CHAPTER 2: FINANCIAL PROPERTY

A. Money

This section covers the basics of the law of money. The initial notes deal with the *public* law of money: what things the government provides for use as money, what it allows to be used as money, and what it prohibits. The second half of the section deals with the *private* law of money: some distinctive doctrines about possession and ownership that have developed to make money work more effectively. The focus in this section is on tangible money; later sections discuss how intangibles can also function as money.

NOTE ON THE DEFINITION OF MONEY

An economist would say that ***money*** is anything that is commonly accepted as ***payment*** for goods and services. This is a functional definition: it defines money in terms of what it does, rather than what it is. But it could hardly be otherwise. Things that people have used as money include precious metals, pieces of paper, shells, beads, salt, cigarettes, and stone wheels weighing up to four tons.

This is also a pre-legal definition: money can exist in the absence of a functioning legal system, as long as people are content to accept it as payment. Indeed, something can be money even if the legal system explicitly prohibits its use. In countries that officially prohibit the use of foreign currencies in private transactions, there is often a black market for them anyway.

In his 1875 book *Money and the Mechanism of Exchange*, William Stanley Jevons distinguished among four different functions that money plays:

- Most obviously, money is used as a ***medium of exchange*** to make payments. If you sell me a bag of potato chips and I pay you in cash, we have used money as my half of the exchange. This is the big advantage of money over a barter system, where I would need to find something else that you want, like a pair of socks. Because you know that *other* people will accept the money as a medium of exchange later (for example, when you buy cartons of bags of potato chips in bulk from a wholesale supplier), you are willing to accept money from me now.
- Money is also often a ***unit of account***: by saying that the price of the bag of chips is $2.00, you specify how much I need to pay you to buy it. Notice that this function requires a degree of ***fungibility***: one dollar is interchangeable with any other dollar, and you don't care which specific bills I pay you with.
- Money functions as a ***store of value***: if you deposit my money in your bank account, you have set it aside to use later. You will use it at the end of the month when you pay your supplier, or next year when you pay a contractor to renovate your shop windows, or decades from now when you retire.
- Finally—although many economists now roll this function into the other three—money is a ***standard of deferred payment***. If your supplier sells to you on sixty days credit, you get the potato-chip cartons now but need to pay

> for them within two months. You have a debt to them, and you can satisfy that debt by paying in, you guessed it, money. One way in which governments use law to regulate money is by defining what forms of money count as ***legal tender*** that can be offered in payment of debts.

These different functions depend to different degrees on money having a stable value. Money can work as a medium of exchange even if its value is likely to change within days, as long as you and I agree on its value now. If you don't want to take on the risk that the value of the money I give you will change, you can immediately convert it into some other more stable asset. Many businesses that take payment in cryptocurrency do this—they're in the business of selling things, not in the business of speculating on the price of Bitcoin. It's convenient for a unit of account to have a stable value, so that posted prices don't need to be updated frequently, but it's not absolutely essential. Currency exchanges use digital signs so that they can adjust the price of one form of money against another in real time, and websites can change their prices dynamically. It's when money becomes a store of value that people really worry about stability, because it becomes dangerous to hold on to it for long. This is a particular concern during periods of high inflation, when money loses value rapidly. Similarly, when money is used to pay off debts, creditors worry that they will be paid back in money that is worth less than when they made the loan. This concern over the long-term stability money's has been one of the drivers of innovation in cryptocurrencies.

Commodity Money

The conceptually simplest, and historically among the earliest, forms of money were ***commodities*** like grain and salt. These were useful for their own sake: even if you didn't want to spend wheat as money, you could take it in payment, grind it up, and bake it into bread. Precious metals, like gold, silver, and bronze were useful in this sense too: they could be made into jewelry or other artifacts. It doesn't matter that most people will never melt down their gold coins to make jewelry. What gives them use value (at leas in theory) is the fact that *someone* might want to, and whoever holds the coins always has the option of selling them to someone who will.

Metals had third great advantages as money compared with other commodities. First, because they were scarcer compared to the demand for them (and thus more valuable), it took much less of one to make up a usefully tradable unit than of something bulkier like grain. Second, in the ancient societies where their use as money developed, the supplies of precious metals were relatively fixed in the short term—mining was slow and difficult—so their value was less likely to fluctuate than other commodities, which could be affected by weather, harvests, and other variabilities of life. Third, they are much more standardized: one atom of silver is physically identical to any other atom of silver, and it never rots or gets moldy, as wheat can. Thus, it made sense to assign precious metals monetary value by weight—by the quantity of the given metal in a lump.

That said, precision-weighing each tiny ingot of silver for every transaction is an enormous hassle, and so ancient governments quickly moved to standardize the circulation of precious metals. These standard units, of course, were ***coins***: metal discs containing a specified amount of precious metal and stamped with an official seal. The seal made it easy to identify the coin and its metal content. The ancient Athenian drachma, for example, contained approximately 4.3 grams of silver in modern units. Prices could be quoted in drachmas, and debts paid in them, and

they could be kept as a store of value. For all these reasons, precious metal coins are important enough that they have their own generic name: ***specie***.

A system of money based on specie, however, must deal with one perpetually recurring problem: *ensuring that a coin contains the quantity of precious metal that it purports to*. The most obvious risk is that someone not authorized to mint coins might create ***counterfeits***: coins that bear an official-looking stamp but contain less than the promised quantity, passing off the counterfeit coin as a genuine one, and pocketing the value of the missing metal. For this reason, counterfeiting has generally been treated as a serious crime. In England, the Treason Act of 1351, for example, made it a capital offense punishable by death. To help prevent counterfeiting, governments also deployed more sophisticated minting technology over time: making coins more uniform, more finely detailed, and generally harder to forge.

A subtler form of monetary cheating was ***clipping***: shaving off small fragments of a coin, and then passing along the clipped coin for full value. But for similar reasons, clipping was also made into a serious crime, as in the Treason Act of 1415, which made it punishable by death. Still, clipping is harder to detect, and it doesn't help that coins will tend to become battered and beat-up over time as they pass from hand to hand. Here too, governments adopted technical countermeasures like ridging the edges of coins to make missing fragments easier to spot.

Frequently, though, it was the government *itself* that would reduce the precious-metal content of its own coins. The motivation was obvious: a cash-strapped government that already had control over the mint could simply produce coins with less than the purported amount. Making the coin with less metal would also make it obviously lighter, so it was more common to ***debase*** coins by mixing them with "base" metals like iron. Debased coins could be detected, but only with more sophisticated procedures like submerging them to measure their volume as well as their weight. Because the government also controlled the legal system, official debasement was a tool of statecraft, rather than a crime.

But just because Emperor Nero declared that a new denarius (containing 3.8 grams of silver) was worth the same as an old denarius (containing 4.0 grams of silver), that didn't mean that people would treat them identically. As between the two coins, any merchant would rather have the old denarius because in times of need, they could get 5% more silver out of it. So they would prefer to hoard their old denarii and spend the new ones. The paradoxical result is that only the newer, lower-silver coins circulate, while the older, higher-silver coins sit unused in storerooms and safeboxes—and anyone taking payment in denarii will demand 5% more of them, because they will expect to be paid only in the newer ones. This phenomenon is known as ***Gresham's law***, that "bad money drives out good." Gresham's law meant that attempts at debasement were often self-defeating. Rather than being able to skim off 5% of the value of each new coin it minted, the government found that it had made its new coins worth 5% less.

Finally, coins have some notable inconveniences. One of them is that they are easy to recognize and to steal; it can be hard to hide or secure them. Another is that their supply is tightly bound to the availability of precious metals. This gives them short-term stability of value, but it also means that the supply cannot adapt to economic changes: as a market economy grows, the same stock of precious-metal coins will have to cover more and larger transactions, and there may simply not be enough coins to go around. This is a ***macroeconomic*** problem: an inadequate money supply acts as a brake on commerce, slowing down the economy. As

we will see, governments would prefer to be able to set ***monetary policy*** by changing the overall supply of money, and that is simply harder to do in a system of commodity money.

On the other hand, when the supply of a metal does change dramatically, it can throw the value of coins made from it out of balance, causing inflation or deflation. This too is a macroeconomic problem, because it makes saving more risky, changes the value of existing debts, and can lead to controversial changes in prices. In the 16th century, the Spanish Empire opened up silver mines on a vast scale in Central and South America (using coerced Native American labor), flooding global markets with silver. Europe experienced a century-long run of inflation, at a rate that was low by modern standards but enough to lead to substantial social disruption in a world where the price of staples like a loaf of bread had never changed *at all* in living memory.

Supply changes can also affect the relative prices of coins in disruptive ways. In the 19th century, the Californian (1848) and Australian (1851) gold rushes pushed the price of gold down. At the time, the United States minted both gold and silver coins, with fixed weights that assumed gold was sixteen times as valuable as silver. The result was that most of the nation's silver supply (now more valuable) moved abroad and domestic transactions took place mostly in (now less valuable) gold coins. Congress responded in 1853 by lowering the quantity of silver in a dollar coin. Adjustments like these—to individual units of money themselves—are necessary in any system of commodity money.

Paper Money

The next conceptual shift in money is to shift from using a commodity *itself* as money to using a *claim on* a commodity as money. Instead of minting gold and silver into coins that circulate as money, suppose that a government issues paper certificates that entitle the bearer to receive a specified quantity of specie from the government on demand by surrendering the note. These certificates, called ***government notes***, are said to be ***backed*** by specie. The gold and silver on which the system depends are held as ***reserves*** in a government vault, there in case note holders call to redeem them. (The United States Bullion Depository—"bullion" is a term for high-purity precious metal—more colloquially known as Fort Knox, to which it is adjacent, plays this role in the popular imagination, as in the 1964 James Bond film *Goldfinger*.)

The key to such a system is that as long as people have confidence that their notes are redeemable, and have confidence that other people will have confidence that they're redeemable, and so on, they will be happy to use the notes as money Redemption itself will be a rare event, because for many everyday purposes, the notes will serve just as well. You can buy things with them, store them as an investment, and pay debts with them.

Now consider how well paper money backed by specie addresses some of the shortcomings of coins. On the plus side, it is easier to transport and easier to hide, if also slightly easier to lose or destroy by accident. It can still be counterfeited (albeit using different skills and equipment), and so counterfeiting of paper money remains a serious crime. Paper money cannot, however, be clipped. Because the value of a paper note is the claim it represents, a clipped portion of one is literally as worthless as the paper it's printed on. *See generally* 31 C.F.R. § 100.7(b)(5) (explaining that the Bureau of Engraving and Printing will not accept "mutilated" bills for redemption when "50% or less of a note are identifiable as United States

currency" unless the presenter can prove that "the missing portion has been totally destroyed").

Another way in which paper money can be more flexible is that it need not be issued by the government. Consider three variations on a theme, all of which were in use in early modern Western Europe:

- Gaston needs to borrow money on January 1 to buy a horse. LeFou agrees to lend Gaston ten *livres*, which Gaston will repay in six months time, plus ten *sous* interest. To prove the debt (and aid in enforcing it if Gaston attempts to avoid repaying), LeFou will require Gaston to sign a document (in modern terms it would be called a ***promissory note***) agreeing to pay LeFou 10 *livres* and 10 *sous* on July 1. LeFou could keep the note locked in his safebox until then ... or, realizing that his annual rent is 10 *livres* he could offer his landlord Gaston's note in payment. The landlord knows Gaston well enough to believe he will be probably able to collect on the debt, and so is willing to *use the note as money*. Here, the note is trading at a ***discount*** to its face value: the 10 *sous* difference between the note and the rent reflects the time value of the money and the risk that Gaston will default. (A note that passes at face value is said to trade ***at par***.) In July, when Gaston comes to repay the debt, he will require that whoever he pays (which could be LeFou, LeFou's landlord, or whoever else it has been sold along to) tear up the note to show that the debt has been discharged.
- Maurice is an itinerant merchant. For reasons of convenience and personal safety, he doesn't want to travel with large quantities of coin. He goes to LeFou, not to borrow money but to deposit it. He gives LeFou 100 *livres*, and in return LeFou gives Maurice a signed document (a ***bill of exchange***) promising to pay Maurice 100 *livres* on demand whenever the document is presented to him at his offices in Ribeauvillé. When Maurice conducts his business at the trade fair in Troyes and buys a cartload of linens from Belle of the weavers' guild, he will sign the bill of exchange over to her. Belle, however, is unlikely to travel to Ribeauvillé herself. Instead, she in turn will use LeFou's bill to pay for her own purchases at the fair, and so on. The bill itself may make its way to other fairs and cities, until someone Ribeauvillé and redeems it with LeFou. The coins will be paid over and the bill torn up.
- Lumière also wants the convenience of carrying around paper rather than coins, but he prefers to deal with a well-established business rather than a merchant network. He goes to the Bank of England, where he maintains an account and has funds on deposit. He requests a ***bank note*** for £20. The teller provides Lumière with a document promising to pay him £20 on demand, and deducts £20 from the Bank's records of his account. Lumière then uses the bank note to pay Cogsworth for an ornate clock. Cogsworth returns to the Bank and gives the teller the note. The teller takes back the note and either gives Cogsworth £20 in coins, or records that his account now has £20 more in it, at Cogsworth's choice. Originally, each bank note was handwritten for a specific amount and made payable to a specific person (much like a bill of exchange), but they evolved over time into more standardized forms with fixed denominations made payable to whoever presented them. In this setting, it's not necessary to tear up a note when it's deposited; instead, the teller can simply put it back in the drawer, ready to be given out to the next person who requests one.

All of these instruments—promissory notes, bills of exchange, and bank notes—are privately issued forms of money. They are defined in terms of an underlying currency (here, *livres* or pounds) but they actually represent private promises to pay. In some cases, these private promises can come very close to governmental ones: although the Bank of England was a privately owned corporation, for many years it enjoyed a banking monopoly granted by Parliament.

Paper money complicates the macroeconomic story. On the one hand, it can help fill in for a shortage of specie; notes and bills can circulate freely and widely while the gold and silver backing them can sit in vaults as ***reserves***. This gives government some tools to adjust the money supply. It can directly adjust how much paper money it itself issues, and it can regulate the issuance of money by private parties like banks.

