

# BANK DEPOSITS AND COLLECTIONS BEFORE AND AFTER THE UNIFORM COMMERCIAL CODE

JACK L. GRIFFITHS\*

Accurate figures are no doubt available concerning the number of checks which the banks of the country are called upon to handle each day. No useful purpose would be served by such information, but I think it may be said that at any given moment day or night millions of checks and similar cash items are in the process of collection and are being handled for such purpose by our vast network of commercial banks and the several Federal Reserve Banks and their branches.

The collection process may be unfamiliar to some or, to others, so common-place that it is taken for granted. Let us explain it briefly by starting in a small Ohio town where the local manufacturer has sold his products to a customer in Lake City, Florida, and has received a check drawn on a Lake City bank in payment of his invoices. A check is not money, especially one drawn on a small bank in a distant city, and the Ohio manufacturer puts the collection process in motion by depositing this check in his own bank, at which time his account is given a conditional credit for its face amount. The depositary bank is not a member of the Federal Reserve System but has a correspondent bank relationship with a large Cleveland bank where the depositary bank carries an account. At the close of business on the day of deposit the check is mailed, along with others, to the Cleveland bank, which bank maintains a night force for the sole purpose of speeding the collection of money for its depositors. At 1:15 A.M. the mail bag in which this check is enclosed is picked up at the Cleveland Post Office by an employee of the Cleveland bank and rushed to its Main Office for sorting. In a matter of minutes the check is packaged with others and dispatched by automobile to the Federal Reserve Bank in Cleveland, where it again receives prompt attention by the night crew on duty there. Early the next morning our check takes its place on a fast plane bound for Jacksonville, Florida where it arrives before noon and is picked up by a messenger for the Jacksonville branch of the Federal Reserve Bank of Atlanta. The payor bank in Lake City is a member of the Federal Reserve System and its account at the Jacksonville branch of the Federal Reserve Bank is charged with the amount of the check, which is then placed in the mail and received by the Lake City Bank early the next morning,

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\* Counsel, National City Bank of Cleveland, Ohio. Member of Ohio Bar Association.

two days after the check was originally deposited in the Ohio bank. Thus, the payor bank has been charged with the check even before it has received it. If the check is "good," it is charged to the account of the drawer and the transaction is complete, but if the amount of the deposit to the credit of the drawer is insufficient, if payment has been stopped or if the check cannot be paid for any other reason, the journey back to the small town in Ohio is promptly started by the payor bank, with corresponding charges and credits being made all along the line.

Article 4 of the Uniform Commercial Code has been created with the dual purpose of establishing the rules, in clear and concise language, for application to the legal problems which are sure to arise from time to time and to make these rules uniform in the many states through which a single item may pass from the time it is deposited until it is finally paid.

It will be the author's purpose to point out the principal changes in the collection process which will be brought about by article 4 and also to call attention to existing practices which will not be changed by the Code. Before proceeding further it should be noted that the title to article 4 is "Bank Deposits and Collections," and its scope consequently includes deposit items which do not require "collection" in the true sense, since they consist of items drawn on the depository bank. Therefore, let us first consider some of the common problems which can arise from such transactions.

In Ohio, *Petrie v. Garfield Savings Bank Company*,<sup>1</sup> is often cited as the principal authority for the proposition that when a bank gives credit to a depositor for a check drawn on that bank, such action constitutes not only acceptance, but also final payment of that check. The court goes so far as to state that "this transaction was the equivalent of paying over the counter to Petrie \$208." The check in question was deposited on November 18, and on November 19 the drawer was declared a bankrupt. The court stated that, "the bank was not justified, the day following, in sur-charging Petrie's account with the \$208 it had credited to him on receiving the check the day before." The bank attempted to reverse this transaction so that the account of the drawer would have a larger balance against which the bank could set off an indebtedness owing by the drawer to it.

In *Provident Savings Bank and Trust Company v. Hildebrand*,<sup>2</sup> the court cites the *Petrie* case with approval and purports to follow the same rule. But in the *Hildebrand* case the drawer had sufficient

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<sup>1</sup> 8 Ohio App. 266 (1917).

