

RETENTION OF A CHECK: PAYOR BANK'S LIABILITY UNDER SECTION 4-302

The American business community utilizes checks¹ as the primary means of transferring funds.² Approximately fifty million checks are handled in the United States during the course of a single business day,³ and the Federal Reserve System annually handles an estimated 4.7 trillion checks of which 99.5% are paid in due course.⁴ Because of the interstate nature of American business, the vast volume of items⁵ handled by banks and the large percentage of these items that pass for collection and payment across state lines, there is a need for uniform legislation which can be consistently applied and understood. Articles 3 and 4 of the Code were promulgated to meet this need. Article 3 of the Code, entitled Commercial Paper, concerns the handling of negotiable instruments. Article 4 of the Code, which supersedes Article 3 in the area of bank collection and deposits concerns the practice set up for handling the huge volume of checks processed by the banking community. A purpose of Article 4 is to aid the flow of items passing for collection and payment,⁶ and a means of aiding this flow is to insure the rapid processing of these items. A small but important part of this process is the action taken by the payor bank⁷ in paying, dishonoring⁸ or returning the item, for this action determines whether the person who

¹ U.C.C. § 3-104(2)(b) defines a "check" as "a draft drawn on a bank and payable on demand." Unless otherwise specified, all references to the Uniform Commercial Code are to the 1962 Official Text.

² See, e.g., Leary, Check Handling Under Article Four of the Uniform Commercial Code, 49 Marq. L. Rev. 331 (1965).

³ Id. at 333 n.6. There appears to be no official pronouncement as to the volume of checks handled or processed in this country. U.C.C. § 4-103, Comment 3 states that banks handle 25 million items every business day. Malcolm, How Bank Collection Works—Article 4 of the Uniform Commercial Code, 11 How. L.J. 71, 73 (1965) states that 50 million checks are handled a day.

⁴ Leary, *supra* note 2, at 333 nn. 6 & 7. Owen, Jr., Article 4—Bank Deposits and Collections, 38 U. Colo. L. Rev. 65, n.1 (1965) states:

The 99.5% figure is one that has been quoted for years by bankers and writers on banking matters. The Denver branch of the Federal Reserve Bank of Kansas City recently indicated the figure is still accurate as to Denver clearings. Returned check tabulations by a large Denver bank for the week of September 30-October 6, 1965, showed an average daily "short check" rate of only .46%.

⁵ U.C.C. § 4-104(g) defines "item" as "any instrument for the payment of money even though it is not negotiable but does not include money."

⁶ U.C.C. § 4-101, Comment states that with the huge volume of checks flowing back and forth across the country "a proper situation exists for uniform rules that will state in modern concepts at least some of the rights of the parties and in addition aid this flow and not interfere with its progress."

⁷ U.C.C. § 4-105(b) defines the "payor bank" as "a bank by which an item is payable as drawn or accepted."

⁸ U.C.C. § 3-507(1) provides that an instrument is dishonored when:

- (a) a necessary or optional presentment is duly made and due acceptance or payment is refused or cannot be obtained within the prescribed time or in the case of bank collections the instrument is seasonably returned by the midnight deadline (Section 4-301); or
- (b) presentment is excused and the instrument is not duly accepted or paid.

deposited the check will receive payment and thus fulfills the purpose for which the check was drawn.⁹ Section 4-301 allows a payor bank to revoke a settlement¹⁰ or credit if it returns the check by its midnight deadline.¹¹ If the payor bank does not revoke the settlement in the time and manner provided by section 4-301 the payor bank becomes accountable¹² for the amount of the item as provided by section 4-302. The payor bank becomes accountable regardless of whether the item is properly payable¹³ or whether actual damages result from the bank's inaction. If the payor bank becomes accountable under section 4-302 the holder¹⁴ can take action against the bank for the full amount of the item. Thus, section 4-302 requires rapid action by the payor bank. The purpose of this comment is to trace the derivation of section 4-302 and to analyze its effectiveness in light of the commercial circumstances in which it must be employed.