More controversially, governments can engage in ***seignorage*** by issuing paper money whose face value exceeds the bullion reserves kept on hand. Seignorage is attractive to governments for two reasons. First, it gives them far more macroeconomic flexibility to expand or contract the money supply and to allow their currency to move relative to other currencies. Second, it is literally a source of free money: instead of raising taxes or borrowing money, the government can simply print more.

That said, seignorage is to paper money as debasement is to specie; it dilutes a fixed amount of the underlying commodity by spreading it across more nominal units of money. To the extent that users of the currency are relying on their ability to redeem it for specie, a government that engages in it runs the risk that it will be unable to honor all redemption demands, because the specie reserves will run out. And if that happens—or if people think that it is likely to happen—the value of the paper will collapse, because people will be unwilling to take it in payment.

Something similar can happen with private paper money: if LeFou doesn't have the coins on hand to satisfy the bill of exchange that he gave to Maurice, then other people holding LeFou's bills will find that they can only pass them in trade at a steep discount. When a bank that has issued bank notes fails—or when people suspect that it may fail—the results can be similarly severe. At the same time, however, it was entirely natural for merchants and bankers not to keep on hand enough specie to satisfy every theoretically outstanding obligation at once. The reason is simple: if LeFou has on hand 100 *livres* from Maurice's deposit with him for a bill of exchange, why shouldn't he put those coins to work by lending 10 of them to Gaston for a few months? LeFou will make a profit from the interest, Gaston will be able to afford a horse, and the economy will hum along just a little faster.

Fiat Money

From here, the next conceptual leap is to drop redeemability entirely. The government, or a bank acting under its authority (like the Federal Reserve System in the United States), issues ***fiat money***: notes with specified values that no longer represent any underlying commodity. This may seem paradoxical, but it is really just an extension of the basic idea of money: money is anything that people generally accept in payment. As long as people generally believe that other people will take fiat money in payment, they will take it themselves in payment, and the entire system will continue to work just fine. A system of specie or paper money already functions to a large degree on confidence: if you take a coin without weighing it, or a bank note without investigating the bank's reserves, you are already relying on public confidence in the coin or note, rather than on its precious-metal bona fides.

Fiat money simply takes this to the next step and recognizes that what matters is maintaining *confidence* in the currency. Reserves and redeemability are one way to maintain confidence, but not the only one.

Fiat money gives governments enormous power to shape the economy by by setting monetary policy. They can issue more during times of economic distress to make transactions smoother. They can help the currency rise or fall against other currencies to affect trade and investment balances; they can issue more or less to affect the inflation rate. And, of course, they can quickly pay for pressing needs by printing money.

This power—especially the last point—is a great temptation. Many governments throughout history have tried to spend their way out of crises (or even just recurring needs) by printing more money. A common consequence, however, is that the value of the money falls, because there is more of it in circulation. People demand $20 where they would previously have been satisfied with $10. ***Inflation*** is an annoyance for merchants who must change their prices, and for anyone else (such as employers and employees negotiating over wages) who find that a fixed nominal amount of money no longer has the same real purchasing power it once did. But creditors absolutely hate inflation, because loans made using older and more valuable money can be paid back using newer and less valuable money. (Conversely, debtors tend to favor inflationary monetary policy, because it effectively erases a portion of their debts.)

For these reasons, fiat money has been highly controversial throughout history. Some critics regard it as an essential tool for managing a modern economy. Others consider it to be a a form of financial sin, one that leads inevitably to inflation and panics. Members of this second group have played a significant in the rise of digital currencies. Some of them are attracted to cryptocurrencies like Bitcoin because they have a fixed supply and are not subject to manipulation by a centralized authority.

NOTE ON MONETARY REGULATION

Now that we have considered the various forms of money, let us consider how money is regulated. You can lead a horse to water, goes the saying, but you can't make it drink. People will make payments to each other using whatever assets they mutually consider to be safe and convenient. Governments can't directly control that choice. Instead they have a variety of legal tools they can use to influence it:

- First, as we have seen, they can literally *make money*. By minting coins or bills and putting them in circulation, a government provides assets that will hopefully be widespread and convenient.
- Second, they can accept payments (e.g. for taxes) in their preferred form of money. This provides a known and reliable use for the money, which helps establish it as having value.
- Third, they can define some assets as ***legal tender*** by saying that *private* debts can be paid using those assets. Parties writing a contract can specify how and in what currency payments can be made, but in the absence of such a clause, or when a debt arises in some other way (e.g., as a result of a tort judgment), the debt is discharged if the debtor offers (or "tenders") payment using whatever the government defines as legal tender. *See generally* 31 U.S.C. § 5103 ("United States coins and currency … are legal tender for all

debts, public charges, taxes, and dues. Foreign gold or silver coins are not legal tender for debts.").

- Fourth, they can require that some transactions take place only using the preferred forms of money and not unwanted ones.
- Finally, they can prohibit the ownership of unwanted forms of money entirely. During the Cold War, the Soviet Union banned Western currencies, as a way of reducing the influence of capitalist countries on its own economy.

The monetary history of the United States provides a nice illustration of all of these tools in action. What follows is based heavily on Brief History of the Gold Standard in the United States (CRS Report R41887, June 23, 2011).

Under the Constitution, Congress has the power to "coin Money, regulate the Value thereof, and of foreign Coin," and to punish counterfeiters. U.S. Const. art. I § 8 cl. 8. Meanwhile, states are forbidden to "coin Money; emit Bills of Credit; [or] make any Thing but gold and silver Coin a Tender in Payment of Debts." *Id.* art. I § 10. Meanwhile, two provisions refer to specific dollar amounts: the Slave Trade Clause sets a maximum tax of "ten dollars for each Person," *id.* art. I § 9, and the Seventh Amendment guarantees a jury trial for "Suits at common law, where the value in controversy shall exceed twenty dollars," *id.* amdt. 7. These rules presume that there will be some kind of national currency denominated in "dollars."

Congress established the United States Mint in 1792, defined the dollar in terms of 371.25 grains of silver content (about 28 grams), and authorized the minting of $1 silver coins and $2.50 and $10 gold coins. These coins were made legal tender, along with some foreign currencies, such as the Spanish silver dollar. Over the next decades, Congress occasionally adjusted the ratios and authorized denominations to respond to changes in gold and silver prices.

These coins coexisted with a system of paper money including bank notes, bills of exchange, and some government debts. Two national banks (the First and Second Banks of the United States) issued bank notes, but so did numerous local banks chartered under state law. Bank notes were not legal tender, but the federal government accepted national bank notes as payment for taxes, which helped them circulate at par. State bank notes were less reliable, and tended to trade at a discount that increased the further away one got from the bank. Merchants consulted published volumes with samples of numerous banks' notes to avoid falling for counterfeits, and newspapers published tables of the discounts at which various notes traded. The system was notably fragile: in the Panic of 1819 and again in the Panic of 1837, numerous state banks collapsed when they were unable to satisfy requests for redemption of their notes.

The Civil War created immense strain on the financial system and left the federal government in urgent need of money to raise and support its armies. It issued some debts using "Treasury notes" that were convertible into gold and silver, but soon found itself forced to suspend convertibility. Instead, in 1862 it issued "greenbacks"—paper notes that were legal tender but not convertible. Creditors sued, arguing that Congress violated their constitutional Due Process rights when it declared the new, less valuable greenbacks to be legal tender for debts incurred in old, more valuable gold-backed dollars. The Supreme Court initially agreed, but in the so-called Legal Tender Cases, it reversed itself and held that Congress had the power to make greenbacks legal tender. *See Knox v. Lee*, 79 U.S. 457 (1871); *Juilliard v. Greenman*, 110 U.S. 421 (1884).

Following the war, the government kept greenbacks in circulation, but gradually worked to restore convertibility to the gold standard, which it achieved in 1879.

The result was to restore the pre-war *status quo*, except that paper money had moved from (primarily state) bank-issued notes to government-issued ones, and was now legal tender.

Due to the relative exchange rates of silver and gold and some quirks of legislative codification, the United States was effectively on a ***gold standard***—paper notes backed by gold—from then until the Great Depression. This was controversial at times. The most famous example is populist presidential candidate William Jennnings Bryan's 1896 "Cross of Gold" speech, which included a passage criticizing the gold standard: "You shall not press down upon the brow of labor this crown of thorns; you shall not crucify mankind upon a cross of gold." This was effectively a fight over inflation: creditors and bankers generally preferred the tighter gold standard, while debtors and farmers generally preferred a larger money supply and its potential devaluation of the dollar. In 1900, however, the federal government made the gold standard legally explicit. In 1913, Congress established a national system of Federal Reserve banks. They were authorized to lend to private banks in times of need, and to issue gold-backed Federal Reserve notes to serve as money when needed. (These notes are now the primary form of paper currency in the United States.)

This system permanently broke during the Great Depression. Following the stock market crash of 1929, numerous banks failed as customers tried to withdraw more cash than the banks had on hand. People and countries hoarded cash precious metals, leading to a sharp contraction in the money supply and exacerbating the economic slowdown. When Franklin Roosevelt was inaugurated as president in 1933, one of his administration's first priorities was to restore public confidence in the banking sector. By presidential proclamation, he closed all banks for a week so that regulators could inspect their books, and so that the government could take action to stabilize the money supply. In a flurry of legislation and presidential action, the United States left the gold standard.

Not only did the government suspend convertibility into gold, it nationalized private holdings of gold at a fixed price and prohibited private transactions in gold. Even where existing contracts required payment in gold, the Gold Clause Resolution, 48 Stat. 112 (1933), declared these clauses void. In a series of cases known as the Gold Clause Cases, the Supreme Court upheld the resolution as a valid exercise of Congressional powers. *See Perry v. United States*, 294 U.S. 330 (1935).

Following the Great Depression and World War II, gold still played a role in the international monetary system under the Bretton Woods agreement of 1944. The United States dollar was still defined in terms of gold, it redeemed dollars for gold in international transactions, other countries' currencies were pegged at fixed ratios to the dollar, and countries kept gold reserves—but very few transactions settled in gold and few people took advantage of the dollar's convertibility. This system, however, was difficult to maintain, as it tightly coupled countries' monetary policy to the dollar. Facing pressures to keep more money in circulation (especially as the dollar was now widely used internationally), Congress gradually relaxed the rules requiring the Federal Reserve to hold reserves against its deposits and notes.

The final collapse of the gold standard came in the 1970s. Among other things, the United States was running large deficits to finance its participation in the Vietnam War, other countries were reducing their dollar reserves, and the economic 1973 oil embargo led to worldwide economic shock. The United States suspended convertibility of dollars to gold in international exchange in 1971, made a

series of failed attempts to restore convertibility by devaluing the dollar, and finally gave up and switched to a pure fiat-money dollar in 1976. Without a need to defend gold reserves, the United States repealed its restrictions on private ownership of gold in 1975 and allowed parties to use gold clauses again after 1977.

The United States does, however, forbid private currencies. It is a crime to make or pass as payment "any coins of gold or silver or other metal ... intended for use as current money, whether in the resemblance of coins of the United States or of foreign countries, *or of original design*." 18 U.S.C. § 486 (emphasis added). This isn't just an anti-counterfeiting rule; it is designed to prohibit currencies that would compete directly with the official dollar.

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THE CURRENCY OF MONEY
55 CAMB. L.J. 547 (1996)

[This passage describes the legal treatment of coins in England in the 17th and 18th centuries.]

The original explanation for the currency of money followed from the practical difficulty of proving title to coins in another person's possession. Money, it was said, had "no earmark." One coin was practically identical to all others of the same denomination. The maxim was often quoted in actions where the plaintiff sued the defendant for breaching his duties as a bailee of money. When the first actions appear in the reports during the sixteenth century, metallic coin was the only form of money in use so people who wished to save their money were forced to amass hoards of coins. They sometimes deposited the money with a trustworthy person in a bag or strongbox to hold on a bailment. The bailee was bound to keep the money safe and return it specifically. From the practical and legal points of view, the transaction was no different from the bailment of a valuable chattel.

If the bailee failed to return the money the proprietor might have an action in detinue, claiming its specific return or damages for its value. He could also seek damages by suing in case for trover and conversion because the court would readily infer that there must have been a conversion if the bailee could not satisfactorily explain his failure to return the money. ... [T]he plaintiff in a detinue action faced formidable problems of proof. None of the coins had distinctive earmarks so the plaintiff would usually find it difficult to establish that it was precisely his money that the defendant detained. Accordingly it was said in the cases: "[Money] cannot be known from other money"; a "certain property" in money could not be ascertained, because "one mans [*sic*] money is not to be known from anothers [*sic*]". The courts held as a consequence that detinue would not lie for money unless it was contained in a bag or box. That was the only way to give a distinct identity to the coins which would otherwise be without earmarks. Specific identification was essential because the defendant had the option of returning the plaintiff's property or paying damages. ...

Conversely, the action for trover would lie for the conversion of money that was not contained in a bag when it was alleged to have been appropriated. The only remedy for the conversion was damages so it did not matter whether the defendant could specifically return the plaintiff's money after it was alleged to have been converted. Indeed the very act that constituted the conversion, as where the defendant spent the money or mixed it with his own, might have caused the plaintiff's money to lose its specific identity.

It may have been the practical difficulty of specifically recovering money in detinue that underlay the early explanations for the currency of money. Title to money generally vested in the person who had it in his possession. Because coins had no earmark which would have allowed them to be specifically identified, it was generally impossible for the original owner of money to prove his title once the money passed into the possession of another person. At that point it would usually become mixed with other coins so that the original owner could not prove his title and recover the money. The money effectively became the property of the new recipient. Title to money passed with possession, provided that the coins could not be specifically traced to their original owner.

