Checks Lost in the Collection Process

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I. Introduction

Given the millions of checks that are transferred among banks every year, the opportunity for loss and misplacement of such checks is enormous and the liabilities associated with such loss can be significant. This section deals with the collecting bank's liability for the check's loss before it is delivered to payor bank. If the payor bank receives and then loses the check, it will be subject to a different set of liabilities; those liabilities will be discussed elsewhere in the program.

II. Basic Liability

A. Basic liability of a collecting bank set out in section 4-202 of the Uniform Commercial Code. That section reads in full as follows:

§ 4-202. Responsibility for Collection; When Action Seasonable

(1) A collecting bank must use ordinary care in

(a) presenting an item or sending it for presentation; and

(b) sending notice of dishonor or non-payment or returning an item other than a documentary draft to the bank's transferor [or directly to the depositary bank under subsection (2) of Section 4-212] (see note to Section 4-212) after learning that the item has not been paid or accepted, as the case may be; and

(c) settling for an item when the bank receives final settlement; and

(d) making or providing for any necessary protest; and

(e) notifying its transferor of any loss or delay in transit within a reasonable time after discovery thereof.
(2) A collecting bank taking proper action before its midnight deadline following receipt of an item, notice or payment acts seasonably; taking proper action within a reasonably longer time may be seasonable but the bank has the burden of so establishing.

(3) Subject to subsection (1)(a), a bank is not liable for the insolvency, neglect, misconduct, mistake or default of another bank or person or for loss or destruction of an item in transit or in the possession of others.

Note that the bank has liability only if it does not use ordinary care. There is no absolute liability and, at least theoretically there could be a variety of losses for which the collecting bank would have no liability if it were not negligent in its handling of the item.

Note that the collecting bank's actions will be called into question under 4-202 anytime its loss of the check causes it to fail to act before its midnight deadline. It may successfully prove that it has a longer time to act, but the collecting bank has the burden of proving that its later action was seasonable.

B. Relation to 4-212.

Section 4-212 authorizes a collecting bank that has made a provisional settlement to charge-back amounts so credited to the account when the bank fails to receive a final settlement. Section 4-212(1) authorizes this charge-back "if by its midnight deadline or within a longer reasonable time after it learns the facts it returns the item or sends notification of the facts."

The inference from the statement in 4-212 is that the collecting bank may not charge-back the account if it fails to send notification or to return the item by its midnight deadline or within the longer reasonable time. Thus the question is presented: How does 4-212 relate to 4-202? Even though the bank is not negligent, does 4-212 in effect give an absolute liability and deny it the right to charge-back? Subsection 5 of 4-212 would seem to leave 4-202 as the basic rule of liability. That subsection reads in full as follows: "A failure to charge-back or claim refund does not affect other rights of the bank against the customer or any other party."

Notwithstanding subsection 5, the Utah Supreme Court recently has held a bank liable on the basis of 4-212(1). In Valley Bank and Trust Co. v. First Security Bank of Utah, 17 UCC Rep.
Serv. 480 (Utah 1975) the plaintiff bank deposited a check for collection in defendant bank. The check was drawn on a Chicago bank. Defendant forwarded the check to Chicago where it was dishonored. At the trial an employee of defendant First Security testified that she gave oral notice of the dishonor to the plaintiff Valley Bank & Trust Co. The check was lost and no written notification of dishonor was sent to plaintiff Valley Bank & Trust until six months after the transaction occurred. The court first held that there was an obligation to send written notice and, finding that written notice had not been timely sent, concluded that First Security Bank was liable in the amount of the check to Valley Bank & Trust on the basis of 4-212. The court did not discuss section 4-202 nor did it consider the possibility that there might be a conflict between 4-202 and 4-212.

Note that 4-212(4) authorizes a collecting bank to charge-back against its customer pending the outcome of litigation and despite the fact that the collecting bank may turn out to be negligent and thus liable under 4-202.

C. Damages

If one agrees with the Utah court and applies 4-212, the "damages" would equal the amount of the check. That is so because the consequence of a finding that the bank may not charge-back the customers account is to leave the customer with a credit in his account equal to the amount of the check.

