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COUNTERMANDED CHECKS AND FAIR DEALING UNDER THE UNIFORM COMMERCIAL CODE

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INTRODUCTION

Under the Uniform Commercial Code ("Code"),[1] a bank customer has a virtually unqualified right to stop payment of a check.[2] The right can be exercised for any reason, or for no reason at all.[3] Countermanded checks are not "properly payable,"[4] therefore, the bank cannot charge the customer's account.[5] Nor can the bank excuse the improper payment by

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[1]U.C.C. § 4-403 (1987).

[2]*E.g.*, Del State Bank v. Patton, 513 P.2d 868 (Okla. 1973). "The position taken by this section is that stopping payment is a service which depositors expect and are entitled to receive from banks notwithstanding its difficulty, inconvenience and expense." U.C.C. § 4-403 official comment 2.

[3]*See* Berler v. Barclays Bank, 82 A.D.2d 437, 439, 442 N.Y.S.2d 54, 55 (1981) (the right is "absolute"; "[The Code] makes clear that a stop payment order need not be supported by a sound legal basis"); Sunshine v. Banker's Trust Co., 34 N.Y.2d 404, 413 n.5, 314 N.E.2d 860, 865 n.5, 358 N.Y.S.2d 113, 121 n.5 (1974), *modified*, 34 N.Y. 2d 994, 318 N.E.2d 608, 360 N.Y.S.2d 419 (1974).

[4]U.C.C. § 4-401(1) provides:

> As against its customer, a bank may charge against his account any item which is otherwise properly payable from that account even though the charge creates an overdraft.

Since the section does not define the term, "[T]he question of what is 'properly payable' can be resolved by examining the deposit agreement and specific U.C.C. provisions regulating bank/customer relationships." G & R Corp. v. American Sec. & Trust Co., 523 F.2d 1164, 1170 (D.C. Cir. 1975).

[5]*E.g.*, Able & Assocs., Inc. v. Orchard Hill Farms, 77 Ill. App. 3d 375, 395 N.E.2d 1138 (1979). In Dynamite Enters., Inc. v. Eagle Nat'l Bank, 517 So. 2d 112 (Fla. Dist. Ct. App. 1987) (per curiam), a customer sought to stop payment of a check because his account contained insufficient funds. The court pointed out that, while a customer's account can properly be charged when the bank creates an overdraft by paying a check (*see* U.C.C. § 4-401(1)), the customer can, by his stop payment order, remove the bank's discretion from so doing and prohibit the charge. *Dynamite Enters.*, 517 So. 2d at 112-13.

pointing to a waiver of the right to stop payment[6] or an exculpatory clause in the contract of deposit.[7] If the bank has enough time to act on the stop payment order[8] and it reasonably identifies the check,[9] the stop payment order is "binding,"[10] and must be obeyed.

In reality, no right is absolute, including the right to stop payment. This can be a particularly harsh reality for bank customers. Banks routinely charge their customers' accounts when they make improper payments. As a result, absent overdraft privileges, checks that the customer writes on the assumption that there are sufficient funds in the account to cover these checks will be returned for "not sufficient funds" ("NSF"). The bank that improperly pays then requires the customer to convince it that the account should be recredited[11] and that it should make amends for the bounced checks.[12]

To preserve good will and avoid litigation costs, the bank may accede to these requests with no more than an affidavit from its customer alleging that an improper payment was made.[13] When it will be more cost efficent

[6]*See Del State Bank*, 513 P.2d at 868; Thomas v. Bank of Springfield, 631 S.W.2d 346 (Mo. Ct. App. 1982) (oral stop order effective because bank waived contractual right to written notice); *see generally* WHITE & SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE (3d ed. 1988) [hereinafter WHITE & SUMMERS].

[7]Under U.C.C. § 4-103(1), a bank may not disclaim responsibility "for its own lack of good faith or failure to exercise ordinary care . . . ." If the customer files a binding stop payment order and the bank nevertheless pays, the bank would seem to act either in bad faith or carelessly. In any event, some courts have held that exculpatory clauses in stop payment cases are void as against public policy irrespective of bad faith or negligence. *See* Stanek v. National Bank, 171 Mich. App. 734, 739, 430 N.W.2d 819, 821 (1988), *appeal denied*, 432 Mich. 885 (1989); Thomas v. First Nat'l Bank, 376 Pa. 181, 185-88, 101 A.2d 910, 911-12 (1954).

[8]U.C.C. § 4-403(1); *see id.* § 4-303.

[9]Sherrill v. Frank Morris Pontiac-Buick-GMC, 366 So. 2d 251, 256 (Ala. 1979) (check need only be identified with reasonable accuracy).

[10]U.C.C. § 4-403(2) (fourteen calendar days if oral, six months if in writing). Considerable litigation has arisen over whether an order was "binding." *E.g.*, Kunkle v. First Nat'l Bank, 393 N.W.2d 265 (N.D. 1986).

[11]The customer's right to a recredit is implied from U.C.C. section 4-401. Isaac v. American Heritage Bank & Trust Co., 675 P.2d 742, 744 (Colo. 1984) (en banc). "The negative implication [from section 4-401] that a bank may not charge against an account an item that is not properly payable is clear. In such case the customer may demand that his account be recredited." *Id.* at 744.

[12]Section 4-402(1) provides that, "A payor bank is liable to its customer for damages proximately caused by the wrongful dishonor of an item . . . . A check is wrongfully dishonored if it should have been paid." Eaton Nat'l Bank & Trust Co. v. Welcome, No. CA86-03-007 (Ohio Ct. App. Jan. 13, 1986) (WESTLAW, 724 at 12).

[13]*See* Marine Midland Bank v. Umber, 96 Misc. 2d 835, 410 N.Y.S.2d 25 (1978).

to litigate the claim, however, the banks' response to its customers is apt to be a terse, "see you in court."[14]

Banks exercise great discretion in determining whether to recredit after a wrongful charge for an improper payment. Under the Code, however, losses resulting from improper payments are supposed to settle on "culpable"[15] parties. This design may be frustrated when a bank charges a customer's account for an item that was not properly payable, bounces a check, and then refuses to acknowledge its error. Confronted with litigation costs that outweigh the losses that result from the improper payment, the customer will be unwilling, or unable, to commence the loss shifting process that the Code drafters contemplated.