<sup>2</sup> 49 Ohio App. 207, 196 N.E. 790 (1934).

funds in his account to pay the check and the depositor was not notified for four years that the check was not being paid.

The *Petrie* and *Hildebrand* cases are unsatisfactory to say the least, and are unrealistic and impossible in their practical application. Imagine the confusion in a long line at a bank teller's window if he were unable to accept for deposit a check drawn on his own bank without first calling the bookkeeping department to determine whether or not the drawer had a sufficient balance of collected funds to pay the check in question and that there was no outstanding stop-payment order against the check he was about to receive on deposit!

Another problem arises concerning the manner in which it is necessary for the bank to process such a check through its own books and records. As a practical matter a check is often credited to the account of a depositor *before* being charged to the account of the drawer. If not good for any reason when it reaches the ledger where the drawer's account is carried, the check is charged back to the depositor's account. This necessary procedure does not mesh with the law as it is interpreted by the *Petrie* and *Hildebrand* cases and is one of the reasons for the elaborate rules and regulations established by all banks defining the rights of the bank and the depositor in connection with deposited items. Such rules and regulations uniformly reserve to the bank the fundamental right, which it must have, to charge back items which for any reason are not found to be good.

Article 4 of the Uniform Commercial Code changes this by the enactment of Ohio Revised Code section 1304.18(C), which states that a depository bank which is also the payor bank may charge back the amount of an item to its customer's account or obtain a refund in accordance with Revised Code section 1304.21, which latter section stipulates that an action to revoke a credit previously given must be taken by the bank before midnight of the first banking day following its receipt. This time may be further extended if the bank has established an afternoon cut-off hour of 2 P.M. as authorized by section 1304.05. All items received after the cut-off hour are considered as having been received on the next banking day. Hence, an item drawn on the depository bank and deposited on Friday at 2:30 P.M. could be treated by the bank as if deposited on the following Monday (if the bank is not open on Saturday), and any credit given by the bank for such item could be reversed at any time before midnight on Tuesday.<sup>3</sup>

Thus it can be seen that the provisions of Revised Code sections

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<sup>3</sup> See Ohio Rev. Code § 1304.19(D) (2), which provides that in any case where a bank is both a depository bank and a payor bank and an item is finally paid, the credit becomes available for withdrawal by the customer at the opening of the second banking day following receipt of the item.

1304.18(C) and 1304.21 will in no way change the present practices of most banks which have been established by their rules and regulations governing commercial accounts, but since many of the contractual rights established by such rules and regulations will now become statutory, much of the fine print found on the back of the deposit slip and elsewhere may gradually disappear.

One of the important provisions of the Code is found in section 1304.03 which authorizes a variation by agreement of the statutory rules governing bank deposits and collections, except that a bank may not disclaim responsibility for its own lack of good faith or failure to exercise ordinary care. Subsection (B) provides that Federal Reserve regulations and operating letters, clearing house rules, and the like, have the effect of agreements and are binding upon all parties interested in the items being handled, whether or not such parties have specifically assented thereto. This provision has the effect of leaving the collection process substantially in the same condition as it was before the adoption of the Uniform Commercial Code.

The Federal Reserve banks constitute by far the most important factor in the collection of cash items in this country. All items handled by them are subject to Regulation J promulgated by the Board of Governors of the Federal Reserve System, and to operating letters issued by the various Federal Reserve banks themselves. Regulation J has been in effect for many years and has made provision for conditional payments or credits, return of items by midnight of the first day following conditional payment, the medium of payment which may be accepted in settlement of a cash item, and other similar matters. Regulation J will not be changed or affected by the adoption of the Uniform Commercial Code in Ohio so that all collection items handled by a Federal Reserve bank will continue to be handled exactly as before, and subject to the same conditions.

Clearing house rules, such as those governing banks located in Cleveland, will have much the same effect. These rules govern the return of items for which conditional payment has been made by a member bank at a clearing house settlement. The law in Ohio, governed by the case of *Akron Scrap Iron Company v. Guardian Trust Co.*,<sup>4</sup> has been much the same as the rule established by the Code. In *Akron Scrap Iron* the court held that one who deposited a check in an Akron bank drawn on a Cleveland bank was bound by the rules of the Cleveland Clearing House Association, even though the depositor did not know of the existence of such rules.

