it is not a holder in due course and because a presentation for payment is not a negotiation. It should be noted that only N.I.L. §§ 62, 66 have any application to the bank's liability for paying forged checks, and that neither of them directly solves the problems in the field. Thus, all of the rules discussed are a case-law gloss upon the statute.

rely upon an express "Prior Indorsements Guaranteed" warranty stamp, if any, to recover from collecting banks.[77]

Against prior holders, the U.C.C. provides that the payment of a check by a drawee bank to a holder in due course is final, except for liability for breach of warranty.[78] The bank's ability to recover from prior holders and collecting banks is therefore placed upon a warranty basis, and presentment warranties are provided.[79] These warranties are statutory, and thus are applicable whether or not a "Prior Indorsements Guaranteed" stamp is added to a collecting bank's indorsement.[80]

The present case-law distinction between the drawee bank's recovery rights on forged drawer's signatures and forged indorsements is maintained. The prior parties warrant that they have good title,[81] which means they warrant all prior indorsements necessary to their title. The drawee bank may recover from them if any such indorsement is forged. The warranty of good title does not, however, warrant that the check itself is genuine, so warranties of the drawer's signature are treated separately. Prior parties warrant only that they have no knowledge that the drawer's signature is forged.[82] Thus there is no right of recovery from any holder in due course who in good faith presented the check for payment.[83] There is, however, a right of recovery against holders not for value, whether or not they had knowledge of the forgery.[84] These rules conform to the present Tennessee law.[85]

77. Such warranty stamps are required by the Federal Reserve and most clearing houses. 12 C.F.R. § 210.5 (1959).

78. U.C.C. § 3-418.

79. U.C.C. §§ 4-207, 3-417. This is a change from the N.I.L., which provides only transfer warranties. If a prior party has breached a presentment warranty, the bank may employ any remedy normally available for breach of warranty. U.C.C. § 3-417, comment 1. Thus, it may rescind its acceptance or payment and charge back the amount credited to prior parties; or it may sue for damages, including reasonable collecting expenses and attorneys fees. U.C.C. § 4-207, comment 5. It must, however, pursue its remedy within a reasonable time after discovering the breach, or the prior parties will be discharged to the extent of any loss caused by the delay. U.C.C. § 4-207(4).

80. U.C.C. § 4-207(3). The statutory warranties cover not only forged indorsements, but also material alterations. U.C.C. § 4-207(1)(c).

81. U.C.C. § 4-207(1)(a).

82. U.C.C. § 4-207(1)(b).

83. An exception to this rule is made for a holder in due course, which may be a collecting bank, who either obtains the instrument or has it certified without knowledge of the defect, and obtains payment after learning of the defect. Under § 4-207 (1)(b)(iii), the bank may not recover from him. His good faith at the time he obtained the instrument itself or a certification of it insulates him from liability. At present, Tennessee has no rule to cover such a situation.

84. U.C.C. § 3-418 makes final only payments to holders in due course. Donees of the forger could not qualify for such final payment.

85. See text accompanying note 68 *supra*.

### B. Altered Checks

When a check has been materially[86] altered, the bank may not automatically charge the check in its altered form to the depositor's account. It may charge the depositor's account only according to the check's original tenor,[87] unless the depositor has been negligent in executing the instrument.[88] To charge the depositor, the bank must itself be without fault and the depositor's negligence must proximately cause the payment in altered form.[89] Where the depositor has been negligent, he has both breached a contractual duty owed the bank and misled the bank by his actions. Thus, the bank may either seek to shift the loss to him under a breach of contract theory or defend against a suit by the depositor under an estoppel theory.[90] However, the proximate cause requirement is not well defined in this state. The only Tennessee case on point held that the requirement was met when the depositor (1) authorized the payee to fill out the check (2) in pencil and (3) permitted blank spaces to be left before the amount.[91] Whether less extreme negligence, involving only one of these three faults, would also be held sufficiently causal is still undecided.[92] The effect of the depositor's failure to discover alterations when his checks are returned is also an open question.[93]

The Code would continue the presently-settled rules. The bank

86. See N.I.L. § 125, Tenn. Code Ann. § 47-156 (1956), listing the types of alterations considered material. The types of alterations considered material under the U.C.C. are defined in § 4-407.

87. N.I.L. § 124, Tenn. Code Ann. § 47-255 (1956). If the amount of the check has been altered, the bank may charge the account with the original amount. If the payee's name has been altered, the entire payment is wrongful, and no amount may be charged to the depositor's account. If the date of a post-dated check has heen altered, the charge must be delayed until proper.

88. Young v. Grote, 4 Bing. 253, 130 Eng. Rep. 764 (C.P. 1827).

89. Foutch v. Alexandria Bank & Trust Co., *supra* note 55. The "criminal instrumentality rule" does not limit the depositor's duty to execute the check properly. There is nothing in N.I.L. § 124 to indicate that the depositor's negligence may preclude him from setting up the alteration. Britton argues that section 23 provides this result, because "forgery," as used in that section, should include material alterations. Britton 367. The Tennessee court relied on common law, not statutory, principles to reach its decision, however.

90. Both theories are mentioned in *Foutch*, note 55 *supra*, and neither is said to be exclusive. Either remedy would permit the bank to recover, but the estoppel theory would also permit a holder in due course to recover the altered amount from a negligent drawer.

91. Foutch v. Alexandria Bank & Trust Co., *supra* note 55.

92. For a survey of cases on this subject from other jurisdictions, see 1 Paton 111, 116-19. *But see* Britton 666, for a contrary conclusion on the effect of the same cases.

93. It would seem that the same principles would apply to discovery of altered checks as to the discovery of checks bearing forged drawer's siguatures. Both should be regulated by equitable estoppel doctrines. This is the majority view in other states. Britton 362; 9 C.J.S. *Banks and Banking* § 356, at 743 (1938). Therefore, for more detailed rules regarding the depositor's liability for failing to discover the alteration of his checks, see text accompanying notes 50-67 *supra*.

could charge the depositor's account only according to the check's original tenor, unless the depositor is precluded by his negligence from asserting the alteration.[94] Negligence in the execution of the check must "substantially contribute" to the alteration in order to preclude the depositor.[95] As with forged checks, there is no attempt to define the conduct which would meet this proximate cause test,[96] so that the present confusion in the Tennessee law in this area would not be clarified. Another unresolved problem, however, would be answered. Under the Code material alterations are defects which are discoverable, so that the depositor would have a duty to examine his returned checks for alterations, and failure to discover them could preclude him from asserting the defect.[97] The specific rules as to the depositor's duty to examine for alterations are the same as those concerning his duty to examine for forgeries of his signature.[98]

Recovery by the bank against prior holders on altered checks was allowed at common law, on a mistake of fact theory.[99] Under the N.I.L., however, there is a conflict of authority on the issue, a minority holding that section 62 has changed the common-law rule.[100] Such a case has not yet arisen in Tennessee, so this issue is presently undecided. The Code would provide a definite answer to this question—drawee banks would be allowed to recover from prior parties on altered checks.[101] As with forged indorsements, the recovery would be on a statutory warranty basis.[102] Thus the Code would solve two out of three unresolved major problems in the altered check field.