NOTES

1. Suppose that Abel has twenty-one pounds ten shillings in coin. Baker breaks into Abel's house, puts the coins in a bag *by themselves*, and runs down the road. He is apprehended ten minutes later. Abel can recover his 2*ll*. 10*s*. from Baker: those exact coins. He can do so by bringing the writ of detinue, which allowed the plaintiff to recover specific property held by the defendant. But now suppose that Baker puts the coins in a bag *with other coins* before he is taken. Abel cannot bring detinue, because he cannot prove which of the coins were originally his. Money has no earmark. Abel can, however, bring the writ of trover—the ancestor of modern tort of conversion—which will entitle him to recover the value of the stolen property. He will receive twenty-one pounds ten shillings, but he is not guaranteed that they will be the exact same coins that Baker stole from him. In modern terminology, money is treated as almost perfectly fungible: every shilling coin is considered equivalent to every other shilling coin.
2. Now suppose that Baker makes it to Liverpool, where he uses the coins to buy a pair of horses from Chauncey. Baker rides off, never to be seen again, but Abel shows up soon after, demanding his coins. The doctrine of the" currency of money" is that Abel cannot recover from Chauncey because "money has no earmark": Abel cannot bring detinue because he cannot prove which of Chauncey's coins are his, and he cannot bring conversion because Chauncey did not convert Abel's property to his own use (Baker did). In theory, there was a possibility that Abel could identify his coins if he shows up quickly enough, but in practice it seems to be have become widely accepted that the coins were Chauncey's property now.
3. This resembles the good-faith purchase rule, but it is in fact something stronger. It allows Chauncey to take good title even when Baker was a thief who had what we would today call "void" rather than "voidable" title. This is a special rule for money.

MILLER V. RACE

[1758] 97 Eng. Rep. 398 (K.B.)

It was an action of trover against the defendant, upon a bank note, for the payment of twenty-one pounds ten shillings to one William Finney or bearer, on demand.

The cause came on to be tried before Lord Mansfield at the sittings in Trinity term last at Guildhall, London: and upon the trial it appeared that William Finney, being possessed of this bank note on the 11th of December 1756, sent it by the general post, under cover, directed to one Bernard Odenharty, at Chipping

Norton in Oxfordshire; that on the same night the mail was robbed, and the bank note in question (amongst other notes) taken and carried away by the robber; that this bank note, on the 12th of the same December, came into the hands and possession of the plaintiff, for a full and valuable consideration, and in the usual course and way of his business, and without any notice or knowledge of this bank note being taken out of the mail.

It was admitted and agreed, that, in the common and known course of trade, bank notes are paid by and received of the holder or possessor of them, as cash; and that in the usual way of negotiating bank notes, they pass from one person to another as cash, by delivery only and without any further inquiry or evidence of title, than what arises from the possession. It appeared that Mr. Finney, having notice of this robbery, on the 13th December, applied to the Bank of England, "to stop the payment of this note:" which was ordered accordingly, upon Mr. Finney's entering into proper security "to indemnify the bank."

Some little time after this, the plaintiff applied to the bank for the payment of this note; and for that purpose delivered the note to the defendant, who is a clerk in the bank: but the defendant refused either to pay the note, or to re-deliver it to the plaintiff. Upon which this action was brought against the defendant. ...

Lord Mansfield now delivered the resolution of the Court.

After stating the case at large, he declared that at the trial, he had no sort of doubt, but this action was well brought, and would lie against the defendant in the present case; upon the general course of business, and from the consequences to trade and commerce: which would be much incommoded by a contrary determination.

It has been very ingeniously argued by Sir Richard Lloyd for the defendant. But the whole fallacy of the argument turns upon comparing bank notes to what they do not resemble, and what they ought not to be compared to, viz. to goods, or to securities, or documents for debts.

Now they are not goods, not securities, nor documents for debts, nor are so esteemed: but are treated as money, as cash, in the ordinary course and transaction of business, by the general consent of mankind; which gives them the credit and currency of money, to all intents and purposes. They are as much money, as guineas themselves are; or any other current coin, that is used in common payments, as money or cash. ...

Here, an inn-keeper took it, bona fide, in his business from a person who made an appearance of a gentleman. Here is no pretence or suspicion of collusion with the robber: for this matter was strictly inquired and examined into at the trial; and is so stated in the case, "that he took it for a full and valuable consideration, in the usual course of business." Indeed if there had been any collusion, or any circumstances of unfair dealing; the case had been much otherwise. If it had been a note for 1000*l.* it might have been suspicious: but this was a small note for 2*ll.* 10*s.* only: and money given in exchange for it. ...

A bank-note is constantly and universally, both at home and abroad, treated as money, as cash; and paid and received, as cash; and it is necessary, for the purposes of commerce, that their currency should be established and secured. ...

NOTES

1. *Miller v. Race* is one of the crucial cases in the history of what would now be called "commercial law"—the mix of contract law and property law that applies to sales, leases, payments, secured transactions and other financial

dealings among businesses. It requires, and repays, close reading. In particular, make sure you understand who the parties are, and the nature of their dispute.

2. A "bank note" is a piece of paper issued by a bank (in this case the Bank of England) promising to pay the bearer a certain sum "on demand"—i.e., when the bearer presents the note to the issuing bank. If a bank note merely gives the bearer the right to receive coins of a stated value, *why did bank notes even exist*? Why did William Finney send Bernard Odenharty a bank note rather than twenty-one pounds and ten shillings in coin? Conversely, in a world with bank notes, why would anyone ever carry around coins?
3. The bank note itself is a physical piece of paper ordinarily subject to property law. But the bank's promise to pay is an intangible obligation ordinarily subject to contract law. One of the deep ideas of commercial law is that under the right circumstances, a contractual promise can become a kind of property. The first step, which is based on the terms of the bank note itself, is ***assignment***. Suppose that Finney goes to the bank and purchases a bank note, and then sends the note to Odenharty, who presents it for payment. Do you see how assignability is needed to turn the personal promise to Finney into property that he can use in his dealings with Odenharty? And do you see the role that the physical piece of paper plays in making the assignment effective?
4. The second step, which *Miller* takes, is ***negotiability***. Miller can present the bank note for payment even though the note was previously stolen. Why? Think about the case in which everyone is using coin. This is the point of *Miller*'s argument that "[a] bank-note is constantly and universally, both at home and abroad, treated as money, as cash."
5. Notice that the *Miller* rationale for negotiability is different than the fungibility rationale Fox discusses. It also leads to different consequences, because *Miller* is more clearly concerned with good-faith purchase for value.
6. A right to payment on a bearer instrument is a prototypical example of an intangible property interest merged in a document. So how important is the physical bank note to the holding here? What would happen if the bank note had been destroyed in a fire?
7. Make sure you understand the limits of the holding. Why would the result be different if "there had been any collusion, or any circumstances of unfair dealing"? And why would the result be different if it involved other goods, say a cartload of beer?
8. Finally, what happens now? Who loses as a result of this holding, and what can they do about it? (And what if the case had gone the other way?)

NOTE ON NEGOTIABLE INSTRUMENTS

A bank note is just one of many types of ***negotiable instruments***: contractual promises relating to some underlying property embodied in a tangible document that can be assigned (or "negotiated") from one party to another. Some common types include:

- A ***promissory note*** (or sometimes just a "note") is a promise by the signer (the "maker" or "issuer") to pay a specified amount. Promissory notes are used extensively in loans—the borrower's promise to repay the loan is typi-

cally embodied in one. Note (pun intended) that the bank note in *Miller v. Race* was itself a promissory note, where the Bank of England undertook to pay in specie—but under other circumstances, a bank note might itself have been used to make the payment required by a promissory note. Today, notes are governed by Article 3 of the Uniform Commercial Code.

- A ***check*** or ***draft*** is an instruction by the signer (the "drawer") instructing a third party (the "drawee," typically a bank) to pay a specified amount. As with notes, some checks are payable on demand, while others are payable on a specified date. When a check is "presented" for payment to the drawee, it is said to be "honored" if the drawee pays as directed, and "dishonored" if they do not. The most common reason for dishonor is that the drawer's account has insufficient funds (a/k/a "NSF") in it. Checks and drafts are also governed by UCC Article 3.
- To avoid the risk of dishonor, some payees in high-stakes transactions like car sales will insist on a ***cashier's check***—a check that the bank draws on itself. One reason to insist on one is that the bank itself will almost always have sufficient funds available to pay—particularly because the customer essentially has to buy it from the bank up front, irrevocably transferring sufficient funds to the bank to cover its value. Another reason is that the issuing bank is obligated to honor a cashier's check under almost all circumstances, *see* U.C.C. § 3-412, whereas a drawee bank has more discretion about whether to honor an ordinary check, *see id.* § 3-408.
- A ***letter of credit*** is a promise by a bank (the "issuer") that it will guarantee a customer's (the "applicant") promise to pay a third party (the "beneficiary"). The reason to use a letter of credit rather than a note or check is that the right to payment is typically *conditional*: the beneficiary is only entitled to the funds once it demonstrates that it has fulfilled its part of the underlying transaction. For example, in an international sale of goods, the seller may demand that the buyer provide a letter of credit from a bank that the seller knows and trusts; the letter of credit will state that the funds are to be released only once the seller presents documents demonstrating that the goods have been delivered into the buyer's control. Letters of credit are governed by UCC Article 5.
- Now think about the other half of that transaction: what kind of documentation will be needed to make sure that the goods are properly released to the buyer? The seller and the buyer will typically not interact directly; instead, the seller will entrust the goods to a carrier that will transport them to the buyer's location, or to a warehouse that will store them until the buyer picks them up. The carrier or warehouse is a bailee of the goods and the seller is a bailor, but the twist is that the goods need to be given to the buyer instead of back to the seller. Thus the carrier or warehouse (the "issuer") will give the seller a ***document of title*** (called a ***bill of lading*** for transportation or a ***warehouse receipt*** for storage) promising to release the goods as directed. The seller will transfer the document of title to the buyer, and the buyer can then present the document to the issuer and receive the goods. Observe that the letter of credit and the document of title flow in opposite directions; they embody the two essential parts of the transaction (the payment and the goods). Documents of title are governed by UCC Article 7.

Each type of negotiable instrument has its own governing body of commercial law, and lawyers who work with them must be attentive to the details. We will concern ourselves here with only a few high-level points.

First, some negotiable instruments, like the bank note in *Miller*, are ***bearer*** instruments; anyone who is in possession of them is entitled to enforce their terms. Others are ***to order*** of a named party; only that party is entitled to enforce them. Bearer instruments can be assigned simply by transferring possession of the document; instruments to order can be assigned only if the named party signs (or ***indorses***) them over. The distinction is primarily based on how they are written, and different commercial settings call for different treatment. Cash would be extremely annoying if it were to order and every dollar bill had to be signed when using it to buy a bag of chips. On the other hand, a multi-million dollar letter of credit is a bespoke document drafted for a specific transaction and can be written to order of the payee; it would create substantial unnecessary risk to make it a bearer document that could be stolen and presented for payment by the thief.

Second, while some instruments' obligations are enforceable immediately ("on ***demand***"), others are enforceable only on or after a specified date. This is the purpose of the date field on a check. If you fill it in with today's date when you write a check, you are letting the payee present it for payment as soon as they want. If you fill in a date in the future, the payee can only present it as of that date. This is how promissory notes are typically used for loans: the borrower gives a note that specifies the repayment date. The note can (and often does) circulate before that date, as the lender may sell the debt onward to someone else, but it can't be enforced until the date it bears.

Third and most importantly, the defining characteristic of negotiable instruments is right there in the name: they follow the negotiability rule of *Miller v. Race*. We have seen what this means in the case of stolen bank notes, but it has some other surprising consequences. The most significant is that a "holder in due course" typically takes the instrument free of many defenses that its original creator could have asserted against the party to whom it first gave the instrument.

An example will help. Suppose that Abel contracts to buy a cartload of barrels of wine from Baker and pays with a £200 promissory note. But when the cartload arrives, Abel discovers that the wine has gone bad and is usable only as vinegar. If Baker demands payment on the note, Abel could refuse; in modern terms, this is a straightforward breach of the seller's warranty of merchantability, U.C.C. § 2-314, and Abel could respond to Baker's breach by withholding payment. But now suppose that Baker has already indorsed the note over to Crumleigh, who has indorsed it to Daniels. When Daniels demands payment on the note, *Abel is not entitled to refuse*; Crumleigh and Daniels "take free" of Abel's "personal" defenses against Baker's enforcement of the note, such as non-conforming goods.

The reasoning is essentially the same as in *Miller*. If Daniels needs to check the details of the Abel-Baker transaction—including inspecting the wine—to determine whether he will be paid on Abel's note, he will refuse. He doesn't know Abel; he doesn't even know Baker. The doctrine of *Miller v. Race* lets Daniels rely on the note itself, rather than inspecting the details of the underlying transaction. That in turn lets the note circulate as money, enabling other transactions that otherwise would have frozen up for lack of financing.

The UCC sets out the modern rules for notes and checks. First, a "holder in due course" entitled to the benefits of the negotiability rule is someone who receives the document under the following circumstances:

(1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity; and

(2) the holder took the instrument (i) for value, (ii) in good faith , (iii) without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, (iv) without notice that the instrument contains an unauthorized signature or has been altered, (v) without notice of any claim to the instrument described in Section 3-306 , and (vi) without notice that any party has a defense or claim in recoupment described in Section 3-305(a) .

U.C.C. § 3-302(a). Once someone has holder in due course status, they are not subject to defenses that would be available when "enforcing a right to payment under a simple contract," *id.* § 3-305(a)(2). Only defenses that would make the instrument itself void, such as fraud or duress, are available against them. *Id.* § 3-305(a)(1).

And third, because negotiability is such a strong rule, it poses significant risks to individuals who may not realize what they are giving up when they sign a negotiable instrument. For this reason, the Federal Trade Commission's Holder in Due Course Rule, 16 C.F.R. pt. 433, requires consumer credit contracts to include language specifically disclaiming negotiability.