Today, however, the "see you in court" attitude tends to backfire. Banks risk liability for improper payments that can dwarf the disputed items and their consequent litigation costs if they adopt this attitude. A new and controversial tort, breach of the covenant of fair dealing, subjects banks to punitive damages for mishandling their customers' funds. At least one court has stated that the tort will occur when the stonewalling party knows that the aggrieved party "cannot afford to contest the matter in court."[16]

This article evaluates the potential effect of this tort on the bank and its customer where the improper payment is an indisputable[17] binding stop payment order. Part I examines a bank's duty to properly pay checks.[18] Part II describes the bank's reimbursement rights.[19] Part III examines the breach of covenant of good faith tort.[20] Part IV analyzes liability under the Code.[21] Part V argues that banks must promptly

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[14]In almost all the reported stop payment cases, the customer sued the bank for a recredit. Two exceptions are Ward v. First Nat'l Bank, *aff'd in part, rev'd in part*, 94 N.M. 701, 616 P.2d 414 (1980), and Middle Georgia Bank v. Continental Real Estate & Assoc., 168 Ga. App. 611, 309 S.E.2d. 893 (1983).

[15]According to Professor Phillips, who coined the term, the most culpable parties are those, like forgers, who intentionally cause the loss. Beneath them on the scale are parties who know of a problem with the instrument, followed by parties who carelessly cause the loss. On the bottom rung are parties who, under strict liability principles, could have avoided the loss at the least cost. Phillips, *The Commercial Culpability Scale*, 92 YALE L.J. 228, 228 (1982).

[16]Romero v. Mervyn's, 109 N.M. 249, 258 n.6, 784 P.2d 992, 1001 n.6 (1989).

[17]The same argument would apply whenever the improper payment is indisputable *e.g.*, incompleted checks or checks without necessary signatures are paid. *See infra* note 26.

[18]*See infra* notes 23-41 and accompanying text.

[19]*See infra* notes 42-48 and accompanying text.

[20]*See infra* notes 49-61 and accompanying text.

[21]*See infra* notes 62-76 and accompanying text.

recredit customers' accounts when banks improperly pay over binding stop payment orders.[22] The article concludes that upon being notified that it has overlooked a binding stop payment order, a bank must promptly recredit the customer's account, pay interest on the withheld funds, and make good on any NSF checks. A refusal to do so exposes it to tort damages for breach of the convenant of fair dealing.

I. A BANK'S DUTY TO PROPERLY PAY CHECKS

A check orders a bank to disburse funds credited on its books[23] to its customer[24] in accordance with the check's terms. The bank looks to the check for its payment duties in all cases except that the check may be countermanded by an oral stop payment order.[25] These commands, written or oral, must be strictly obeyed. If they are breached, the check is not "properly payable" and the bank cannot charge its customer's account.[26]

There are several reasons a bank might improperly pay a check. A careful bank may not be able to determine that its customer's signature was expertly forged,[27] skillfully altered[28] or endorsed by the wrong person.[29] A careless or frugal[30] bank might overlook crude forgeries,

[22] *See infra* notes 77-102 and accompanying text.

[23] *See* P.M.F. Serv., Inc. v. Grady, 698 F. Supp. 141 (N.D. Ill. 1988); Susen v. Citizens Bank & Trust Co., 111 Ill. App. 3d 909, 444 N.E.2d 701 (1982) (debtor-creditor relationship between customer and bank); Stone & Webster Eng'g Corp. v. First Nat'l Bank & Trust, 345 Mass. 1, 184 N.E.2d 358 (1962).

[24] *See* U.C.C. § 4-104(1)(e). The bank handles the customer's "items." These are "instrument[s] for the payment of money." *Id.* § 4-104(1)(g). A "check" is an Article 3 instrument drawn on a bank. *See id.* §§ 3-102(1)(e), 3-104(2)(b).

[25] U.C.C. § 4-403(2).

[26] *Id.* § 4-104(a).

[27] U.C.C. § 3-401(a) provides: "[N]o person is liable on an instrument unless his signature appears thereon."

[28] Under U.C.C. § 3-407, a drawer is discharged on both the instrument and the underlying obligation by a fraudulent and material alteration as defined in that section.

[29] A "holder" is the person who is entitled to enforce the instrument. *See* U.C.C. § 1-201(20); *id.* § 3-603(1). To negotiate an order instrument to a "holder", the instrument must be both delivered and "endorsed" by the current holder or someone authorized to affix his endorsement. *See id.* §§ 3-202, 3-404. A person having the "rights" of a holder may also enforce the instrument. *See id.* §§ 3-603, 3-201.

[30] To cut costs, some banks do not examine checks below a certain dollar amount for signatures. *See* Five Towns College v. Citibank, N.A., 108 A.D.2d

alterations or missing signatures.[31] These banks also pay postdated checks prematurely[32] or over binding stop payment orders. Regardless, none of these checks are "properly payable."[33] By debiting them against the customer's account, the bank breaches the contract of deposit.

The Code requires that customers help the bank avoid making improper payments. For example, customers must act with due care to prevent their checks from falling into the wrong hands.[34] They must also alert the banks to their unauthorized signatures[35] or material alterations.[36] These are, however, secondary duties under the Code. The bank is strictly liable for improper payment.[37] Finally, even if the customer has failed to protect the bank in these ways, the customer can still assert liability against the bank if it can demonstrate that the bank did not act with due care in paying the item.[38]

Although these mutual duties to avoid improper payments are established by the Code, they may be modified by the contract of deposit. Under this contract, the parties may shape the standards governing their relationship.[39] However, bargaining between the customer and the bank only goes so far. The Code prohibits the bank from disclaiming its

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420, 489 N.Y.S.2d 338 (1985) (bank did not attempt to verify all signatures because of time constraints).

[31]*See* Spec-Cast, Inc. v. First Nat'l Bank & Trust Co., 128 Ill. 2d 167, 538 N.E.2d 543 (1989) (check missing drawer's signature); Ford Motor Credit Co. v. United States Automobile Ass'n, 11 U.C.C. Rep. Serv. (Callaghan) 361 (Aug. 21, 1972) (check missing indorsement).

[32]Because it orders the bank to pay on or after its date, a postdated check is not properly payable before its date. *See* U.C.C. § 3-114(2); *see also* Siegel v. New England Merchants Nat'l Bank, 386 Mass. 672, 675, 437 N.E.2d 218, 221 (1982).

[33]Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Chemical Bank, 57 N.Y.2d 439, 445-46, 442 N.E.2d 1253, 1256 (1982) (forged indorsement); Winkie, Inc. v. Heritage Bank, 99 Wis. 2d 616, 622, 299 N.W.2d 829, 834 (1981) (forged check); *see also* City Nat'l Bank v. Crocker Nat'l Bank, 150 Cal. App. 3d 290, 197 Cal. Rptr. 721 (1983) (materially altered check), *appeal dismissed en banc*, 38 Cal. 3d 243, 695 P.2d 1058, 211 Cal. Rptr. 517 (1985). Certain materially altered items are, however, properly payable. *See* U.C.C. § 4-401(2).

[34]U.C.C. § 3-406.

[35]*Id.* § 4-406(1).

[36]*Id.*

[37]*See generally* McDonnell, *Bank Liability for Fraudulent Checks: The Clash of the Utilitarian and Paternalistic Creeds Under the Uniform Commercial Code,* 73 GEO L.J. 1399 (1985).