### C. STALE CHECKS

A stale check is not per se defective, but its staleness deprives a purchaser of the status of a holder in due course and puts the bank on inquiry as to its right to pay the check.[103] This means that the

94. U.C.C. § 3-407. See also §§ 3-406, 4-406.
95. U.C.C. § 3-406.
96. *Ibid.* See text accompanying notes 91 and 92 *supra.*
97. U.C.C. § 4-406.
98. *Ibid.* See text accompanying notes 50-67 *supra.*
99. Bank of Commerce v. Union Bank, 3 Comst. 230 (N.Y. 1850).
100. Wells Fargo Bank & Union Trust Co. v. Bank of Italy, 214 Cal. 156, 4 P.2d 781 (1931); National City Bank v. National Bank, 219 Ill. App. 343, 132 N.E. 832 (1921); Kansas Bankers Surety Co. v. Ford County State Bank, 184 Kan. 529, 338 P.2d 309 (1959). The majority view is that the common law rule is unchanged.
101. U.C.C. § 4-207(1c). An exception is provided for checks which have been certified before alteration and a partial exception for ones certified after alteration. U.C.C. § 4-207(1)(c)(iii). In the latter case, a bank may not recover from any holder in due course who took the check after certification. Thus, the negotiability of certified checks is strengthened because a person who purchases a check after certification may enforce the check against the bank for its face amount, whether altered or not.
102. See note 100 *supra.*
103. 1 PATON 1108.

depositor may assert against the bank any of the defenses which negotiability cuts off, if the facts so warrant. Thus, a stale check is not necessarily defective, but the bank is shorn of its normal defenses if there is a defect somewhere in the background. Although the one Tennessee court presented such a fact situation ignored this doctrine,[104] a bank which pays such a check bears the risk of loss if such a defect is present, under the existing law.[105] On the other hand, a refusal to pay a stale check creates the risk of a slander of credit suit, if there is no infirmity in the instrument.[106] The often-repeated recommendation is that the bank contact the depositor before paying to ascertain whether it is irregular. This may be impossible in many cases, and is economically unfeasible as a standard procedure. Thus, the present law provides no guide as to how a bank may safely handle a stale check presented to it for payment. Nor does the N.I.L. provide any standard to determine precisely when a check becomes stale. Section 53 makes a check stale when it "is negotiated an unreasonable length of time after its issue."[107] Banking custom in various states sets the time limit as six months or a year after issue. In Tennessee there is a statement in a 1917 case that demand paper becomes stale in two to six months,[108] but this is not very definite either.

Section 4-404 of the Code provides that the staleness of a check no longer puts a bank on inquiry as to its right to pay the check. As long as payment is in good faith, a bank may pay checks even though they are over six months old. Banks may also refuse to pay

104. Pan Am. Petroleum Corp. v. American Nat'l Bank, 165 Tenn. 66, 52 S.W.2d 149 (1931). The defendaut drawer seems to have argued that the check was stale, but the court never considered that argument. Instead, the court held that N.I.L. § 186 offercd no defense, which, although true, was not relevant. See note 107 *infra*. The court also stated that the facts of the case were analogous to a Kansas case which did not involve a stale check, again indicating its unawareness of the staleness issue. Therefore, the decision cannot be read to eliminate stale check problems from the present Tennessee law. *Cf.* Easley v. East Tenn. Nat'l Bank, 138 Tenn. 369, 198 S.W. 66 (1917).

105. Staleness deprives a purchaser of the status of a holder in due course. N.I.L. § 53, TENN. CODE ANN. § 47-153 (1956); State & City Bank & Trust Co. v. Hedrick, 198 N.C. 374, 151 S.E. 723 (1930); La Due v. First Nat'l Bank, 31 Minn. 33, 16 N.W. 426 (1883). Thus, the depositor may assert against the purchaser defenses based upon the underlying transaction, even if the purchaser is the drawee bank. Lancaster Bank v. Woodward, 18 Pa. 357 (1852).

106. Banking custom and statutes in some states permit a bank to refuse payment of a stale check without liability for wrongful dishonor. See 1 PATON 1110. Tennessee has no such legislation.

107. TENN. CODE ANN. § 47-153 (1956). It should be noted that staleness is not the same concept as a statute of limitations. Only the negotiability is destroyed by staleness, not the obligation itself. Nor is § 186 of the N.I.L. involved. The issue is not necessarily whether the delay has caused a loss to the depositor, but whether the depositor has any defense to the obligation.

108. Easley v. East Tenn. Nat'l Bank, *supra* note 105, citing several decisions from other states, each having a different time limit.

such checks without fear of a slander of credit suit. Thus, under the Code, a bank has the option to pay or not to pay a check over six months old, and runs no risk in taking either course of action. Under the present law, a bank presented a six months old check does not know whether it is stale; and, even if it did, it runs a discernable risk whether it pays the check or not.

### III. WRONGFUL PAYMENT: NO PURPORTED ORDER FROM THE DEPOSITOR

Wrongful payment comprises not only the payment of defective checks, but also payments which are not ordered by the depositor. For example, a bank using electronic signature codes may find that a third party has written a check on a check form bearing the depositor's electronic signature. The bank's computer will charge the depositor's account; but obviously this charge may not stand, even though the check itself is valid, because the bank has no order from him. There are two well-known exceptions to the rule that a bank may pay only orders from the depositor. One exception is the banker's set-off—the banker's right to pay debts owed by the depositor to the bank out of his deposit. The second exception is the payment of a third party under a court order.[109]

It is axiomatic that a depositor could not successfully sue his bank for monies in his account if he owed the bank a greater amount under a matured note. The bank could assert an equitable set-off against the account and prevent recovery.[110] On the same reasoning, a bank may refuse to pay the depositor from his account if the depositor owes it a greater matured debt.[111] Since the depositor's checks are not an assignment of the funds in his account,[112] the bank may also debit the account and refuse to pay the depositor's checks.[113] If it does so, it has exercised what is commonly known as a "banker's lien" or set-off.

There are, however, two rigid limitations on the types of debts which may be the object of a banker's set-off. First, the debt must be liquidated—*i.e.*, it must be reduced to precise figures, or capable of being made certain by calculation without the intervention of a jury

109. Payments under either of these claims may cause a depletion of the depositor's account, so that his checks are dishonored for insufficient funds. Such a dishonor will not subject the bank to liability if the depletion was due to a payment within the limits of the recognized exceptions. If the claims paid are outside these limits, however, the bank will be liable for both the wrongful payment and the wrongful refusal to pay the depositor's checks. The claim of insufficient funds will not protect the bank where the insufficiency is due to a wrongful payment. See note 13 *supra.*

110. Ford v. Harrison, 150 Tenn. 369, 265 S.W. 89 (1924).

111. Doughty-Stephens Co. v. Greene County Union Bank, 172 Tenn. 323, 112 S.W.2d 13 (1937).

112. N.I.L. § 189, TENN. CODE ANN. § 47-406 (1956).

113. People's State Bank v. Caterpillar Tractor Co., 213 Ind. 235, 12 N.E.2d 123 (1937).

to estimate the sum.[114] Thus, a set-off may not be used to satisfy a debt arising out of a breach of contract, unless the bank has obtained a judgment ascertaining the amount of damages. On the other hand, a set-off may be used to satisfy a matured promissory note, even if it bears interest and the amount of interest must be calculated. Secondly, the debt must be matured.[115] Thus, any judgment relied upon must be final, and any note must be past-due. A note having an acceleration clause may, however, be accelerated to meet this requirement.[116]

Since the primary effect of the assertion of a banker's set-off is to permit dishonor of the depositor's checks, an important question is when must the bank assert its rights in order to dishonor checks validly. This question is especially important where an acceleration clause is used to mature an obligation under a note. Two rules may be regarded as settled. Checks which have been paid or certified will not be affected by the bank's debit of the account, for they have already become obligations of the bank.[117] Checks which are presented after the set-off is asserted may be validly dishonored for insufficient funds, for the bank has no obligation to the holders before presentment.[118] There is still a problem concerning checks which have been presented, but not paid, before the bank's assertion of a set-off. This problem arises most clearly when the bank attempts to mature an obligation by use of an acceleration clause after the presentment of a large check. In one case, the bank was permitted to assert its set-off and dishonor the check, but in that case the depositor himself had presented the check for payment to himself.[119] The majority view, however, seems to be that the bank may not assert its set-off after presentment.[120]

114. Carsey v. First Nat'l Bank, 11 Tenn. App. 137 (M.S. 1929), quoting from Tallapoosa County Bank v. Wynn, 173 Ala. 272, 55 So. 1011 (1911).

