Loyola of Los Angeles Law Review

Volume 40
Number 1 *Symposium: Contracting Out of the Uniform Commercial Code*

Article 12

11-1-2006

Contracting out of the UCC: Variation by Agreement under Articles 3, 2, and 4A

Paul S. Turner

CONTRACTING OUT OF THE UCC: VARIATION BY AGREEMENT UNDER ARTICLES 3, 4, AND 4A

Paul S. Turner[*]

I. CONTRACTING OUT GENERALLY: VARIATION BY AGREEMENT

This Article is concerned with "contracting out" of the liability imposed by Articles 3, 4, and 4A of the Uniform Commercial Code ("UCC"). Article 3 relates to "Negotiable Instruments" such as bills and notes, Article 4 to "Bank Deposits and Collections," and Article 4A to "Funds Transfers."

The practice of contracting out of liability may be formulated in a number of different ways. The UCC typically describes the practice as "variation by agreement."[1] In addition to contracting out

[*] Paul S. Turner was a retired Assistant General Counsel of Occidental Petroleum Corporation. He was a co-author of THE ABCS OF THE UCC: ARTICLE 4A: FUNDS TRANSFERS (Amelia H. Boss ed., 2d ed. 2006), published by the American Bar Association; author of NEGOTIATING WIRE TRANSFER AGREEMENTS: A GUIDE FOR TREASURY EXECUTIVES, BANKERS & ATTORNEYS (1996), published by the Treasury Management Association; co-author of MANAGING THE RISKS OF PAYMENT SYSTEMS (2003), published by John Wiley & Sons, Inc.; co-author of STANDBY AND COMMERCIAL LETTERS OF CREDIT (3d ed. 2006), published by Aspen Publishers; and contributor to THE LAW OF ELECTRONIC FUNDS TRANSFERS, published by Matthew Bender & Co. Mr. Turner co-chaired the Payments Subcommittee of the UCC Committee of the Business Law Section of the American Bar Association. He was the editor of the MODEL FUNDS TRANSFER SERVICES AGREEMENT AND COMMENTARY (1994), published by the Business Law Section of the American Bar Association, and was the author or co-author of numerous articles on banking and commercial law subjects, including *Payments*, published in THE BUSINESS LAWYER each year as part of the Uniform Commercial Code Annual Survey. He has published numerous academic articles, including *The UCC Drafting Process and Six Questions about Article 4A: Is There a Need for Revisions to the Uniform Funds Transfers Law?*, LOY. L.A. L. REV. 351 (1994). Mr. Turner was an Official Advisor to the Uniform Law Commissioners who wrote UCC Article 4A (Funds Transfers) and revised UCC Articles 3 (Negotiable Instruments), 4 (Bank Deposits and Collections), and 5 (Letters of Credit). Mr. Turner thanked Rejena Saulsberry and Brian N. Smith of the University of Arkansas, Little Rock, School of Law for their assistance, and was very grateful to Professor Frederick H. Miller of the University of Oklahoma School of Law and Professor Stephen C. Veltri of Ohio Northern University School of Law for their contributions. Mr. Turner consulted on funds transfers, letter-of-credit, and other banking and commercial law matters in Los Angeles, California.

1. *See, e.g.*, U.C.C. §§ 4A-501, 4-103, 4A-205 cmt. 3 (2003).

and variation by agreement, the practice may be formulated as "disclaiming" or "waiving" liability. A disclaimer is a disavowal of liability by the obligor. The counterpart of a disclaimer is a waiver of the obligor's liability by the obligee.

In UCC Articles 3, 4, and 4A, it is typically the bank, not the bank's customer, that seeks to contract out by varying the rules regarding liability for checks and wire transfers. The principal issue addressed in this Article is the extent to which the rules of UCC Articles 3, 4, and 4A permit a bank to disclaim liability to its customers for checks and wire transfers. The Article begins with a brief discussion of the general rule for disclaimers under the UCC. The Article then examines the rules applicable to checks under UCC Articles 3 and 4, and the rules applicable to funds transfers under Article 4A. The Article closes with a summary of conclusions that can be derived from the discussion of the rules.

A. General UCC Rule: Freedom of Contract

The general rule for parties to all transactions subject to the UCC grants the parties "autonomy," that is, freedom of contract, such that a bank is generally free to disclaim its liability in its agreement with the customer. The UCC states this general rule in section 1-302:

> (a) Except as otherwise provided in subsection (b) or elsewhere in [the Uniform Commercial Code], the effect of provisions of [the Uniform Commercial Code] may be varied by agreement.
>
> (b) The obligations of good faith, diligence, reasonableness, and care prescribed by [the Uniform Commercial Code] may not be disclaimed by agreement. The parties, by agreement, may determine the standards by which the performance of those obligations is to be measured if those standards are not manifestly unreasonable.[2]

Section 1-304 imposes an obligation to act in "good faith" on all parties to transactions governed by the UCC:

> Every contract or duty within [the Uniform Commercial Code] imposes an obligation of good faith in its

2. *Id.* § 1-302(a)–(b).

performance and enforcement.[3]

"Good faith" means "honesty in fact and the observance of reasonable commercial standards of fair dealing."[4] The obligation to act in good faith and to exercise care in connection with checks is addressed in greater detail in UCC Articles 3 and 4.

B. The 2002 UCC Amendments

In a 1994 symposium issue of this periodical, I posed questions regarding ambiguities in UCC Article 4A and suggested how the ambiguities might be resolved in future revisions to Article 4A.[5] In late 1999 or early 2000, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") organized a drafting committee (the "Drafting Committee") to implement a project to import Regulation CC[6] into UCC Article 4.[7] The Drafting Committee's chair was Edwin E. Smith, now a partner at Bingham McCutchen LLP in Boston, and its reporter was Professor Ronald J. Mann, now the co-director of the Center for Law, Business, and Economics at the University of Texas School of Law.

The Regulation CC project was canceled in 2001, but the Drafting Committee was determined to continue in existence for the purpose of making general amendments to UCC Articles 3, 4, and 4A.[8] At the Drafting Committee meetings, I represented the interests of the business users of the payments systems on behalf of the Association for Financial Professionals, a corporate treasury trade association. The Drafting Committee considered action on a wide range of issues, including contracting out issues and the ambiguities

---

3. *Id.* § 1-304.

4. *Id.* § 1-201(b)(20). This definition applies to other articles of the UCC, including Articles 3, 4, and 4A. *See id.* § 1-201(a) ("Unless the context otherwise requires, words or phrases defined in this section, or in the additional definitions contained in other articles of [the Uniform Commercial Code] that apply to particular articles or parts thereof, have the meanings stated."); § 1-201 cmt. 20 (discussing the definition of "good faith" and noting its applicability to other articles, except Article 5).

5. Paul S. Turner, *The UCC Drafting Process and Six Questions About Article 4A: Is There a Need for Revisions to the Uniform Funds Transfers Law?*, 28 LOY. L.A. L. REV. 351 (1994).

6. 12 C.F.R. pt. 229 (2006). Regulation CC was issued by the Board of Governors of the Federal Reserve System to implement the Expedited Funds Availability Act and the Check Clearing for the 21st Century Act. *Id.* § 229.1.

7. *See* Memorandum from Ronald J. Mann & Edwin Smith to the 3-4-4A Drafting Committee (Mar. 30, 2000), http://www.law.upenn.edu/bll/ulc/uccpayment/ucc3m300.pdf.

8. Alvin C. Harrell, *Electronic Checks*, 55 CONSUMER FIN. L.Q. REP. 283, 283 (2001).

in Article 4A I had written about in 1994.[9]

In the summer of 2001, the NCCUSL executive committee adopted a sharply truncated agenda of the Drafting Committee's recommendations, and the few amendments adopted at the following summer 2002 NCCUSL meeting failed to address any of the contracting out issues.[10] The discussion below refers to possible resolutions of these issues considered by the Drafting Committee.

II. UCC ARTICLES 3 AND 4: LIABILITY FOR FRAUDULENT CHECKS

The general rule for contracting out of liability for checks is stated in the Article 4 section 4-103(a) rule for bank deposits and collections:

> The effect of the provisions of this Article may be varied by agreement, but the parties to the agreement cannot disclaim a bank's responsibility for its lack of good faith or failure to exercise ordinary care or limit the measure of damages for the lack or failure. However, the parties may determine by agreement the standards by which the bank's responsibility is to be measured if those standards are not manifestly unreasonable.[11]

Thus, while the parties have autonomy and the bank may disclaim its liabilities,[12] the bank may not disclaim its obligation to act in good faith and to exercise ordinary care.

A. Good Faith and Ordinary Care

As noted above, section 1-304 imposes an obligation to act in good faith on all parties to transactions governed by the UCC.[13] However, section 3-406 does not unconditionally impose an

9. *See* Robyn L. Meadows, Carl S. Bjerre & Stephen L. Sepinuck, *The Uniform Commercial Code Survey: Introduction*, 56 BUS. LAW. 1743, 1745 (2001).

10. *See* U.C.C. arts. 3, 4 (Draft for Approval 2002), http://www.law.upenn.edu/bll/ulc/uccpayment/annual2002.pdf. The prefatory note states that the agenda was limited to items "where the need for reform is plain and the opportunity for justifiable controversy small." *Id.*

11. U.C.C. § 4-103(a) (2003).

12. *See id.* § 1-302 cmt. 1 (stating that "freedom of contract is a principle of the Uniform Commercial Code" and "'the effect' of its provisions may be varied by 'agreement'"); *see also id.* § 4-103 cmt. 1 (stating that the section "permits within wide limits variation of the effect of provisions of [Article 4] by agreement").

13. *See supra* Part I.A. For a general discussion of the standard of good faith, see RESTATEMENT (SECOND) OF CONTRACTS § 205 & cmts. a–d (1981), and *PEB Commentary* No. 10, [PEB Commentaries] U.C.C. Rep. Serv. 2d (CBC) (Feb. 10, 1994).

obligation to exercise ordinary care on the paying bank. Instead, section 3-406(b) imposes that obligation indirectly and conditionally "if the person asserting the preclusion fails to exercise ordinary care," that is, by allocating proportional liability to the bank for check fraud when the bank fails to exercise ordinary care in paying a check.[14]

The UCC also imposes the obligation to exercise ordinary care directly on collecting banks that take a check for value or for collection.[15] "Ordinary care," with respect to a person engaged in business, means the "observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged."[16] "Ordinary care" is the UCC term for traditional negligence.