Negotiable instruments and negotiability are essential concepts for thinking about modern financial property, particularly its new digital variants. But don't overestimate their importance in daily life. Checks, in particular, used to be widely used by consumers but are now on extinction watch, or at least endangered. In decades gone by, you might have received a physical paycheck that you deposited in person at a bank branch and paid by check for your rent, your electric bill, and your groceries. (In the opening scene of *The Big Lebowski*, set in 1991, the lead character pays for a quart of half-and-half with a personal check for sixty-nine cents.) Today, many or most of these payments are made electronically, using other payment systems we will discuss in due course—payment systems that do not involve pushing around pieces of paper subject to the holder-in-due-course doctrine. And even when people write and receive physical checks, it is extremely uncommon to negotiate them to another holder. Instead, the one and only thing the recipient will do with the check is deposit it at their own financial institution, which will present it to the drawer's bank for payment. In a world where fewer hands touch a typical negotiable instrument, the complicated doctrinal machinery of UCC Article 3 and the rule of *Miller v. Race* may be anachronisms. *See generally* JAMES STEVEN ROGERS, THE END OF NEGOTIABLE INSTRUMENTS (2011) (arguing for the elimination of the negotiability rule for checks and notes).

B. Banking

KEYES V. PADUCAH & ILLINOIS RAILROAD CO.
61 F.2d 611 (6th Cir. 1932)

Simons, Circuit Judge:

Appellee brought suit in the court below against the sheriff of McCracken county, and others, seeking to enjoin the collection of certain taxes. A temporary injunction was sought and granted. Instead of requiring the plaintiff to execute bond as a condition precedent to the issue of the temporary injunction, the order contained the following provision: "This injunction is conditioned upon deposit by plaintiff in the National Bank of Kentucky of Eight Thousand Dollars, to abide the event of this cause, and it appearing to the court that this has been done, said sum so deposited shall be at all times subject to the order of this court."

In compliance with the order, appellee deposited with the National Bank of Kentucky a draft for $8,000 and a copy of the order of the court. The bank executed its receipt, which, after reciting the entry of the order by the court, concludes:

> Whereas, the National Bank of Kentucky is willing to act as depository for that purpose, and in obedience to said order.
>
> Therefore, the National Bank of Kentucky hereby acknowledges receipt, from the Paducah & Illinois Railroad Company, of a draft dated June 11th, 1929, in the sum of Eight Thousand ($8000.00) Dollars, drawn by Fitzgerald Hall on L. E. McKeand, Treasurer of the Nashville, Chattanooga & St. Louis Railway at Nashville, Tennessee, and will when said draft shall have been cleared acknowledge receipt in writing of said cash; it being understood that said National Bank of Kentucky holds said fund subject as aforesaid to the order of said United States District Court.

Subsequently, on June 15, 1929, the bank, by its assistant cashier, advised plaintiff's counsel of the payment of the draft in a letter as follows:

> Acknowledging receipt of your letter of the 12th, beg to advise that the draft for Eight Thousand Dollars which you left with this bank for collection has been paid, and we are holding the proceeds in form of a cashier's check awaiting the time when your treasurer will, as you suggested in your letter, take the matter up with us.
>
> The court order accompanying your letter in the case of Paducah & Illinois Railroad Company, plaintiff, v. Holt, Sheriff, et al., defendant, has been filed for future reference.

On November 16, 1930, the National Bank of Kentucky was closed by order of its board of directors, and on the following day the Comptroller of the Currency of the United States appointed appellant as receiver, who duly qualified and took charge of all of the bank's assets. In February, 1931, the court entered its final decree in the tax suit, making permanent the preliminary injunction therein, and granting the relief prayed for by the plaintiff. Thereupon the appellee demanded that the receiver turn over to it the full sum of $8,000 as a special deposit, and, upon the refusal of the receiver to comply with the demand, filed a motion in the tax suit and obtained a rule requiring the receiver to show cause why he should not be compelled to do so. ...

The first question to be decided is whether the fund deposited with the bank is a trust fund, either because it is a special as distinguished from a general deposit, or because it must be construed as a trust by reason of its being a deposit for a specific purpose. If a trust fund, the depositor is entitled to preferential payment as against general creditors, providing the deposit augmented the bank's funds coming into the hands of the receiver, and providing the money can be traced into his possession. The doctrines of augmentation and tracing are, however, to be considered only if the trust relationship exists; otherwise they are unimportant.

We are concerned first with the distinction between special and general deposits.

> All deposits made with bankers may be divided into two classes, namely, those in which the bank becomes bailee of the depositor, the title to the thing deposited remaining with the latter; and that other kind of deposit of money peculiar to banking business, in which the depositor, for his own convenience, parts with the title to his money, and loans it to the banker, and the latter, in consideration of the loan of the money, and the right to use it for his own profit, agrees to refund the same amount, or any part thereof, on demand.

Commercial Nat. Bank of Pennsylvania v. Armstrong, 148 U.S. 50, 59 (1893), quoting with approval from *Marine Bank v. Fulton Bank*, 69 U.S. 252, 256 (1865). A special deposit consists in the placing of specific kinds of money or property in the possession of the bank, with an obligation of the bank to return the identical thing deposited; the depositor retaining title. On the other hand, a deposit is general where a sum of money is left with the bank for safe-keeping, subject to order, and payable, not in the specific money deposited, but in an equal sum, whether it bears interest or not. As was said by the Supreme Court in *Bank of Republic v. Millard*, 77 U.S. 152, 155 (1869):

> It is an important part of the business of banking to receive deposits, but when they are received, unless there are stipulations to the contrary, they belong to the bank, become part of its general funds, and can be loaned by it as other moneys. The banker is accountable for the deposits which he receives as a debtor, and he agrees to discharge these debts by honoring the checks which the depositor shall from time to time draw on it. The contract between the parties is purely a legal one, and has nothing of the nature of a trust in it.

Whether a deposit in a bank is general or special depends upon the mutual understanding and intention of the parties at the time such deposit is made, and a deposit made in the ordinary course of business is presumed to be general, and the burden of proof is upon the depositor to overcome such presumption by proving that the deposit was made upon such terms and conditions as constituted a special deposit, or a deposit for a specific purpose, as distinguished from a general deposit.

Having in mind the nature of a special deposit, the trust relationship that results, and the initial presumption against its existence, it becomes necessary to determine what kind of a deposit was made in the instant case. If the deposit was special, its character must be derived from the terms of the court order directing it, the receipt given by the bank, and the bank's letter acknowledging payment of the draft. There is no other evidence. We fail to find in any of these instruments, herein sufficiently recited, any indication that it was the intention of the court or

of the parties that the avails of the draft were to be segregated and kept as a separate fund until its disposition was directed by an order of the court. There was certainly no express direction in the order of the court to keep the funds deposited separate and distinct from the general funds of the bank, nor is any such direction to be clearly implied. That the parties did not themselves so interpret the arrangement seems equally clear. The bank's letter of June 15, 1929, informed the depositor that the bank was holding the proceeds of the deposited draft in the form of a cashier's check. This could have but one meaning, and that is that the funds received were held as part of the general funds of the bank, and were represented by the bank's check upon itself, to be delivered to the successful litigant upon the order of the court. Although this letter was received by the depositor seventeen months before the determination of the litigation, and fifteen months before the bank failed, it does not appear that any protest was made to the bank's method of handling the fund, nor was a contrary understanding expressed by the depositor.

It would of course have been competent for the court, or for the parties, to have created a trust fund awaiting the outcome of the litigation. ... Trusts have been impressed upon funds which are not strictly special deposits, and where there is no intention expressed or clearly to be implied that the funds deposited should be segregated and not commingled with the general funds of the bank. Such trusts are generally held to result from some wrongful act on the part of the bank, such as the acceptance of a deposit by the officers of the bank, knowing at the time that the bank, is insolvent. No such situation is here involved. Another ground for such declaration of trust is the receipt of funds to be applied and used for a definitely designated purpose, but which are in fact fraudulently or unlawfully appropriated to other uses. This misapplication constitutes a wrongful act, and makes the recipient a trustee. These decisions are not applicable here. Nor are we concerned with the so-called "collection" cases. While funds received by banks as avails of checks or drafts deposited for collection are sometimes referred to as trust funds, the relationship between the bank and the depositor is, strictly speaking, one of agency and not of trust, and title to the paper while collection is being made is in the depositor and not in the bank. ...

QUESTIONS

1. What is a bank? If you go to your bank and ask to examine your account, what will you see?
2. What happened between June 1929 and November 1930 that prevented the National Bank of Kentucky from paying out the $8,000 at issue here? Why didn't the fact that the bank was holding a cashier's check for that sum mean that it was available to return to the appellee?
3. As *Keyes* explains, under most circumstances—a "general deposit"—a bank takes title to deposited funds. The depositor becomes a creditor of the bank, entitled to repayment on demand. The alternative rule—a "special deposit"—is followed only in specific cases, usually involving specifically identified property, where the bank agrees to serve as a bailee. Do you see how treating most deposits as general deposits simplifies banking and commercial transactions?
4. Under modern U.S. bankruptcy law, a debtor's "estate" (i.e., the assets available to be distributed to creditors) does not include "[p]roperty in which the debtor holds ... only legal title and not an equitable interest." 17 U.S.C.

§ 541(d). Thus, if a bank declares bankruptcy, general deposits are property of the estate, but any assets that the bank holds as a trustee are not, and can be distributed to the trust beneficiaries, or transferred to another trustee. *See id.* § 725. When might it make sense to expressly name a bank as trustee, rather than making a general deposit? Does this also help explain the exceptions in the final excerpted paragraph of *Keyes*?

NOTE ON BANKING REGULATION

A defining feature of banking is ***demand deposit***: the depositor is entitled to withdraw their funds on demand; this distinguishes it from a typical loan agreement, in which the lender is only entitled to repayment at a particular time or times. The idea that the depositor is allowed to get their money back may seem so obvious that it goes without saying, but throughout history banks in distress have tried to suspend withdrawals while they get their books in order, and also throughout history people in the borderland between "entrepreneurs" and "con artists" have come up with schemes that look a lot like banks except that the "bank" keeps your money forever. The Expedited Funds Availability Act, 12 U.S.C. ch. 41, and the Federal Reserve's Regulation CC, 12 C.F.R. pt. 229, put strict time limits on how long a bank can hold on to a customer's funds after deposit before they must be made available for withdrawal—typically within one or two business days.

There is another and subtler consequences of the demand-deposit rule. Banks typically invest deposited funds, for example by making loans to businesses in need of capital. The resulting mismatch creates a risk that depositors will demand their money back at a time when the bank doesn't have enough funds on hand. Indeed, the fear that a bank might be unable to repay depositors can drive them to rush to be the first to withdraw, which exacerbates the mismatch. The resulting spiral is called a ***bank run*** and it can be debilitating to a bank or to a larger financial system.

As a result, banks are among the most heavily regulated institutions in the economy. Significant regulations typically include:

- Banks must be specifically ***chartered*** by an appropriate regulator, i.e., approved to open and accept deposits. (Contrast this with typical state incorporation statutes, which automatically create a corporation upon the filing of appropriate paperwork. *See, e.g.* DEL. GEN. CORP. L. § 101(a).)
- ***Capital*** regulations require the bank's investors to contribute a sufficient amount of their own capital to provide a layer of protection against losses. The principal framework here is the Basel Accords, a set of recommendations developed by an international group of national central bankers, which are then enforced by national regulators. *See generally* BANK CAPITAL REQUIREMENTS: A PRIMER AND POLICY ISSUES (CRS Report R47447, Mar. 9, 2023).
- ***Reserve*** regulations require the bank to keep sufficient amounts of liquid assets on hand at all times. These vary widely from country to country. The United States has had reserve requirements in the past but has not since 2020; instead, the Federal Reserve encourages banks to keep reserves by paying interest on "excess reserves" that they deposit with the Fed.
- In banking s***upervision,*** regulators monitor banks to ensure that they are appropriately managed and are not taking unwarranted risks. The process is

intensive; employees of the regulator often physically work in the bank's offices and are able to inspect all aspects of their operations.

- If a bank fails to meet its regulatory requirements, or is in danger of failing in a crisis, regulators may engage in ***resolution***: taking control of the bank and immediately selling it to a better-capitalized partner, or liquidating it and returning deposits to customers.
- ***Deposit insurance*** reassures customers that even if a bank fails, they will be made whole. Today, the Federal Deposit Insurance Corporation insures bank deposits up to $250,000 per covered account. *See* 12 U.S.C. §§ 1811 *et seq.*

The frontiers of banking regulation can be tricky ground. On the one hand, banking regulation is so onerous that entities will almost always prefer not to be regulated as a bank if they have the option. On the other hand, deposit insurance plays a key role in providing consumer confidence in financial institutions, so there is also a hydraulic pressure for regulators to move consumers into bank deposits over unprotected alternatives.

NOTES AND QUESTIONS

1. Which of the following are subject to banking regulations? If they fail, will your funds held with them be protected by FDIC insurance?
    - Bank of America
    - The Polish & Slavic Federal Credit Union
    - Venmo
    - CapitalOne
    - Roblox
    - Coinbase

NOTE ON MONEY LAUNDERING

[The following text is based on Sarah Allen et al., Design Choices for Central Bank Digital Currency § 10.2 (Brookings Inst. 2020).]

Money laundering is the use of financial transactions to conceal the source of funds. Governments prohibit money laundering not because they care about funds as such, but because money laundering makes it easier for criminals to conceal their crimes, evade taxes, and profit from their ill-gotten gains. Relatedly, governments increasingly prohibit the use of financial transactions to support terrorist organizations. Roughly speaking, anti-money-laundering and countering the funding of terrorism (AML/CFT) laws come in three layers:

1. General prohibitions, such as the Money Laundering Control Act, 18 U.S.C. § 1956, that directly target money laundering itself by prohibiting the use of financial transactions to conceal the source of proceeds of criminal activity. Examples include "spending" cash received from drug dealing at a front business, or making wire transfers to make kickbacks look like legitimate business receipts. Similarly, the Antiterrorism and Effective Death Penalty Act makes it illegal to "knowingly provide[] material support or resources to a foreign terrorist organization." 18 U.S.C. § 2239B(a)(1).
2. Reporting requirements, such as the Bank Secrecy Act (BSA), which requires that financial institutions report to the government all transactions in cash of $10,000 or more. 31 U.S.C § 5313; 31 C.F.R. pt. 1010. Reporting requirements also include Know Your Customer (KYC) rules, which require institu-

tions to verify the identities of their clients, as well as more open-ended standards requiring institutions to report suspicious transactions, and even more open-ended ones requiring institutions to have effective programs to detect and report suspicious transactions. These rules are designed to help regulators find money laundering by enlisting surveillance at the financial institution level.