115. *Ibid.*

116. State Nat'l Bank v. Towns, 36 Ala. App. 677, 62 So. 2d 606 (1952).

117. A bank which has honored an overdraft by payment or certification may not recover from prior holders. BRITTON 388.

118. The bank is not liable to a holder on the check itself until it has accepted the check, because a check does not operate as an assignment of the funds in an account. N.I.L. § 189, TENN. CODE ANN. § 47-406 (1956).

119. Bank of Commerce v. Franklin, 90 Ill. App. 91 (1900). This situation should be distinguished from the case where the bank asserts its set-off after the presentment of a garnishment order, because there is a right of set-off against such orders. State Nat'l Bank v. Towns, *supra* note 116.

120. See 3 PATON 3369. The leading case on point is Niblack v. Park Nat'l Bank, 169 Ill. 517, 48 N.E. 438 (1897). However, that case was decided on the theory that "the drawing and delivery of a check . . . is an assignment" of funds in an account. This theory is no longer correct. N.I.L. § 189. A sounder theory is that the drawee is the holder's agent for collection once a check has been presented, and that it cannot act for its own benefit to the detriment of its principal. Kilsby v. Williams, 5 Barn. & Ald. 815, 106 Eng. Rep. 1388 (K.B. 1822) (bank may not assert its own debt against the deposit); Florida Citrus Exch. v. Union Trust Co., 244

A bank may not pay to third parties funds from its depositor's account unless it has been authorized or directed to do so by the depositor himself or a court.[121] The mere fact that a third party has obtained a judgment against the depositor, or holds his matured note, will not permit the bank to pay out his funds.[122] Either a court order directing the bank to pay from the account, such as a writ of garnishment,[123] or a note authorizing payment by the bank, such as a note "payable at" the bank,[124] is required before payment is proper.

The bank is not, however, completely without obligation to a third party who makes a claim, but has not procured a court order. At common law, notice to a bank of an adverse claim to a deposit created a duty on the bank to withhold payment from the account for a sufficient time to give the claimant an opportunity to assert his claim in court.[125] A bank so notified risks liability if it either pays the depositor's checks or withholds payment of them. If it pays after notice, and the claimant substantiates his claim, it may not charge the account.[126] On the other hand, if it refuses to pay, and the claim is ill-founded, it may be liable for wrongful dishonor.[127]

The U.C.C. impliedly authorizes payments under a banker's set-off or a court order by providing priorities for the payment of such items.[128] It does not attempt to establish a comprehensive rule covering the validity of such items, but merely sets forth rules as to when such items must be asserted in order to affect the depositor's checks. Any such items asserted by the bank or third party may take precedence over any check not yet certified or paid. Thus, under the Code, a bank may mature a note by the use of an acceleration clause and assert its right of set-off to deplete the depositor's account after

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App. Div. 68, 278 N.Y. Supp. 313 (1935) (bank may not delay payment and pay other checks); Joy v. Grasse, 173 Minn. 289, 217 N.W. 365 (1927) (bank may not assert its own debt where account is for a special purpose).

121. Grissom v. Commercial Nat'l Bank, 87 Tenn. 350, 10 S.W. 774 (1889); Carsey v. First Nat'l Bank, *supra* note 114.

122. *Ibid.*

123. The bank may enforce its right of set-off before honoring such a writ. State Nat'l Bank v. Towns, *supra* note 116.

124. N.I.L. § 87, TENN. CODE ANN. § 47-218 (1956). U.C.C. § 3-121 contains alternative sections allowing a state to make notes "payable at" a bank equivalent to checks, or not so equivalent. The proposed Tennessee statute adopts the alternative making them not equivalent, which would change the present law.

125. Miller v. Bank of Wash., 176 N.C. 152, 96 S.E. 977 (1918); Gendler v. Sibley State Bank, 62 F. Supp. 805 (N.D. Iowa 1945) (Semble).

126. *Ibid.* The U.C.C. would not solve this problem. Although § 3-603 concerns payment with knowledge of an adverse claim, it is limited to claims to the check itself, and the claims in the above cases were to the deposit.

127. See note 14 *supra.*

128. U.C.C. § 4-303.

the presentment for payment of the depositor's checks. It may then validly dishonor those checks for insufficient funds.[129]

## IV. Revocations of Authority

### A. Stop Payment Orders

While the depositor wants assurances that the bank will pay his checks, he also wants to be able to stop such payment by revoking the bank's authority to pay particular checks, and to be able to require the bank to obey such revocation orders. The common law granted him the right to stop payment on checks for good reason, or for no reason at all.[130] If the bank obeys his stop payment order and refuses to pay the check, it is protected from both the depositor and the holder of the check. It is protected from the depositor because the stop order authorizes the refusal to pay; and from the holder, including a holder in due course, because it can become liable on the check only by accepting it, which it has not done.[131] The pronouncement by one Tennessee court that a check must be paid over a stop order if presented by a holder in due course, would seem incorrect in view of later statements by the courts.[132] If the bank does pay, through inadvertance or negligence, the relationships become more complex. It is, however, clear that the bank has violated one of its duties to the depositor, so that it has no right to charge the check automatically to the depositor's account;[133] the payment is initially out of the bank's own funds. The Code also recognizes the right of the depositor to stop the payment of his checks, and the duty of the bank to follow such instructions from him.[134] The bank may not automatically charge

129. See Leary, *Article 4: Bank Deposits and Collections Under the U.C.C.*, 15 U. Pitt. L. Rev. 565, 575 (1954).

130. 3 Paton 3447; 7 Am. Jur. *Banks* § 602 (1937).

131. N.I.L. § 189, Tenn. Code Ann. § 47-406 (1956).

132. H. L. Buchanan & Co. v. Madison Bank & Trust Co., 7 Tenn. App. 373 (M.S. 1927). *But see* Mullinax v. American Trust & Banking Co., 189 Tenn. 220, 224, 225 S.W.2d 38, 40 (1949); Third Nat'l Bank v. Carver, 31 Tenn. App. 520, 218 S.W.2d 66 (M.S. 1948); Pan Am. Petroleum Corp. v. American Nat'l Bank, 165 Tenn. 66, 52 S.W.2d 149 (1932); Pease & Dwyer v. State Nat'l Bank, 114 Tenn. 693, 88 S.W. 172 (1905).