A feature of the Code which is new in Ohio and which should

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<sup>4</sup> 120 Ohio St. 120, 165 N.E. 715 (1929).

operate to the advantage of both bank and depositor is the general statement of what is meant by "ordinary care" in the handling by the bank of a collection item.<sup>5</sup> Generally, action or non-action by a bank, approved by the Code, by a Federal Reserve regulation or operating letter, a clearing house rule, or by general banking usage not disapproved by the Code, *prima facie* constitutes the exercise of ordinary care.<sup>6</sup> The Code then defines the measure of damage for failure to exercise ordinary care.<sup>7</sup> Such damage can never exceed the amount of the item itself (unless there is bad faith) reduced by the amount which could not have been realized by the exercise of ordinary care.

In my opinion, one of the most important provisions of the entire Code is found in Revised Code section 1304.07(A). This paragraph settles once and for all the frequently bothersome question of "who owns the item." Did the depository bank buy the item or take it only for collection? Is the situation any different if the depository bank has permitted the customer to draw against the item before final payment? Any number of cases can be found in Ohio in which the courts were troubled by this problem and there is anything but uniformity in the various decisions.<sup>8</sup> Under section 1304.07, the bank is only the collecting agent for the depositor regardless of the form of endorsement on the item and whether or not the depositor is permitted to draw against the item before final payment. The status of collecting agent may of course be varied by agreement, but the Code provision prevails unless contrary intent clearly appears.

Section 1304.08(C) changes the prevailing rule in Ohio, known as the *New York rule*, established by *Reeves v. State Bank*,<sup>9</sup> and *Taylor & Bournique Co. v. National Bank of Ashtabula*,<sup>10</sup> and adopts the *Massachusetts rule* by providing that a bank is not liable for the default or mistake of a subsequent bank in the collecting chain.

It has long been the practice of banks to supply and guarantee missing endorsements, which is in most cases the endorsement of the payee. Various stamps are in use for this purpose such as "Deposited to the Account of the Payee," "Credited to the Account of the Payee"

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<sup>5</sup> Ohio Rev. Code § 1304.03(C).

<sup>6</sup> Ohio Rev. Code § 1304.03(A) states that a bank, even by agreement, may not be relieved of the duty to exercise ordinary care.

<sup>7</sup> Ohio Rev. Code § 1304.03(F).

<sup>8</sup> *Squire v. Goulder*, 131 Ohio St. 106, 2 N.E.2d 2 (1936); *Blake v. Hamilton Dime Savings Bank Co.*, 79 Ohio St. 189, 87 NE 73 (1908); *First National Bank of Belmont v. First National Bank of Barnesville*, 58 Ohio St. 207, 50 N.E. 723 (1898); *Jones v. Kilbreth*, 49 Ohio St. 401, 31 N.E. 346 (1892); *Central Trust Co. of Cincinnati v. Eureka-Security Fire & Marine Ins. Co.*, 50 Ohio App. 308, 198 N.E. 62 (1935).

<sup>9</sup> 8 Ohio St. 466 (1858).

<sup>10</sup> 262 Fed. 168 (1918).

Hereof—Absent Endorsement Hereby Supplied and Guaranteed,” and others containing similar language. The effect of this practice has been somewhat uncertain, but the Code now gives statutory sanction to this custom unless the actual endorsement of the payee is required as indicated by the words “Payee’s Endorsement Required” being written or printed on the item itself.<sup>11</sup> Attention should also be called to section 1304.12 which is so short it may be quoted in full: “Any agreed method which identifies the transferor bank is sufficient for the item’s further transfer to another bank.” Thus, a bank may adopt an identifying number, mark or symbol which, when placed on the item, will carry the full force and effect of the more lengthy endorsements now in use. At the present time a check often has so many large blurred endorsements on the back that only an expert can decipher them and identify the banks which have handled the item. The section quoted above is implemented by section 1304.13(C) which provides that the warranties and engagements imposed upon each customer and each collecting bank arise notwithstanding the lack of an endorsement or words of guarantee or warranty in the transfer or presentment of the item.