[38]*Id.* at 1408-09.

[39]U.C.C. § 4-103.

obligations to act in good faith and with due care.[40] Additionally, none of the customer's backup duties apply to binding stop payment orders. If the order was binding, the payment was improper.[41] The bank can neither charge its customer's account nor blame its customer for its error.

Nevertheless, under the Code, the bank need not just accept its loss. The Code affords the bank methods to indemnify itself when it makes an improper payment for which it is prohibited from charging its customer's account.

II. THE BANK'S REIMBURSEMENT RIGHTS

When a bank pays a check, properly or not, the bank pays out its own funds. This is due to the nature of the customer bank relationship. As a "debtor" to its checking account customers, the bank does not hold their funds in specie.[42] Thus, the bank neither disburses its customer's property when it pays an item nor restores it when it admits that an improper payment was made. Rather, the bank simply acknowledges the amount of its indebtedness to its customers on its books. When it properly pays an item, the bank may debit the account and seek reimbursement from its customer.[43] Upon an improper payment, however, the bank may not debit the account[44] and it must seek reimbursement from the party most culpable under the Code's scheme.

Under the reciprocal policies of preventing unjust enrichment and loss, the Code affords the payor bank several methods by which it can reimburse itself when it makes an improper payment; the loss may be placed on the most culpable party.[45] Customers must establish that

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[40]*Id.*

[41]"A payment in violation of an effective direction to stop payment is an improper payment, even though it is made by mistake or inadvertance." U.C.C. § 4-403 official comment 8.

[42]*See Susen*, 111 Ill. App. 3d at 913, 444 N.E.2d at 704 (title to funds passes from customer to bank).

[43]"[T]he draft itself authorizes the payment for the drawer's account and carries an implied promise to reimburse the drawee." U.C.C. § 4-401 official comment 1. *E.g.*, Continental Bank v. Fitting, 114 Ariz. 98, 100, 559 P.2d 218, 220 (Ariz. Ct. App. 1977) (citing U.C.C. § 4-401 official comment 1).

[44]*E.g.*, AmSouth v. Spigener, 505 So. 2d 1030 (Ala. 1986).

[45]U.C.C. section 4-407 authorizes the payor bank to seek reimbursement for improperly paying over a binding stop payment order, or other circumstances otherwise giving the drawer "a basis for objection" for the payment. Consequently, it affords the payor bank a general reimbursement remedy

improper payments were made before the bank will have any duty to recredit and begin considering reimbursement. In alteration and forgery cases, that fact may not become indisputably settled until the issue has been litigated in a customer initiated lawsuit. However, where the bank has received and overlooked a timely stop payment order, no such fact finding is necessary. Thus, improper payment was made and the bank is deemed to be aware of its breach as soon as the customer notifies the bank.

The Code does not explicitly fix the time when banks must restore funds to their customers after paying over binding stop payment orders.[46]

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whenever it improperly pays an item and cannot charge the drawer's account. Desiree Mines Ltd. v. Provident Nat'l Bank, 7 Pa. D. & C.3d 163 (1978) (section 4-407 not restricted to stop orders); *see Sunshine*, 34 N.Y.2d 404, 314 N.E.2d 860, 358 N.Y.S. 2d 133. WHITE & SUMMERS, *supra* note 6, at 801. In addition to section 4-407, the Code affords the payor bank specific theories of recovery where items have been forged, altered or stolen. Thus, sections 3-417 and 4-207 impose warranty liability on presenters and transferers. The bank may also seek reimbursement from its customer when it pays these items by establishing that he breached duties to protect it under sections 3-405, 3-406 and 4-406.

[46]In early code drafts, the customer's rights to stop payment and to a prompt recredit when the bank paid over a binding stop payment order were assumed, not suprisingly since these were the rules under the Negotiable Instruments Law, the Code's predecessor. The bank's right to reimburse itself was, however, expressly provided for in section 730 of U.C.C. Proposed Final Draft No. 1 Article III (Apr. 15, 1988):

> A payor bank paying an item which it may not charge to its depositor's account is subrogated to the rights against prior parties of any prior holder who receives the proceeds or to the rights of the drawer, the payee or any subsequent party against any such holder either on the instrument or arising out of the transaction in which the item was issued or transferred.

The comment to this section described its unjust enrichment rationale:

> The bank has parted with money and cannot, under its implied contract, charge the drawer's account. However, no social policy requires that such action be penalized by denying all recovery especially if the effect is to enrich a wrongdoer unjustly. Take, for example, the matter of payment in violation of a stop-order. The drawer presumably stopped payment because he believed he had a defense. Assume that he did. . . Having kept his bank balance the drawer sees no need to spend time and money suing the payee, who will, therefore, keep his ill-gotten gains unless the payor bank can recover the payment. . . But the bank was not an officious volunteer, and prevention of unjust enrichment would seem to require that the bank be given an action in the place of the drawer against the wrongdoing payee.
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> But what if the drawer wrongfully stopped payment; his supposed defense not being a good one. Here the payee keeps the money and the drawer is wrongfully enriched, keeping the purchased goods and not paying for them. The bank, having discharged a valid obligation should be subrogated to the rights of the payee or holder, especially if a holder in due course. (original emphasis omitted).

Fair dealing requires that the bank not deprive customers of funds to which they are entitled, pay interest on wrongfully withheld funds, and make good on any checks that were returned NSF because improper payments were charged to their account. Dollars-and-cents considerations, which may or may not be consistent with fair dealing, determine whether, and at what point, banks will recredit a customer's account. Until a recredit occurs, the bank will have the use of the disputed funds and the ensuing profits.[47] If the bank concludes that it will cost less to litigate the claim than restore the credit, the bank will not be inclined to recredit and make amends for the withheld funds and returned checks.[48]

U.C.C. § 3-730 (1988), *Proposed Final Draft No. 1,* UNIFORM COMMERCIAL CODE.

In the U.C.C. Proposed Final Draft (Spr. 1950), the customer's right to stop payment appeared for the first time in section 4-203. Section 4-203 was identical to the current section 4-403 except that there was no subsection 3. Proposed section 4-402(4), which authorized the bank to seek reimbursement, provided that "the bank has no right to charge the customer's account" while maintaining its section 4-402(4) cause of action.

In the Official Draft of the Code, promulgated in 1952, the stop payment and subrogation sections took their current form. Subsection 3 was added to section 4-403 and the express prohibition of the bank charging its customer's account was dropped. Official comment 9 to section 4-403, which also appeared in this version, explained:

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

The Comment was debated before the New York Law Revision Commission which disapproved of it and later eliminated it. The Commission was troubled by the fact that the bank's liability for payment over a binding stop payment order was not based on any breach of a duty of care but for the improper debit for an item that should not have been paid. Pointing out that "nothing in Article 4 would change the rule that [the bank's] liability is on the debt," it opined that the reference to "burden of establishing loss is confusing." 1 N.Y. STATE LAW REVISION COMMISSION REPORT 466-68 (1954). Comment 9 was subsequently deleted from the 1958 official text of the Code. *See generally* WHITE & SUMMERS, *supra* note 6, at 796-97.