The *Buchanan* decision is also incorrect in theory. Although a holder in due course may have a valid right to recover on the check from the drawer, this fact does not affect the bank's duty to obey the drawer's stop payment order. Nor does the bank have any obligation to pay a stopped check merely because it has been presented by a holder in due course, for the check, even in his hands, is not an assignment of the drawer's funds. N.I.L. § 189, Tenn. Code Ann. § 47-406 (1956).

133. Mullinax v. American Trust & Banking Co., *supra* note 132; Third Nat'l Bank v. Carver, *supra* note 132.

134. U.C.C. § 4-403(1). Only the depositor may give the bank a binding stop order. The bank is not bound to recognize such orders from the payee or other holders, but may do so at its option. This decides one question which has not arisen in Tennessee but which has vexed courts in other states. Although payees have no

the payment to the depositor's account,[135] because it is prima facie liable for the loss.[136]

This result does not change even if the bank has used a stop payment order form containing an exculpatory clause. Such clauses presently in use in Tennessee[137] are probably invalid for two reasons. First, clauses which seek to protect a bank against its own negligence seem to be invalid, being against public policy, and Tennessee courts have so held.[138] Also, because the bank has not promised to do anything, there is no consideration in a stop order form for such a clause, so that the clause cannot be binding upon the depositor.[139] Under the Code, exculpatory clauses may not shift the loss to the depositor if they attempt to disclaim liability for "failure to exercise ordinary care."[140] This is true even though the Code gives wide

right to order payment stopped, Polotsky v. Artisans Sav. Bank, 37 Del. (7 W.W. Harr.) 151, 188 Atl. 63 (1936), a stop order has been held sufficient to put the bank on notice of equities against the check, so that subsequent payment was improper. Public Grain & Stock Exch. v. Kune, 20 Ill. App. 137 (1886). Payment when on notice of adverse claims to the check is allowed in many situations by U.C.C. § 3-603.

135. Payment of such a check would not be "a proper payment" under U.C.C. § 4-401. The provision that the depositor has the burden of proving a loss in § 4-403(3) may seem contra, as though it means that no recredit of the account is necessary. This provision, however, only assigns the burden of proof for actions in court, U.C.C. § 1-201 (8), and thus does not affect the bank's proper conduct upon discovery of the improper payment. Leary, *supra* note 129, at 581-82. Three arguments would support this reading: (1) The bank is prima facie liable for payment over a stop order under the Code, § 4-407, comment 1; (2) U.C.C. § 1-201(B) defines "burden of establishing" as concerning only a party's burden of proof in court; and (3) All of the bank's recovery rights are expressly based upon subrogation theories, and subrogation to the rights of others is not available until the bank has paid out its own funds. See text accompanying notes 149, 154 *infra*.

136. U.C.C. § 4-407, comment 1.

137. A common such clause reads: "Should this check be paid through inadvertance, accident, or oversight, it is expressly agreed that the bank will in no way be held responsible."

138. Speroff v. First-Cent. Trust Co., 149 Ohio St. 415, 79 N.E.2d 119 (1948); Winchester Milling Co. v. Bank of Winchester, 120 Tenn. 225, 111 S.W. 248 (1908).

139. Calamita v. Tradesmen Nat'l Bank, 135 Conn. 326, 64 A.2d 46 (1949); BRITTON 521.

If the exculpatory clause were part of the original deposit contract and placed on the signature card rather than the stop order form itself, it would be supported by adequate consideration through the implied promise of the bank to act as the depositor's agent. The argument that such a clause is contrary to public policy might still be valid, but those courts which have considered the problem have indicated otherwise. Haman v. First Nat'l Bank, 115 N.W.2d 883 (S.D. 1962); Reinhardt v. Passaic-Clifton Nat'l Bank & Trust Co., 16 N.J. Super. 430, 84 A.2d 741 (App. Div. 1951). Thus, an exculpatory clause incorporated in the signature card may protect the bank against its own negligence. This would not be possible under the U.C.C. See notes 140-41 *infra* and accompanying text.

As to the advisability of including such clauses, even if invalid, for *in terrorem* value, see COMMITTEE ON PROFESSIONAL ETHICS OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, OPINIONS OF PROFESSIONAL ETHICS 435 (1956).

140. U.C.C. § 4-103(1). Thus, disclaimers of liability for "oversight, inadvertance, or mistake" would be invalid. Leary, *supra* note 129, at 581.

power to the parties to vary their obligations by agreement between themselves.[141] This power of agreement is well-known to present Tennessee law,[142] and is analogously limited by the state public policy against clauses which protect the bank against liability for its own negligence.[143]

Even though the depositor's account may not be automatically charged in this situation, other methods of recovery may be available to the bank. Since the situation involves an improper payment, the bank may also have recovery rights against prior holders. Recovery possibilities against both of these parties must be examined in order to present a clear picture of the bank-depositor relationship, because the rights are interrelated. Recovery against either party may be possible under the check itself or through subrogated rights under the underlying transaction. Thus, there are four methods of recovery which may be attempted. The bank may sue the depositor and it may sue prior parties. Further, against each of these it may sue both under the check itself and through subrogated rights under the underlying transaction.

After payment of a check over a stop payment order, the bank is a transferee and possessor of that negotiable instrument. It is not, however, either a holder or a holder in due course because there has been no negotiation to it.[144] If the bank received the check from a holder in due course, it can argue that it is subrogated to that holder's rights as an equitable purchaser, and may enforce the check against the depositor. This argument is probably not valid in Tennessee. Although one case seems to support the argument,[145] a later case found "no force" in it.[146]

Under the Code, this rule would be changed. The bank would succeed to the rights of any holder in due course from whom it had purchased the check, but recovery from the depositor would be available only to the extent that the depositor had been unjustly enriched.[147] Thus, the mere fact that the bank has purchased the check from a holder in due course will not permit the bank to enforce its payment from the depositor, if he had good cause for stopping

141. U.C.C. § 4-103.
142. Third Nat'l Bank v. Carver, *supra* note 132.
143. See note 138 *supra*.
144. Figuers v. Fly, 137 Tenn. 358, 377, 193 S.W. 117, 122 (1917). See also note 76 *supra*; TENN. CODE ANN. § 47-158 (1956). The bank's argument is based on the fact that the prior holder in due course could have enforced payment from the depositor if the stop order had been followed. The bank then claims that it acquires the same right as an equitable purchaser from the holder in due course. The contra argument is that the bank has paid at its peril in breach of contract, and the status of the person paid is not relevant.
145. Unaka Nat'l Bank v. Butler, 113 Tenn. 574, 83 S.W. 655 (1904).
146. Pease & Dwyer v. State Nat'l Bank, *supra* note 132.
147. U.C.C. §§ 4-407(a),(b).

payment. On the other hand, the bank is not estopped from recovering from the depositor merely because of its negligence in overlooking the stop order, if the depositor had no cause for stopping payment and was unjustly enriched by the bank's payment. The extent of this change may not be accurately judged because of the ambiguities in the present case law.[148] There is, however, a renunciation of the principle that the loss should be placed according to mechanical rules, and an attempt to settle accounts so that there is ultimately no loss to anyone.