In order that the effect of section 4-302's operation may be fully understood, it must be considered in terms of the bank collection process.¹⁵ Relevant aspects of the bank collection process can best be shown by way of a hypothetical situation. A bill owed by the Castor Tire Company to the Pollux Suppliers, Inc. is paid by a check drawn by Castor¹⁶ on its account in the First National Bank.¹⁷ Pollux¹⁸ deposits the check in the Second Savings Bank,¹⁹ which sends the check for collection to the First National Bank. It can either send the check directly²⁰ or through one or a chain of

⁹ Since a check is an instrument for the payment of money, if a check is dishonored and returned it will not be paying the money which it represents, and, therefore, will not be fulfilling its purpose.

¹⁰ U.C.C. § 4-104(j) defines "settle" as "to pay in cash, by clearing house settlement, in a charge or credit or by remittance, or otherwise as instructed. A settlement may be either provisional or final."

¹¹ U.C.C. § 4-104(h) defines "midnight deadline" as "midnight on its next banking day following the banking day on which it receives the relevant item or notice or from which the time for taking action commences to run, whichever is later."

¹² See *Rock Island Auction Sales v. Empire Packing Co.*, 32 Ill. 2d 269, 204 N.E.2d 721 (1965) for its holding on the word "accountable" discussed infra.

¹³ U.C.C. § 4-104(i) defines "properly payable" as "includ[ing] the availability of funds for payment at the time of decision to pay or dishonor."

¹⁴ U.C.C. § 1-201(20) defines "holder" as "a person who is in possession of a document of title or an instrument or investment security drawn, issued or indorsed to him or to his order or to bearer or in blank."

¹⁵ For a greater coverage of the bank collection process see H. Bailey, *The Law of Bank Checks*, 179-181 (3d ed. 1962); Leary, *supra* note 2; Malcolm, *supra* note 3.

¹⁶ The Castor Company is the drawer of the check. The Code does not define the term "drawer." An early case defined a check as "a written request by one person who is called the drawer, directed to another person called the drawee, requesting him to pay to a third person, called the payee a certain sum of money therein specified . . ." *Westminster Bank v. Wheaton*, 4 R.I. 30, 33 (1856).

¹⁷ The First National Bank is the payor bank. For a definition of payor bank see note 7 *supra*.

¹⁸ The Pollux Company is the payee. The "payee" of a check is the individual who is intended by the drawer to be the recipient of the money. *Schweitzer v. Bank of America Nat'l Trust & Sav. Ass'n*, 42 Cal. App. 2d 536, 542, 109 P.2d 441, 445 (1941).

¹⁹ The Second Savings Bank is the depository bank. U.C.C. § 4-105(a) defines "depository bank" as "the first bank to which an item is transferred for collection even though it is also the payor bank."

²⁰ Direct routing is expressly authorized by U.C.C. § 4-204(2)(a).

collecting banks,²¹ each forwarding the check and each receiving a provisional settlement for the amount of the check. At the end of this chain is the First National Bank, the payor bank. The last collecting bank, on presenting²² the check to the First National Bank, receives a provisional settlement from the First. The First National Bank has until midnight of the day of receipt to make the provisional settlement and until its midnight deadline to pay, return or dishonor the check. If it pays the check it posts a debit to the account of the Castor Company,²³ and when it fails to return the check by the same route by which it arrived all the credits and debits between the intermediary banks become final.²⁴ If it decides to dishonor the check the First National Bank returns the check to the intermediary bank,²⁵ thus revoking all settlements, and sends out a notice of dishonor to the Castor Company.²⁶ Section 4-302 operates when the First National Bank does not make a settlement on the day it receives the item from the last collecting bank, or does not pay, return or dishonor the item by its midnight deadline, as, for example, if the First merely retains the item for several days without taking action on it. Section 4-302 provides that:

In the absence of a valid defense such as breach of a presentment warranty (subsection (1) of Section 4-207), settlement effected or the like, if an item is presented on and received by a payor bank the bank is accountable for the amount of

- (a) a demand item other than a documentary draft whether properly payable or not if the bank, in any case where it is not also the depository bank, retains the item beyond midnight of the banking day of receipt without settling for it or, regardless

²¹ U.C.C. § 4-105(d) defines "collecting bank" as "any bank handling the item for collection except the payor bank."

²² U.C.C. § 3-504(1) defines "presentment" as "a demand for acceptance or payment made upon the maker, acceptor, drawee or other payor by or on behalf of the holder."