The obligation to exercise ordinary care requires the bank to observe "reasonable commercial standards" generally.[17] The obligation to act in good faith, on the other hand, requires the bank to observe "reasonable commercial standards of *fair dealing*."[18] Thus, "ordinary care" generally connotes that the conduct was not negligent, while good faith connotes "fairness" and not the "absence of negligence."[19]

In *Cumis Insurance Society, Inc. v. Girard Bank*,[20] an agreement embodied in a corporate resolution for the use of facsimile signatures authorized the bank to honor checks when "bearing or purporting to bear the facsimile signature or any signature" of two authorized representatives of the bank's customer "with the same effect as if the signature or signatures were manual signatures."[21] The agreement also stated that the customer "agrees to indemnify and hold harmless

14. U.C.C. § 3-406(b) (2003).

15. *See id.* § 4-202(a). While the obligation is imposed indirectly under the comparative fault provisions of UCC sections 3-404(d), 3-405(b), and 3-406(b), the obligation is imposed directly on collecting banks under section 4-202(a). *See id.* §§ 3-404(d), 3-405(b), 3-406(b), 4-202(a).

16. *Id.* § 3-103(a)(9). A bank that takes an instrument for processing or collection by automated means need not examine the instrument if the failure to examine it does not violate the bank's prescribed procedures and the procedures do not vary unreasonably from general banking usage not disapproved by Articles 3 or 4. *Id.*

17. *Id.*

18. *Id.* § 1-201(b)(20) (emphasis added).

19. *Id.* § 4-406 cmt. 4.

20. 522 F. Supp. 414 (E.D. Pa. 1981).

21. *Id.* at 416.

the Bank . . . from any damages the Bank may suffer . . . by reason of its acting upon" the agreement.[22]

After the bank had paid checks bearing unauthorized facsimile signatures and debited its customer's account for the amount of the checks, the customer's insurance company sued to recover the funds.[23] The bank argued that the insurer was precluded from denying the validity of the unauthorized signature because the provision in the agreement between the bank and the customer shifted the risk of loss for unauthorized signatures to the customer.[24] The court rejected the bank's argument, holding that if the provision were construed as the bank asserted, it would "have the effect of exculpating the bank from any liability regardless of its own negligence in paying the instruments bearing forged drawer signatures."[25]

B. Payor Banks: Disclaiming the "Properly Payable" Rule

The basic rule of UCC Articles 3 and 4 allocates liability for fraudulent checks between the payor bank and its customer. The rule that the bank may pay a check only when the check is "properly payable" is set forth in UCC section 4-401(a):

> A bank may charge against the account of a customer an item that is properly payable from the account even though the charge creates an overdraft. An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and bank.[26]

The Official Comment to section 4-401 clarifies that a check "containing a forged drawer's signature or forged indorsement is not properly payable."[27] A forged signature is not authorized and does not bind the drawer-customer whose name is forged. An altered check is also not "authorized by the customer" when a wrongdoer alters the name of the payee or increases the amount payable.

Similarly, a check is not properly payable when the drawer

22. *Id.* (internal quotation marks omitted).

23. *Id.* at 417.

24. *Id.* at 418.

25. *Id.* at 422.

26. U.C.C. § 4-401(a) (2003).

27. *Id.* § 4-401 cmt. 1.

writes a check payable to the order of a named payee, and a wrongdoer subsequently forges the payee's indorsement. Section 3-401 states that a person is not liable on an instrument unless the person signed the instrument or an authorized representative signed on the person's behalf.[28] The forgery is not effective as the signature of the named payee whose genuine indorsement is necessary to negotiate the check.[29]

The basic UCC rule can be summarized as follows: the bank, not the customer, is liable for fraudulent checks under section 4-401.[30] However, liability under the UCC is shifted to the customer when the customer fails to exercise ordinary care and the failure substantially contributes to the alteration or forgery of the check.[31] Under these circumstances, the customer is precluded from asserting the alteration or forgery against the bank.[32] When the customer and the bank both fail to exercise ordinary care, the loss is prorated "according to the extent to which the failure of each to exercise ordinary care contribute[s] to the loss."[33]

The parties may vary these UCC rules by agreement. Articles 3 and 4 permit a bank to disclaim its liability under the basic rule, and a bank typically does so in the deposit agreement with its customer.[34]

In a partial disclaimer, the bank purports to accept responsibility for conduct in which the bank has been at fault but disclaims all other responsibilities, such as its liability for fraudulent checks under the basic rule. Disclaimers in deposit agreements take different forms, but the following partial disclaimer is very common:

> The Bank shall have no liability for any losses or damages sustained by the Customer under this Agreement except to

28. *Id.* § 3-401(a).

29. *Id.* § 4-401 cmt. 1.

30. Additional rules relating to fraudulent indorsements have the effect of shifting liability from the bank to the customer when the perpetrator is an employee of the customer and when the perpetrator is an imposter and induces the drawer to issue the check by impersonating the payee. *See id.* §§ 3-404 to -405.

31. *Id.* § 3-406(a).

32. *Id.* Section 3-406 applies to the collecting bank as well as the paying bank. *See id.* (noting that the customer "is precluded from asserting the alteration or the forgery against a [bank] who, in good faith, *pays the instrument* or *takes it for value or for collection*") (emphasis added).

33. *Id.* § 3-406(b).

34. *See, e.g.*, Triffin v. First Union Bank, 724 A.2d 872, 874 (N.J. Super. Ct. App. Div. 1999).

> the extent that the Bank's actions may have constituted gross negligence or willful misconduct.

In a typical fraudulent check case, the bank has not acted negligently and neither the bank nor the customer is at fault.[35] By stating that the bank shall not be liable except to the extent its conduct constitutes gross negligence or willful misconduct, the above disclaimer shifts liability in the typical case from the bank to the customer.

In another form of disclaimer that achieves a similar result, the bank disclaims liability for all forged or altered checks that it pays in the normal course utilizing the bank's automated systems. The use of automated systems, as opposed to the actual manual and sight examination of a check, is consistent with ordinary care.[36]

In the following disclaimer, the bank disclaims liability even when a manual and sight examination fails to disclose fraud, if the fraud is not detectable by a person observing reasonable commercial standards:

> *Standard of Care.* We use automated systems that don't rely on sight review in the processing of checks in order to handle a high volume of items at a lower cost to you. You agree that, to the extent that such systems are consistent with general banking practice, their use will constitute ordinary care and we will not be liable to you for forgeries or alterations not detected by such systems. You also agree that the exercise of ordinary care will not require detecting forgeries or alterations that could not be detected by a person observing reasonable commercial standards.

Thus, by allowing the bank to pay a check that is not properly payable, this form of disclaimer effectively shifts the liability under the basic rule from the bank to the customer.

Another form of indirect disclaimer imposes a broad obligation on the customer to pay for account insufficiencies:

> You also agree to be liable for any account shortage resulting from charges or overdrafts, whether caused by you or another person with access to this account. This liability is due immediately, and can be deducted directly from your

35. *See, e.g.*, Mercantile Bank of Ark. v. Vowell, 117 S.W.3d 603, 608 (Ark. Ct. App. 2003).
36. *See* U.C.C. § 3-103(a)(9) (2003).

> account balance whenever sufficient funds are available. You have no right to defer payment of this liability, and you are liable regardless of whether you signed the item or benefited from the charge or overdraft.

1. Illustration.

As an example of the interplay between the fraudulent check provisions of the UCC, suppose that a deposit agreement contains the following disclaimer:

> The Customer shall be liable for all checks purporting to bear the signature of or on behalf of the Customer, whether or not the signature is unauthorized or has been forged.

Suppose, also, that a wrongdoer has absconded with the proceeds of a successful check forgery or alteration.

(i) Under the basic rule, the check was not properly payable, and the bank is liable for the loss. However, if the customer failed to exercise ordinary care (i.e., by hiring an ex-convict as bookkeeper), and the customer's failure substantially contributed to the loss, the customer would be precluded from asserting the forgery or alteration against the bank.[37] The customer would thus bear the loss.

(ii) Suppose that, in addition to the customer's failure to exercise ordinary care, the bank also failed to exercise ordinary care (i.e., by not observing a timely order to stop payment), and the bank's failure substantially contributed to the loss. Under these circumstances, the loss would normally be allocated proportionally between the bank and the customer under section 3-406(b).

If, however, the above disclaimer by the bank is enforceable, the bank would not be liable for its failure to exercise ordinary care. Instead of a proportional allocation, the entire loss would be borne by the customer. Nevertheless, the disclaimer would seem unenforceable because, under section 4-103(a), the bank may not disclaim responsibility for its obligation to exercise ordinary care.

(iii) Suppose, instead, that the bank has failed to exercise ordinary care, but the customer has not. The bank is at fault and the customer is not at fault so the bank should seemingly still be precluded under section 4-103(a) from enforcing the disclaimer of liability for its lack of care.

37. *Id.* § 3-406(a).

The application of section 3-406(b), however, is uncertain under these circumstances because the obligation of the bank to exercise ordinary care under section 3-406(b) is proportional. In other words, the section does not apply unless the customer has also failed to exercise ordinary care. May the customer hold the bank, which has failed to exercise ordinary care, responsible for the fraudulent check? The answer is probably yes, but Articles 3 and 4 are unclear.

A draft of proposed amendments to Articles 3, 4, and 4A, circulated by the Drafting Committee in 2001,[38] would have clarified the comparative negligence provisions by adding two clauses to section 3-406(b). One of the proposed additions would allow a drawer that has been harmed by the payment of a fraudulent check to recover directly from any person failing to exercise ordinary care in paying or taking the instrument, if that failure substantially contributes to loss resulting from payment of the instrument, to the extent that the failure of that person to exercise ordinary care in paying or taking the instrument contributed to the loss.[39]

In the typical fraudulent check case, the comparative negligence provisions do not apply because the bank generally exercises ordinary care.[40] The bank's disclaimer effectively shifts the entire liability to the customer. Courts have consistently enforced these disclaimers against both consumer and non-consumer customers.[41]

38. The draft amendment was not voted upon by the Drafting Committee, and any reference made in this Article to a provision of the 2001 NCCUSL draft or to any provision produced for consideration by the Drafting Committee is not meant to imply that the provision is, for that reason alone, desirable or should be regarded as having any precedential value by the NCCUSL or others.

39. U.C.C. § 3-406(b) (March 2001 Draft). The Reporter's Note explains that "the drawer need not engage in litigation with the drawee to the point that the drawer is 'bearing a loss' on the instrument before pursuing the other party. Rather, the drawer in such a case should be able to proceed directly against the allegedly negligent party." *Id.* § 3-406 reporter's note 2.