Banks in Tennessee have also argued that, as to the depositor, they are subrogated to any rights the payee has against him on the underlying transaction and may recover on this ground even if they may not recover from him on the check itself. This argument is important where the depositor has stopped the check for no valid reason. The Tennessee courts have never expressly ruled that this method of recovery is available to banks under the present law, nor have they expressly ruled that it is not available.[149] In all the decided cases, the bank has automatically charged the depositor's account and has not rescinded the charge during the suit.[150] In this situation the courts have held, quite properly, that there can be no subrogation to the rights of others until the bank has paid out its own money, and that it has not paid out its own money, but the depositor's, as long as the depositor's account is charged with the check. Thus, it has not been necessary for the courts to decide whether there is any right of subrogation against the depositor, and the question is probably still open in this state.[151]

Under the Code, the bank is subrogated to the rights of the payee based on the underlying transaction, so that it may recover from the depositor if he stopped payment for no valid reason.[152] Recovery is available, however, only if the depositor has been unjustly enriched at the bank's expense.[153] This is a clear answer to a problem probably undecided under the present law, and a problem which has been troublesome to banks.[154]

148. See notes 145-46 *supra.*

149. Mullinax v. American Trust & Banking Co., *supra* note 132; Third Nat'l Bank v. Carver, *supra* note 132.

150. *Ibid.*

151. Even if the bank does not charge the depositor's account, there may be other hurdles to setting up a subrogation claim against him. For example, courts in other states have required that the depositor ratify the original transaction before action may be brought against him. Chase Nat'l Bank v. Battat, 297 N.Y. 185, 78 N.E.2d 465 (1948). Such cases probably show a general reluctance to charge the depositor for what is thought to be the negligence of the bank.

152. U.C.C. § 4-407(b).

153. *Ibid.*

154. The common law rules of subrogation would require that the bank not have

Against prior parties, the present Tennessee law allows the bank to proceed upon the check against at least such parties who were not bona fide holders for value. Whether it may also proceed in this manner against holders in due course is not clear from the one Tennessee case on point.[155] Courts in other jurisdictions have split on this question, with a majority holding that the bank may not recover from a holder in due course on a check it has paid over a stop order.[156] All jurisdictions agree, however, that a prior party, whether he has the status of a holder in due course or not, may seek payment only if he has no knowledge of the stop order. If he has such knowledge, his lack of good faith in receiving payment will permit the bank to recover on grounds of fraud or deceit.[157] Thus, if the payee cashes the check and either has not given value for it through the underlying transaction or has been informed of the drawer's attempt to stop payment, the bank may recover its loss from him.[158]

The bank's subrogation to the rights of the depositor against the payee has not been passed upon by the Tennessee courts. It would seem unnecessary for them to do so, since the bank's right of recovery on the check itself already protects it from loss where the depositor has stopped payment for good cause. Recovery on the check itself is available in all cases where such subrogation is possible, and is also available in other situations as well, making it a more useful theory.

Under the Code, if the depositor stopped payment for good cause, the bank must try to recover from the payee or prior holders, because the depositor will not have been unjustly enriched by the bank's payment. The bank may not recover upon the check from the payee or other prior holders, if their presentment for payment was in good faith. Section 3-418 makes payments by the drawee final against mistake of fact arguments, and there is no warranty of presentment by indorsers against overlooked stop payment orders. The bank may still proceed against persons receiving payment with knowledge of the attempted stop payment, on grounds of fraud or

charged the depositor's account before it attempts to recover from him. These rules are not changed by the Code, but are incorporated into it by § 1-103.

155. Murfreesboro Bank & Trust Co. v. Travis, 190 Tenn. 429, 230 S.W.2d 658 (1950).

156. See 3 PATON 3475-77. The argument for the majority view is that the bank is held to know the state of the depositor's account, including revocation orders, on an analogy to Price v. Neal, 3 Burr. 1354, 97 Eng. Rep. 871 (K.B. 1762). Therefore, payment over a stop order cannot accurately be described as a "mistake of fact" so that the bank has no right of charge back.

157. See 3 PATON 3477-79. Whether this knowledge is to be determined at the time of receiving payment, or of procuring a certification, or of obtaining the instrument for a holder in due course is undecided.

158. *Ibid.*

deceit.[159] The bank is, however, subrogated to the depositor's rights against the payee under the underlying transaction, if the payee has been unjustly enriched.[160] Thus, it may recover from the payee where payment was stopped for good cause.[161] Thus, again, the Code has rejected mechanical rules for placing the loss caused by the bank's payment and would give a clear answer to a problem not well settled by the case law in this state.

When the bank seeks reimbursement for a check it has paid over a stop order, it would prefer not to have to decide whether the stop order was for good cause or not. It would also prefer not to bring two separate actions, one against the depositor and one against the payee, because the two juries may differ and the bank lose both cases. Therefore, banks have attempted to assert claims against both parties in the same action to obtain one consistent ruling on the question presented. These attempts have failed, on procedural grounds,[162] so that banks must continue to risk separate and inconsistent verdicts. Under the Code, the bank would probably still have to decide which party had been unjustly enriched, or risk inconsistent verdicts in two actions, one against the depositor and one against the payee. This is because the Code does not attempt to change procedural rules, and the bank's dilemma under the present Tennessee law is caused by procedural, not substantive-law, problems.[163]

A stop payment order, to be effective, must be given to the bank before the check is paid and must be given a sufficient time before payment to enable the bank to notify its tellers and bookkeepers. Such notification is a simple procedure where the bank has only a single office, but is somewhat more complex for a bank having many widely-scattered branch offices. The depositor need not notify each of the branches; it is the bank's duty to "spread the word" once the depositor has notified one of the bank's offices.[164] In such a situation, the depositor's stop order must precede the payment of the check by enough time for the bank to warn the employee who authorizes the payment. The length of time the courts find necessary for this dissemination of information is small. In one case, the Tennessee Supreme Court held that twenty-five minutes was sufficient time to forward the stop order

159. Incorporated by U.C.C. § 1-103.

160. U.C.C. § 4-407(c).

161. The bank must probably still decide which party has been unjustly enriched, or risk inconsistent verdicts in two actions, one against the depositor and one against the payee. This problem is due to procedural rules, however, which the Code does not attempt to change. See notes 162-63 *infra*.

162. Third Nat'l Bank v. Carver, *supra* note 132, cited with approval in Mullinax v. American Trust & Banking Co., *supra* note 132.

163. U.C.C. § 1-103.

164. Mullinax v. American Trust & Banking Co., *supra* note 132.

notice from one branch office to the bookkeeper of the depositor's branch office, and the bank was liable for not having done so.[165]

The rules requiring notice before payment are also applicable to require notice before certification where a holder procures the certification.[166] A different problem arises, however, where the depositor himself has procured the certification. Certification then does not discharge the depositor from liability on the check,[167] so that the depositor arguably may still stop payment. There is no Tennessee case on this point, and there is a split of authority on the question in other jurisdictions.[168]

The Code would not change the present rule that a stop payment order, to be effective, must be given a sufficient time in advance of payment to allow the bank to notify its employees.[169] Nor does the Code attempt to define "sufficient time," so the present case law on that subject would not be affected. It would, however, provide a definite rule concerning stop orders received after certification of a check. They would be ineffective, whether the certification was procured by a holder or by the depositor himself.[170]

By statute in Tennessee, a stop order, once it has been given to the bank, is effective for only six months, but may be renewed at the end of that period.[171] The original order may be either oral or in writing,[172] but the renewal must be written.[173] The statutory provision requiring a written renewal after six months does not seem very useful because a six months old check is probably stale, thus putting the bank on notice of any possible defect.[174]

Under the Code, the original stop order may still be oral or written. If it is oral, however, it would be valid for only fourteen days, and an extension would be possible only by a written confirmation of the original order.[175] A written order, or a written confirmation of an oral order would be valid for six months, but could be renewed in writ-