3. Anti-evasion (or "structuring") rules that prohibit attempts to circumvent reporting requirements, e.g., by breaking a larger transaction down into smaller ones under the reporting threshold. 31 U.S.C. § 5324.

C. Securities

BOSTON MUSIC HALL ASSOCIATION V. CORY

129 Mass. 435 (1880)

Colt, Justice:

In 1874, Howard L. Hayford sold five shares in the stock of the Boston Music Hall Association to his brother Nathan H. Hayford, to whom he delivered a stock certificate, and upon which he indorsed and signed a written transfer in the usual form. No transfer was made on the books of the corporation, and there was no provision in the charter or by-laws of the association requiring it. It was not until after the shares were levied on as the property of Howard L., in May 1878, that the corporation was notified of the alleged sale and transfer to Nathan H. In the mean time Howard L., with the knowledge of his brother, collected the annual dividends declared on the stock, attended meetings of the stockholders, and served upon committees appointed at such meetings. Under the levy made in 1878, Barney Cory bought the stock as the property of Howard L.; and the question presented by this bill of interpleader is, which of the two acquired the title.

The case comes up on an appeal from the decree of a single judge in favor of Nathan H. Hayford, accompanied by a report of the evidence taken at the hearing. ...

The only evidence of the transaction in 1874 comes from the two Hayfords, who were the parties to it. But we cannot say that the fact that the apparent ownership remained unchanged for such an unusual length of time upon the books of the corporation, and that Howard L. received the dividends and continued to act as the real owner, is sufficient to lead us to believe that the judge erred ...

In the next place, it is strenuously urged that, by force of the various statutes of this Commonwealth relating to the ownership and transfer of stock in corporations, authorizing the attachment of shares, requiring returns to the Secretary of the Commonwealth, and imposing a personal liability on stockholders for the debts of the corporation, there can be no transfer of stock, valid against the claims of an attaching creditor, unless such transfer be recorded in the books of the corporation. The intention of the Legislature, it is said, must have been to provide for the owners of stock a convenient and uniform method of transferring title on the books of the corporation, which should be the only valid transfer as to creditors, and others interested; and, although the statutes have not provided in express terms that, as to creditors, transfers shall not be valid till they are so recorded, yet such, it is contended, is the necessary implication, for otherwise the design of the statutes, requiring registration and making the shares liable to be taken for debts,

would be defeated. But this consideration is not sufficient to control the law as long since settled by the decisions of this court. It requires a clear provision of the charter itself, or of some statute, to take from the owner of such property the right to transfer it in accordance with known rules of the common law. And by those rules the delivering of a stock certificate, with a written transfer of the same to a bona fide purchaser, is a sufficient delivery to transfer the title as against a subsequent attaching creditor.

It would not be in accordance with sound rules of construction to infer, from the provisions of several different statutes passed for the purpose of obtaining information needed to secure the taxation of such property, or for the purpose of subjecting stockholders to a liability for the debts of a corporation, or for protecting the corporation itself in its dealings with its own stockholders, that the Legislature intended thereby to take from the stockholder his power to transfer his stock in any recognized and lawful mode. If a change in the mode of transfer be desirable, for the protection of creditors, or for any other reason, it is for the Legislature to make it by clear provisions, enacted for that purpose.

We see nothing in the facts which can be held to deprive Nathan H. Hayford of the stock in question, on the ground that he is chargeable with laches in not causing the transfer to be sooner recorded, or that he is now estopped from setting up his title to the shares in his possession. It must be taken, upon the findings of the judge, that Nathan H. bought these shares in good faith in 1874; and that all which the law required was done to vest a perfect title in him, as against an attaching creditor of Howard L. He was under no legal duty to have the transfer recorded in order to perfect his title as against strangers, and he can be charged with no neglect or laches which would involve the forfeiture of his title.

The evidence in the case does not require us, against the findings of the single judge, to find that Nathan H. is estopped to set up his title against a creditor of Howard L. The acts and declarations of the latter, after the sale, would not affect the title, except so far as they were authorized by Nathan H., and there is nothing to show any act or declaration authorized by the latter, with intent to give a false credit to Howard L., or that any creditor of his was in fact defrauded.

NOTES AND QUESTIONS

1. What is a share of stock? Be sure that you understand how the *share* is different from the *stock certificate* and from the corporation's *records* of share ownership before proceeding.
2. The problem here, in a nutshell, is that there are two different sets of paper that indicate who is a shareholder of the Boston Music Hall Association. Why are there both stock certificates and corporate records? Why not just have one or the other? How did they get out of sync here? How else might they get out of sync?
3. The court here treats the stock certificates as controlling. Does this make sense? Is it fair to Cory? To other people who might inspect the corporate records and mistakenly conclude that Howard L. Hayford is the owner of the shares? In such a system, what should happen if a stock certificate is stolen or destroyed in a fire? If a stock owner falsely claims that a stock certificate has been stolen or destroyed?
4. What about the opposite rule, that the corporate records are controlling? How would such a system work? What would happen if a stock certificate

were stolen or destroyed in a fire? What about if the corporate records were tampered with or destroyed?

5. Physical stock certificates have gone by the wayside. Most securities today trade electronically. Records of ownership in publicly traded corporations are maintained in digital databases, and trades are recorded by changing the owner of record in those databases. It would be highly inconvenient for corporations themselves to track each trade (why?). Instead, legal title to most shares is held by the Depository Trust & Clearing Corporation (DTCC) on behalf of the economic ("beneficial") owner. A trade is settled by changing the DTCC's records, not the corporation's. In turn, the DTCC's records typically list numerous brokerages, each of which maintain their own list of customers' ownership. A sale from one customer to another requires only a change on the brokerage's records; a sale from one brokerage's customer to another will affect the DTCC's records. UCC Article 8, which governs investment securities, was revised in 1994 to support this electronic system of records.
6. When intermediaries hold stocks and other securities for their customers, they raise similar issues as banks do. SEC regulations require investment advisors to maintain "a separate account for each client under that client's name" or "in accounts that contain only your clients' funds and securities, under your name as agent or trustee for the clients." 17 CFR § 275.206(4)-2. Similar rules apply to broker-dealers. *Id.* § 240.15c3-3. As long as the intermediary retains control over customer assets, those customers have priority over the intermediary's other creditors. *See, e.g.*, UCC § 8-511(a) (priority over secured creditors).

D. Modern Payments

RESTATMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT [PAYMENT BY MISTAKE]

§ 1—*Restitution and Unjust Enrichment*

A person who is unjustly enriched at the expense of another is subject to liability in restitution. ...

Comment: ...

The concern of restitution is not, in fact, with unjust enrichment in any such broad sense, but with a narrower set of circumstances giving rise to what might more appropriately be called unjustified enrichment. Compared to the open-ended implications of the term "unjust enrichment," instances of unjustified enrichment are both predictable and objectively determined, because the justification in question is not moral but legal. Unjustified enrichment is enrichment that lacks an adequate legal basis; it results from a transaction that the law treats as ineffective to work a conclusive alteration in owner-ship rights. Broadly speaking, an ineffective transaction for these purposes is one that is *nonconsensual.* ...

§ 6—*Payment of Money Not Due*

Payment by mistake gives the payor a claim in restitution against the recipient to the extent payment was not due.

Comment: ...

b. Mistake as to payee. A mistaken payor has a claim in restitution when money is mistakenly transferred to someone other than the intended recipient.

Illustrations:

1. Oil Company owes royalties to unrelated lessors named Horace W. Smith and Horatio W. Smith, both of whom are listed in Company's records as H. W. Smith. By a clerical error, Company begins to pay the royalties due under both leases to Horace W. Smith. To the extent that Horace has received payments intended for Horatio, Company has a claim in restitution against Horace. (Horatio's claim against Horace is described in § 47. Horace is potentially liable both to Company and to Horatio, but he can eliminate both liabilities by discharging either of them.)
2. A instructs B Bank to make an electronic funds transfer to C Bank for the account of D. B transmits funds with garbled instructions to C, in consequence of which C credits the funds to the account of E. E withdraws the funds. B has a claim in restitution against E.

g. Negotiable instruments and funds transfers. The modern, largely statutory law of payments encounters recurring instances of payment of money not due. Traditional examples include a bank's payment of a check drawn against insufficient funds, or in the absence of a necessary endorsement, or in disregard of the customer's order to stop payment; more recent examples involve electronic funds transfers that are paid in the wrong amount or to the wrong payee. Such issues were treated at common law as problems of restitution and unjust enrichment, according to the rule of this section and the relevant affirmative defenses ... . While the issues presented are, in a sense, as much a part of the law of restitution and unjust enrichment as they ever were, their traditional common-law formulation has been largely displaced by the applicable provisions of the Uniform Commercial Code. ...

Illustrations:

30. Drawer draws a check for $100 on Bank to the order of Payee, to whom Drawer owes $500. Payee presents the check to Bank for payment in cash over the counter. By inadvertence, Bank's teller pays Payee $120 instead of $100. Bank has a claim in restitution against Payee to recover $20.
31. Drawer draws a check for $100 on Bank to the order of Payee. Bank pays the check by mistake, failing to note that Drawer's account was closed before the check was presented. Bank has a claim in restitution against Payee to recover $ 100. By the rule of U.C.C. § 3–418(c) (rev. 1990), Payee has an affirmative defense if it can establish that it took the check "in good faith and for value" or that it changed position in reliance on the payment. The same defenses to restitution appear in this Restatement as § 67(1)(b) (bona fide payee) and § 65 (change of position).

NOTES AND QUESTIONS

1. Restitution is one of the fundamental branches of private law, of equal importance to tort, contract, and property. Property law defines the parameters of what rights people have in thing, contract law deals with voluntary changes to those rights, tort law deals with involuntary harms to them, and restitution fills the remaining space: involuntary benefits that the recipient is not justified in keeping.. The "restitution" that shows up in the remedies sec-

tion of a first-year contracts course is about one specific type of unjustified enrichment, but the principle is broader.

2. Mistaken payments are the paradigm case of restitution. As between the bank that pays a customer an extra $20 and the customer, the bank is the one that made a mistake and the customer has done nothing wrong. Still, § 6 illustration 30 states that money properly belongs to the bank and the customer is required to return it. Why?

DEAN WITTER REYNOLDS INC. V. THE VARIABLE ANNUITY LIFE INSURANCE CO.

373 F. 3d 1100 (10th Cir. 2004)

McConnell, Circuit Judge:

In a world of instantaneous electronic fund transfers and online financial transactions, one would think that the old problems of disappearing checks, uncertain mail deliveries, and unknown thieves—long the staple of law school hypotheticals—would cease to have much practical significance. In this case, however, Defendant, the Variable Annuity Life Insurance Company ("VALIC"), opted to do it the old-fashioned way: It sent two checks via the postal service to its customer's broker in Houston, Texas. True to form, an unknown thief intercepted one of the checks and used it to open a fraudulent account in Los Angeles. As a result of vacations, horse-and-buggy procedures, and (allegedly) willful foot-dragging and miscommunications, payment was not stopped on the stolen check until some two months after it was mailed—by which time the thief had made away with most of the proceeds. In determining who should bear the loss, this Court has found it necessary to blow the dust off of ancient common law doctrines of negotiable instruments, bailments, and assignability of choses in action. In tribute to the enduring character of the common law, we apply these legal concepts to this twenty-first century dispute.

I. BACKGROUND

The facts in this case are largely undisputed, and we record them essentially as stated by the district court.

In September of 1998, Mrs. Merle Bass, a customer of VALIC, requested that the two accounts she maintained be liquidated and the proceeds sent to Dean Callender, a securities broker at Dean Witter's Houston office. To accomplish this transfer, Mrs. Bass filled out the appropriate "Rollover/Transfer Out Request Form" ("the Form").

As a result, VALIC generated two checks. The first ("Check I") was cut on September 29, 1998, for the amount of $211,041.66. The second ("Check II") was cut on September 30, 1998, for $126,947.59. Both checks were made payable to "Morgan Stanley Dean Witter FBO: Merle B. Bass" and contained Mrs. Bass's social security number.

Thereafter, Mrs. Bass left the country on a three-week vacation. Shortly after her return, on November 2, 1998, she called the Dean Witter office in Houston and discovered that the funds had not arrived. This prompted her to contact VALIC, which informed her that the checks had been mailed as per the instructions on the Form. According to Mrs. Bass, during this conversation she asked that VALIC stop payment on both checks. In any event, it is undisputed that on November 12, 1998, someone from Dean Witter's Houston office spoke to VALIC and requested stop payments on both Check I and Check II.

VALIC issued the stop payment order on November 16, 1998, and payment on Check II was stopped. Check II was reissued and the funds were eventually received by the Houston office. As to Check I, however, VALIC was unable to fulfill the stop payment request because the check had already been negotiated on November 9, 1998, and paid by VALIC's bank on the following day.

In December, Dean Witter became aware of a suspicious account opened in its Los Angeles office. Investigation revealed that the account was opened in the name of "Mevle Bass" using Merle B. Bass's social security number, which was printed on the face of the check. Someone—presumably the person who stole the check—had been depleting the account since November 24, 1998. Dean Witter promptly froze the account, but by that time, over $160,000 had been stolen.

Dean Witter reimbursed Mrs. Bass for her loss, and in exchange Mrs. Bass assigned her claims to Dean Witter. Dean Witter then initiated this action against VALIC in the District of Colorado pursuing claims under theories of: (i) misdelivery of bailment, (ii) breach of contract, (iii) fraud, (iv) promissory estoppel, (v) the Colorado Consumer Protection Act (C.R.S. §§ 6-1-101 *et seq.* "CCPA"), and (vi) breach of fiduciary duty. The contract, bailment, and fiduciary claims are all premised on Dean Witter's assertion that its non-receipt of the checks constitutes failure by VALIC to perform its duties under the various agreements entered into with Mrs. Bass. The fraud, promissory estoppel, and CCPA claims likewise have a common point of departure. In essence, Dean Witter claims that VALIC knew or should have known that Check I had been negotiated on November 10, 1998, yet it continued to reassure Mrs. Bass that her stop payment request would be processed and honored. According to Dean Witter, Mrs. Bass relied on this information and did not further pursue the matter with VALIC until November 30. These dates are significant because the thief did not begin to deplete the account until November 24. Dean Witter argues that had VALIC provided Mrs. Bass with accurate information regarding Check I, the account would have been frozen prior to the thief's depletion of the funds.