40. *See, e.g.*, *Vowell*, 117 S.W.3d at 608 (holding no allocation of loss because neither the bank nor the customer failed to exercise ordinary care); Halla v. Norwest Bank Minn., 601 N.W.2d 449, 453 (Minn. Ct. App. 1999) (affirming summary judgment for bank when there was no evidence of failure to exercise ordinary care).

41. *See, e.g.*, Triffin v. First Union Bank, 724 A.2d 872, 874–75 (N.J. Super. Ct. App. Div. 1999) (enforcing an agreement that shifted the risk of loss from the bank to the customer unless the loss was caused by the bank's gross negligence or willful misconduct). *But see* Cumis Ins. Soc'y, Inc. v. Girard Bank, 522 F. Supp. 414, 421–22 (E.D. Pa. 1981) (referring to "strict liability" under the basic rule of section 4-101 and holding that the disclaimer was ambiguous in effect and void because it would exculpate the bank from its obligations to act in good faith and exercise ordinary care).

C. Reporting Requirements

A reporting requirement imposes an obligation on the customer to report the payment of a forged or fraudulent check within a specified period of time.[42] The reporting requirement is not a disclaimer or waiver and does not directly vary the UCC rules on check fraud. When the time allowed for reporting is a very brief period, however, the reporting requirement can have the same effect as a disclaimer.

UCC section 4-406(c), (d), and (f) contain two sets of reporting requirements. The failure of the customer to comply with either of these requirements shifts liability for a fraudulent check from the bank to the customer, even if the bank might otherwise be liable for payment of a check that was not "properly payable."[43]

1. "Thirty-Day" Rule

The first set of reporting requirements is contained in section 4-406(c) and (d). These subsections, which are often misunderstood, prescribe different time periods for reporting (i) a single forged or altered check, or the first in a series of fraudulent checks, and (ii) the second or any subsequent fraudulent check perpetrated by the same wrongdoer.[44]

With respect to a single check or the first in a series of fraudulent checks, after the bank sends or makes available the customer's statement, section 4-406(c) and (d) require the customer to "exercise reasonable promptness" in examining the statement or the checks to determine whether a payment was fraudulent by reason of an alteration or a forged signature.[45] If the customer should have reasonably discovered the fraud based on the statement, the customer is required to "promptly" notify the bank of the fraud.[46] However, if the bank proves both that the customer failed to comply with this requirement and that the bank suffered a loss because of the customer's failure to report the fraud promptly, the customer is precluded from asserting the fraud.[47]

42. *See, e.g.*, U.C.C. § 4-406(c).
43. *Id.* § 4-406.
44. *See id.* § 4-406 cmt. 2.
45. *Id.* § 4-406.
46. *Id.* § 4-406(c).
47. *Id.* § 4-406(c)–(d)(1).

Thus, the time allowed with respect to a single or the first in a series of fraudulent checks is, firstly, "reasonable promptness" in examining the statement, and secondly, notification "promptly" after the discovery of the fraud.[48] The concept of "promptness"—as opposed to any finite period—applies.[49]

With respect to any subsequent fraudulent check perpetrated by the same wrongdoer before the bank is notified of the fraud, the customer must report the activity to the bank within a "reasonable period of time," but that period may not exceed thirty days.[50] Thus, the thirty-day period is the maximum allowable period for reporting the second or subsequent check.

If the customer is liable for failing to comply with these requirements, but proves that the bank failed to exercise ordinary care and that this failure substantially contributed to the loss, the comparative fault rule applies.[51] The loss is allocated between the bank and the customer "according to the extent to which the failure of the customer [to report the fraud] and the failure of the bank to exercise ordinary care contributed to the loss."[52] If the customer proves, however, that the bank did not pay the check in good faith, the customer is not precluded for failing to report, and the bank is wholly liable for the loss.[53]

These obligations and the preclusion of the customer described above are sometimes referred to by practitioners collectively as the "thirty-day rule," and the notice periods under the rule as the "thirty-day period." These terms are convenient but misleading. With respect to a single check or the first fraudulent check, the customer simply must act with reasonable promptness in examining the statement and reporting the fraud.[54] With respect to any subsequent fraudulent check perpetrated by the same wrongdoer, the time allowed is not thirty days but instead, the lesser of a reasonable period or thirty days.[55] The Official Comment to section 4-406

---

48. *Id.* § 4-406(c).
49. *See id.* § 4-406 cmt. 2.
50. *Id.* § 4-406(d)(2).
51. *Id.* § 4-406(e).
52. *Id.*
53. *Id.*
54. *Id.* § 4-406(c).
55. *Id.* § 4-406(d)(2).

explains why the thirty-day period applicable to the subsequent fraudulent check *does not of necessity apply to a single or the first fraudulent check*:

> One of the most serious consequences of failure of the customer to comply with the requirements of subsection (c) is the opportunity presented to the wrongdoer to repeat the misdeeds. Conversely, one of the best ways to keep down losses in this type of situation is for the customer to promptly examine the statement and notify the bank of an unauthorized signature or alteration so that the bank will be alerted to stop paying further items. Hence, the rule of subsection (d)(2) is prescribed, and to avoid dispute a specific time limit, 30 days, is designated for cases to which the subsection applies. *These considerations are not present if there are no losses resulting from the payment of additional items. In these circumstances, a reasonable period for the customer to comply with its duties under subsection (c) would depend on the circumstances [section 1-205]* and the subsection (d)(2) time limit should not be imported by analogy into subsection (c).[56]

2. One-Year Statute of Repose

The second set of reporting requirements, contained in section 4-406(f), constitutes the Article 4 one-year "statute of repose." The customer may not assert fraud after one year has elapsed from the date that either the statement or the checks are made available to the customer, irrespective of either the customer or the bank's care or lack of care.[57]

3. Comparing the Requirements and Shortening the Notice Periods

May the thirty-day and one-year time periods be shortened? The answer is yes. The courts have consistently so held, even as applied to customers that are consumers.[58]

---

56. *Id.* § 4-406 cmt. 2 (emphasis added).

57. *Id.* § 4-406(f).

58. *See, e.g.*, Mercantile Bank of Ark. v. Vowell, 117 S.W.3d 603, 612 (Ark. Ct. App. 2003) (enforcing a thirty-day limit); W.J. Miranda Constr. Corp. v. First Union Nat'l Bank, 40 U.C.C. Rep. Serv. 2d 8, 13 (Fla. Cir. Ct. 1999) (allowing one-year period to be shortened to sixty days); Cross Creek Invs., Inc. v. First State Bank, 44 U.C.C. Rep. Serv. 2d 827, 832 (Tex. App. 2001) (holding a reduction of the thirty-year period to fourteen days to be enforceable); Borowski v.

The policy underlying the thirty-day rule is to alert the bank to the possibility of subsequent attempts at fraud by the same wrongdoer.[59] The customer's obligations under the thirty-day rule are thus tantamount to an obligation to exercise ordinary care. If the bank and the customer both fail to exercise ordinary care, the comparative fault of the parties is determined, and liability is apportioned between the bank and the customer to the extent which the conduct of the parties contributed to the loss.[60] The thirty-day rule with the comparative fault provision may be said to be "negligence-based" as to the conduct of both parties.

By contrast, the policy underlying the statute of repose is to prevent stale claims and avoid assertions by the customer that may be difficult to prove or disprove due to the passage of time.[61] Accordingly, the one-year statute of repose applies "[w]ithout regard to care or lack of care of either the customer or the bank."[62]

The difference in the application of the thirty-day rule and the statute of repose seems clear. When the customer fails to report the unauthorized item within the thirty-day period, the bank may assert that the customer is precluded from objecting to the item. However, the customer may in turn assert that the bank failed to exercise ordinary care, thereby invoking the comparative fault provisions of section 4-406(e). If, on the other hand, the customer fails to report the item within the one-year period under the statute of repose, the customer is precluded from objecting to the item *and is not allowed to invoke the comparative fault provisions.*

Section 4-406 does not offer any guidance, however, as to how a court should apply these provisions when the bank and the customer have reduced the notice period by agreement. Suppose, for example, that a deposit agreement requires the customer to give notice of any unauthorized item within fourteen days after the date of the bank

---

Firstar Bank Milwaukee, 579 N.W.2d 247, 252–53 (Wis. Ct. App. 1998) (concluding the fourteen-day period was not "manifestly unreasonable").

59. *See* U.C.C. § 4-406 cmt. 2.

60. *Id.* § 4-406(e).

61. *See, e.g.*, Falk v. N. Trust Co., 763 N.E.2d 380, 384 (Ill. App. Ct. 2001) (noting that section 4-406(f) "evidenced a public policy in favor of imposing on customers the duty of prompt examination of their bank accounts and the notification to banks of forgeries and alterations and in favor of reasonable time limitations on the responsibility of banks for payment of forged, altered or unauthorized items").

62. U.C.C. § 4-406(f).

statement. Is the fourteen-day period enforceable against the customer? If so, is the period enforceable as a reduction of the thirty-day period (allowing the customer to assert the bank's negligence) or as a reduction of the statute of repose (not allowing the customer to assert the bank's negligence)? Would the results be the same if the period were reduced to three days—or even one day?

In *Borowski v. Firstar Bank*,[63] the court enforced a fourteen-day notice period, treating the period as a shortening of the one-year period under the statute of repose.[64] The *Borowski* court noted that while section 4-103(a) prohibits disclaimers of the bank's responsibility to act in good faith and exercise ordinary care, it does allow the parties to establish "standards by which [the bank's] responsibility is to be measured," provided the standards "are not manifestly unreasonable."[65] The *Borowski* court also noted that four states have passed non-uniform versions of Article 4 that shorten the one-year period.[66]

The *Borowski* decision, however, is questionable. Neither the shortening of the one-year period by the parties in the deposit agreement nor by the four state legislatures supports a determination that the fourteen-day period is a "reasonable" one. While periods of sixty and 180 days may be commonly thought of as reasonable, a much shorter period, such as a period of only fourteen days, may certainly be regarded by some as "manifestly unreasonable." A dissenting judge in *Borowski* stated that the fourteen-day period failed the "manifestly unreasonable" test based "not only on the limited authorities, but on unlimited common sense as well."[67]

---

63. 579 N.W.2d 247 (Wis. Ct. App. 1998).

64. *Id.* at 252–53. *See also* Nat'l Title Ins. Corp. Agency v. First Union Nat'l Bank, 559 S.E.2d 668, 672 (Va. 2002) (enforcing a sixty-day reporting period and commenting that the period is not "manifestly unreasonable"); Am. Airlines Employees Fed. Credit Union v. Martin, 29 S.W.3d 86, 92–93, 99 (Tex. 2000) (enforcing a sixty-day reporting requirement applicable to "journal vouchers" as items used by bank clerks to evidence instructions to transfer funds out of the depositor's account); Parent Teacher Ass'n, Pub. Sch. 72 v. Mfrs. Hanover Trust Co., 524 N.Y.S.2d 336, 340 (N.Y. Civ. Ct. 1998) (enforcing a fourteen-day reporting requirement against a Parent Teacher Association).