[47]*See* Bank of El Paso v. Statler, 550 S.W.2d 383 (Tex. Civ. App. 1987) (bank accountable to customer for "profits" on wrongfully withheld funds).

[48]An attorney for a large Ohio bank, who decides whether an account will be recredited after an item is paid over a binding stop payment order, described these two different cases:

> In one case, our customer ordered a huge crane, stopped payment on the check and then rejected the crane. We missed the stop payment order. When the

In that case, the customer's only alternative is to litigate. If the bank's projection about litigation costs is correct, however, no suit will arise. Any loss from the improper payment will fall on the customer, disrupting the Code's culpability scheme. If customers have incentives that serve to offset their litigation costs, however, the Code's plan might operate as the drafters intended. Such incentives exist when the bank faces tort damages for its wrongful refusal to restore funds to them.

III. THE BREACH OF THE COVENANT OF FAIR DEALING

A venerable common law maxim holds that parties are free to refuse to perform their contracts if they pay damages.[49] The breach and subsequent damages are traditionally established through litigation, with each side bearing its own costs.[50] A breaching party may force the

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> customer demanded that we recredit, we sent our security department out to investigate it. The customer swore that the crane didn't work right—that the seller breached warranties in the sales transaction. The seller's story is that the buyer didn't know how to operate the crane. To top it off, we find out that the buyer is the seller's son-in-law. We suspect that there might be some fraud involved. The seller now has the crane—it's sitting on his loading dock—and the money. This is a hundred thousand dollar crane, mind you, and we're not sure what's going on. We can't recredit. We're going to hold tight and let the customer sue us.
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> We had another case where a welfare mother paid $200 for a TV set that didn't work so she stopped payment. We missed that one, too. The seller disappeared and she's stuck with this broken-down TV. It seemed pretty clear to us that she had been taken and we didn't want to bother litigating a $200 case. So we recredited her account.

[49]
> The only universal consequence of a legally binding promise is that the law makes the promisor pay damages if the promised event does not come to pass. In every case it leaves him free from interference until the time for fulfillment has gone by, and therefore free to break his contract if he chooses.

O. HOLMES, THE COMMON LAW 301 (1923). A current justification for the maxim is the so-called "Efficient Breach" theory. This theory holds that a contract is broken when the breaching party calculates that he will receive a net benefit after paying damages. The duty to pay damages in lieu of performance, moreover, prevents waste because resources are not consumed needlessly in producing unwanted goods or performing undervalued services. *See* R. POSNER, ECONOMIC ANALYSIS AND THE LAW 106 (3d ed. 1986); Birmingham, *Breach of Contract, Damage Measures and Economic Efficiency*, 24 RUTGERS L. REV. 273 (1970).

[50]Critics contend that the "Efficient Breach" theory, which depends on the organizing force of expectation damages, does not adequately account for these unrecoverable "transaction" costs. "[T]o assume the absence of such costs is to create a 'model' that is very different from the real world of contracting parties." KNAPP & CRYSTAL, PROBLEMS IN CONTRACT LAW 885 (1987) (citing Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443, 1448 (1980)).

aggrieved party to establish an indisputable liability through wasteful litigation.[51] Such stonewalling[52] has prompted courts to impose tort liability for breach of the "covenant of fair dealing."

The covenant of fair dealing is not found in the contract. It is a separate duty imposed on certain contracting parties.[53] Because of a perceived public interest in the insurance contract, the covenant was originally used to protect insureds from unreasonable refusals by insurers to pay claims.[54] It was then extended to employers[55] and banks.[56] In addition to recovering for noneconomic losses such as mental distress,[57]

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[51]Aggrieved parties may sometimes cut these expenses by obtaining an interlocutory summary judgment on the issue of liability alone. *See, e.g.*, FED. R. CIV. P. 56(c).

[52]*E.g.*, Thompson Enters., Inc. v. Coskrey, 168 Ga. App. 181, 308 S.E.2d 399 (1983) (the "so sue me" ploy).

[53]"Whereas contract actions are created to enforce the intentions of the parties to the agreement, tort law is primarily designed to vindicate 'social policy'." Foley v. Interactive Data Corp., 47 Cal. 3d. 654, 683, 765 P.2d 373, 389, 254 Cal. Rptr. 211, 227 (1988) (en banc) (citing W. PROSSER, LAW OF TORTS 613 (4th ed. 1971)); *see also* Luxonomy Cars v. Citibank, N.A., 65 A.D.2d 549, 408 N.Y.S.2d 951 (1978) (the duty is separate from the contract and arises independently of it).

[54]*E.g.*, Crisci v. Security Ins. Co., 66 Cal. 2d 425, 433, 426 P.2d 173, 178, 58 Cal. Rptr. 13, 18 (1967) (en banc).

[55]*E.g.*, *Foley*, 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211.

[56]*E.g.*, Tribby v. Northwestern Bank, 217 Mont. 196, 704 P.2d 409 (1985). In Commercial Cotton Co. v. United California Bank, 163 Cal. App. 3d 511, 516, 209 Cal. Rptr. 551, 554 (1985), a California court of appeals reasoned that the same public interest that imposed the covenant on the insurance industry imposed it on banks. Concluding that banking was a "highly regulated industry performing a vital public service substantially affecting the public welfare," the California court said:

> A depositor in a noninterest bearing checking account, except for state or federal regulatory oversight, is totally dependent on the banking institution to which it entrusts deposited funds and depends on the bank's honesty and expertise to protect them. While banks do provide services for the depositor by way of monitoring deposits and withdrawals, they do so for the very commercial purpose of making money by using the deposited funds. The depositor allows the bank to use those funds in exchange for the convenience of not having to conduct transactions in cash and the concomitant security of having the bank safeguard them. The relationship of bank to depositor is at least quasi-fiduciary.

See Note, "*Contort*": *Tortious Breach of the Covenant of Good Faith and Fair Dealing in Non-Insurance, Commercial Contracts—Its Existence and Desirability*, 60 NOTRE DAME L.REV. 510 (1985).

[57]First Nat'l Bank v. Twombly, 213 Mont. 66, 689 P.2d 1226 (1984); *Crisci*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13. The injury must, however, be "substantial." *Commercial Cotton*, 163 Cal. App. 3d at 517, 209 Cal. Rptr. at 555.

an aggrieved party may also be entitled to punitive damages and attorney's fees for the breach.[58] Today, few courts apply the covenant of fair dealing to all commercial transactions.[59]

As the courts have molded the concept, the covenant is breached by a refusal to pay benefits to which an aggrieved party is presently entitled under the contract.[60] A countermanded check is not properly payable and a bank would therefore appear to breach the covenant when it refuses to recredit its customer's account after being notified that it violated a binding stop payment order.[61] To determine whether the tort action might arise after a bank pays over a binding stop payment order, it is necessary

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[58]*Tribby*, 217 Mont. 196, 704 P.2d 409.