²³ U.C.C. § 4-213(1)(c) provides that "an item is finally paid by a payor bank when the bank has done any of the following, whichever happens first . . .

(c) completed the process of posting the item to the indicated account of the drawer, maker or other person to be charged therewith. . . ."

²⁴ U.C.C. § 4-213(2) provides:

If provisional settlement for an item between the presenting and payor banks is made through a clearing house or by debits or credits in an account between them, then to the extent that provisional debits or credits for the item are entered in accounts between the presenting and payor banks or between the presenting and successive prior collecting banks seriatim, they become final upon final payment of the item by the payor bank.

²⁵ U.C.C. § 4-105(c) defines "intermediary bank" as "any bank to which an item is transferred in course of collection except the depository or payor bank."

²⁶ U.C.C. § 4-301(1) provides:

Where an authorized settlement for a demand item (other than a documentary draft) received by a payor bank otherwise than for immediate payment over the counter has been made before midnight of the banking day of receipt the payor bank may revoke the settlement and recover any payment if before it has made final payment (subsection (1) of Section 4-213) and before its midnight deadline it

- (a) returns the item; or
- (b) sends written notice of dishonor or nonpayment if the item is held for protest or is otherwise unavailable for return.

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of whether it is also the depository bank, does not pay or return the item or send notice of dishonor until after its midnight deadline; or

- (b) any other properly payable item unless within the time allowed for acceptance or payment of that item the bank either accepts or pays the item or returns it and accompanying documents.

In this case the First National Bank would be accountable to the Pollux Company²⁷ whether or not the Castor Company had funds²⁸ in its account to cover the check.²⁹

The policy underlying section 4-302 can best be understood after an analysis of the earlier relevant laws. At common law the drawee could be liable for conversion of an instrument if after acceptance³⁰ and demand it refused to return the instrument. For a drawee to be liable at common law in an action of tortious conversion there had to be a demand by the holder and an acceptance by the drawee.³¹ Destruction or retention of an item did not amount to acceptance at common law, and mere retention, even for an unreasonable time, did not render the drawee liable as acceptor of the instrument. Thus, at common law, checks could be held for long periods of time before they were deemed to have been accepted, and therefore, before payment could be received.

As commerce and trade developed and more and more checks passed for collection across state lines, the need became apparent for a uniform act governing bills of exchange, notes and checks.³² In 1896 the National Conference of Commissioners on Uniform State Laws sponsored the Uniform Negotiable Instrument Act (U.N.I.A.), which was ultimately enacted by all of the states.³³ The question of whether a drawee is liable for mere retention of an item has been answered in two conflicting ways under the U.N.I.A. The U.N.I.A. allowed the drawee twenty-four hours to decide whether to accept an item.³⁴ Section 137 of the U.N.I.A. provided that if

²⁷ U.C.C. § 4-201 provides that the collecting banks are agents of the owner of the item. Thus the payor bank would not be accountable to the collecting bank but to the owner of the item, in this case to the Pollux Company.

²⁸ U.C.C. § 4-302(a) applies whether or not the item is properly payable.

²⁹ A payee of a dishonored check is required to exercise with reasonable promptness its election to hold the payor bank liable for failure to return the check within the time allotted. In *Exchange Bank & Trust Co. v. Pure Ice & Cold Storage Co.*, 415 S.W.2d 897 (Tex. 1967), the payee did not elect to hold the drawee liable until after two years, and thus the court held that the payee could not then collect.

³⁰ U.C.C. § 3-410(1) defines "acceptance" as "the drawee's signed engagement to honor the draft as presented. It must be written on the draft, and may consist of his signature alone. It becomes operative when completed by delivery or notification."

³¹ In *Jeune v. Ward*, 106 Eng. Rep. 240 (K.B. 1818), a bill was left for acceptance and was retained by the drawee for 41 days, after which he destroyed it. The court held that it was the duty of the party leaving it to inquire. The court held also that destruction does not constitute acceptance. The court mentioned that for the drawee to be liable on a bill there would have to be a conversion making him liable in an action of trover. See 2 New York Law Revision Commission Report, Study of the Uniform Commercial Code 457 (1955); see also W. Britton, *Bills and Notes* 830 (1943).

³² H. Bailey, *The Law of Bank Checks* 5 (3d ed. 1962).