65. *Borowski*, 579 N.W.2d at 249 n.3 (quoting WIS. STAT. § 404.103(1) (1995)).

66. *See id.* at 252 (noting that Alabama, Oregon, Georgia, and Washington have all made "substantial reductions" to the one-year period).

67. *Id.* at 254 (Schudson, J., concurring in part and dissenting in part); *see also* Neil O. Littlefield, *Payments: Articles 3, 4, and 4A*, 54 BUS. LAW. 1865, 1877–78 (1999) (discussing the unreasonableness of shortened periods). The apparent unreasonableness of the shortened period in *Borowski* may have contributed to the suggestion that the agreement to reduce the period to

The NCCUSL drafters of the UCC have traditionally adopted the view, perhaps wisely, that legislative reform constituting consumer protection is better drafted by consumer protection legislators than by UCC Law Commissioners.[68] However, a draft circulated by the Drafting Committee in 2001 included an amendment to section 4-406 that would have made any shortening of the one-year period of the statute of repose to a period of less than three months unenforceable against a consumer.[69] Although the Reporter's Note emphasizes that the provision "is included solely as a basis for further discussion by the Drafting Committee,"[70] a March 2, 2001 memorandum to the Drafting Committee by the chair and the reporter noted "[t]here is considerable support on the Drafting Committee for an amendment that would reverse existing case law and provide that, as to consumer accounts, the statute of repose in UCC [section] 4-406(f) {Section 4-406(g) of the March 2001 draft} cannot be altered by contract to a period of less than three months."[71]

Pending possible consumer protection additions to the retail banking laws, short-period reporting requirements that have the effect of allowing banks to contract out of their liability for fraudulent checks seem to be enforceable.

D. Liability of Collecting Banks

In addition to the liability of payor banks for fraudulent checks, discussed above, collecting banks may become liable or accountable for forged checks. While no bank may disclaim its obligations to act in good faith or exercise ordinary care, the liability of banks that take a check for collection, like that of payor banks, may otherwise be disclaimed under UCC Articles 3 and 4.

---

fourteen days might have constituted a contract of adhesion. *Borowski*, 579 N.W.2d at 250 n.4. However, since the plaintiff failed to argue adhesion, the court did not discuss or decide the issue, noting, "[w]e leave these issues for another day." *Id.*

68. For a critique of the general disregard of consumer protection interests in the UCC "Payment" Articles (Articles 3, 4, and 4A), see Edward L. Rubin, *The Code, the Consumer, and the Institutional Structure of the Common Law*, 75 WASH. U. L.Q. 11 (1997).

69. *See* U.C.C. § 4-406(g) (March 2001 Draft) (stating that "any agreement that shortens [the one-year] period to a time less than three months shall be deemed to be an agreement to shorten that period to three months").

70. *Id.* § 4-406 reporter's note 3.

71. Memorandum from Edwin E. Smith & Ronald J. Mann to the Drafting Committee to Revise Payment Articles of the UCC, Observers and Advisers (Mar. 2, 2001) (on file with Loyola of Los Angeles Law Review).

Under section 4-214(a), for example, a depositary bank has the right to revoke its provisional settlement for a check, charge back for the credit, or obtain a refund from the depositor.[72] However, these rights are limited. If the bank delays beyond its midnight deadline, or longer than a reasonable time after it learns of the facts before returning the item or sending notice of the facts, the bank retains the charge-back rights but becomes liable for the loss resulting from the delay.[73]

In *Lema v. Bank of America*,[74] Lema maintained two business accounts at Bank of America.[75] A friend of Lema deposited a check into one of these accounts after altering the amount of the check from $3,000 to $63,000.[76] The bank processed the check, received payment for $63,000, and credited the account in that amount.[77] Lema, unaware of the alteration, withdrew the $63,000 and gave or credited the proceeds to his friend.[78] When the payor bank later notified Bank of America of the alteration, the bank debited both of Lema's accounts to try to recover its payment.[79] Lema sued the bank to recover the debits.[80]

Lema based his suit on section 4-214(a).[81] Bank of America had delayed in returning the check both beyond the bank's midnight deadline and beyond a reasonable time after the bank learned of the alteration.[82] Lema argued that the bank was thus precluded from debiting his accounts under section 4-214(a).[83]

Lema also argued that he could not be liable for the check because he never indorsed it.[84] Section 3-401 states that a person is not liable on an instrument unless the person signed the instrument or

72. *See* U.C.C. § 4-214(a) (2003).
73. *Id.*
74. 826 A.2d 504 (Md. 2003).
75. *Id.* at 505.
76. *Id.* at 505–06.
77. *Id.* at 506.
78. *Id.* at 506–07.
79. *Id.* at 506.
80. *Id.*
81. *Id.* at 508.
82. *Id.* at 523 (Harrell, J., dissenting).
83. *See id.* at 508.
84. *Id.*

an authorized representative has signed on the person's behalf.[85]

In addition, Lema argued that he could not be liable under the transfer warranties of the UCC because he was not a transferor.[86] Section 4-207(a)(3) provides that when a bank customer transfers an item to the bank and receives consideration, the customer warrants to the bank that, among other things, "the item has not been altered."[87] In this case, however, it was Lema's friend, not Lema, who had transferred the item to the bank.[88]

Despite Lema's arguments, the Court of Appeals of Maryland enforced the following disclaimer in the deposit agreement against Lema:

> Unless prohibited by applicable law or regulation, we also reserve the right to charge back to your account the amount of any item deposited to your account or cashed for you which was initially paid by the payor bank and which is later returned to us due to an allegedly forged, unauthorized or missing endorsement, claim of alteration, encoding error or other problem which in our judgment justifies reversal of credit.[89]

The court explained that the phrase "unless prohibited by applicable law" did not apply to the bank's liability for the check under section 4-214(a), and held that the disclaimer in the deposit agreement was not a disclaimer of the bank's obligations to act in good faith and exercise ordinary care.[90] The disclaimer thus constituted a permissible variation by agreement of the liability of the bank under section 4-214.

E. Consequential Damages

In addition to the general damages available and disclaimable under UCC Articles 3 and 4, consequential damages are available to the bank's customer.[91] However, these damages may be disclaimed (i) when the bank, without justification, refuses to pay a cashier's,

85. U.C.C. § 3-401 (2003).
86. *Lema*, 826 A.2d at 508.
87. U.C.C. § 4-207(a)(3).
88. *Lema*, 826 A.2d at 506.
89. *Id.* at 505.
90. *Id.* at 513–14.
91. *See* U.C.C. § 3-411.

teller's, or certified check under section 3-411,[92] or (ii) when the bank wrongfully dishonors a check that is properly payable under section 4-402(b).[93] A bank would be well advised to disclaim liability for these damages.

III. UCC ARTICLE 4A

The drafters sought to balance the liability provisions of Article 4A between the competing interests in the funds transfer system, such as those between the banks and the users of the system.[94]

> In the drafting of Article 4A, a deliberate decision was made to write on a clean slate and to treat a funds transfer as a unique method of payment to be governed by unique rules that address the particular issues raised by this method of payment. . . .
>
> Funds transfers involve competing interests—those of the banks that provide funds transfer services and the commercial and financial organizations that use the services, as well as the public interest. These competing interests were represented in the drafting process and they were thoroughly considered. The rules that emerged represent a careful and delicate balancing of those interests and are intended to be the exclusive means of determining the rights, duties and liabilities of the affected parties in any situation covered by particular provisions of the Article.[95]

In balancing the interests of parties to funds transfers, the UCC drafters' goal was to maintain the speed, efficiency, and security of wholesale wire transfers while maintaining the low cost of their transmission.[96] To attain this goal, the drafters designed the legislation to minimize the risk of loss to the transmitting and receiving banks.[97] Thus, the legislation favors the banks by severely limiting their liability in provisions relating to (i) the acceptance of

92. *Id.* § 3-411(b).

93. *Id.* § 4-402(b).

94. *Id.* § 4A-102 cmt.

95. *Id.*

96. *See* Stephen C. Veltri, Marina I. Adams & Paul S. Turner, *Payments*, 58 BUS. LAW. 1575, 1596 (2003); Hyung J. Ahn, Note, *Article 4A of the Uniform Commercial Code: Dangers of Departing from a Rule of Exclusivity*, 85 VA. L. REV. 183, 188–89 (1999).

97. *See* Veltri, Adams & Turner, *supra* note 96, at 1596.

payment orders, (ii) improperly executed payment orders, (iii) fraudulent payment orders, and (iv) the availability of damages.

To achieve a degree of balance on behalf of the users, the drafters specified that banks cannot disclaim their liability under the unauthorized funds transfer provisions and certain other provisions in their funds transfer agreements with their customers.

> Article 4-A was intended, in significant part, to promote finality of banking operations and to give the bank relief from unknown liabilities of potentially indefinite duration. This legislative purpose does not suggest that those interests alter (or should alter) the statute's fine-tuned balance between the customer and the bank as to who should bear the burden of unauthorized transfers.[98]

As a result, despite the UCC's policy favoring freedom of contract, Article 4A limits the ability of banks to disclaim their liabilities. The discussion below examines the Article 4A liabilities that clearly may not be disclaimed and liabilities under ambiguous provisions that the drafters may have intended to not be disclaimable.

A. Liabilities that May Not Be Disclaimed

Section 4A-501 states that rights and obligations under Article 4A may be varied by agreement "[e]xcept as otherwise provided in this Article."[99] In Article 4A, the the bank's ability to contract out of liability arises in connection with (i) the bank's improper execution of payment orders, (ii) the non-completion of a funds transfer, (iii) unauthorized payment orders, (iv) the bank's erroneous execution of payment orders, (v) the obligation of the beneficiary's bank to pay the beneficiary, and (vi) the obligation of the beneficiary's bank to pay consequential damages.[100]

1. Improper Execution

Under section 4A-305, "improper"[101] execution of a payment

98. Regatos v. N. Fork Bank, 838 N.E.2d 629, 633 (N.Y. 2005) (internal citation omitted).

99. U.C.C. § 4A-501.

100. *See* discussion *infra* Part III.A.1–6.