165. *Ibid.*
166. Third Nat'l Bank v. Carver, *supra* note 132.
167. N.I.L. § 188, TENN. CODE ANN. § 47-405 (1956).
168. See Merchants & Planters Bank v. New First Nat'l Bank, 116 Ark. 1, 170 S.W. 852 (1914) (drawer may not stop payment); Florida Power & Light Co. v. Tomasello, 103 Fla. 1076, 139 So. 140 (1932). *But see* Sutter v. Security Trust Co., 96 N.J. Eq. 644, 126 Atl. 435 (Ct. Err. & App. 1934) (drawer may stop payment).
169. U.C.C. § 4-403(1). See also § 1-201(27), which defines when notice to an organization becomes effective.
170. U.C.C. § 4-303(1a). This would provide a definite rule for another problem not yet solved in Tennessee. See note 168 *supra.*
171. TENN. CODE ANN. § 45-421 (1956).
172. *Ibid.* This rule apparently may be varied by provisions in the deposit contract. Third Nat'l Bank v. Carver, *supra* note 132, at 530.
173. *Ibid.*
174. See text accompanying note 103 *supra.*
175. U.C.C. § 4-403(2).

ing.[176] The written renewal provision of the Code would be effective because of the provision that a bank may pay stale checks.[177]

### B. DEATH OF DEPOSITOR

The death of the depositor operates in the same manner as a stop payment order. When the bank receives notice of the depositor's death, its power to pay his checks and charge his account is revoked.[178] The depositor's death alone does not revoke the bank's authority; notice to the bank of the death is also required.[179] One problem for the bank in this area is whether the bank is chargeable with constructive notice from such sources as items in newspapers. There is no Tennessee case on this point, so the issue is undecided.[180] A second problem is that many holders of checks issued shortly before death must file a claim in probate to receive payment, even if the checks are given in immediate payment of an obligation of the decedent. Not only the holder and the estate, but also the bank, is burdened by this formality, which is useless in most cases.

Under the Code, the death of a depositor would not revoke the bank's authority to pay his checks until it has actual knowledge of his death.[181] Thus, newspaper notices conld not revoke its authority to pay, relieving the bank of any duty to scan such notices. Even after knowing of the depositor's death, the bank could still pay any checks drawn by him and received within ten days of the date of death, unless ordered to stop such payments.[182] This is a novel provision and allows the holders of checks drawn shortly before the death to obtain payment without filing a claim in probate. This will reduce the present burdens on the holders of such checks, the depositor's estate, the bank, and the courts. Adequate safeguards are provided through the possibility of claimants ordering payments from the account stopped and through actions by executors to recover improper payments from the persons paid.

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176. *Ibid.*

177. U.C.C. § 4-404.

178. Glennan v. Rochester Trust & Safe Deposit Co., 209 N.Y. 12, 102 N.E. 537 (1913); 7 AM. JUR. *Banks* § 606 (1937); BRITTON 522; Feezer, *Death of a Drawer of a Check*, 14 MINN. L. REV. 124 (1929).

179. *Ibid.*

180. There is one Tennessee case, involving the death of the payee, which requires actual knowledge. Darling Stores, Inc. v. Fidelity-Bankers Trust Co., 178 Tenn. 165, 156 S.W.2d 419 (1941). This does not necessarily determine the present question, however, because the number of persons who may be payees is unlimited, while the persons who are depositors are more known and of a limited number. Thus, the amount and difficulty of the notice scanning required is quite different.

181. U.C.C. § 4-405(1).

182. U.C.C. § 4-405(2). Only persons claiming an interest in the account—executors, administrators, surviving relatives, creditors—may stop such payments.

## V. Time of Payment

The solutions to many of the problems discussed in the foregoing sections depend on whether the check has been paid or not. For example, this fact determines whether a forged check (drawer's signature forged) may still be charged back to prior holders, whether a check may still be validly dishonored to pay a garnishment or banker's lien, and whether a stop payment order is requested in time to be effective. Thus, in these situations the precise time when a check may be said to be paid is quite important to the bank-depositor relationship. The N.I.L. does not define what actions of the drawee bank constitute payment, and therefore does not define the time at which a check is paid,[183] nor have the cases set up any clear and distinct rules on this subject.[184]

The Tennessee courts have distinguished between three types of situations in defining when a check is paid. A check may be paid in cash over the drawee bank's counter; a check drawn by one depositor may be deposited in the drawee bank for credit to a second depositor; and checks may be deposited in another bank for collection from the drawee bank. The first situation presents no problem in determining when the check is paid. Where a check is presented to the drawee

183. N.I.L. § 88, Tenn. Code Ann. § 47-219 (1956), only defines what payments are made in due course. N.I.L. § 137, Tenn. Code Ann. § 47-311 (1956), provides for constructive acceptance if the drawee takes no action within 24 hours after presentment, but this rule has been superseded by the Deferred Posting Statute. Tenn. Code Ann. § 45-417 (1956). The Bank Collection Code would have added more statutory law on the subject, but Tennessee did not enact this legislation.

184. A good illustration is found in Malcolm, "Article 4—Bank Deposits and Collections" (outline used in connection with a speech delivered at The Symposium on Banking Law held at Vanderbilt University in May, 1962):

"Some Pre-Code rules as to time of final payment of item.

1. When check cashed over the counter by payor bank. *Chambers v. Miller*, 13 C.B.N.S. 125 (1862).
2. When check deposited to credit of account of holder in payor bank, regardless of extent of processing. *Cohen v. First National Bank of Nongales*, 22 Ariz. 394, 400 (1921).
3. Contra, if payor bank has reserved a right of chargeback. *Pollack v. National Bank of Commerce*, 168 Mo. App. 368, 374 (1912).
4. If appropriate employee of payor bank verifies that there are funds to cover and stamps an item 'paid.' *Nineteenth Ward Bank v. First National Bank*, 184 Mass. 49 (1903). Contra: *Hunt v. Security State Bank*, 910 Oregon 362 (1919).
5. 'Fishback rule.' *Bohlig v. First National Bank in Wadena*, 48 N.W.2d 445 (Minn. 1951).
6. When an item charged to drawer's account and remittance draft mailed by payor bank and accepted by collecting bank. *Page v. Holmes-Darst Coal Co.*, 269 Mich. 159 (1939).
7. When account of collecting bank credited. *Utah Const. Co., v. Western Pac. Ry.*, 174 Cal. 156 (1919).
8. At election of collecting bank under certain circumstances. A.B.A. Code Sec. 11."

for payment in cash, and cash is handed over the counter to the holder, the check has been paid under both the Tennessee case law[185] and the U.C.C.[186] After that time the bank may no longer return forged checks, nor dishonor checks to pay garnishments, nor assert stop payment orders.

Where both the holder and the drawer have accounts in one bank, and the holder deposits the check in the drawee for credit (presentation of an "on us" item), the common-law rule is that the check is paid when the drawee places its amount to the holder's credit.[187] The common-law rule has been abrogated in Tennessee by the adoption of the Deferred Posting Statute.[188] That statute provides that the bank may revoke any credit given until midnight of the day after the check has been presented to the bank.[189] All of these rules may, however, be modified by agreement or a contract between the parties,[190] and banks regularly employ such modification contracts by printing them on their deposit slips. The modifying clauses currently in use in Tennessee allow the bank to charge back until "close of business on day of deposit."[191] Thus the banks seem, in this situation, to have waived the benefits available to them under the Deferred Posting Statute, due to their own affirmative action. At least, there is some question as to how long after presentment a bank may still revoke credit. This situation would not be changed by adoption of the U.C.C. The Code's statutory rule allows the same delay as the Deferred Posting Statute.[192] It also provides, however, that such statutory rules may be modified by agreement;[193] so that, as now, the written agreements on the deposit slips would probably control the relations between the parties.