VALIC, on the other hand, maintains that responsibility for the theft lies with Dean Witter. VALIC argues that since the check was negotiated by Dean Witter and the fraudulent account was opened in its Los Angeles branch with Mrs. Bass's social security number, Dean Witter should have realized that the check missing from its Houston office was used to open an account in its Los Angeles office. VALIC thus argues that Dean Witter was in the better position to prevent the theft. ...

We emphasize that this case comes to us on appeal from the district court's grant of summary judgment in favor of defendant VALIC on all claims. Thus, the issue is not which party ultimately will or should prevail, but whether there are any disputed questions of material fact, drawing all reasonable inferences in favor of Dean Witter as the party opposing the grant of summary judgment. ...

II. LIABILITY FOR MISDELIVERY

We begin with the contract claim because the district court's analysis of that issue guided its thinking about the entire case. Further, as explained below, our interpretation of the contract depends in part on our analysis of the bailment claim.

The district court interpreted the Form signed by Mrs. Bass as a contract requiring:

> VALIC to transfer her funds by mailing them to:
>
> Morgan Stanley Dean Witter

FBO: Merle B. Bass
The Callenders
1990 Post Oak Blvd., Suite 2000
Houston, Texas 77056.

Proceeding on this assumption, the court considered whether VALIC failed to perform its duties under this contract. In granting VALIC summary judgment the court reasoned:

> [T]he evidence does not show that VALIC failed to perform its promised service with respect to the checks. The instructions of Mrs. Bass on the Rollover/Transfer Out Request Form directed VALIC to transfer the funds by mailing them to the address set forth on the form. The evidence submitted by VALIC shows that the checks were made payable to the proper party and addressed correctly. VALIC asserts that it mailed the checks, and there is no evidence that it did not. The fact that the checks did not arrive at Dean Witter's Houston office does not prove that VALIC failed to follow Mrs. Bass's instructions.... The plaintiff's evidence with respect to delivery of the checks does not provide a sufficient basis for its claims for violation of the CCPA, breach of contract, promissory estoppel, or breach of fiduciary duty.

As an initial matter, we are somewhat hesitant to adopt the district court's interpretation of the contractual agreement between Mrs. Bass and VALIC as memorialized in the Form. First, while the Form may be construed as instructing (or at least authorizing) VALIC to transfer her funds by mail, it does not imply that placing a check in the mail will satisfy any obligation created by Mrs. Bass's deposit of funds with VALIC. Moreover, the Form is silent with regard to the allocation of risk while the payment is in transit. Nothing in the contract leads us to understand that by filling out the payee's mailing address Mrs. Bass assumed the risk of the check being stolen en route.

Parties are presumed to contract with reference to existing principles of law, and in the absence of clear contractual language the relationship is governed by the rules mandated by law. For this reason, the nature of the legal relationship between Mrs. Bass and VALIC is relevant to understanding the contract. In its motion for summary judgment, Dean Witter argued that VALIC was Mrs. Bass's bailee and should be liable for misdelivery of bailment. If we were to accept Dean Witter's theory, the gap in the contract would be filled by the common law rules governing the bailee's obligation to redeliver the bailment. VALIC, however, responded that the relationship between a depositor and a financial institution is not that of bailor/bailee but of creditor/debtor. Under VALIC's interpretation, the contract should be read in light of the law governing a debtor's obligation to remit payment to the creditor. We find that under either construction, the district court's grant of VALIC's summary judgment motion on the contract claim was improper. ...

While early common law doctrine held that only corporeal personal property could be the subject of a bailment, for nearly a century it has been "well settled ... that there may be a bailment of incorporeal as well as corporeal personalty. .... Thus, there may be a bailment of negotiable notes, bonds, corporate stock and insurance policies as well as horses, watches or furniture." Armistead M. Dobie, *Handbook on the Law of Bailments and Carriers* 20 (1914).

A check is undoubtedly a negotiable instrument, *see* C.R.S. § 4-3-104 (check is a negotiable instrument under the U.C.C.), and the check itself, which can be assigned to others, takes on commercial significance apart from the underlying funds it represents. *See, e.g., Meyers v. Johanningmeier,* 735 P.2d 206 (Colo. Ct. App. 1987) (in general, a holder in due course takes the instrument free from all claims and defenses of any party to the instrument); C.R.S. § 4-3-301, 3-302 & 3-305 (defining rights of holders in due course under the U.C.C.). Thus, there is little doubt that under Colorado law, if A gives B a check to deliver to C, B is A's bailee and can be liable for misdelivery.

VALIC, however, is correct to point out that the relevant question is not whether a check in the abstract can be bailed, but the status of *this* check as it relates to Mrs. Bass's funds deposited with VALIC. After all, the check was drawn up by VALIC, and payable from VALIC's funds. It is far from clear that this check is best characterized as a bailment of Mrs. Bass's funds rather than as VALIC's attempt to satisfy its debt to Mrs. Bass. The answer to this question depends largely on the common law status of deposits with financial institutions. Some 140 years ago, the United States Supreme Court summarized the considerations as follows:

> All deposits made with bankers may be divided into two classes, namely, those in which the bank becomes bailee of the depositor, the title to the thing deposited remaining with the latter; and that other kind of deposit of money peculiar to banking business, in which the depositor, for his own convenience, parts with the title to his money, and loans it to the banker; and the latter, in consideration of the loan of the money and the right to use it for his own profit, agrees to refund the same amount, or any part thereof, on demand.

Marine Bank v. Fulton Bank, 69 U.S. 252, 256 (1864). The common law thus conceptualized a general deposit as a loan of the funds to the financial institution. Unlike a bailment, a general deposit passes title to the financial institution, which is required to repay the loan from its own funds upon demand.

In general, the law presumes that deposits made to financial institutions in the ordinary course are general deposits; the burden rests on the depositor to prove otherwise. "A special deposit is one made under an express or clearly implied agreement that is for some particular purpose, while a general deposit includes all others forms of deposits." 5B *Michie on Banks and Banking* § 328, at 533 (2002). Thus, while courts have held that monies placed in accounts for certain specific purposes, such as escrow accounts, are special deposits, in the ordinary course, title to deposited funds passes to the bank and a debt in the amount deposited is created between the financial institution and the depositor. Dean Witter has not pointed to any agreement, express or implied, indicating that the funds were held specially, and we therefore conclude that Mrs. Bass's account with VALIC is properly characterized as a general deposit. It follows that VALIC's attempted transfer of funds by means of mailing a check to Mrs. Bass's broker was not the delivery of a bailment but an attempt to satisfy its outstanding obligations as Mrs. Bass's debtor.

But this does not mean that VALIC bears no legal responsibility for misdelivery of the check. Just as a bailee has the duty to redeliver the bailment at the instructions of the bailor, a debtor is obliged to remit payment to the creditor or his order. Based on the record as it stands, we conclude that the district court erred in granting summary judgment in favor of VALIC on the contractual claim.

In essence, the district court held that the contract between Mrs. Bass and VALIC required only that VALIC mail the check in accordance with her mailing instructions—not that funds actually be transferred to her in satisfaction of her deposit. We think this takes too narrow a view of the contractual relation between Mrs. Bass and VALIC. In general, a debt is discharged not when the debtor mails a check, but when the creditor negotiates the check. *Denver Elec. & Neon Corp. v. Phipps, Inc.*, 143 Colo. 530 (1960); *see also Nguyen v. Calhoun*, 105 Cal. App. 4th 428 (2003) (in general, the deposit of a payment check in the mail does not constitute payment; debtor assumes the risk that the deposited payment will be delivered and received by the creditor). If a householder attempts to pay the electric bill by mailing a check, he continues to be liable if the check is delayed or lost.

This presumption may be rebutted by evidence demonstrating a specific course of dealing or express agreement to the contrary. VALIC argues, in effect, that the Form executed by Mrs. Bass constituted an express agreement that its obligations to Mrs. Bass would be satisfied by mailing the check to her broker, even if the check was never delivered. We do not read the Form that way. Contracts are presumed to be drafted with reference to existing principles of law, and in general, intent to modify applicable law by contract is effective only where expressly stated. To be sure, the contract contains mailing instructions, and thus authorizes VALIC to use the mails for the fund transfer. But nothing on the Form suggests any intention to shift the risk of misdelivery from VALIC to Mrs. Bass, or suggests that VALIC's debt was satisfied upon the act of mailing the check. Thus, even if VALIC is correct that the Form itself imposed only the obligation to "send," and not to "deliver," the check, we do not believe that VALIC's duty to repay Mrs. Bass on demand was thereby exhausted. ...

NOTES

1. How does a check actually work behind the scenes? Typically, the payee of a check signs it and deposits it at their bank (the *presenting bank*), which then presents the check for payment to the drawee. Suppose first, for simplicity that the same bank is both the drawee and the presenting bank—i.e., the drawer and payee have accounts at the same bank. How does "the money" get from the drawer's account to the payee's? What if they are are using different banks? How does "the money" get from the drawer's bank to the payee's bank?
2. Merle Bass asked VALIC to satisfy its debt to her by transferring the funds to Dean Witter. Thus, a *deposit* issue becomes a *payment* issue. Notice how the court distinguishes "mailing" a check from "transferring" funds, and notice also the statement, "If a householder attempts to pay the electric bill by mailing a check, he continues to be liable if the check is delayed or lost." What result if the electric company receives the check but then loses it?
3. But then those pieces of paper go missing, and as in *Miller v. Race*, the wrong person presents one for payment. Why doesn't the rule from *Miller v. Race* resolve this case? Why isn't "Mevle Bass" entitled to keep the funds deposited from Check I to Dean Witter's Los Angeles office?
4. Suppose that VALIC wins on remand. Who, if anyone, will need to repay someone else? What if Dean Witter wins on remand?

BEAU TOWNSEND FORD LINCOLN, INC. V. DON HINDS FORD, INC.

No. 17-4177 (6th Cir. Nov. 27, 2018)

Siler, Circuit Judge:

Don Hinds Ford agreed to purchase twenty Ford Explorers from Beau Townsend Ford for about $736,225. When it came time to close the deal, Beau Townsend's commercial sales manager asked, via email, that Don Hinds pay via wire transfer to an out-of-state bank. Don Hinds agreed, wired the money, and picked up the Explorers.

Just one problem—a hacker had infiltrated the email account of the Beau Townsend manager and sent Don Hinds fraudulent wiring instructions. Although Don Hinds thought it had paid Beau Townsend for the Explorers, it had actually wired the $736,225 to the hacker, who quickly drained the bank account and made off with the money. This case is about who must bear that loss. ...

I.

Beau Townsend Ford Lincoln, Inc., a Ford dealership located in Vandalia, Ohio, offered to sell seventy-five excess Ford Explorers to other dealers. Beau Townsend's commercial sales manager, Jeff Columbro, contacted John Colglazier, the commercial account manager at Don Hinds Ford, Inc., a dealership in Fishers, Indiana. Columbro and Colglazier were acquainted and had previously worked together on dealer trades, as had their dealerships. Past dealer trades between Beau Townsend and Don Hinds had been for one or two vehicles at a time, and the purchaser had typically paid with a check at the time of delivery.

This deal, however, was much bigger. On September 25, Colglazier received an email from Columbro (jcolumbro@btford.com) asking if Don Hinds would be interested in purchasing some of the Explorers. Colglazier (jcolglazier@donhindsford.com) responded that same day, and after a flurry of emails, Don Hinds agreed to buy twenty Explorers. Columbro testified that Colglazier called him on the afternoon of September 25 to confirm the deal, and during the call the two agreed Don Hinds would pay by check. Colglazier, however, testified he did not recall ever speaking with Columbro on the phone regarding the Explorer deal, and all their correspondence occurred via email. In any event, the parties' September 25 communications concluded with Columbro's promising to send Colglazier invoices for the Explorers the next day.

Four days later, Columbro had still not sent the invoices, so Colglazier sent a follow-up email. This email (and the remainder of the emails Columbro received from Colglazier) came from a different email address (jcolglazier.donhindsford@gmail.com). However, the text of the emails Columbro received from Colglazier were authored by Colglazier.

Columbro responded to Colglazier's inquiry, saying that he would send the invoices once the Explorers moved "from fleet to stock." After Columbro sent half of the invoices, Colglazier replied stating that Don Hinds intended to pay for the vehicles with a check. Aside from the disputed telephone call mentioned earlier, this was the first time the parties discussed the method of payment. Colglazier received an email in reply, purportedly from Columbro, rejecting Don Hinds's offer to pay by check: "Due to some tax related procedures we will prefer a wire transfer, let me know when you need wiring instructions?"

Later that day, Colglazier received wiring instructions, again purportedly from Columbro, instructing Don Hinds to wire the money to a Bank of America in Missouri City, Texas, into the account of "K.B. Key Logistics LLC." The wire instructions stated, "Please follow the Standard Settlement Instructions below to remit

payment to Beau Townsend Inc. and its subsidiaries," and contained the line "K.B. KEY LOGISTICS LLC d.b.a BEAU TOWNSEND FORD." Colglazier testified that he did not think Columbro's request for a wire transfer was unusual since this was a high-dollar trade involving a large number of vehicles.

The next day, September 30, Columbro sent Colglazier the remaining ten invoices. This allowed the parties to calculate the final sales price of $736,225.40. Colglazier responded that Don Hinds would send drivers to start picking up the Explorers on October 5.