[59]Seaman's Direct Buying Serv., Inc. v. Standard Oil Co., 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984) (no fiduciary relationship and no absence of arms-length bargaining).

[60]Davis v. First Nat'l Bank, 124 Ariz. 458, 605 P.2d 37 (Ariz. Ct. App. 1979); Bowler v. Fidelity & Casualty Co., 53 N.J. 313, 327, 250 A.2d 580, 588 (1969) ("implied covenant of good faith and fair dealing that the insurer will not do anything to injure the right of its policyholder to receive the benefits of his contract"); April Enter., Inc. v. KTTV, 147 Cal. App. 3d 805, 816, 195 Cal. Rptr. 421, 425 (1983) ("a party to a contract will not do anything which would deprive the other party of the benefits of the contract"); *see* Sawyer v. Bank of Am., 83 Cal. App. 3d 135, 139, 145 Cal. Rptr. 623, 625 (1978) (covenant breached by actions with "motive intentionally to frustrate the obligee's enjoyment of contract rights").

At first, the courts required that the plaintiff prove "bad faith" conduct, which they described as "dishonesty, fraud or concealment." *Crisci*, 66 Cal. 2d at 430, 426 P.2d at 176, 58 Cal. Rptr. at 16. Because of its imprecision, the bad faith requirement was eventually eliminated and the emphasis was placed on fair dealing. *See* Egan v. Mutual of Omaha, 24 Cal. 3d 809, 598 P.2d 452, 157 Cal. Rptr. 482 (1979) (implied covenant imposed duty on insurer to thoroughly investigate claim before it could reasonably and in good faith deny payments to insured). According to one court, "blind faith," without a reasonable basis, is not fair dealing. *Crisci*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13.

[61]In *Commercial Cotton*, 163 Cal. App. 3d. at 516, 209 Cal. Rptr. at 554, a California court of appeals held that the covenant was breached when the payor bank asserted a spurious defense against its customer after it paid checks with forged indorsements. The court said, "depositors reasonably expect a bank not to claim nonexistent legal defenses to avoid reimbursement when the bank negligently disburses the entrusted funds." Although *Commercial Cotton* has been roundly debated in the California appeals courts, *see, e.g.*, Price v. Wells Fargo Bank, 213 Cal. App. 3d 465, 261 Cal. Rptr. 735 (1989); Lee v. Bank of Am., 218 Cal. App. 3d 914, 923, 267 Cal. Rptr. 387, 392 (1990) (Johnson, J., concurring and dissenting), it has not been overruled. Several states have applied the covenant to banks. *See generally* Annotation, *Bank's Liability for Breach of Implied Covenant of Good Faith and Fair Dealing*, 55 A.L.R. 4th 1026 (1987). A few, however, have not. *E.g.*, Keeton v. Bank of Red Bay, 466 So. 2d 937 (Ala. 1985).

to identify exactly when the Code obligates the bank to recredit its customer's account.

IV. INDISPUTABLE CODE LIABILITIES

When, as in the typical forgery and alteration cases, the improper payment has not been fixed, the bank should be permitted to litigate genuine factual issues without fear of tort liability for its refusal to recredit. Yet, when a binding stop payment order is overlooked, banks force their customers to become plaintiffs to receive an indisputable recredit.

The issue in these cases is not the bank's liability for the improper payment, which must be conceded,[62] but whether the bank must recredit at all. Customers contend that, upon notification to the bank, they are entitled to an immediate recredit and damages for the wrongful dishonor[63] of any checks that were returned NSF as a result of the bank's improper payment. The banks rejoin that the customer must show that the stop payment order, though binding, was legally justified before they are required to recredit the account and pay damages for dishonoring checks.

Courts have held for both sides.[64] The legal issue focuses on the relationship between section 4-403, which gives the customer the right to stop payment, and section 4-407,[65] which gives the bank reimbursement

[62]"A payment in violation of an effective direction to stop payment is an improper payment, even though it is made by mistake or inadvertance." U.C.C. § 4-403 official comment 8.

[63]*See* U.C.C. § 4-402.

[64]*Compare* Hughes v. Marine Midland Bank, N.A., 127 Misc. 2d 209, 484 N.Y.S.2d 1000 (1985) *with* Southeast First Nat'l Bank v. Atlantic Telec, Inc., 389 So. 2d 1032 (Fla. Dist. Ct. App. 1980), *review denied*, 398 So. 2d. 779 (1981). New York and Georgia favor the customers. *See Hughes*, 127 Misc. 2d 209, 484 N.Y.S.2d 1000; Whitmore v. Woodbury, 154 Ga. App. 159, 267 S.E.2d 783 (1980), *rev'd on separate grounds*, 246 Ga. 349, 271 S.E.2d 491 (1980); *see also* Cincinnati Ins. Co. v. First Nat'l Bank, 63 Ohio St. 2d 220, 407 N.E.2d 519 (1980) (bank must recredit when any improper payment made). Most courts, however, favor the banks. The leading commentators are unsure: "What outcome did the drafters intend? They seem to have spoken out of both sides of their mouths." WHITE & SUMMERS, *supra* note 6, at 797.

[65]U.C.C. § 4-407 provides:

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

rights against the Code's "culpable party" when it pays a countermanded check.

Under section 4-407, the culpable party will be the party in the underlying transaction that was unjustly enriched by the bank's payment.[66] Section 4-407 requires the culpable party to make restitution to the bank for its loss.[67] While the bank is prohibited from charging its customer's account when it pays over a binding stop payment order, section 4-407 authorizes the bank to reimburse itself for its "loss" by recovering, in a proper case, from its customer. Therefore, the culpable party may turn out to be the bank's customer.

The customer may also suffer a "loss" in the underlying transaction because the bank paid the check. The goods or services for which the check was issued might not have conformed to the contract, hence, the stop payment order. Section 4-403(3) imposes "the burden of establishing the fact and amount of loss" on the customer whose binding stop payment order is ignored.[68] The conflict thus becomes which party, the bank or the customer, must establish its "loss."

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

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

(c) of the drawer . . . against the payee or any other holder of the item with respect to the transaction out of which the item arose.

[66]Under the doctrine of unjust enrichment "one person should not be permitted unjustly to enrich himself at the expense of another, but should be required to make restitution . . . ." BLACK'S LAW DICTIONARY 1377 (5th ed. 1979). "The essential question is whether there is the unjust retention of benefit to the loss of another, or the retention of money or property of another against the fundamental principles of justice or equity and good conscience." Starcraft Co. v. C.J. Heck Co., 748 F.2d 982, 988, *reh'g denied*, 753 F.2d 1075 (5th Cir. 1989) (quoting Fun Time Centers, Inc. v. Continental Nat'l Bank, 517 S.W.2d 877, 884 (Tex. Civ. App. 1974)).