101. "Improper" execution is distinguished in the captions of Article 4A from "erroneous" execution. *Compare* U.C.C. § 4A-305 ("Liability for Late or Improper Execution"), *with id.* § 4A-303 ("Erroneous Execution of Payment Order"). A receiving bank's maladroit execution of a sender's payment order could constitute both erroneous execution under section 4A-303 and improper execution under section 4A-305. *See id.* §§ 4A-303, 4A-305. There is a degree of

order by the bank includes (a) the execution of an order that results in a delay in payment to the beneficiary,[102] and (b) the execution of an order that results in (i) non-completion of the transfer, (ii) failure to use the intermediary bank designated by the originator, or (iii) the issuance of a payment order contrary to the terms of the originator's payment order.[103]

A bank cannot disclaim liability for improper execution under the circumstances described above.[104] The liability of the bank under these circumstances, however, is severely limited; only interest, transactional damages, and incidental damages are recoverable.[105] Additional damages for improper execution, including consequential damages, are not recoverable unless the parties have agreed otherwise.[106]

Improper execution also includes the bank's failure to execute a customer's payment order that the bank was expressly obliged to execute.[107] The bank may be liable under these circumstances for the sender's transaction expenses, incidental expenses, and limited interest losses.[108] The bank will not be liable for additional damages except as otherwise agreed,[109] and the bank's liability for these amounts may be disclaimed.[110]

2. The "Money-Back Guarantee": Non-Completion of a Funds Transfer

When the payment order goes astray or is otherwise not properly completed, and the funds are not returned to the customer, the sender is not obliged to pay for the order; if the sender has already paid, the sender is entitled to a refund.[111] These provisions are known as the

overlap between the "improper" execution provisions of section 4A-305 and the "erroneous" execution provisions of section 4A-303; these sections also overlap with the "money-back guarantee" provisions of section 4A-402(c) and (d). *See id.*; *see also id.* § 4A-402(c)–(d).

102. *Id.* § 4A-305(a).

103. *Id.* § 4A-305(b).

104. *Id.* § 4A-305(f).

105. *Id.* § 4A-305(a)–(b).

106. *Id.* § 4A-305(a)–(c). Attorneys' fees may also be recoverable. *Id.* § 4A-305(e).

107. *Id.* § 4A-305(d).

108. *Id.*

109. *Id.*

110. *See id.* § 4A-305(f) (stating that only the liability of a receiving bank under subsections (a) and (b) may not be varied by agreement).

111. *Id.* § 4A-402(c)–(d).

"money-back guarantee."[112] The bank cannot disclaim its liability under the money-back guarantee.[113]

The money-back guarantee provisions of section 4A-402 are related to and overlapped by the provisions that allow the sender to recover its funds when the bank has erroneously executed the sender's payment order.[114]

3. Unauthorized Payment Orders

The bank is liable for unauthorized payment orders and losses resulting from fraudulent funds transfers when:

(i) the bank and the customer have not agreed that the bank will use a security procedure that is "commercially reasonable," or they have agreed on such a procedure, but the bank has not complied with it;

(ii) the bank has accepted a payment order in bad faith or contrary to the customer's written instructions restricting the acceptance of payment orders; or

(iii) the customer can prove that the perpetrator of the fraud was an "interloper," that is, somebody not connected with the customer's payment operations (such fraud is referred to below as "interloper fraud").[115]

The allocation of liability described above is achieved under sections 4A-202(b), 4A-203(a)(2), and 4A-204(a). Under section 4A-202(b), a payment order accepted in good faith and in compliance with both a commercially reasonable security procedure and the customer's instructions is "effective as the order of the customer, whether or not authorized."[116] Under section 4A-203(a)(2), the bank is "not entitled to enforce" a payment order when the customer can prove that the order was issued by an "interloper."[117] Under section 4A-204(a), when an unauthorized payment order is neither effective as an order of the customer nor enforceable against the customer, the bank must refund any payment

112. *Id.* § 4A-402 cmt. 2.
113. *Id.* § 4A-402(f).
114. *See infra* Parts III.A.4, III.B.
115. *See* U.C.C. §§ 4A-202(b), 4A-203(a)(2), 4A-203 cmts. 3, 5 (2003).
116. *Id.* § 4A-202(b).
117. *Id.* § 4A-203(a)(2).

of the order received by the bank, including interest.[118] The customer loses its entitlement to interest, however, when it fails to exercise ordinary care both to determine that the order was not authorized, and to report the order within a "reasonable time," not to exceed ninety days after the customer was notified that the order was accepted or that the customer's account was debited for the order.[119]

The bank's liability for the principal amount of fraudulent funds transfers under these provisions may not be disclaimed.[120] However, under section 4A-204(b), the "reasonable time" allowed to the customer for reporting the unauthorized transfer in order to retain its entitlement to interest may be fixed by agreement.[121]

4. Erroneous Execution of Payment Orders: Payment to the Wrong Person

The bank is liable for its own errors and seemingly cannot disclaim liability when, as a result of its error, funds are transferred to the wrong person.[122] When the bank erroneously sends funds to a person that is not the beneficiary designated in the sender's order, the sender is excused from its obligation to pay the bank.[123] All previous senders in the funds transfer chain are also excused from the obligation to pay for their payment orders.[124]

A sender's obligation to pay for its payment order when erroneous execution results in payment to the wrong person is excusable under the money-back guarantee provisions of section 4A-402, as well as the erroneous execution provisions of section 4A-303(c). The sender's obligation to pay is excused under section 4A-402(c) if the transfer is not completed by the acceptance of the beneficiary's bank of a payment order instructing payment "to the

118. *Id.* § 4A-204(a).

119. *Id.*

120. *Id.* § 4A-204(b).

121. *See id.* § 1-302(b) (explaining that when the UCC requires any action to be taken within a reasonable time, any time that is not "manifestly unreasonable" may be fixed by agreement).

122. *See id.* § 4A-303(c); *see also id.* § 4A-505 cmt. (implying that the receiving bank's obligation to refund a payment when the bank erroneously executes a payment order may not be varied by agreement).

123. *Id.* § 4A-303(c).

124. *Id.* Erroneous execution under section 4A-303 also occurs when funds are erroneously transferred from the sender's account by reason of (i) the bank's issuance of a duplicate payment order, or (ii) the bank's transfer in an amount different from the amount of the sender's payment order. *See id.* §§ 4A-303(a)–(b). These kinds of errors are discussed *infra* Part III.B.

beneficiary of that sender's payment order."[125] The bank's liability for this type of error cannot be disclaimed.[126]

5. Obligation of the Beneficiary's Bank to Pay the Beneficiary

The bank must pay the beneficiary after the beneficiary's bank accepts a payment order, unless the bank has already done so.[127] The bank must allow the credit to be withdrawable by the beneficiary as of right.[128]

Once the beneficiary's bank has paid the beneficiary, the bank cannot recover the funds.[129] The payment is irretrievable, even if it was made in the form of a "loan" or if the beneficiary agreed to repay the funds should the bank not receive payment from the sender of the payment order.[130] The bank may not disclaim its obligation to pay the beneficiary and refrain from retrieving the payment, and any agreement to the contrary is not enforceable by the bank against the beneficiary.[131]

6. Obligation of the Beneficiary's Bank to Pay Consequential Damages

Article 4A equates the position of the beneficiary, after the beneficiary's bank accepts the payment order, to the position of the holder of a cashier's, teller's, or certified check under Article 3. Just as a holder of these types of checks is entitled to be paid and may claim consequential damages if not paid,[132] the beneficiary is allowed to recover consequential damages from the beneficiary's bank under Article 4A.[133]

The beneficiary may recover consequential damages from the beneficiary's bank if, after accepting a payment order, the

125. *Id.* § 4A-402(c).

126. *Id.* § 4A-402(f).

127. *Id.* § 4A-404(a).

128. *See id.* §§ 4A-404(a), 4A-405(a).

129. *Id.* § 4A-405 cmt. 2.

130. *Id.*

131. *Id.* §§ 4A-404(c), 4A-405 cmt. 2. A funds transfer may be excepted from the rule that credits to the beneficiary cannot be provisional if a funds transfer system rule so provides. *Id.* § 4A-405(d). The transfer may also be excepted pursuant to a net settlement system with a loss-sharing agreement among its participants. *See id.* § 4A-405(e).

132. *Id.* § 3-411.

133. *Id.* § 4A-404(a).

beneficiary's bank fails to pay the beneficiary when the beneficiary both demands payment and gives the bank notice of the circumstances that may result in consequential damages.[134] However, the beneficiary's bank can avoid paying consequential damages if it can prove that it had "a reasonable doubt concerning the right of the beneficiary to payment."[135] The obligation of the beneficiary's bank to pay consequential damages may not be disclaimed by the bank in an agreement between the bank and the beneficiary.[136]

B. Erroneous Execution of Payment Orders: Excessive and Duplicate Payments

As noted above, a bank cannot disclaim liability under the erroneous execution provision of section 4A-303(c) when, as a result of the bank's error, funds are transferred to the wrong person.[137] In addition to payment to the wrong person, section 4A-303 applies to duplicate payment orders (i.e., the bank executes the same order twice) and to payment orders issued in an excessive or deficient amount (i.e., the bank executes a $10,000 order for $100,000).[138] Whether the bank is allowed to disclaim its liability for these kinds of errors is ambiguous under Article 4A.[139]

Under the money-back guarantee provision of section 4A-402(d), when the sender of a payment order pays the order but "was not obliged to pay all or part of the amount paid," the bank must refund payment to the sender in the amount that the sender was not obliged to pay.[140] Section 4A-303(a) and (b) stipulate that the amount that the sender of a payment order is "not obliged to pay" is the amount of the duplicate order or the amount of the excess over the sender's order.[141]

---

134. *Id.*

135. *Id.*

136. *Id.* § 4A-404(c).

137. *See supra* Part III.A.4.

138. *See id.* § 4A-303(a)–(b).

139. Under section 4A-205, the bank may be liable for an error committed by the customer if the bank fails to comply with a security procedure for the detection of errors. *Id.* § 4A-205. That liability, however, may be and is typically disclaimed by the bank in the funds transfer agreement. *See id.* § 4A-205 cmt. 3.

140. *Id.* § 4A-402(d).

141. *See id.* § 4A-303(a)–(b).

The sender's rights under the money-back rule of section 4A-402(d) cannot be varied by agreement of the parties.[142] Thus, taking together sections 4A-303 and 4A-402, it would seem that the bank is not allowed to disclaim its liability for a refund to the sender when the bank has issued a duplicate payment order or a payment order in an excessive amount.

The ambiguity nevertheless exists because Article 4A does not expressly forbid a variation of the bank's liability under section 4A-303. Although the bank's liability for errors may not be waived under section 4A-402, it appears that its liability may be disclaimed under section 4A-303(a) and (b), unless the disclaimer is forbidden under section 4A-402.[143]

For the two reasons set forth below, it is the better view that the bank cannot disclaim its liability under section 4A-303(a) and (b).