If the court follows what I believe to be the correct route and concludes that there is liability only under 4-202, it must then refer to 4-103(5) which describes the appropriate damages as follows:

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

In many cases no damages would result as a consequence of the loss of the check. If, for example, the drawer never had funds in the account and was insolvent from the time the check was originally drafted, nothing would have been "realized by the use of ordinary care" and thus nothing would be lost by the collecting bank's failure to use ordinary care. A case that is probably characteristic of those in which damages can
be recovered is First Security Bank of Utah v. Ezra C. Lundahl Inc., 454 P.2d 886, 6 UCC Rep. Serv. 765 (Utah 1969). In that case First Security again acted as collecting bank and transmitted a check on which Lundahl was the payee to a Canadian payor. The Canadian bank responded that there were insufficient funds but that unless instructed otherwise it would hold the check to attempt to collect. About a month and a half later the Royal Bank of Canada returned the check to First Security and First Security charged it back to Lundahl's account. First Security did not give notice of the dishonor to the defendant. The court commented on the evidence as follows:

"Evidence was presented to the effect that with the passage of time conditions of the Heathfield Company [drawer] changed substantially, and that if timely notice had been given, there would have been no loss due to its insolvency."

In such a case the payee-depositor must show that he could somehow have got some cash out of the drawer's hide if he had been put on notice at the time of the original dishonor but that there was no money available at a later time when he discovered the check had been dishonored. Of course the critical questions are who has the burden of proving that loss and, secondly, what evidence is adequate to show that there was such a loss. Presumably the plaintiff who seeks damages from the bank must prove his damages. One cannot define with any precision what testimony the plaintiff must produce to convince a court that he could have collected the money had he had prompt notice, but that the money had become unavailable when he received notice.

III. Some Defenses and Miscellaneous Additional Issues

A. If the check is not lost forever but there is only a delay in the collection process, the collecting bank may not be negligent and they may have no liability. Section 4-108(2) specifically provides for such delay.

§ 4-108(2). Delay by a collecting bank or payor bank beyond time limits prescribed or permitted by this Act or by instructions is excused if caused by interruption of communication facilities, suspension of payments by another bank, war, emergency conditions or other circumstances beyond the control of the bank provided it exercises such diligence as the circumstances require.
B. In most cases in which it has lost a check the collecting bank will have a cause of action against the drawer, for whatever it is worth, either on the check itself, if the check can be found (3-413), or as the "owner" of the lost check (3-804); moreover in most cases, the bank should be able to qualify as a holder in due course. At one point the bank presumably had possession of the check, gave value in good faith and without notice of a defense. The fact that it no longer possesses the check at time of trial and at that time it might then have notice of an alleged defense should not deprive it of the right it once had as a holder in due course.

C. Confusion as to who is the collecting and who is the payor bank.

Particularly in cases in which a check drawn on one branch of a bank is deposited at another branch of that bank, there may be doubt about whether the branch where the check is deposited is a "collecting" bank or a "payor" bank. If the branch is a payor bank, it is much more likely to have liability for loss of the item because of the operation of sections 4-301 et seq and 4-213 than if it has liability only under 4-202. In a rather backhanded manner section 4-106 makes branches separate banks for some purposes. (Note that California has enacted a non-standard version of 4-106.) However at least one court, without explicit consideration of 4-106, has implicitly concluded that one branch of a Virginia bank in which a check was deposited was itself a payor bank who "paid" when it gave cash across the counter and accepted deposit for partial credit. (See Kirby v. First & Merchants National Bank, 210 Va. 88, 168 S.E.2d 273 (Va. 1969).)

In a state like California with statewide branches one should normally treat each branch as a separate bank and should find that a bank who receives a check drawn on another branch is itself a collecting bank liable only under 4-202. Note, however, that in other states where there is no statewide branching, one might come to the opposite conclusion. Note too that 4-106 does not explicitly address branch-separate bank questions unless one reads the language broadly.