[67]"A person who has been unjustly enriched at the expense of another is required to make restitution to the other." RESTATEMENT OF RESTITUTION § 1 (1937). Under prior law, the bank's cause of action was for restitution. *See* NEW YORK STATE LAW REVISION COMMISSION. 2 A STUDY OF THE UNIFORM COMMERCIAL CODE 1558-59 (1955 and photo. reprint 1980). U.C.C. section 4-407 subsumed the theory. *See Sunshine*, 34 N.Y.2d 404, 314 N.E.2d 860.

[68]U.C.C. section 4-403(3) was a concession offered to the banks when the drafters refused to backdown on allowing oral stop payment orders. According to one of the Article 4 drafters, during the Article 4 debates, "somebody said from the floor would it not be fair if at least in this situation the burden of proof was placed upon the depositor to establish that there was a stop payment order and the extent of his damages." 1 NEW YORK LAW REVISION COMMISSION, HEARINGS OF THE UNIFORM COMMERCIAL CODE 467 (1955 and photo. reprint 1980) (comments of Walter Malcolm).

Banks argue that the customer must prove that the payee or other holder could not enforce the instrument, or the underlying transaction for which it was given, before they are obligated to recredit. If the customer cannot meet this burden, it did not suffer any section 403(3) "loss" and, consequently, was unjustly enriched by it. The banks argue that they should not be responsible for any returned checks. By failing to prove that the stop payment order was legally justified, the customer, in effect, did not prove a right to stop payment; therefore, the bank acted properly in reimbursing itself from the account when it paid the check.[69]

Under this view, the customer has the ultimate burden of proof and the bank, acting as a plaintiff in a subrogation suit under section 4-407, has no burden of proof. Thus, the bank may assert its subrogation rights defensively in a suit brought by the customer to force the bank to recredit and to recover for the NSF checks.

The opposing view requires the bank to restore the disputed credit and then affirmatively pursue whatever subrogation rights it might possess. This scheme is modeled after insurance subrogation where the insurance company first pays its insured and then pursues culpable parties.[70] This view states that under its contract with the insured, the insurer must deliver benefits due to its insured before seeking reimbursement. The same, they reason, should apply to banks.[71]

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[69]White & Summers concur. "Having sustained [its right to debit the account] with respect to the first check, it follows that the bank may dishonor checks subsequently presented against insufficient funds." WHITE & SUMMERS *supra* note 6, at 797-98. Their position here, however, is inconsistent with their position on NSF checks that result when postdated checks are paid prematurely. If the bank jumps the gun, "the bank's improper payment of the post-dated check led it to dishonor the [subsequent] check wrongfully." *Id.* at 766-67. Because the premature payment of a post-dated check is also improper, see U.C.C. § 3-114(2), the bank would have no right to debit the account with either check. The drafters of the revised articles 3 and 4 seem to agree: "The loss from an item contrary to a binding stop payment order may include damages for dishonor of subsequent items pursuant to Section 4-402." Section 4-403(3) UNIFORM COMMERCIAL CODE *Proposed Final Draft* (Apr. 12, 1990) [hereinafter *Proposed Draft*].

[70]After reimbursing its insured, "the insurer is 'substituted' for the insured in regard to either all or some portion of the rights that the insured has to receive compensation from another source. [In its subrogation suit,] the insurer is "usually viewed as 'standing in the shoes' of the insured." KEETON & WIDISS, INSURANCE LAW 219 (1988). Because of their fear of juries, insurers will seek, with mixed success, to bring their subrogation suit in the name of their insured. The problem is that the insurer, not the insured, "will derive the benefit of a favorable determination" in the subrogation suit. *Id.* at 241.

[71]"The bank's contract obligations with their customers are separate and distinct from the commercial transactions which the customers may have with

Since insurers are subject to tort liability for their refusal to pay policy benefits to which the insured is indisputably entitled, the insurance subrogation analogy is a powerful litigation argument.[72] However, it falters in that it has tended to equate the section 4-403(3) "loss" with the wrongful charge to the customer's account and resolves the statutory issue by brute force.[73] If the section 4-403(3) "loss" is synonymous with the wrongful charge to the customer's account for the improper payment, the customer's "burden" under that section would be nonexistent.[74] Nevertheless, this view makes sense under the Code. If the payor bank has an insurer that reimburses it for improper payment, which larger banks do, the bank would recredit its customer's account and the insurer would become the plaintiff in a section 4-407 subrogation suit.[75] This view prevailed under the Uniform Negotiable Instrument Law, the Code's predecessor.[76]

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others . . . . Here, the debtor-creditor contract [of deposit] governs the bank's liability. The bank's subrogation rights . . . are [therefore] irrelevant." *Hughes*, 127 Misc. 2d at 216, 484 N.Y.S.2d at 1005.

[72]So mused the dissent in *Lee*, 218 Cal. App. 3d 914, 267 Cal. Rptr. 387 (1990) (Johnson, J., concurring and dissenting). In this case, however, the bank promptly recredited when the customer complained about the charge to his account.

[73]*Hughes*, 127 Misc. 2d 209, 484 N.Y.S.2d 1000. Other courts have used this rationale to manipulate the burden of proof in the customer's favor when the customer brings suit. *E.g.*, Cicci v. Lincoln Nat'l & Trust Co., 46 Misc. 2d 465, 260 N.Y.S.2d 100 (1965). In Thomas v. Marine Midland Tinkers Nat'l Bank, 86 Misc. 2d 284, 381 N.Y.S.2d 797 (N.Y. Civ. Ct. 1976), the court held that plaintiff customer made out a prima facie case by proving the bank's payment over a binding stop payment order. Although the ultimate burden of proof remained on the customer to prove his "loss," the burden of coming forward shifted to the bank to show an absence of loss by the customer.

[74]Commenting on *Thomas*, 86 Misc. 2d 284, 381 N.Y.S.2d 797, White & Summers opine:

> The Thomas interpretation does violence to the drafters intent under 4-403. While we do not think a court's disregard of rather clear statutory directions is appropriate, we suspect that the bankers . . . who had a large hand in the drafting of Article 4 here suffer the consequences of being a bit too greedy in the drafting process.

WHITE & SUMMERS, *supra* note 6, at 799.

[75]Pointing out that large banks typically have insurers who reimburse them when they pay over stop payment orders, the *Hughes* court, 127 Misc. 2d at 216 n.7, 484 N.Y.S.2d at 1005 n.7, said that for small banks "subrogation . . . is more than an analogy, it is a fact." *See* Commercial Ins. Co. v. Scalamandre, 56 Misc. 2d 628, 289 N.Y.S.2d 489 (N.Y. Civ. Ct. 1967) (bank recredited after paying over binding stop payment order and obtained payment from plaintiff insurer for "loss sustained by mistake").