On October 2, Colglazier emailed Columbro, copying Don Hinds' office manager, Alicia Robinson. Colglazier asked if Columbro could review Colglazier's paperwork to see if everything was in order, and asked Robinson to transfer the money on October 5. Colglazier received a reply email purportedly from Columbro, stating that Colglazier's paperwork was in order. That email contained another copy of the wiring instructions. Colglazier forwarded the instructions to Robinson so she could arrange the payments.

Beginning on October 5 and continuing the next two days, drivers from Don Hinds picked up the Explorers from Beau Townsend. Due to daily transfer limits at Don Hinds' bank and the size of the transaction, Robinson wired the money in three installments, also beginning on October 5. Each time, Robinson sent a wire transfer confirmation to Columbro, and she received emails purportedly from Columbro that Beau Townsend had received the money. By October 7, Beau Townsend had wired over $736,000, and it had possession of the twenty Explorers, titles in hand. Everything seemed fine.

Unfortunately, however, some of the emails Colglazier had received from Columbro were not actually from Columbro. Rather, they were sent by a hacker who had infiltrated Columbro's email account as early as August 3.

Beau Townsend used a third-party email service called FuseMail. FuseMail allows users to set up "rules" for how certain messages will be handled. Those rules can, for instance, automatically forward emails from a specified sender to a different email address. They can also automatically send emails affected by the rule to a different folder, such as the deleted items folder. After gaining access to Columbro's email, the hacker set up rules for how emails from certain senders, including Colglazier, would be handled in Columbro's FuseMail account. From September 28 onward, two things automatically happened when Columbro received an email from someone at Don Hinds: (1) the email was diverted to Columbro's deleted items folder, and (2) the email was forwarded to jcolglazier.donhindsford@gmail.com, a Gmail account the hacker created on September 28.

This setup enabled the hacker to perpetrate the scam. With access to Columbro's FuseMail account, the hacker could send emails to Colglazier from Columbro's official Beau Townsend Ford email address (jcolumbro@btford.com). Those emails appeared to Colglazier as if Columbro had sent them. Any emails from Don Hinds to Columbro were automatically diverted to Columbro's deleted items folder, where Columbro was unlikely to see them. But the Don Hinds emails were also forwarded to the Gmail account the hacker had created. The hacker then had the ability to forward the Don Hinds messages back to Columbro, where they would appear in his inbox. Although those messages arrived from a different email address than the first messages Columbro received from Colglazier—jcolglazier.donhindsford@gmail.com rather than jcolglazier@donhindsford.com—Columbro never noticed this switch because the messages still appeared as if they were sent by "John Colglazier" in Columbro's Microsoft Outlook email system. Thus, the hacker could

filter the messages from Don Hinds to Columbro, allowing Columbro to see only the messages the hacker wanted him to see.

The parties' initial negotiations regarding the Explorer deal were conducted between Columbro and Colglazier. Once talk turned to payment, the hacker stepped in. Posing as Columbro, the hacker asked Don Hinds to pay via wire transfer and sent Colglazier the wire instructions. The hacker filtered out any messages from Don Hinds that would have tipped off Beau Townsend to the scheme. And once the wire transfers were complete, the hacker emptied the bank account and vanished.

Around the same time, Bill Estes Ford, located in Indianapolis, agreed to buy six Explorers for about $220,000, and received wire instructions purportedly from Columbro on October 9. These instructions differed from those received by Beau Townsend. Officials at Bill Estes became suspicious and contacted Beau Townsend. Columbro, who was away from the office, said he had not sent the wiring instructions. Columbro then called John Wanamaker, Beau Townsend's IT manager. Wanamaker asked Columbro to change his email password. He also contacted FuseMail to alert them that one of Beau Townsend's email accounts might have been compromised.

On Tuesday, October 13, Columbro received a call from a business contact, asking why he had not responded to her emails. Columbro said he had not received any such emails. He then called Wanamaker, who discovered that the emails Columbro had not seen were in Columbro's deleted-items folder. This prompted Wanamaker—for the first time—to look at the settings in Columbro's email account. Wanamaker discovered that the aforementioned "rules" had been set up to divert some emails into Columbro's deleted items folder, and to forward those emails to the fraudulent Gmail account.

Later that day, Columbro called Colglazier to ask when Beau Townsend could expect a check for the twenty Explorers. Colglazier told Columbro that Don Hinds had already wired the funds, in line with the instructions received via email. Beau Townsend requested that Don Hinds return the Explorers. Don Hinds refused.

Beau Townsend sued Don Hinds for (1) breach of contract, (2) conversion, and (3) unjust enrichment, constructive trust, and disgorgement. Following discovery, the parties filed cross-motions for summary judgment.

The district court granted summary judgment in Beau Townsend's favor. The court observed:

[B]oth parties were negligent in their business practices. . . . Beau Townsend Ford should have maintained a more secure email system and taken quicker action upon learning that it might have been compromised. Don Hinds should have ascertained that an actual agent of Beau Townsend was requesting that it send money by wire transfer.

Nevertheless, the court held that Don Hinds breached the parties' agreement because "Beau Townsend Ford has not received any funds from Don Hinds Ford, or [] the funds wired to Missouri City, Texas on behalf of Don Hinds Ford." The court rejected Don Hinds' arguments that it was a good-faith purchaser for value and that equitable estoppel applied, and awarded Beau Townsend the $736,225.40 it requested. This appeal followed.

III.

A.

This case could be evaluated, in our estimation, in at least two distinct ways: under contract law or under agency law. Under contract principles, Ohio's codification of

the Uniform Commercial Code (UCC) governs this case, as one involving the sale of goods. Additionally, we may look to an applicable Restatement (here, the Restatement of Contracts) for guidance when there is no controlling state law on point when the state has indicated that it considers the Restatements to be persuasive authority. ...

The ultimate question here is which party should bear the $736,225 loss attributable to the scheme perpetrated by an unidentified third-party fraudster. Beau Townsend sees this case as a simple one—it delivered the twenty Explorers, but never received payment from Don Hinds. According to Beau Townsend, Don Hinds did not satisfy its obligation to pay for the Explorers by wiring the money to the Bank of America account in Texas, because Beau Townsend never received that money. Therefore, Beau Townsend says, Don Hinds still owes Beau Townsend $736,225.

Don Hinds, meanwhile, argues that it was only obligated to follow the payment instructions it received from Beau Townsend, and not to ensure the payment made it to Beau Townsend. Because Don Hinds followed those instructions, and because it reasonably believed those instructions came from Beau Townsend, Don Hinds says it fulfilled its duties under the contract.

On the one hand, this case could turn upon a basic principle of contract law: mutual mistake. *See Raffles v. Wichelhaus*, 2 H. & C. 906, 159 Eng. Rep. 375 (Ex. 1864).[3] In the contract setting, "[a] mistake is a belief that is not in accord with the facts." *Restatement (Second) of Contracts* § 151 (1981). Here, both parties held the mistaken belief that they had agreed on a method of payment. Colglazier had emailed Columbro saying Don Hinds intended to pay with a check, as they had in the past. Due to the hacker's deception, Columbro never saw any emails that would have caused him to second-guess Colglazier's assertion, and on October 13, he asked Colglazier when Beau Townsend could expect a check. Likewise, after the hacker posing as Columbro told Colglazier that Beau Townsend would prefer a wire transfer and sent instructions, Colglazier complied. Each party thought its own belief regarding payment was correct, and neither party knew the other was mistaken.

Normally, "[w]here a mistake of both parties . . . as to a basic assumption on which the contract was made has a material effect on the agreed exchange of performances, the contract is voidable by the adversely affected party unless he bears the risk of the mistake." *Id.* § 152(1). "A party bears the risk of a mistake when (a) the risk is allocated to him by agreement of the parties, or (b) he . . . treats his limited knowledge as sufficient, or (c) . . . it is reasonable in the circumstances to [allocate the risk to a party]." *Id.* § 154.

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3. *Raffles v. Wichelhaus* is the classic English case where two parties contracted for a shipment of cotton to be delivered from Bombay aboard a ship called the Peerless. The parties did not know, however, that there were in fact two ships called the Peerless, one departing in October, and the other in December. The buyers refused to accept or pay for the cotton delivered by the December Peerless, saying they had intended to buy cotton from the October Peerless. The court found that the existence of the two identically-named ships created a latent ambiguity in the contract. Because the buyer meant the October Peerless and the seller the December Peerless, and neither party had reason to know the meaning the other had assigned, the court held there was no mutual assent, and thus no binding contract.

Reilley v. Richards, 632 N.E.2d 507, 509 (Ohio 1994), provides a good example. There, a buyer purchased a piece of real estate, upon which he planned to build his family home. After signing the contract, the buyer discovered the property lay within a floodplain, and a city ordinance prohibited building any structure in such an area. Neither the seller nor the buyer knew the property was in a floodplain at the time of contracting. The Ohio Supreme Court held that "the lack of knowledge that a significant portion of the lot is located in a floodway is a mistake of fact of both parties that goes to the character of the property such that it severely frustrates the appellant's ability to build a home on the property." It allowed the buyer to rescind the contract because "a mutual mistake existed as to the character of the property which is material to the subject matter of the contract and the appellant was not negligent in failing to discover the mistake."

In this case, however, rescission is impractical at best, impossible at worst, and can never make the parties whole. Rescission would presumably involve the return of the Explorers to Beau Townsend. In that scenario, Don Hinds would still be out $736,225. Beau Townsend would also be worse off than when it started, since the Explorers' value will have depreciated. Moreover, the parties do not say whether Don Hinds resold the Explorers. If so, the buyers of those vehicles are likely good-faith purchasers for value, and the court cannot compel the buyers to return the vehicles to Beau Townsend. *See* Ohio Rev. Code § 1302.44(A).

So if rescission isn't an option, how should the loss be allocated? As noted earlier, in the case of a mutual mistake, the Restatement permits the court to allocate the risk of loss to a party when "it is reasonable in the circumstances to do so." Restatement (Second) of Contracts § 154(c). And *Reilley* suggests that the negligence (or lack thereof) of the parties should play at least some role in allocating the risk. There, the court pointed out "that appellant, an unsophisticated buyer, was not negligent in failing to discover that the lot was in a designated floodplain." *Reilley*, 632 N.E.2d at 509. The property inspection had not revealed this information, and the buyer "could not have discovered the floodplain by looking at the property." *Id.* Presumably, had the buyer failed to conduct an inspection or ignored obvious signs that the property was within a floodplain, the court would have allocated the risk of loss to the buyer rather than allowing rescission. *See also Marshall v. Beach*, 758 N.E.2d 247, 251 (Ohio Ct. App. 2001) ("[I]t is well established in Ohio that relief for a unilateral mistake of material fact *will not* be provided where such mistake is the result of the negligence of the party seeking relief.").

The two factually similar cases cited by the parties also support the notion that the loss should be borne by the party best able to avoid it. *Arrow Truck Sales, Inc. v. Top Quality Truck & Equipment, Inc.* involved the sale of twelve trucks. No. 8:14-cv-2052-T-30TGW, 2015 WL 4936272, at *1 (M.D. Fla. Aug. 18, 2015). Joe Gelfo, a salesman for Top Quality, and Nick Lombardo, an assistant manager for Arrow, negotiated via email and eventually agreed that Arrow would purchase the trucks for $570,000. Gelfo emailed Lombardo several documents, including copies of the truck titles and wiring instructions for payment. Gelfo and Lombardo had previously done business together, and the wiring instructions were identical to the ones Gelfo had provided Lombardo in the past.

During the parties' negotiations, third-party fraudsters hacked into the email accounts of both Gelfo and Lombardo. They also created new email accounts that appeared nearly identical to Gelfo and Lombardo's accounts. Eventually, the hacker used Gelfo's account to send Lombardo an email with "updated" wiring instructions, different from the ones he had previously received in this transaction and

others. The updated instructions specified an out-of-state bank and a different beneficiary, though Top Quality was still listed on the document. Arrow followed the "updated" instructions and unknowingly wired the $570,000 to the hacker. at Top Quality never received the money and refused to deliver the trucks to Arrow. Arrow filed suit, asserting (as relevant here) that Top Quality breached its contract with Arrow by failing to deliver the trucks and, by failing to use reasonable security measures to protect its email accounts, negligently caused Arrow to wire $570,000 to the wrong account.

Following a bench trial, the district court granted judgment in favor of Top Quality. The court held that Arrow, not Top Quality, breached the contract because Arrow never provided payment; therefore, Top Quality was not obligated to deliver the trucks. As to negligence, the court found that "neither Gelfo nor Lombardo was negligent in the manner that they maintained their e-mail accounts. They were both victims of a sophisticated third-party fraudster. . . ." But the court also found that "Lombardo had more opportunity and was in the better position to discover the fraudulent behavior based on the timing of the e-mails and the fact that the fraudulent wiring instructions involved . . . different account information from all of the previous wiring instructions." "At the very least," the court said, "the change in wiring instructions and conflicting e-mails should have prompted Lombardo to confirm the information with Gelfo prior to wiring any funds." Because Lombardo failed to "exercise reasonable care after receiving conflicting e-mails containing conflicting wire instructions," the court held that "Arrow should suffer the loss associated with the fraud."

In *Bile v. RREMC, LLC,* No. 3:15cv051, 2016 WL 4487864 (E.D. Va. Aug. 24, 2016), the plaintiff, Amangoua Bile, won a $63,000 settlement in an employment discrimination suit. A few days after reaching the settlement, Bile's counsel, Uduak Ubom, received an email purportedly from Bile, asking that the settlement funds be wired to a Barclay's account in London. Ubom called Bile, who told Ubom that she had not sent the email. Ubom deleted the email and did not notify LeClairRyan, P.C., the firm representing the defendants, that someone had attempted to divert the settlement.

Two days later, Ubom and Olaolowaposi Oshinowo, an attorney at LeClairRyan, agreed over the phone that LeClairRyan would send Bile a check for the settlement funds to his residence. Ubom emailed Bile's home address to Oshinowo following their conversation. Later that day, however, Oshinowo received another email, purportedly from Ubom, asking that the settlement funds be wired to the Barclay's account. Oshinowo believed this email came from Ubom because it was sent from his email address and used syntax consistent with the emails Oshinowo had previously received from Ubom. LeClairRyan followed the wire instructions and transferred the money to the Barclay's account. Eventually, the parties discovered that the wire instructions were sent by a hacker who had infiltrated Ubom's email account. LeClairRyan refused to send another payment, and the parties filed cross-motions to enforce the settlement agreement.