First, the wording of section 4A-402(c) may be construed as generally applicable to all types of errors. As noted above, the sender is excused under section 4A-402(c) if the funds transfer is not completed by the acceptance by the beneficiary's bank of "a payment order instructing payment to the beneficiary of that sender's payment order."[144] The quoted phrase clearly excuses the sender's payment obligation when the funds are transferred by the bank to the wrong person. However, the quoted phrase is also subject to another interpretation.

When the *sender* sends an order that the receiving bank executes twice or in an excessive amount, then the order that is accepted by the beneficiary's bank is not *that sender's* order. Instead, the beneficiary's bank has failed to accept "a payment order instructing payment to the beneficiary *of that sender's payment order*."[145] Thus, if the sender sends an order to pay the beneficiary $10,000, but the receiving bank sends an order to pay $100,000, the $100,000 order is not literally "that sender's payment order." The sender's obligation to pay the receiving bank would accordingly be excused under the quoted wording of section 4A-402(c), as well as under the wording in section 4A-402(d), which excuses the sender from paying amounts that the sender was not obliged to pay.

---

142. *Id.* § 4A-402(f).

143. *See* Turner, *supra* note 5, at 366–67.

144. U.C.C. § 4A-402(c).

145. *Id.* (emphasis added).

Second, there are indications that the drafters of Article 4A intended to prohibit variation of the bank's obligations under section 4A-303(a) and (b). The legislative history, the statutory scheme, and the Official Comments of Article 4A all support this interpretation.

As explained above, Article 4A strictly limits the liability of a bank and the amount of damages available from a bank. Article 4A also limits a bank's ability to disclaim liabilities under the Article by prohibiting disclaimers of a bank's liability (i) for improper execution,[146] (ii) under the money-back guarantee,[147] and (iii) for unauthorized funds transfers.[148] The intended legislative balance between the banks and the users of the funds transfer system is, arguably, better achieved if the prohibition on disclaimers applies to erroneous execution under section 4A-303 as well.

The Official Comment to section 4A-304 notes that the section is "identical in effect" to section 4A-204, which states that the bank's liability for unauthorized transfers may not be varied by agreement.[149] The Official Comment to section 4A-505 states that a "similar analysis" of the bank's liability for unauthorized payment orders under the money-back guarantee applies to the bank's erroneous execution of a payment order under section 4A-303.[150] The latter Comment appears to indicate that the drafters intended that receiving banks may not disclaim their liability for erroneous execution.

The Drafting Committee's 2001 draft adopted the view that a bank's liability for errors under section 4A-303 cannot be disclaimed.[151] The draft included a new section, 4A-303(d), which stated that rights and obligations arising under this section may not be varied by agreement.[152]

146. U.C.C. § 4A-305(f).

147. *Id.* § 4A-402(f).

148. *Id.* §§ 4A-202(f), 4A-204(b).

149. *See id.* §§ 4A-204, 4A-304 cmt.

150. *See id.* § 4A-505 cmt.

151. U.C.C. § 4A-303(d) (March 2001 Draft).

152. *Id.* The Reporter's Note states that "[t]he new subsection (d) is intended to clarify that the allocation of responsibility for erroneous execution of a payment order cannot be altered by agreement. The same result is implicit in existing law under Section 4A-402(c) & (f)." *Id.* § 4A-303 reporter's note 1.

C. Liability Disclaimers

Despite the provisions described above that expressly forbid banks from disclaiming certain liabilities under Article 4A, banks nevertheless typically disclaim these liabilities. In their disclaimers, banks use:

(i) broad general indemnity provisions that purport to cover all or nearly all of the liabilities arising out of the bank's provision of funds transfer services;

(ii) provisions that impose additional duties on the customer, the breach of which would purport to shift liability from the bank to the customer;

(iii) other forms of indirect disclaimers or broad agreements to pay, which have the effect of disclaiming the bank's liabilities;

(iv) partial disclaimers, which exclude from coverage the liability the bank might typically incur; and

(v) agreements pursuant to section 4A-202(c) regarding security procedures that may be less than commercially reasonable.[153]

Samples of typical disclaimers used by banks are set forth below.

1. Broad Indemnities

A broad indemnity generally disclaims the bank's responsibility for all obligations and liabilities arising out of the agreement. An example of a broad indemnity is set forth below:

> The Customer shall indemnify the Bank, its officers, directors, agents and employees (each an "Indemnitee") and hold each Indemnitee harmless from and against any and all liabilities, obligations, actions, suits, costs, expenses, losses, damages, or other claims, including reasonable attorneys' fees and litigation costs, of whatever nature, arising out of or relating to the performance by the Bank of funds transfer services under this Agreement.

Such a broad indemnity conflicts with the provisions that forbid disclaimers by purporting to disclaim the bank's liability for the improper execution of payment orders, the failure to properly complete funds transfers, unauthorized payment orders, the erroneous execution of payment orders, and consequential damages.

---

153. *See* discussion *infra* Part III.C.1–5.

Therefore, the indemnity would not be enforceable.

2. The Imposition of Additional Customer Duties

By imposing additional duties on the customer, such as confidentiality, as well as those attributable to the customer when the customer seeks to prove interloper fraud,[154] the bank purports to shift liability to the customer for an unauthorized payment order when the customer has not complied with these additional duties. The following disclaimer appears in a Sample ODFI-Originator Agreement contained in the National Automated Clearing House Association ("NACHA") Operating Guidelines:

> Company is strictly responsible to establish and maintain the procedures to safeguard against unauthorized transmissions. Company warrants that no individual will be allowed to initiate transfers in the absence of proper supervision and safeguards, and agrees to take reasonable steps to maintain the confidentiality of the security procedures and any passwords, codes, security devices and related instructions provided by Financial Institution in connection with the security procedures described in Schedule B. If Company believes or suspects that any such information or instructions have been known or accessed by unauthorized persons, Company agrees to notify Financial Institution immediately followed by written confirmation.[155]

3. Indirect Disclaimers: Broad Agreements to Pay

Broad indemnities and provisions imposing additional duties on the customer, described above, are forms of indirect disclaimers. An indirect disclaimer typically does not use normative terms, such as "liability," "obligation," "fault," or "error."

Another common form of indirect disclaimer is a broad agreement to pay for all payment orders:

> The Customer agrees to pay the Bank the amount of all payment orders issued by the Bank in the execution of

154. The customer must prove that the interloper did not "obtain[] access to transmitting facilities of the customer" or obtain "from a source controlled by the customer . . . information facilitating breach of the security procedure." U.C.C. § 4A-203(a)(2).

155. NACHA OPERATING GUIDELINES 2.1.30 (2006) (Sample ODFI-Originator Agreement ¶ 2(b)).

> payment orders purporting to be the payment orders of the Customer.

In the following variation, the customer is made liable for all payment orders accepted in compliance with the agreed upon security procedure:

> Bank and Customer agree to use a unique Wire Transfer Authorization Code as the security procedure. Customer's Authorized Representative shall provide Bank with a unique Wire Transfer Authorization Code when initiating, amending or canceling a Wire Transfer Request. Bank may execute any Wire Transfer Request where Bank is provided a Wire Transfer Authorization Code properly assigned to Customer's account, thereby assuming that such Wire Transfer Request is authorized. Customer is responsible and assumes all liabilities in connection with an Order where a valid Wire Transfer Authorization Code is used.

Of course, the above disclaimers would not be enforceable in cases where a security procedure was not commercially reasonable, the bank failed to act in good faith or in compliance with the customer's instructions, or there was interloper fraud.

In the following variation, the bank limits its damages to a nominal amount:

> The liability of the Bank in connection with its execution of the Customer's payment orders shall not exceed the charges and fees paid by the Customer to the Bank for all funds transfer services rendered by the Bank during the three-month period preceding the month in which the payment order was executed by the Bank.

All of the disclaimers quoted above would be unenforceable to the extent that each conflicts with the prohibitions on disclaimers in Article 4A, including the prohibitions relating to the improper execution of payment orders, the non-completion of funds transfers, unauthorized payment orders, and the erroneous execution of payment orders.

4. Partial Disclaimers

In a partial disclaimer, the bank purports to accept responsibility for conduct in which the bank itself was at fault, but disclaims all other responsibilities. Typically, the bank purports to accept responsibility only for its own negligence, bad faith, or "willful misconduct," thereby indirectly excluding the liability allocated to the bank by Article 4A for the improper execution of payment orders, the non-completion of funds transfers, unauthorized payment orders, and the erroneous execution of payment orders.

The following provisions, for example, appear in the NACHA Sample ODFI-Originator Agreement:

> Financial Institution shall be responsible only for performing the services expressly provided for in this Agreement, and shall be liable only for its negligence or willful misconduct in performing those services.[156]

However, the foregoing disclaimer would not be effective to vary the bank's liability for the improper execution of payment orders, the non-completion of funds transfers, unauthorized payment orders, and the erroneous execution of payment orders.

The following disclaimer, which also appears in the NACHA Sample ODFI-Originator Agreement, relates to unauthorized payment orders:

> If an Entry (or a request for cancellation or amendment of an Entry) received by Financial Institution purports to have been transmitted or authorized by Company, it will be deemed effective as Company's Entry (or request) and Company shall be obligated to pay Financial Institution the amount of such Entry even though the Entry (or request) was not authorized by Company, provided Financial Institution accepted the Entry in good faith and acted in compliance with the security procedures referred to in Schedule B with respect to such entry.[157]

In this disclaimer, the bank accepts its responsibility to act in good faith and in compliance with the security procedure, but the customer otherwise accepts responsibility for fraudulent payment orders. Despite the disclaimer, the bank would be liable for a fraudulent transfer if the security procedure was not "commercially reasonable," if the bank failed to comply with the customer's written instructions restricting the acceptance of payment orders, or in the case of

156. *Id.* (Sample ODFI-Originator Agreement ¶ 14(a)).

157. *Id.* (Sample ODFI-Originator Agreement ¶ 3).

interloper fraud.[158]

5. Agreements Pursuant to Section 4A-202(c)

Section 4A-202(c) contemplates that some customers will be unwilling to pay for a commercially reasonable security procedure.[159] When that occurs, the section allows the bank to agree to a procedure that may not be commercially reasonable and still avoid liability for fraudulent transfers, despite the procedure's commercial unreasonableness.[160] The bank avoids liability, however, only if the customer has expressly consented to the procedure in writing.[161] The wording of the customer's consent is dictated by section 4A-202(c) and is typically as follows:

> The Bank has offered and the Customer has rejected the security procedure described on Exhibit A. The Customer has chosen instead the security procedure described on Exhibit B (the "Security Procedure"). The Customer agrees to be bound by any payment order, whether or not authorized, issued in its name and accepted by the Bank in compliance with the Security Procedure.