Section 1304.13 deals at length with the warranties of each customer and collecting bank. Much could be said about the subject matter of this section, which in itself might well be the subject of a law review article. In general, the warranties of customer and bank under the Code are substantially the same as they have been heretofore.<sup>12</sup>

In passing, I cannot avoid a few words concerning section 1304.13 (A)(3)(c) insofar as it relates to certification of checks by banks. At the present time, when certifying a check, most banks by the language they place on the item as a part of their certification, agree to pay it “as originally drawn.” In this manner they hope to protect themselves against the possibility of the check being raised or altered, either before or after certification. Under the Code provision mentioned above, the bank which has certified the check is not entitled to the usual warranty of “no alteration” if the alteration took place *prior* to certification and if the item is in the hands of a holder in due course who acquired it *after* certification. Nevertheless, the bank may charge the drawer only for the amount of the item as originally drawn. A bank wishing to protect itself against this possible liability might adopt a policy of refusing to certify any item for the holder thereof or might make a charge for so doing. It should be noted that the

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<sup>11</sup> Ohio Rev. Code § 1304.11.

<sup>12</sup> See Clarke, Bailey, and Young, *Bank Deposits and Collections Under the Uniform Commercial Code*, Chapter 7.

situation described above would not operate to the advantage of the one who obtained the certification, even though he himself were a holder in due course.

Section 1304.18 deals with the right of a bank to charge back or obtain a refund for an item for which it has given conditional credit. We dealt with this subject previously insofar as it related to an item drawn upon the depository bank. But section 1304.18 is much broader in scope and operates to bring about the same result as the deferred posting statute which we now have in Ohio<sup>13</sup> (section 1105.13) and for which similar provision is made in Regulation J of the Federal Reserve System. The Code makes it doubly clear that this right of the bank to charge back an item if not found good is in no way altered or affected by prior use of the credit given for the item, or even by the failure of any bank to use ordinary care with respect to the handling of the item.

The Code also settles, or attempts to settle, the old question—"when is an item paid?" Section 1304.19 of the Ohio Revised Code needs little explanation and is certainly a welcome substitute for the rule we now have in Ohio which is apparently one of "intention."<sup>14</sup> Did or did not the payor bank *intend* to pay the item? This question never rises unless the bank finally decides not to pay the item and then it may become important to know whether or not the conduct of the bank has been such that it no longer has the right to refuse payment. Even under the rules established by the Code, certain difficulties may arise under Revised Code section 1304.19(A)(3) which says that an item is finally paid when the bank has "completed the process of posting the item to the indicated account of the drawer, maker or other person to be charged therewith." In actual practice, I believe, it is customary, at least with many banks, to charge the item to the account of the drawer, and, if the charge creates an overdraft, the bank *then* determines whether or not to pay the item notwithstanding the overdraft or to reverse the transaction and refuse payment. The charge to the account has probably been made by the bookkeeper and the decision to permit or not to permit the overdraft by a supervisor. One bank, which is in the process of installing an electronic computer, reports that they intend to charge all items to the account of the drawer, whether or not an overdraft is created. The computer will automatically furnish a "report" of all overdrafts, and the day after the charge has been made an officer or supervisor will determine whether to permit the overdraft to stand or to reverse the transaction

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<sup>13</sup> Ohio Rev. Code § 1105.13.

<sup>14</sup> See Akron Scrap Iron Co. v. Guardian Trust Co., *supra* note 4.

and return the item unpaid before the midnight deadline. Is the payor bank precluded from returning the item after it has been "posted" to the account of the drawer, even though an overdraft is thus created? The entire matter may hinge upon the meaning of the word "completed" as used in the statute. If posting is not deemed to be completed until the bank has decided to allow an overdraft brought about by the charge, then payment still remains a matter of intention. I am inclined to believe that this particular provision of the Code may cause difficulty and should probably be studied for possible clarification.

Section 1304.23(A)(4) is subject to the same criticism. The purport of this section is to deprive a bank of its fundamental right of setoff if served with legal process after an item has been posted to the account of the drawer, even though such process is served before the midnight deadline and while the bank would otherwise have a right to return the item unpaid. The remaining language of this section "or otherwise has evidenced by examination of such indicated account and by action its decision to pay the item" is subject to the objection of being uncertain. Frankly, I am not sure I know what it means or what it was intended to mean.