[76]Chase Nat'l Bank v. Battat, 297 N.Y. 185, 78 N.E.2d 465 (1948) (validity or invalidity of underlying transaction no defense to bank); *see generally* E.

V. THE CASE FOR PROMPT RECREDITING

The banks' argument has little merit. It is contrary to Code payment principles because payment over a binding stop payment order is improper. The bank has no right to reimburse itself from its customer's account. Therefore, it should be required to pay interest on the withheld funds and to answer for checks that were returned NSF because of the improper debit.[77] Additionally, the bank's refusal to recredit distorts the rights in the underlying transaction.[78] The customer must forgo exactly what it sought by the stop payment order, namely, the tactical advantage over the payee.[79]

The bank's position can be justified on the ground that there is no other way to reconcile section 4-403(3)'s mandate that the customer prove "the fact and amount of his loss" with section 4-407. The contrary view, the banks assert, renders section 4-403(3) useless. Yet, if there is nothing left of section 4-403(3) under the contrary view, the banks' view virtually destroys whatever stop payment rights a customer has under the Code.

A literal reading of these two sections supports the banks' interpretation. Under unjust enrichment principles, which require the customer to make restitution to the bank for whatever benefits the bank conferred on it by paying the check, the section 4-403(3) "loss" undoubtedly means more than the improper charge to the account.

FARNSWORTH, COMMERCIAL PAPER COURSES AND MATERIALS 215-19 (3d ed. 1984). The banks responded with exculpatory clauses that were upheld by the courts. *E.g.*, Gaita v. Windsor Bank, 251 N.Y. 152, 167 N.E. 203 (1929).

[77]This is the view of the revised Article 4: "The loss from payment of an item contrary to a binding stop payment order may include damages for dishonor of subsequent items pursuant to Section 4-402." *Proposed Draft*, § 4-403(3).

[78]For example, under U.C.C. section 2-601, a buyer may always reject goods that fail or whose tender of delivery fail in any respect to confrom with the contract, rightfully or wrongfully. In either case, he will be able to foist the goods back on the seller and "rightfully" withhold payment for them. *See* U.C.C. § 2-709 (seller's action for the "price"). A buyer may also accept non-conforming goods without waiving the breach. *See* U.C.C. § 2-717. If the bank refuses to recredit his account, the buyer's Article 2 rights to manipulate the price with a stop payment order in these ways is defeated.

[79]Assume, for example, that buyer orders a fixed price dishwasher from seller, a large retailer, and then cancels the order. As a matter of good will, seller will probably swallow his claim for the lost profit, see U.C.C. § 2-708(2), and accept buyer's offer of termination, see U.C.C. § 2-106(3), rather than hold buyer for the breach. A countermanded check gives buyer some bargaining muscle or, depending on how one looks at it, allows him to "weasle out of" the contract more easily. WHITE & SUMMERS, *supra* note 6, at 801.

Banking law is more, however, than Article 4 stop payment orders and bank subrogation. These rights are an integral part of the Code's general culpability scheme.

Until liability to reimburse is fixed, the bank will not know the culpable party. Thus, section 4-407 authorizes the bank to seek reimbursement by proceeding against all possible parties.[80] Such parties include its customer,[81] the payee, or other holder on the underlying transaction.[82] If it proceeds against its customer, the bank will subrogate to the "rights" of a "holder in due course"[83] or of any other "holder"[84] on the item or under the transaction out of which the item arose. These rights, which do not exist in a vacuum, are not defined in section 4-407. Rather, the bank must look to other Code sections.

A payor bank acquires reimbursement rights against its customers under Articles 3 and 4 whenever it pays a check, properly or otherwise. If the item was properly paid, Article 4 grants the bank the right to enforce the customer's implied duty to reimburse and the bank need not look elsewhere.[85] Yet, the bank will also take by *transfer*[86] whatever rights the

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[80]Professional Sav. Bank v. Galloway Farm Nursery, Inc., 514 So. 2d 76, 77 (Fla. Dist. Ct. App. 1987) ("most comprehensive and effective remedy possible"). Unjust enrichment of all the defendants is not required. South Shore Nat'l Bank v. Donner, 104 N.J. Super. 169, 177, 249 A.2d 25, 30 (1969). "Permitting retention of [the drawer and payee] is not unlike an inverse interpleader. At least one, and possibly both of the real parties in interest have been unjustly enriched. The bank stands as an embarrassed, but innocent, third party." *Professional Sav. Bank*, 514 So. 2d 76, 77 n.2. *See* Manufacturer's Hanover Trust Co. v. Ava Indus., Inc., 98 Misc. 2d 619, 414 N.Y.S.2d 425 (N.Y. Sup. Ct. 1978) (even outsiders who contributed to the bank's loss are properly joined).

[81]U.C.C. § 4-407(a) and (b). A stop payment order attempts to dishonor the check. *See* U.C.C. § 3-507(1)(a) ("an instrument is dishonored" when payment is refused.) Upon dishonor, a holder may pursue the drawer on either the instrument or the underlying obligation. *See* U.C.C. § 3-802(1)(b). In seeking reimbursement against its customer, the bank will subrogate, respectively, to the rights of "the holder in due course" *and* "of the payee or any other holder on the item." These subsections are intended to confer on the bank whatever "rights" any "holder" in the transaction had to enforce either the instrument or the underlying transaction that generated it. U.C.C. § 4-407 official comments 1 & 2.

[82]U.C.C. § 4-407(c).

[83]*Id.* § 3-302(1).

[84]*Id.* § 1-201(20).

[85]It is fundamental that upon proper payment of a draft the drawee may charge the account of the drawer . . . since the draft itself authorizes the payment for the drawer's account and carries an implied promise to reimburse the drawee." U.C.C. § 4-401 official comment 1.

[86]*Id.* § 3-201(1). Dalton v. George B. Hatley Co., Inc., 634 S.W.2d 374, 379 (Tex. Ct. App. 1982). A payor bank acquires such rights on payment. Nida

holder had to the instrument or in the underlying transaction. These rights are asserted under section 4-407 when it makes an improper payment. They are enunciated in sections 3-305,[87] 3-306,[88] and enforced under section 3-307.[89]

Section 3-305 supplies the payor bank with the rights it may assert against its customer under section 4-407(a), namely "the rights of a holder in due course."[90] Section 3-306 supplies the bank with the rights it will assert against its customer under section 4-407(b), namely, "the rights of one not [a] holder in due course."[91] As drawers of checks, bank customers will be liable to them under their Article 3 contracts.[92]

Article 3 rights to be paid are enforced against drawers under section 3-307. Although the party to be paid has the ultimate burden of proof, his task as a plaintiff is facilitated by certain presumptions.[93] The holder

v. Michael, 34 Mich. App. 290, 191 N.W.2d 151 (1971); *see* Commercial Sav. Bank v. G & J Wood Prod. Co., 46 Mich. App. 133, 207 N.W.2d 401 (Mich. Ct. App. 1973). *Cf.* U.C.C. § 3-415(5) (accommodation party who pays also has right of recourse on the instrument).