Two problems arise in connection with the use of section 4A-202(c) agreements. First, some banks use the agreements as a standard provision within their funds transfer agreements, rather than as an exception to the general rule. Second, the wording of the section 4A-202(c) agreement conflicts with the Article 4A provisions on interloper fraud.

a. Use of the section 4A-202(c) agreement as a standard provision

The section 4A-202(c) agreement should only be used under circumstances in which the bank has actually offered the customer a security procedure that is commercially reasonable, and the customer has rejected the proffered procedure and knowingly chosen a security procedure that may not be commercially reasonable. In other words, the bank should not attempt to apply the section 4A-202(c) exception to the general rule *in lieu of the general rule.*

158. *See* U.C.C. §§ 4A-202(b), 4A-203(a)(2) (2003).

159. *Id.* § 4A-202(c).

160. *Id.*

161. *Id.*

The last sentence of the section 4A-202(c) agreement sometimes appears as a standard provision in the bank's funds transfer agreement, shorn of the recitals that normally precede it. The literal result is a broad disclaimer of liability for unauthorized payment orders accepted in compliance with the security procedure:

> The Customer agrees to be bound by any payment order, whether or not authorized, issued in its name and accepted by the Bank in compliance with the Security Procedure.

It is not good practice, and reflects poorly on the bank's good faith, for the bank to incorporate the section 4A-202(c) agreement into its standard funds transfer agreement form. Nor is it good practice for the customer to agree to the section 4A-202(c) agreement except when (i) the customer has knowingly accepted the lesser security procedure, (ii) the section 4A-202(c) agreement contains the appropriate recitals, and (iii) the recitals are true.

b. Section 4A-202(c) agreements and interloper fraud

In agreeing "to be bound by any payment order, whether or not authorized, issued in its name and accepted by the bank," the customer would seem to literally agree to be liable for fraud perpetrated by an "interloper."[162] Under section 4A-203(a)(2), an interloper is a person who (i) was not entrusted to act for the customer with respect to either payment orders or the security procedure, or (ii) did not obtain access to the customer's transmitting facilities or to information facilitating a breach of the security procedure from a source controlled by the customer.[163] Section 4A-203(a)(2) provides that the bank is liable for losses caused by fraud when the customer can prove that the payment order was issued by an interloper.[164]

Suppose, for example, that the customer has agreed to use a security procedure that is less than commercially reasonable under section 4A-202(c). Fraud is perpetrated, and the customer can prove

162. *See id.* § 4A-202(c)(ii); *see also* THOMAS C. BAXTER, JR., STEPHANIE A. HELLER & PAUL S. TURNER, THE ABCS OF THE UCC: ARTICLE 4A: FUNDS TRANSFERS 67 (Amelia H. Boss ed., 2d ed. 2006) (explaining that the term "interloper" is commonly used by practitioners to describe a perpetrator of fraud who is not associated with the customer). The customer would also seem to be liable when the bank fails to act in good faith or in compliance with the customer's written instructions restricting the acceptance of payment orders. *See id.* § 4A-202(b).

163. *Id.* § 4A-203(a)(2).

164. *Id.*

that the wrongdoer is the president of the bank. The president would be an interloper under section 4A-203(a)(2), with the apparent result that the bank would be liable for the loss under that section. The bank, however, would seek to enforce the customer's agreement to be "bound by any payment order, whether or not authorized," as provided in the section 4A-202(c) agreement.[165] Whether or not the customer's agreement is enforceable under these circumstances is an ambiguity under Article 4A.[166]

The Drafting Committee's 2001 draft would have clarified this ambiguity by stating, in a Comment, that the section 4A-202(c) agreement only resolves the issue of commercial reasonableness and does not otherwise shift any liability to the customer, as follows:

> Subsection (c) [of section 4A-202] provides that a security procedure to which a customer agrees in specified circumstances is deemed to be commercially reasonable. Such an agreement resolves only the issue of commercial reasonableness. When the commercial reasonableness of the security procedure has no bearing on the issue of responsibility for a fraudulent order, that provision does not cause the customer's agreement otherwise to shift liability under the rules that apply to such orders. Thus, for example, the customer's agreement to be bound under subsection (c) would be subject to the rule that the bank is liable (as specified in subsection 4A-203(a)(ii)) for certain orders authorized by commercially reasonable security procedures, if the fraud is perpetrated by a person not associated with the customer's fund-transfer operations.[167]

D. Reporting Requirements

A reporting requirement in the funds transfer agreement obliges the customer to report an objectionable funds transfer to the bank within a specified period of time. The reporting requirement is not a disclaimer and does not directly vary the Article 4A liability rules. However, when the time allowed for reporting the objectionable

165. *Id.* § 4A-202(c)(ii).

166. *See* Turner, *supra* note 5, at 360–63.

167. U.C.C. § 4A-202 cmt. 1 (March 2001 Draft). I participated in the wording of the Comment and understand that the Reporter spoke to one of the Article 4A Reporters before incorporating the Comment into the draft.

transfer is a very brief period, the reporting requirement can shift liability to the customer, and thus, have virtually the same effect as a disclaimer.

1. Interest Entitlement

The bank is obliged to pay interest to the customer, *inter alia*, when the bank is liable to the customer in the principal amount of (i) an unauthorized funds transfer,[168] (ii) a payment order that the bank erroneously executes,[169] and (iii) a funds transfer that is not properly completed and is subject to the "money-back guarantee."[170] The customer loses entitlement to interest, however, when the customer fails to exercise ordinary care to determine that the order was not authorized or was erroneously executed, and fails to report the order within a "reasonable time" not exceeding ninety days after notice.[171]

While the bank's liability for these principal and interest amounts may not be directly disclaimed,[172] the bank's funds transfer agreement typically provides that the bank's liability is subject to the customer's compliance with a reporting requirement. With respect to the principal amount of the transfer, the New York Court of Appeals has held that a bank cannot enforce a provision in a funds transfer agreement that requires the customer to report an unauthorized funds transfer within a period that is less than the one-year period specified in section 4A-505, as discussed below.[173]

With respect to interest on the principal amount, however, the reporting requirement is statutory, and the statutory period of a reasonable time not to exceed ninety days may be varied by an agreement fixing any reasonable period other than ninety days.[174] Under section 1-302(b), when the UCC requires any action to be taken within a reasonable time, any time that is not "manifestly unreasonable" may be fixed by agreement.[175]

---

168. U.C.C. § 4A-204(a) (2003).

169. *Id.* § 4A-304.

170. *Id.* 4A-402(d). Unless otherwise agreed, the interest rate is an average of the Federal Funds rate of the New York Federal Reserve Bank. *Id.* § 4A-506(b).

171. *Id.* §§ 4A-204(a), 4A-304, 4A-402(d).

172. *Id.* §§ 4A-204(b), 4A-402(f). Whether the bank may disclaim its liability for erroneous execution involving duplicate or excessive payment orders is discussed *supra* Part III.B.

173. Regatos v. N. Fork Bank, 838 N.E.2d 629, 633 (N.Y. 2005), discussed *infra*.

174. *See* U.C.C. § 1-302(b).

175. *Id.*

2. The One-Year Statute of Repose

Section 4A-505, commonly known as the Article 4A "statute of repose,"[176] allows the customer a period of one year after notification to object to any payment order purporting to be the customer's order.[177] If the customer fails to object to an order that is disclosed in the customer's periodic bank statement within one year of receiving the statement, the customer is thereafter precluded from objecting to the bank being paid for that order.[178]

As a result, a customer who delays in objecting to a transfer until after the one-year period has expired is precluded from asserting the bank's liability for the transfer, even though the customer might have been entitled to hold the bank liable for the transfer under the nonvariable provisions of Article 4A, such as (i) the "money back guarantee,"[179] (ii) the provisions relating to fraudulent transfers,[180] or (iii) the provisions relating to improper or erroneous execution by the bank.[181]

Suppose the funds transfer agreement has shortened the period under the statute of repose from the one-year period to a fifteen-day period. Would a customer asserting these nonvariable provisions be barred from objecting to a transfer when the customer has failed to object within the fifteen days?[182]

As noted above, section 4A-501(a) provides that rights and obligations under Article 4A may be varied by agreement "[e]xcept as otherwise provided in this Article."[183] Article 4A contains no provision that prohibits a bank from reducing the one-year period to a lesser period. Thus, at the threshold, it seems that a bank may enforce a reduction of the one-year period to a lesser—perhaps *any lesser*—period.

On the other hand, if the lesser period is enforceable in a case in which the bank would otherwise be liable, and the bank's liability

176. *See id.* § 4A-505 cmt.

177. *Id.* § 4A-505.

178. *Id.*

179. *Id.* § 4A-402(c)–(d).

180. *Id.* §§ 4A-202 to -204.

181. *Id.* §§ 4A-303, 4A-305.

182. *See* Turner, *supra* note 5, at 358–60 (examining the conflicts between the variable and nonvariable provisions of Article 4A and discussing whether the one-year period under the statute of repose may be shortened by agreement).

183. U.C.C. § 4A-501(a).

may not be varied by agreement, the result of enforcing the reporting requirement *is to vary a provision* of Article 4A *that may not be varied by agreement.*

To illustrate the conflict between the apparently variable one-year period under the statute of repose and the nonvariable provisions regarding fraudulent funds transfers, suppose the bank fails to verify the customer's payment order in accordance with the agreed upon security procedure, and funds are fraudulently transferred out of the customer's account. The bank would normally be liable for the loss and be required to refund the amount of the transfer to the customer under sections 4A-202(b) and 4A-204(a).

Suppose, also, that the customer breaches an obligation to give notice within thirty days after receipt of the periodic statement, in accordance with the following provision:

> Entries transmitted by Financial Institution or credited to a Receiver's account maintained with Financial Institution will be reflected on Company's periodic statement issued by Financial Institution with respect to the Account pursuant to the agreement between Financial Institution and Company. Company agrees to notify Financial Institution promptly of any discrepancy between Company's records and the information shown on any periodic statement. If Company fails to notify Financial Institution of any discrepancy within [fifteen] days of receipt of a periodic statement containing such information, Company agrees that Financial Institution shall not be liable for any other losses resulting from Company's failure to give such notice or any loss of interest or any interest equivalent with respect to an Entry shown on such periodic statement. *If Company fails to notify Financial Institution of any such discrepancy within [thirty] days of receipt of such periodic statement, Company shall be precluded from asserting such discrepancy against Financial Institution.*[184]

It is not clear whether the thirty-day preclusion period in the foregoing provision should be held to be (i) *enforceable* against the customer as a *permissible* reduction of the statute of repose under

184. NACHA OPERATING GUIDELINES 2.1.30 (2006) (Sample ODFI-Originator Agreement ¶ 12) (emphasis added). The NACHA form contains blanks for the numbers of days.

section 4A-505, or (ii) *unenforceable* as an *impermissible* variation of the *nonvariable* section 4A-202.