³³ *Id.*

³⁴ U.N.I.A. § 136 allows 24 hours for a payor bank to decide whether to accept an

the drawee refused to return the item within twenty-four hours the drawee would be deemed to have accepted the item.³⁵ The majority of jurisdictions³⁶ accepted the view that retention constitutes acceptance.³⁷ In *State Bank v. Weiss*³⁸ and *Wisner v. First Nat'l Bank*,³⁹ two cases that were decided under the U.N.I.A., it was held that presentation for acceptance is a demand for acceptance which implies a demand for return and that a mere failure to return the bill within twenty-four hours is an acceptance, thus rendering the drawee liable on the item. The opinion of the *Wisner* case states that prior to the U.N.I.A., the theory of implied or verbal acceptance applied, wherein the liability of the drawee was not determined by any fixed rule or standard, but by whether a jury found the drawee's conduct to amount to an implied acceptance. The court in the *Wisner* case held that the U.N.I.A. abolished the implied acceptance and left only actual acceptance. The court held that actual acceptance under the U.N.I.A. can occur in only two ways: written acceptance, as under section 132⁴⁰ of the U.N.I.A., and actual acceptance under section 137. The court explained that the U.N.I.A.'s purpose was to protect the holder, but that if the holder were required to make a demand for the return of an item he was not protected. An underlying purpose of the *Weiss* and *Wisner* decisions was to effect the prompt and rapid return of checks. If the payor bank could retain checks without liability, the entire bank collection processes would be slowed down. A contrary result was reached in *Westberg v. Chicago Lumber & Coal Co.*⁴¹ where the court applied the doctrine of constructive acceptance, in that if the drawee retains the item for over twenty-four hours the question of whether his action constitutes constructive acceptance is a jury question. Mere retention is not sufficient. The court stated that constructive acceptance is determined in only two ways: first, on a quasi-contractual basis, in that by custom or otherwise the drawee knows that his retention implies acceptance; and second, on a basis of a tortious conversion, in that the drawee's conduct is such that it constitutes a conversion of the item. *St. Louis Southwestern Ry. Co. v. James*,⁴² another case relying on the doctrine of constructive acceptance,

instrument. If there is a deferred posting statute the payor bank has until its midnight deadline. See H. Bailey, *supra* note 32, at 279.

³⁵ U.N.I.A. § 137 provides: "Where a drawee to whom a bill is delivered for acceptance destroys the same, or refuses within 24 hours after such delivery, or within such other period as the holder may allow, to return the bill accepted or not accepted to the holder, he will be deemed to have accepted the same."

³⁶ The following states have cases representing the majority view: California, Colorado, Louisiana, Minnesota, Montana, North Carolina, North Dakota, Oklahoma, Oregon, Tennessee and Texas. F. Beutel, *Brennan's Negotiable Instruments Law* 1249 (7th ed. 1948).

³⁷ For an annotation on this subject see Annot., 63 A.L.R. 1138 (1929).

³⁸ 46 Misc. 93, 91 N.Y.S. 276 (Sup. Ct. 1904).

³⁹ 220 Pa. 21, 68 A. 955 (1908); Annot., 17 L.R.A. (N.S.) 1266 (1909).

⁴⁰ U.N.I.A. § 132 provides:

"The acceptance of a bill is the signification by the drawee of his assent to the order of the drawer. The acceptance must be in writing and signed by the drawee. It must not express that the drawee will perform his promise by any other means than by the payment of money."

⁴¹ 117 Wis. 589, 94 N.W. 572 (1903).

⁴² 78 Ark. 490, 95 S.W. 804 (1906).

interpreted section 137 of the U.N.I.A. as requiring action of a tortious character which would constitute an unauthorized conversion of the item by the drawee. The court said that since acceptance must be in writing, under section 132 of the U.N.I.A., mere retention would not be sufficient for acceptance.⁴³ The different applications and interpretations of section 137 of the U.N.I.A. prevented the bank collection laws in this area from being uniform.