[87]U.C.C. § 3-305 is entitled, "Rights of a Holder in Due Course." According to U.C.C. § 1-109, "section captions are part of this Act."

[88]U.C.C. § 3-306 is entitled, "Rights of One Not Holder in Due Course."

[89]U.C.C. § 3-307 is entitled, "Burden of Establishing Signatures, Defenses and Due Course."

[90]U.C.C. § 3-305.

[91]*Id.* § 3-306.

[92]U.C.C. § 3-413(2) provides:

> The drawer engages that upon dishonor of the draft and any necessary notice of dishonor . . . he will pay the amount of the draft to the holder . . . .

Under § 3-511(2)(b), because the stop order amounts to a "dishonor" of the instrument by the drawer, see U.C.C. § 3-507(1)(a), notice of dishonor would be excused and the holder would have an immediate right of recourse against the drawer. *See* U.C.C. § 3-507(2). So will the bank if the drawer is the culpable party under § 4-407(a) or (b).

[93]*See* U.C.C. § 3-307(2). Official comment 2 to this section explains how the presumptions work:

> [A] holder makes out his case by mere production of the instrument, and is entitled to recover in the absence of any further evidence. The defendant has the burden of establishing any and all defenses, not only in the first instance but by a preponderance of the total evidence . . . . If [a person] establishes a transfer which gives him the rights of a holder (Section 3-201), this provision becomes applicable, he is then entitled to recover unless the defendant establishes a defense.

"The normal scheme of the Uniform Commercial Code . . . contemplates that a bank making an erroneous payment over a stop order can recover from either the drawer or payee. If the drawer has no defense to payment of the check, the bank recovers by charging the drawer's account." Swiss Credit Bank v. Balink, 614 F.2d 1269, 1272 (10th Cir. 1980); *see* Bryan v. Citizens Nat'l Bank, 628 S.W.2d 761 (Tex. 1982).

makes out a prima facie case by proving his right to enforce the instrument.[94] The drawer then "establishes the fact and amount of loss" to the extent that he proves a viable defense.[95] If such a defense is made, the holder will again have the burden of going forward. If such rights are available to the holder under section 3-305, he may prove that he has the rights of a holder in due course and overcome any defenses that cannot be asserted against such holders.[96] If holder in due course rights are unavailable, the holder may then assert whatever rights are available to it under section 3-306 and enforce the underlying obligation that gave rise to the instrument.[97]

All holders are subject to these burdens of proof when they seek to enforce their rights to Article 3 instruments. Improperly paying banks that assume their position by subrogating to their rights should be treated identically. The newly revised Article 3, recently approved by the American Law Institute, endorses this view.[98]

This view can be further supported. Until the bank's rights are fixed in the section 4-407 suit, under section 3-307 procedures, the customer will bear a "contingent" as opposed to a "fixed" or indisputable liability to the bank. A contingent liability must be fixed to become enforceable.[99] The customer's liability at this stage is identical to the type of liability the bank typically bears to the customer when a claim of improper payment is made. If the customer has no right to a recredit until it fixes the bank's liability for the improper payment, the bank should have no right to

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[94] *See* U.C.C. § 3-307(2).

[95] *Id.* § 3-307(2). Such defenses are found in U.C.C. section 3-305.

[96] U.C.C.§ 3-305.

[97] *Id.* § 3-802(1)(b); *see supra* note 76.

[98] The payor bank would become the "person entitled to enforce the instrument under the proposed final draft section 3-301. According to the official comment to this section, "the definition recognizes that enforcement is not limited to holders. It . . . includes a person that acquired rights of a holder by subrogation or by [transfer]."

One writer describes section 4-407 as "a procedural device for the accomplishment of . . . substantive principles." Rogers, *The Irrelevance of Negotiable Instruments Concepts in the Law of the Check-Based Payment System*, 65 TEX. L. REV. 929, 951 n.70 (1987). Professor Rogers would probably quibble with my analysis, indeed, with revised Article 3 as well, since he believes that negotiable instruments principles should not guide payment transfers. He complains, however, that the prevailing interpretation of section 4-403(3) renders stop payment rights "nugatory." *Id.* at 951-52 n.72.

[99] *See* Escambia Chem. Corp. v. United Ins. Co. of Am., 396 So. 2d 66 (Ala. 1981) (the fund sought to be garnished must be due absolutely and without contingency).

withhold funds from its customer until it fixes its reimbursement rights against the customer.[100]

Finally, this interpretation is consistent with established law that predates the Code. Unless the customer is insolvent, a bank may only set off a fixed indebtedness against its customer's account.[101] It is prohibited from charging contingent liabilities. If it does, it will be liable for prejudgment interest dating from the wrongful charge "under the equitable principle that one should be compensated for the unauthorized use or detention of his money."[102] The bank should have the same liability to its customer when it overlooks his binding stop payment order and charges his account for the improper payment.

VI. CONCLUSION

When claims of improper payment are asserted by customers, banks exercise an almost unfettered discretion in determining whether to restore credits. This is not an unreasonable position when disputed factual issues exist. Until the case is litigated and the liabilities are fixed, it may be impossible to know whether the payment was improper or whether the customer bears some responsibility for it. Contemporaneously, the bank would have no notice that it was withholding funds that belonged to its customer and could not therefore breach the covenant of fair dealing.

The bank does, however, expose itself to tort liability when it pays over a binding stop payment order and refuses to recredit. It cannot contend that a proper payment was made or that it had the right to charge its customer's account. Nor will it have any Code defense based on its customer's misconduct. Whatever reimbursement obligations exist will be fixed.

In the meantime, the customer's right to draw on the funds is indisputable. Fair dealing requires that the bank acknowledge its errors to its customer before launching its search for the Code's culpable party.

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[100]"The bank can hardly claim an opposing party has been unjustly enriched when the bank is holding the funds in question under color of right." *Sunshine*, 34 N.Y.2d at 415, 314 N.E.2d at 866 n.7, 358 N.Y.S.2d at 122.

[101]*E.g.*, Gonsalves v. Bank of Am., 16 Cal. 2d 169, 105 P.2d 118 (1940). For the Code rule, *see, e.g.*, Elizarraras v. Bank of El Paso, 631 F.2d 366 (5th Cir. 1980).

[102]First Nat'l Bank v. Estate of Hackworth, 673 S.W.2d 218, 224 (Tex. Ct. App. 1984) (citing Phillips Petroleum Co. v. Stahl Petroleum Co., 569 S.W.2d 480, 485 (Tex. 1978)).