The issue of the enforceability of a short-period reporting requirement arises not only in the case of a fraudulent payment order, but also in the case of the customer's nonvariable right to a refund from the bank under the money-back guarantee provisions of section 4A-402(c) and (d). Similarly, a shortened notice period could conflict with the customer's nonvariable right to compensation or a refund in the case of a payment order improperly or erroneously executed by the bank.[185]

3. The *Regatos* Case

The issue of the enforceability of a short-period reporting requirement was squarely confronted in *Regatos v. North Fork Bank*.[186] Regatos conducted a construction business from an office in his home in Brazil and maintained a bank account at the Commercial Bank of New York in New York City.[187] Regatos originated funds transfers from his office out of the account in New York.[188]

The deposit agreement required Regatos to report unauthorized funds transfers within fifteen days of the time the bank statement was mailed or made available to him.[189] A constructive notice provision in the agreement stipulated that if he authorized the bank to withhold his correspondence, the fifteen-day reporting requirement would apply as if he received the statement on the date shown on the statement.[190] Whether Regatos had authorized the bank to withhold his correspondence was a disputed issue in the litigation, but in fact, his bank statements were sent to him only when he requested them.[191]

The security procedure that the bank and Regatos used was a telephone-confirmation procedure.[192] Regatos would fax a payment order form to a bank representative at the bank's office in Sao Paulo, and then call the representative on the telephone to confirm receipt of

---

185. *See supra* note 101.

186. 257 F. Supp. 2d 632 (S.D.N.Y. 2003), *aff'd*, 431 F.3d 394 (2d Cir. 2005), *conforming to certified questions answered by* 838 N.E.2d 629 (N.Y. 2005).

187. *Id.* at 635–36.

188. *Id.* at 636.

189. *Id.* at 635.

190. *Id.*

191. *Id.* at 635–36.

192. *Id.* at 636.

the fax.[193] If Regatos failed to call right away, the representative would call him to confirm the order.[194]

In March and April 2001, two funds transfers totaling $600,000 were made out of the account.[195] Regatos asserted that the transfers were unauthorized and notified the bank of his objection to the transfers in August, on the same day he received actual notice of the transfers but about five months after the date of the account statement disclosing the first transfer, and four months after the date of the statement disclosing the second transfer.[196]

Regatos sued to recover the transfers, alleging that the Sao Paulo office had not complied with the security procedure by calling him to confirm the payment orders initiating the transfers.[197] The bank moved for summary judgment based on Regatos' failure to comply with the fifteen-day reporting requirement.[198] The district court denied the motion, holding that the reporting requirement was not enforceable because it conflicted with Regatos' nonvariable right to a refund when the bank failed to comply with the security procedure.[199]

The jury found in favor of Regatos, and the district court awarded him both principal and interest from the date the bank had transferred the funds.[200] The bank appealed, and the United States Court of Appeals for the Second Circuit certified to the New York Court of Appeals the following questions:

> [1] Can the one-year statute of repose established by . . . U.C.C. Article [4A]-505 be varied by agreement? If so, are there any minimum limits on the variation thereof (such as "reasonable time") that estop [the bank] from denying Regatos recovery in this case?
>
> [2] In the absence of agreement, does . . . U.C.C. Article [4A] require actual notice, rather than merely constructive notice? If so, can this requirement be altered

193. *Id.*

194. *Id.*

195. *Id.* at 636–37.

196. *Id.* at 637.

197. *Id.* at 634, 637.

198. *Id.* at 634–35.

199. *Id.* at 643.

200. Regatos v. N. Fork Bank, 838 N.E.2d 629, 631 (N.Y. 2005).

by agreement of the parties and was such achieved here?[201]

The New York Court of Appeals affirmed the district court's holding that the one-year period could not be reduced by agreement.[202] The Court of Appeals considered whether the one-year period should be regarded as an integral part of the bank's obligation to refund payment under section 4A-204, in which case the period *could not* be reduced by agreement, or whether the customer's duty to notify the bank of the error before recovering the transferred funds is an obligation separate from the refund provisions of section 4A-204, in which case the period *could* be reduced by agreement.[203] The court deemed the one-year period integral to the customer's right of recovery and accordingly held that the period was nonvariable.[204] It explained that "[p]ermitting banks to vary the notice period by agreement would reduce the effectiveness of the statute's one-year period of repose as an incentive for banks to create and follow security procedures."[205]

The Court of Appeals also cited the distinction drawn by the district court between the substantive rights and obligations addressed in Parts 1 through 4 of Article 4A and the "Miscellaneous Provisions" addressed in Part 5.[206] The court noted that "[t]he period of repose in section [4A-505] is essentially a jurisdictional attribute of the 'rights and obligations' contained in [section 4A-204(a)]."[207] As a "jurisdictional attribute," the one-year period under section 4A-505 is presumably subordinate to the customer's substantive rights under section 4A-204(a), and that consideration supported the court's conclusion that to "vary the period of repose would, in effect, impair the customer's section [4A-204(a)] right to a refund, a modification that section [4A-204(a)] forbids."[208]

The court thus answered the first of the certified questions in the negative: the one-year statute of repose established under section 4A-

201. Regatos v. N. Fork Bank, 396 F.3d 493, 498–99 (2d Cir. 2005) (footnote omitted).

202. *Regatos*, 838 N.E.2d at 633.

203. *Id.* at 632.

204. *Id.* at 633.

205. *Id.*

206. *Id.*

207. *Id.*

208. *Id.*

505 may not be varied by agreement.[209] Accordingly, Regatos was entitled to recover the principal amount of the transfers.[210]

The court then addressed the second of the certified questions and held that constructive notice was not sufficient, that the statute required actual notice, and that the requirement of actual notice could not be varied by agreement.[211] Since Regatos gave notice of his objection to the transfers promptly upon receipt of actual notice, he acted well within the "reasonable time not exceeding [ninety] days" period stipulated in section 4A-204(a), and was thus entitled to interest.[212] The court stated:

> Just as the one-year notice limitation is an inherent aspect of the customer's right to recover unauthorized payments, the actual notice requirement provides the bedrock for the exercise of that right. Permitting banks to enforce "agreements" to accept constructive notice would defeat [A]rticle [4A]'s guarantee of recovery for unauthorized payments.[213]

Based on the New York Court of Appeals' answers, the United States Court of Appeals for the Second Circuit affirmed the district court.[214] Thus, any variation purporting to reduce the one-year period of the Article 4A statute of repose, (or to impose constructive notice in lieu of actual notice as stipulated in the statute), would not be enforceable under the *Regatos* decision.

IV. SUMMARY OF CONCLUSIONS

The principle conclusions that may be drawn from the foregoing discussion are summarized below.

A. General Rule

The general rule applicable to the UCC applies as well to Articles 3, 4, and 4A. Under the general rule, the bank is free to contract out of its liabilities, except that:

(i) the bank cannot disclaim its obligations under the UCC to act

209. *Id.*

210. *Id.*

211. *Id.* at 634–35.

212. *Id.* at 635.

213. *Id.* at 634.

214. Regatos v. N. Fork Bank, 431 F.3d 394, 395 (2d Cir. 2005).

in good faith and exercise ordinary care, and

(ii) the bank cannot disclaim a UCC obligation to the extent that a UCC provision expressly prohibits the disclaimer.

B. UCC Articles 3 and 4

(i) Banks are generally permitted to disclaim their liability under UCC Articles 3 and 4 for fraudulent checks. They commonly do so.

(ii) Banks are permitted under Articles 3 and 4 to shorten the periods in which their customers are required to report fraudulent checks.[215] The one-year period for reporting fraudulent checks under the Article 4 statute of repose may be shortened, for example, to a fourteen-day period, if not an even lesser period.

(iii) Banks are permitted to disclaim their liability for consequential damages under Articles 3 and 4.

C. UCC Article 4A

Banks are permitted to disclaim their liabilities under Article 4A, except as stated below.

(i) *Improper Execution.* The bank cannot disclaim its liability for interest or transactional and incidental costs when it executes a payment order improperly, such that the execution results in a delay in payment to the beneficiary, or in (1) non-completion of the transfer, (2) failure to use the intermediary bank designated by the originator, or (3) the issuance of a payment order contrary to the terms of the originator's payment order.

(ii) *The Money-Back Guarantee.* Under the "money-back guarantee," the bank cannot disclaim its liability to refund the amount of the transfer when the payment order goes astray or is otherwise not properly completed, and the funds are not returned to the customer.

(iii) *Fraud.* Banks cannot disclaim their Article 4A liability for unauthorized payment orders.

(iv) *Erroneous Execution: Payment to the Wrong Person.* The bank cannot disclaim liability when, as a result of its erroneous execution of a payment order, funds are transferred to the wrong person.

(v) *Erroneous Execution: Duplicate Transfers or Excessive*

---

215. U.C.C. § 4-406(d), (f) (2003).

Amounts. Although there is ambiguity with respect to the issue, it is the better view that the bank cannot disclaim liability when, as a result of its erroneous execution of a payment order, funds are transferred in duplicate or in an amount that exceeds the amount of the sender's order.

(vi) *Payment to the Beneficiary*. The beneficiary's bank cannot disclaim its liability to pay the beneficiary after the bank has accepted a payment order, and it cannot enforce an agreement with the beneficiary to retrieve the payment after it has been made.

(vii) *Consequential Damages*. The beneficiary's bank cannot disclaim its liability to pay consequential damages to the beneficiary if, after accepting a payment order, the bank fails to pay the beneficiary and the beneficiary has given notice of the circumstances that may give rise to the consequential damages. This is subject to the right of the bank to decline payment, if the bank can prove that it had a reasonable doubt concerning the beneficiary's right to the payment.

(viii) *Short-Period Reporting Requirements*. Article 4A is ambiguous with respect to the enforceability of an agreement to reduce the one-year period of the statute of repose. However, the decision in *Regatos* maintains that a bank cannot disclaim its liability under Article 4A for the principal amount of a funds transfer by enforcing a requirement that the customer report objectionable transfers within a period that is less than one year after the customer receives actual notice that the bank has been paid for the transfer.