Another attempt to codify the law regarding bank practices was the Bank Collection Code which was drafted in the 1920's and enacted in a number of states.⁴⁴ This was the first comprehensive statute designed to deal uniformly with the collection process. In 1948 the American Banking Association drafted the Model Deferred Posting Statute as an amendment to section 3 of the Bank Collection Code.⁴⁵ This statute provided that the payee has until midnight of the following banking day to dishonor or refuse payment on the item.⁴⁶ Under the Deferred Posting Statute, final payment should take place at the expiration of the time limit for return, and if payment takes place the payor bank is liable on the item.⁴⁷ As such this statute is the forerunner of section 4-302 of the Code. The Bank Collection Code was not adopted in many states, in part because of a decision of the Illi-

⁴³ Britton, *supra* note 31, at 831 presents an argument, based on section 150 of the U.N.I.A., that inaction is not acceptance. U.N.I.A. § 150 provides: "Where a bill is duly presented for acceptance and is not accepted within the prescribed time, the person presenting it must treat the bill as dishonored by non-acceptance or he loses the right of recourse against the drawer and indorsers." Thus, Britton argues that a non-acceptance should be treated as dishonored after the running of 24 hours. Britton in this section does not say what recourse the payee has and against whom it will lie. This argument was not considered in either the *Westberg* or the *St. Louis* case.

⁴⁴ The Bank Collection Code was enacted in the following states: Alaska, Colorado, Idaho, Indiana, Maryland, Michigan, Missouri, Nebraska, New York, South Carolina, Washington, West Virginia and Wisconsin. H. Bailey, *supra* note 32, at 5-6 n.14.

⁴⁵ T. Paton, *Digest of Legal Opinions, Collections* § 27 (Supp. 1966).

⁴⁶ The Model Deferred Posting Statute provides:

"[A]ny credit so given, together with all related entries on the books of the receiving bank, may be revoked by returning the item, or if the item is held for protest or at the time is lost or is not in the possession of the bank, by giving written notice of dishonor, nonpayment, or revocation; provided that such item or notice is dispatched in the mails or by other expeditious means not later than midnight of the bank's next business day after the item was received. For the purpose of determining when notice of dishonor must be given or protest made under the law relative to negotiable instruments, an item duly presented, credit for which is revoked as authorized by this Act shall be deemed dishonored on the day the item or notice is dispatched. . . ."

Paton, *supra* note 45.

⁴⁷ In *First Nat'l Bank v. Universal C.I.T. Credit Corp.*, 132 Ind. App. 353, 170 N.E.2d 238 (1960), the court held the payor bank liable under the Model Deferred Posting Statute when it retained an item for five days without charging the drawer's account. The court held that, since the payor bank did not revoke the credit given to the collecting bank within the time allowed under this statute, the credit became irrevocable. The court held that failure to revoke the credit constitutes final payment. This is one of the few cases on the subject. In the opinion the court notes that "extended independent research has failed to produce for us a case on the precise question now considered." *Id.* at 363, 170 N.E.2d at 243.

nois Supreme Court holding the Bank Collection Code unconstitutional in Illinois.⁴⁸

In 1949 the first proposed draft of the Uniform Commercial Code was published. There have been three changes in the provisions of section 4-302 of the Code. In the 1949 draft, the provisions which were in section 3-629(2) allowed the customer of the depositary bank to recover as if he were a depositor in the payor bank. Their purpose was to secure the preferences upon insolvency granted under some state laws and to give the benefit of depositor insurance. In the 1950 draft, section 4-402, the provision allowing the customer of the depositary bank to recover as if a depositor in the payor bank, remained, but the present provision pertaining to presentment warranty was added. In section 4-302 of the 1952 version, the provision allowing recovery as if a depositor was dropped, but the Code still allowed only the customer of the depositary bank to recover. The New York Commission studying the Code noted the error of restricting recovery to the customer of the depositary bank. As they stated, it is possible that the customer of the depositary bank may no longer be the owner of the item and as such should not be the party to recover in that he would have sold his interest in the item.⁴⁹ In 1958 section 4-302 of the Code was changed to its present form making no mention of who can recover but merely saying that the payor bank is accountable. Section 4-302 reaches the same result as the majority view of the U.N.I.A. and the American Banking Association Model Deferred Posting Statute, but it is different in its approach and method. Section 4-302 substitutes the theory of "accountability" for that of "acceptance." Section 4-302 holds the payor bank accountable on the item while section 137 of the U.N.I.A. held the payor bank as accepting the item. Under the Model Deferred Posting Statute, the payor bank's liability was not spelled out but was inferred from the fact that as the time limit expired the settlement became final. The approach and method of section 4-302⁵⁰ and the meaning of the word "accountable" can be seen by its application in the two cases that have been decided under this section.⁵¹