185. Federal Sav. & Loan Ins. Corp. v. Third Nat'l Bank, 173 F.2d 192, 199 (6th Cir. 1949); Lebanon Bank & Trust Co. v. Grandstaff, 24 Tenn. App. 162, 169, 141 S.W.2d 924, 929 (M.S. 1940).

186. U.C.C. § 4-213(1a).

187. Federal Sav. & Loan Ins. Corp. v. Third Nat'l Bank, *supra* note 185; Lebanon Bank & Trust Co. v. Grandstaff, *supra* note 185.

188. TENN. CODE ANN. §§ 45-417, -418 (1956).

189. The statute expressly provides that credit may be revoked after entries evidencing this credit have been made in the bank's books. The credits and the entries are revoked by returning the item. *Ibid.*

190. Dean Tobacco Warehouse Co. v. American Nat'l Bank, 173 Tenn. 365, 368-69, 117 S.W.2d 746 (1938), citing Federal Reserve Bank v. Mallory, 264 U.S. 160 (1924).

191. This time limit applies only to "on us" items—*e.g.*, "Credit given for items drawn on this bank not good at close of business of day of deposit may be charged back to depositor."

192. U.C.C. §§ 4-301, -302. The Code's terminology is that the drawee bank may retain the check until its "midnight deadline" without liability for inaction. The "midnight deadline" refers to midnight on the day after the day of presentment. This is the same deadline as is presently imposed by the Tennessee Deferred Posting Statute. TENN. CODE ANN. § 45-417 (1956).

193. U.G.C. § 4-103.

Regardless of the problems concerning the length of time the bank may delay before revoking credit, there are also additional problems concerning the effect of this ability to delay. Certainly the ability to revoke credit after a delay allows the bank to charge back due to insufficient funds, forgeries, garnishments, and stop orders made before the presentment but discovered later.[194] The problem arises, however, as to whether the bank must obey a garnishment or stop payment order received after it has provided credit to the holder, but while this credit is still revocable under the statute or deposit slip agreement. A Tennessee court has held that the bank may obey such orders when received after crediting the holder's account, although it did not reach the question of whether the bank must obey such orders.[195]

The Code recognizes that two distinct problems are involved and treats each problem separately. Section 4-213 provides a series of rules for determining whether a bank may still charge back due to a discovery of insufficient funds, a forgery, or a previously-received garnishment or a stop payment order.[196] In general, a bank may still charge back for such reasons either until it has completed its posting process or until the midnight deadline has passed without any posting action.[197] Section 4-303, on the other hand, provides rules as to when a garnishment or stop order must be received for the bank to honor such an order and give it priority over a check presented for payment.[198] Such an order is too late, not only if the midnight deadline has passed, but also if the bank has already "evidenced . . . a decision to pay the [check]."[199] Thus, once the bookkeeper has "sight posted"[200] the check, even though the posting will not be completed until the end of the day, the depositor may not order payment stopped; nor may a creditor cause dishonor of the check by ordering the account

194. Traders' Nat'l Bank v. First Nat'l Bank, 142 Tenn. 229, 217 S.W. 977 (1920); First Nat'l Bank v. First Nat'l Bank, 127 Tenn. 205, 154 S.W. 965 (1913); U.C.C. § 4-303.

195. Lebanon Bank & Trust Co. v. Grandstaff, *supra* note 185.

196. Section 4-213 provides rules as to when final payment occurs. Section 3-418 provides that payment is binding upon the drawee, except for breach of warranty claim. No warranty is breached by a holder merely because the drawee failed to discover the drawee's insufficiency of funds (U.C.C. § 3-418, comment 2), a forgery of the drawer's signature (U.C.C. § 3-418, comment 1), or a stop payment order (U.C.C. § 4-403(1) ).

197. See note 192 *supra.*

198. The deadline for the assertion of a banker's lien or set-off is also covered by the same rule.

199. U.C.C. § 4-303(1)(d). "Midnight deadline" is defined at note 192 *supra.*

200. *I.e.,* the bookkeeper has examined the account and has made a decision to pay the check, but has postponed making the posting entries. U.C.C. § 4-303, comment 3. See also U.C.C. § 4-109, defining "process of posting," and comments thereto.

attached; nor may the drawee dishonor the check by asserting a banker's lien.[201]

Where a check drawn on one bank is deposited in another bank for collection, the check must be transferred to the drawee bank before payment can occur.[202] The drawee must have an opportunity to check its records and take action upon them before it is obligated to pay a check sent to it for collection.[203] In Tennessee, the nature of the action required for payment of such a check depends upon the relationship between the drawee and the collecting banks. Where these banks maintain reciproeal accounts, and credit is transferred through them, the check is paid when the collecting bank is credited on the drawee bank's books.[204] The collecting bank does not need to receive notification of this credit for payment to be final.[205] On the other hand, where payment is to be made by remittance draft, the check is not paid until the remittance draft has been actually received by the collecting bank.[206] Thus, the drawee bank may still decide to

201. *Cf.* First Nat'l Bank v. First Nat'l Bank, *supra* note 194, at 215, 154 S.W. at 967. A check was held not yet "accepted" after it had been stamped "Paid" because the cancellation mark was later erased. "Acceptance" was held to require that the posting process bave been completed. *Id.* at 216, 154 S.W. at 968.

202. Until the drawee has paid the check, the collecting bank is merely an agent for its collection. Dean Tobacco Warehouse Co. v. American Nat'l Bank, *supra* note 190. This is usually expressly stated in the deposit slip. If a chain of collecting banks is used for a long-distance collection, each collecting bank is an agent of the holder and is not an agent of the depository bank. *Ibid.* Thus, the depository bank is only responsible for selecting a suitable correspondent bank to forward the check for the holder, and is not liable for that bank's negligence. Bank of Louisville v. First Nat'l Bank, 67 Tenn. 101 (1874). The U.C.C. would continue these rules. U.C.C. §§ 4-201, -202.

A collecting bank may, however, become a holder of the check by giving a right to draw immediately against the check, before the proceeds are collected. The collecting bank may also become a holder by making advances, but this is not necessary to the bank's title if it has given its customer the right to make immediate withdrawals. First Trust & Sav. Bank v. Kent, 119 F.2d 151 (6th Cir. 1941); Flat Creek Sav. Bank v. Federal Reserve Bank, 15 Tenn. App. 527 (M.S. 1932). *Cf.* DeJarnett v. First Nat'l Bank, 1 Tenn. App. 191 (M.S. 1925) (collection of bills of lading, not a check). The Code gives a bank a security interest in such items, and gives it the status of a holder in due course to the extent that it has a security interest. U.C.C. § 4-208, -209.

For a thorough discussion of collection problems, which is outside the scope of this article, see Leary, *Deferred Posting and Delayed Returns—The Current Check Collection Problem,* 62 HARV. L. REV. 905 (1949); Malcolm, *Article 4—A Battle With Complexity,* 1952 WIS. L. REV. 265.