The leading case in Ohio relating to the obligation of a bank to its customer for failing to pay a check when presented is *Mouse v. Central Savings & Trust Company*.<sup>15</sup> The Code makes no fundamental change in the Ohio rule.<sup>16</sup> If dishonor by the bank results from mistake, the liability of the bank is limited to actual damages suffered by the customer. Damages proximately caused may include damages for arrest or prosecution or other consequential damages. Whether any consequential damages are proximately caused by wrongful dishonor is a question to be determined in each case.

As heretofore, a customer can stop payment of an item if the stop-payment order is received by the payor bank in time and manner to afford the bank an opportunity to act. If the bank misses a stop-payment order, the burden of establishing the amount of the resulting loss is on the customer. The present rule in Ohio is established by *Speroff v. First Central Trust Company*.<sup>17</sup> However, a new provision found in section 1304.30 will give the bank some relief if a check is paid contrary to a stop-payment order and the customer suffers a loss. Under such circumstances, the bank becomes subrogated to the rights of any holder in due course of the item, the payee or any other holder or to the drawer, in connection with the transaction out

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<sup>15</sup> 120 Ohio St. 599, 167 N.E. 868 (1929).

<sup>16</sup> Ohio Rev. Code § 1304.25.

<sup>17</sup> 149 Ohio St. 415, 79 N.E.2d 119 (1948).

of which the item arose. This statutory provision is new in Ohio but closely follows the rule established by *Central National Bank of Cleveland v. International Sales Company*.<sup>18</sup>

Under the Code forgeries and other irregularities in connection with a customer's account are treated in section 1304.29. Heretofore, forgeries were governed by sections 1307.08 and 1307.09. Under existing statutes the customer has one year to report forgeries of the drawer's signature and other alterations, and two years to report forged endorsements. In either case suit must be brought against the bank within one year after the date of reporting a forgery or alteration of any kind. All periods of time begin to run when the bank sends the customer a statement of account accompanied by the paid and cancelled items or otherwise makes such statement and items available to the customer. These same principles are carried forward into section 1304.29 but the period of limitation for reporting forged endorsements has been changed from two to three years.

Section 1304.29 of the Ohio Revised Code also contains some provisions which are new to Ohio. The customer will hereafter be required to examine his statements promptly and use reasonable care to discover his unauthorized signature or any alteration of the paid item and must notify the bank promptly after discovery. If he fails in this respect the customer is precluded from asserting against the bank any claim based on such forgery or alteration if the bank has been injured by the delay. Most important of all is the provision found in Revised Code section 1304.29(B)(2) which relates to repeated forgeries by the same wrongdoer and bars recovery against the bank on items paid after the first forged item was made available to the customer for a reasonable period of time, not exceeding 14 days, and before the bank is notified of the first forgery. Too often in the past the trusted employee forged the boss's signature month after month and the boss never took time to examine the bank statements and cancelled checks, this chore being delegated to the employee who was guilty of the forgery. When finally discovered the bank was frequently requested to make good the loss, and could be expected to interpose the defense that the loss would have been greatly minimized by even a casual examination of the bank statements and cancelled checks. Even before adoption of the Code, the courts have frequently recognized the unfairness of charging a bank with losses of this kind.<sup>19</sup>

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<sup>18</sup> 87 Ohio App. 207, 91 N.E.2d 532 (1950).

<sup>19</sup> Portsmouth Clay Products Co. v. Nat'l Bank of Portsmouth, 78 Ohio App. 271, 69 N.E.2d 653 (1946); White Castle Systems, Inc. v. Huntington Nat'l Bank of Columbus, 36 Ohio L. Abs. 253, 43 N.E.2d 737 (1941).

All of the foregoing is subject to the proviso in section 1304.25(C) that the relief granted to the bank by the other provisions of this section is predicated on the exercise of ordinary care by the bank. What this means and what effect it will have on the rights of the parties as otherwise fixed by the statute, will probably be a matter for judicial decision in each individual case.