⁴⁸ *People ex rel. Barrett v. Union Bank & Trust Co.*, 362 Ill. 164, 199 N.E. 272 (1935) held that section 13 of the Bank Collection Code, which gives preferred claims against banks that have drawn drafts and checks instead of paying in cash on items presented by an agent collecting bank and who have failed to pay on the draft, was unconstitutional under the Illinois Constitution. The court held also that since the entire act was "essentially and inseparably" connected in substance the whole act was unconstitutional.

⁴⁹ 2 New York Law Revision Commission Report, Study of the Uniform Commercial Code 1452 (1955).

⁵⁰ Section 4-302 is to be read in conjunction with §§ 4-213(1)(d) and 4-301, which establish when an item is finally paid. By § 4-213(1)(d) an item is finally paid when a payor bank has failed to revoke the settlement in the time and manner prescribed by statute, clearing house rules or agreement. § 4-301 establishes this time and manner. If the item is finally paid it cannot be revoked and the payor bank is "accountable" on it. § 4-302 spells this out specifically and thus prevents the state courts from giving another interpretation to this section as was the case with § 137 of the U.N.I.A.

⁵¹ The two cases decided under § 4-302 were concerned only with subsection (a). Subsection (b) differs from (a) in that it does not exclude documentary drafts from its provisions. Another difference is that for subsection (b) to apply the item must be properly

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In *Rock Island Auction Sales v. Empire Packing Co.*⁵² the court held a payor bank, which had retained a check for seven days, accountable for the full amount of the check. The payor bank had retained the item relying on the drawer's assertion that he would deposit funds to cover the check. The drawer did not deposit these funds and the check was returned unpaid. Two and a half months later the drawer went into bankruptcy. The payee thus sued the payor bank. The court interpreted "accountable" as synonymous with "liable." The court held the payor bank liable for the full amount of the check, rejecting the defendant payor bank's argument that the measure of damages should be the same as that provided for by section 4-103(5)⁵³ of the Code. The defendant argued that the measure of damages should be the amount of the item reduced by the amount that would not have been paid by the payor bank had it exercised ordinary care. This in effect is the amount that would have been paid had the bank exercised ordinary care. The amount of the check was \$14,706.90 and had the payor bank exercised ordinary care it would have dishonored and returned it since the drawer had insufficient funds. Thus, the amount that would not have been paid was \$14,706.90. By the defendant's argument, in applying section 4-103(5), the payor bank would have been liable for the amount of the item minus that which would not have been paid; this net amount would be zero. The court rejected this argument and held that the payor bank was liable for the full amount of the item. It stated that the measure of damages in section 4-103(5) should apply only to collecting banks whose mistakes could be attributed to negligence. Because of the customer relationship between the payor bank and the drawer, failure of the payor bank to take timely action is often due to a purposeful effort to protect the drawer's credit. This is a laudable purpose but the effect is harmful to the payee, in that the payment is delayed, and if the item was dishonored after a delay the payee would be slow in taking action against the drawer. The court also mentioned that the role of the payor bank is crucial in that it knows the status of its customer's account and thus the worth of the item. Therefore, section 4-302 does not operate with respect to ordinary care but imposes a liability for breach of its provisions whether or not the payor bank exercised ordinary care. In *Farmer's Cooperative Livestock Market v. Second Nat'l*

payable. Subsection (b) states that the payor bank is accountable for properly payable items unless "within the time allowed for acceptance or payment of that item the bank either accepts or pays the item or returns it and accompanying documents." The phrase "within the time allowed" does not refer to § 4-301 for that section, like § 4-302(a), is concerned only with demand items other than documentary drafts. The "time allowed" refers to § 3-506 which states the time for acceptance or payment for all instruments except drafts drawn under a letter of credit. For letters of credit the time limits for honor or rejection are stated in § 5-112.

⁵² 32 Ill. 2d 269, 204 N.E.2d 721 (1965).