203. N.I.L. § 74, TENN. CODE ANN. § 47-205 (1956). The check must be exhibited to the drawee, the person from whom payment is demanded. N.I.L. § 137, TENN. CODE ANN. § 47-311 (1956), gives the drawee 24 hours to decide whether to accept or pay a check, or to refuse to do so.

204. Dean Tobacco Warehouse Co. v. American Nat'l Bank, *supra* note 190; First Trust & Sav. Bank v. Kent, *supra* note 202, at 156.

205. *Ibid.*

206. Traders' Nat'l Bank v. First Nat'l Bank, *supra* note 194.

dishonor a check for insufficient funds after mailing a remittance draft, but before its actual delivery to the collecting bank.[207] Presumably, the drawer of a check may also require the drawee to stop the payment of the check after a remittance draft has been mailed, if the remittance draft may still be withdrawn from the mails.[208] However, the Deferred Posting Statute now applies to all of these situations, allowing the bank to charge back until midnight of the day after presentment, after crediting the collecting bank, or even after a remittance draft has been received.[209] Presumably, therefore, the drawee bank should obey a garnishment or stop order received at any time on the day after presentment, regardless of any payment action it has initiated.

The U.C.C. would again recognize the different problems involved and provide separate rules for each problem. Section 4-213 would allow the bank to charge back, due to the discovery of insufficient funds, a forgery, or a previously received garnishment or stop payment order, until the bank had completed its posting process.[210] Section 4-303, on the other hand, would prevent the depositor or a third person from forcing the bank to dishonor a check, through use of a stop payment or garnishment order, once the bank had proceeded sufficiently with its posting process to evidence a decision to pay the check.[211] Neither may the bank dishonor a check by exercising a banker's lien or set-off after it has progressed to such a point in posting the check.[212] The Code also provides that payment becomes final after the midnight deadline, but this standard is to be used only if the bank fails to initiate the posting process before that time.[213]

207. *Ibid.*

208. No Tennessee case has yet ruled upon this issue, but the bank would seem obligated to follow its depositor's orders to protect his interests in any case where it could protect its own interests. Bohlig v. First Nat'l Bank, 233 Minn. 523, 48 N.W.2d 445 (1951). And the Tennessee courts have held that the drawee bank can protect its own interests by withdrawing the remittance check from the mails. Traders' Nat'l Bank v. First Nat'l Bank, *supra* note 194.

209. TENN. CODE ANN. §§ 45-417, -418 (1956). The problems, caused by the use of clauses printed on the deposit slips which limit the time for charging back checks, would not arise where the check is being collected through another bank. The deposit slip time limitation clauses presently in use are expressly limited to "on us" items. See note 191 *supra.*

210. Once the posting process has been completed, final payment has occurred. Notification to the collecting bank of this crediting is not required. U.C.C. § 4-213, comment 2. This rule conforms to the present Tennessee law. See text accompanying note 205 *supra.*

211. U.C.C. § 4-303(1)(c). See note 200 *supra.*

212. *Ibid.* As to other considerations which might prevent the drawee from asserting a banker's lien after presentment of the check, see note 120 *supra.*

213. U.C.C. § 4-302. The "midnight deadline" permits the same delay as does the Tennessee Deferred Posting Statute. TENN. CODE ANN. § 45-417 (1956). See note 192 *supra.*

## VI. CONCLUSION

Very few of the problems discussed in this article are determined by statute in the present Tennessee Code. N.I.L. section 23 provides the broadly stated basic rule on the effect of a forged signature, but does not solve most of the practical problems which arise in defective check transactions. For a solution to such problems, the Tennessee attorney must consult the case-law gloss extending back to *Price v. Neal*.[214] Neither the N.I.L. nor any other part of the Tennessee Code provides any statutory authority for the solution of the many problems involving stop payment orders.[215] The time when payment of a check occurs is not set out in any statute, except for the Deferred Posting Statute provision regarding the maximum possible delay in payment allowed.[216]

Lack of statutory solutions to such problems is not per se bad, but it does have certain disadvantages. First, not all of the factual situations in this area have come before the Tennessee courts. Thus, this state has no settled answer to many of these problems.[217] This is true even in areas where the courts have pronounced language which seems sufficiently broad to cover all possible situations.[218] This lack of specific decisions prevents Tennessee attorneys from accurately advising clients on some business decisions. And, even though decisions from other states may be used to "fill in the gaps" in Tennessee law, at times these states offer only a confusing split of authority.[219] A second disadvantage is the conflict of decisions and language which is present not only in cases from other jurisdictions, but also in cases decided within our own borders.[220]

A third disadvantage concerns the attorney's search for answers to such problems. Where the authority consists entirely of case decisions, the Tennessee Code Annotated is not much help in research. The entire Tennessee Reports, or the entire West Reporter System, must be consulted to find an answer. This, in turn, involves utilizing a battery of secondary sources to locate the proper cases.

A fourth disadvantage is that case law originated before the widespread use of clearing houses may impede the handling of checks

214. 3 Burr. 1354, 97 Eng. Rep. 871 (K.B. 1762). N.I.L. § 23 has no application to the drawee's right to charge defective checks back to prior holders, nor do §§ 62 or 66. See note 76 *supra*. Nor does the word "precluded" in § 23 precisely define either the conduct encompassed or the theory of preclusion. See, *e.g.*, notes 40, 50, & 54 *supra*.

215. The one attempt in Tennessee to use an N.I.L. section (§ 58) to solve a stop order problem failed due to a split of authority in the two Tennessee decisions on the point. See notes 144-46 *supra*.

216. TENN. CODE ANN. § 45-417 (1956).

217. See, *e.g.*, notes 55, 72, 83, 93, 107, 151, 155, 168, 195 & 208 *supra*.

218. See, *e.g.*, notes 43, 180, 195 & 209 *supra*.

219. See, *e.g.*, notes 100, 108, 151, 156, 168 & 184 *supra*.

220. See, *e.g.*, notes 57, 108, 132, 144-46 & 201 *supra*.

under modern conditions.[221] This is especially true in regard to the use of electronic computers to process checks.[222]

Adoption of the U.C.C. would not eliminate all of the problems caused by these disadvantages of case-law authority. It would, however, provide answers to many problems presently undecided in this state.[223] It would also provide these answers in a single body of authority, with a corresponding decrease in the amount of conflicting language.[224] And, although the U.C.C. is a large volume with complex language, it is smaller than the Tennessee Reports and has a table of contents and cross-indexing. Further, it has been expressly designed to be flexible in changing conditions and to allow the use of improved check collection methods by permitting variations, with limitations, of the statutory rules by Federal Reserve regulations, clearing house rules, and the like.[225]

221. See, *e.g.*, text accompanying notes 77 & 180 *supra*.

222. For example, an electronic data processing center might be established for the presentation and handling of checks for a group of banks or for one large bank having many branches. If this center were established at a location where there was no office of any member bank, no effective presentation of cheeks for payment could be made under the N.I.L. N.I.L. §§ 72(3), 73. Thus, drawers and endorsers would not be bound under § 70. There would be no such problem under U.C.C. § 3-504.

223. See, *e.g.*, notes 64, 83, 98, 152, 160, 170, 196-99 & 213 *supra*.

224. See, *e.g.*, notes 49, 61, 101, 147, 152, 170, 181, 196-99 & 213 *supra*.

225. See note 222 *supra*, and U.C.C. § 4-103 and comments.