⁵³ U.C.C. § 4-103(5) provides: "The measure of damages for failure to exercise ordinary care in handling an item is the amount of the item reduced by an amount which could not have been realized by the use of ordinary care, and where there is bad faith it includes other damages, if any, suffered by the party as a proximate consequence."

*Bank*⁵⁴ the court also held the payor bank liable to the payee and interpreted section 4-302 in the same manner as did *Rock Island*.⁵⁵

A realistic reading of this statute [section 4-302] compels the conclusion that failure to meet the midnight deadline authorizes the person presenting the check to assume that it has been honored and will be paid. Banking practices require the prompt settlement of such items because of the chain of credit dependent thereon.⁵⁶

For the purpose of evaluating the operation of section 4-302 certain facts concerning banking collection codes and banking practices must be considered. The American banking community needs laws that will facilitate the smooth and rapid handling of checks. One objective is to reduce the amount of funds involved in "float" items.⁵⁷ These are the items that are currently in transit in the collection system. The more rapid the collection system, the fewer items will be tied up in float. Another consideration is that of the huge volume of checks handled in the United States. Those which are initially dishonored appear to be about $\frac{1}{8}\%$; $99\frac{1}{2}\%$ by number and $99\frac{3}{4}\%$ by dollar value are paid in due course, $\frac{1}{2}$ of which are paid on representation.⁵⁸ This large volume of checks processed should not be held up by the small percentage in the area of risk. Also, a general principle of a bank collection code is that it makes an equitable and fair allocation of losses so that no great burden is placed on any one bank.

Section 4-302 requires the payor bank to decide rapidly whether to honor an item. The result is that the owner of an item may not be best served if a payor bank rejects the item too quickly.⁵⁹ If the payor bank were able to wait for the item to be covered it might not only protect the drawer's credit but also prevent the additional paper work caused by a rejection and the additional work by the payee to collect on the item. Of the items dishonored one-half are paid on representation⁶⁰ and more are paid in cash outside of banking circles.

Section 4-401⁶¹ allows the payor bank to charge to the account of the drawer any otherwise properly payable item even though the charge creates an overdraft. Thus, if the payor bank receives an item and the drawer has insufficient funds, the payor bank may pay the item and hold the drawer for

⁵⁴ 427 S.W.2d 247 (Ky. 1968).

⁵⁵ The *Farmer's* case also involved an issue as to whether the instrument was a demand item and the bank a collecting bank. The court held that since the item was payable on demand it was a demand item in reference to § 4-302(a). The court held also that since the item was drawn on the bank it was a payor bank and not a collecting bank.

⁵⁶ 427 S.W.2d 247, 250 (Ky. 1968).

⁵⁷ King, Kuenzel, Lauer, Littlefield & Stone, Cases and Materials on Commercial Transactions under the Uniform Commercial Code 11-46 (1968).

⁵⁸ Leary, *supra* note 2, at 333.

⁵⁹ This idea is mentioned in U.C.C. § 4-211, Comment 6. In this context it refers to a collecting bank rejecting an item, but the idea can also be applied to § 4-302 and payor banks.

⁶⁰ Leary, *supra* note 2, at 333. See also note 4 *supra*.

⁶¹ 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."

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the amount of the item since the draft itself authorizes the payment for the drawer's account and carries an implied promise to reimburse the drawee.⁶² In this case the payee would be well served, since the item would be honored, the drawer's credit would be protected and the payor bank would be able to collect on the item from the drawer. The real problem is that the payor bank often cannot recover from the drawer because the drawer has absconded, has gone into bankruptcy or has no available assets.⁶³ In these cases the payor bank would bear the loss for it would be too late to revoke the settlement and therefore it could not collect from the payee. Since the payor bank does not always know the drawer's financial condition or intention, if there is a risk of large loss, the payor bank would be hesitant to pay on the item and charge the drawer's account. For these reasons, even with the provision of section 4-401, the payor bank would often reject items that may have been covered by the drawer.

The Code could be adapted to meet this problem by the addition of a provision similar to that of section 4-108(1),⁶⁴ but made applicable to payor banks. That section allows a collecting bank to grant a payor bank an extra day in a good faith effort to secure payment. That section only applies in the case of specific items⁶⁵ and it operates without liability to the transferor or any prior party. The problem is that it rests with the collecting bank to grant this extra time and that this process entails more transaction between the collecting bank and the payor bank. This is an act of discretion on the part of the collecting bank in that the collecting bank is under no obligation to grant this extra time.⁶⁶ A better provision would be to allow the payor bank to set aside and record, for example on the back of the item, specific items that the payor bank feels will be covered before an additional day expires. The extra day could put a burden on the payee who is the owner of the check, not on the payor bank, since the delay in the return of the check may make it more difficult for the payee to collect because a delay in collecting from the drawer may result in the availability of less funds. Since the payee is the person who would profit by this provision, for it is an attempt to get payment on a check that he holds, the risk of non-collection should lie most appropriately on him. This allocation would not encumber the collecting

⁶² This is set out in Comment 1 to § 4-401.

⁶³ In both the *Rock Island* and *Farmer's* cases it was the inability of the drawer to cover the items and the initiation of bankruptcy proceedings against the drawer which forced the payee to go against the payor bank.

⁶⁴ U.C.C. § 4-108(1) provides:

Unless otherwise instructed, a collecting bank in a good faith effort to secure payment may, in the case of specific items and with or without the approval of any person involved, waive, modify or extend the time limits imposed or permitted by this Act for a period not in excess of an additional banking day without discharge of secondary parties and without liability to its transferor or any prior party.

⁶⁵ By specific items it is meant that the payor bank would earmark these items and process them separately. This procedure would insure that they be kept to a minimum since these items would be specially handled outside the flow of checks and therefore would require more work on the part of the payor bank.

⁶⁶ It appears that the collecting bank is not required to grant this extra day. See Brown, *Bank Deposits and Collections*, 48 Ky. L.J. 232, 243 (1960).

banks with more transactions. The flow of items would remain unimpeded and the amount of items in float would not be significantly increased for this suggested provision would involve only the less than one half percent of the items which would have been initially dishonored by the payor bank. This process would allow the payor bank to differentiate between the various items that are not properly payable: for example forged items, those signed by a drawer who has no account in the bank and those partially covered. The payor bank can then quickly return and dishonor those items which are forged or signed by an unknown drawer. In situations where the payor bank feels that the drawer may cover the item it could notify the drawer and give him an extra day to cover the item. The interested parties are the payor bank, the drawer and the payee. The collecting banks are conduits between the payee and the payor bank. The collecting banks generally have little opportunity to learn of a drawer's insolvency, impending bankruptcy or forgery. If an item were retained by the payor bank beyond the time limit of section 4-301 and less than the additional time limit of this proposed provision, the payor bank would be accountable if it did not treat the item as a specific item. This could easily be established by examination of the records of that item, for instance those on the back of the check. This procedure would have the same effect as section 4-108(1) for the item would be specially handled but without the additional steps involved if the payor bank must request an additional day and the collecting bank must grant it. The general provision of good faith⁶⁷ would have to be relied upon so that the payor bank would not treat all items as specific and thus give themselves an additional day for payment or dishonor.⁶⁸

Section 4-302 of the Code effects the purpose for which it was proposed. It aids the rapid processing of the voluminous amount of checks by requiring the payor bank to take prompt action on a check. It corrects the problem of judicial interpretation which resulted in the application of similar provisions of the U.N.I.A. in a non-uniform manner. The one difficulty is that it allocates the losses heavily on the payor bank so that they reject items that may have been covered. As a result neither the payee nor the drawer is best served, since the item owned by the payee is dishonored and the drawer's credit is hurt. A better solution would be to have the item covered so that the payor bank can honor it. The addition of a section allowing the payor bank, in a good faith effort to secure payment, to retain the item for an extra day would greatly alleviate the problem.

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⁶⁷ U.C.C. § 1-203 establishes the general provision of good faith. That a bank cannot disclaim this responsibility is established by U.C.C. § 4-103(1).

⁶⁸ As § 4-302 now stands, its provisions are somewhat mitigated by § 4-108(2) which excuses delays beyond the time limit of § 4-302 if caused by interruption of "communication facilities, suspension of payments by another bank, war, emergency conditions or other circumstances beyond the control of the bank. . . ." § 4-302 is also mitigated by § 4-103(1) which allows provisions of the Code to be varied by agreement.