Following a bench trial, the district court ruled in the defendants' favor. Recognizing there was "no case law precisely on point," the court looked to "common law contract principles and . . . Article 3 of the U.C.C." to conclude that the defendants "substantially performed under the Settlement Agreement." *Id.* at *6. In particular, the court found persuasive the UCC's rules regarding fraud in the transfer of negotiable instruments. Typically, "if a payor issues an instrument but fails to deliver the instrument to the payee's possession, then the payor is still liable on the under-

lying obligation." *Id.* at *8 (citing UCC § 3-420 & cmt. 1). However, under UCC §§ 3-404 and 3-406, which address third-party fraud in negotiable instruments, "a party whose failure to take ordinary care results in loss must be the party to bear that loss," and "a blameless party is entitled to rely on reasonable representations, even when those reasonable representations are made by fraudsters."[5]

Applying those general principles, the court concluded "Ubom failed to use ordinary care under the circumstances, and that failure substantially contributed to the $63,000.00 loss." "Two days before the fraud was perpetrated on LeClairRyan, both Ubom and Bile were aware that an unidentified third party had targeted the settlement funds for diversion to a Barclay's bank account that had nothing to do with Bile"; still, they did not warn LeClairRyan that the settlement had been targeted by a third-party fraudster. If LeClairRyan had been aware of this suspicious activity, the court found it "self-evident" the firm would not have initiated the wire transfer. In contrast, the court found LeClairRyan "exercised ordinary care" in carrying out its end of the transaction. The court held the defendants were entitled to enforce the settlement agreement without paying a second settlement because Ubom's failure to alert opposing counsel to the fraud "substantially contributed" to the loss.

Arrow and *Bile* illustrate the principle that losses attributable to fraud should be borne by the party in the best position to prevent the fraud. So too here. The district court erred by taking an overly simplistic view of this case. The court observed that, "if there is a policy implicit in the UCC's rules for the allocation of losses due to fraud, it surely is that the loss be placed on the party in the best position to prevent it." Further, the court declared that "both parties were negligent in their business practices." Nevertheless, the court awarded summary judgment to Beau Townsend simply "because Don Hinds Ford has not conveyed the contractual purchase price to Beau Townsend Ford." In so holding, the court ignored the authority it cited, as well as record evidence suggesting Beau Townsend was at least partially responsible for its own losses. Here, if principles taken from UCC Article 3 are applied, the court would have to determine whether either Beau Townsend's or Don Hinds' failure to exercise ordinary care contributed to the hacker's success, and would then have to apportion the loss according to their comparative fault.

B.

Agency law also provides useful guideposts here. For questions of agency law, the Ohio Supreme Court has consulted the Restatement (Third) of Agency. According to the Restatement, if a person "carelessly caused [the] belief" that "an actor has authority as an agent," the person "is subject to liability to a third party who justi-

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5. UCC § 3-404 governs cases where an imposter has induced someone to issue a check. The section states that, if the imposter "induces the issuer" to issue a check "by impersonating the payee," then "an indorsement of the instrument by any person in the name of the payee is effective . . . in favor of a person who, in good faith, pays the instrument[.]" UCC § 3-404(a); OHIO REV. CODE § 1303.44(A). The section adds, however, that whoever bears the loss could recover from the person paying the check if that person "fail[ed] to exercise ordinary care . . . that substantially contributes to [the] loss." OHIO REV. CODE § 1303.44(D). Likewise, § 3-406 states that, "[a] person whose failure to exercise ordinary care substantially contributes to . . . the making of a forged signature on an instrument is precluded from asserting [that] forgery against a person who, in good faith, pays the instrument[.]" *See also* OHIO REV. CODE § 1303.49(A).

fiably is induced to make a detrimental change in position because the transaction is believed to be on the person's account." *Restatement (Third) of Agency* § 2.05. This is true even if the person did not make "a manifestation that [the] actor has authority as an agent." *Id.* The Restatement explains that this doctrine, which it calls "agency by estoppel," "encompasses definitions of 'ostensible authority' that hold a principal accountable for an appearance of authority arising solely from the principal's failure to use ordinary care." *Id.* cmt. b.

The Restatement cites an Ohio Court of Appeals case, *Luken v. Buckeye Parking Corporation*, 68 N.E.2d 217 (Ohio Ct. App. 1945). In *Luken,* a company operated a parking lot in Cincinnati. Although the company typically hired an attendant to man the lot, it was unable to staff the lot one day. The company closed the lot for the day and blocked the entrance with a log. That same day, a seventeen-year-old boy began posing as the attendant. No one at the company knew that the boy was there, let alone pretending to be the lot attendant. Soon thereafter, Ms. Luken, who had used the lot for two years, sought to park her car. As the court described it, "she found nothing different from the lot's appearance on previous occasions." The lot's sign was up; the entrance was open; cars were parked there; and a young man, "with what appeared to be parking tickets in his hand," approached Ms. Luken. She thought the boy was the parking attendant, so she left her keys with him. After she left the lot, the boy took her car for a joyride and crashed it. She sued the company for negligence.

The Ohio Court of Appeals described the company's failure to secure the parking lot and characterized the boy as "an imposter who took advantage of the situation to enter the place and transact business as though he were authorized." The court determined that the company's omissions estopped it from "denying that the imposter was its duly authorized agent." The company could be liable, the court held, if a "customer who was justified in relying . . . did rely on the appearance of authority." The court added, however, that the customer could be justified in relying on the appearance of authority only if she did so in good faith and exercised reasonable care. Ultimately, the court concluded that "[t]his situation raised issues for submission to the jury."

Here, the application of the Restatement and *Luken* suggest that, if Beau Townsend had failed to exercise ordinary care in maintaining its email server, thus allowing the hacker to pose as Columbro, then Beau Townsend could be liable for Don Hinds's reasonable reliance on the hacker's emails. In addition, any potential liability would be reduced if Don Hinds also failed to exercise reasonable care. ...

C. ...

Given the amount of business transacted online, the assignment of liability in a case like this is important. Indeed, both parties acknowledge that they regularly sell cars by email. The district court did not adequately analyze the issue. Instead, the court begged the question, concluding (without citing legal authority) that "it was not Beau Townsend that instructed Don Hinds to send funds to 'K.B. KEY LOGISTICS, L.L.C.' in Missouri City, Texas."

The district court aptly observed that "both parties would each have the Court find that the other was in the best position to avoid the misfortune that occurred in this case." Beau Townsend, pointing to the suspicious nature of the wire instructions, says Don Hinds could have prevented the loss; Don Hinds, pointing to the fact that Beau Townsend's email was hacked, says the same about Beau Townsend.

And both parties support their respective arguments with record evidence suggesting the other party was at fault.

No court can resolve these factual disputes at the summary judgment stage. Rather, the district court must hold a trial to decide whether and to what degree each party is responsible for the $730,000 loss in this case. ...

NOTES

1. What is a wire transfer? Obviously, it is a way of moving money from an account at one one bank to an account at another. But what does it actually take to make one work? I.e., how do the two banks coordinate to make the transfer happen?
2. "Wire transfer" is a generic name for a transfer on one of several different inter-bank payment networks. The court here does not name the specific network used, but it is probably Fedwire, a system operated by the Federal Reserve, which processes hundreds of millions of transfers annually. Others include CHIPS, a privately-operated network used for high-value transfers and international transfers, and the Automated Clearing House or ACH, which is used to perform check transfers without delivering physical checks from one bank to another. More broadly, the payments industry refers to "payment rails"—the different networks used to make and settle payments. The Visa and American Express credit-card networks, for example, are payment rails for consumers to make payments to merchants. Although paying with a debit card is very similar to paying with a credit card from a consumer's perspective, debit payments travel over entirely different payment rails—e.g., Visa operates the Interlink network for debit payments. A payment app, like Venmo or Zelle, establishes its own payment rail, and so on.

EXPERI-METAL, INC. V. COMERICA BANK

No. 09-14890 (E.D. Mich. July 8, 2010)

Duggan, District Judge: ...

II. Factual Background

Experi-Metal is a Michigan corporation with its principal place of business in Macomb County, Michigan. It began banking with Comerica since incorporating in September 2000. Experi-Metal entered into agreements with Comerica to permit Experi-Metal to access its bank accounts via the Internet using Comerica's online banking system.

On November 21, 2003, Experi-Metal's President, Valiena A. Allison, signed an agreement with Comerica "to send payment order[s] or receive incoming funds transfers" using Comerica's NetVision Wire Transfer Service— i.e. "Treasury Management Services Agreement Comerica NetVision Wire Transfer." At this time, Experi-Metal designated Valiena Allison and Keith Maslowski (its Controller) as authorized users to initiate monetary transfers through Comerica's wire transfer service. Debra Nosanchuk, a Comerica Vice President, trained Allison on the use of the service. According to Nosanchuk, she informed Allison at this time that Experi-Metal's account could be set up to require the approval of one or two individuals for each wire transfer or wire transfers above a specified dollar amount. Allison did not request this feature.

Beginning January 23, 2006, Comerica's NetVision Wire Transfer Service became known as TM Connect Web. This was a change in name only; the program remained the same. ...

From 2001 until May 2008, Comerica employed a security process known as "digital certificates" for its wire transfer service. Users had to routinely "renew" these "digital certificates" in order to initiate monetary transfers for their accounts. Comerica sent e-mails to the users, requiring the users to click on a link specified in the e-mail. Once on the linked website, users were required to log in and enter certain information to obtain the renewal of the digital certificate.

In April 2008, Comerica notified the administrators for all online banking accounts that, though it still would be providing online banking services through TM Connect Web, it was switching its security process from digital certificates to "secure token technology." Under this system, a user accesses the Comerica Business Connect website by entering his or her user ID, his or her confidential 4-digit PIN, and a six-digit code from a secure token. The code displayed on the secure token is a randomly generated number that changes every 60 seconds.

Comerica thereafter sent account administrators a list of the users for their accounts who had been active for the last six months, user IDs, and a secure token for each user. Comerica asked account administrators to notify Comerica if the registration for any user should be removed. Experi-Metal received this information from Comerica on April 25, 2008. Apparently Comerica listed Maslowski as an authorized user of the TM Connect Web service and provided a secure token for his use; however, Experi-Metal never notified Comerica that Maslowski should be removed as an authorized user. Comerica instituted the secure token technology in May 2008.

On January 22, 2009, Maslowksi received an e-mail that purported to be from Comerica. According to Maslowski, the e-mail was similar to previous e-mails that he had received from Comerica when it utilized digital certificate technology, prompting him to renew Experi-Metal's digital certificates.[4] Like those previous e-mails, Maslowski was directed to click on a link specified in the e-mail. After clicking on the link, Maslowski was diverted to a website that appeared to be a Comerica website. He was then prompted to log in and enter his confidential customer ID number and password and Experi-Metal's confidential customer ID number and password. When he did this, Maslowski unknowingly gave an unauthorized third party access to Experi-Metal's account through Comerica's wire transfer service from which this third party began transferring funds out of Experi-Metal's account to various accounts in Russia, Estonia, Scotland, Finland, and China, as well as domestic accounts.

Forty-seven wire transfers were initiated from Experi-Metal's account between 7:30 a.m. and 10:50 a.m. on January 22, 2009. Sometime between 11:39 a.m and 12:04 p.m. on that date, Comerica's wire transfer room contacted its Treasury

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4. Comerica disputes the similarity of the e-mails, indicating that the renewal e-mails were sent in April or May of each year and not January, the renewal e-mails directed users to the website of their security vendor VeriSign and not a Comerica website, and when users entered the VeriSign website they were instructed to enter a one time Renewal ID/PIN that Comerica supplied to them for the sole purpose of renewing their certificate. As Comerica informed customers in an April 28, 2008 e-mail warning them about recent "phishing" scams for confidential information, it would never initiate an unsolicited e-mail asking customers for their confidential information such as IDs and passwords.

Management Relationship Center by telephone regarding the activity in Experi-Metal's account. Denise Ling, Comerica's Treasury Management Services Implementation Specialist, handled the call. After reviewing the activity, Ling telephoned Allison at Experi-Metal at approximately 12:05 p.m. Allison informed Ling that Experi-Metal had not made any wire transfers that day and instructed that Comerica should not honor any requested wire transfers or other transfers until further notice. After speaking with Allison, Ling immediately sent an e-mail to Comerica's wire transfer room and asked that all wires out of Experi-Metal's account be recalled and future wires stopped.

Within twenty-four minutes of Ling's call, most wire transfer activity on Experi-Metal's account was stopped and Comerica began recalling the wire transfers that it was able to recall. Between 10:53 a.m. and 2:02 p.m., however, forty-six additional wire transfers were initiated from Experi-Metal's account. All wire transfer activity was stopped shortly thereafter. In total, $1,901,269 was wire transferred from Experi-Metal's account. Comerica was able to recover all but $560,000, which amount was charged to Experi-Metal's account.

Experi-Metal filed this lawsuit to recover the amount it was charged. Experi-Metal contends that the wire transfers from its account on January 22, 2009 were not effective as payment orders of the company under Michigan Compiled Law Section 440.4702(2) in that Comerica did not act in compliance with the written agreements between it and Experi-Metal and/or Allison's instructions when contacted by Ling that Comerica should not honor any further wire transfer requests. Experi-Metal also seeks interest, costs, statutory interest, attorneys' fees, and such other relief as the Court deems appropriate.

III. Applicable Law and Analysis

Whether the risk of loss for an unauthorized wire transfer order falls upon the bank or its customer is governed by Sections 440.4702 and 440.4703 of Michigan's Uniform Commercial Code— Funds Transfers, which are adopted from Sections 4A-202 and 4A-203 of the Uniform Commercial Code ("U.C.C."). Pursuant to Section 440.4702, wire transfer orders are effective as orders of the customer, even though the customer did not authorize the payment orders, if: (1) the bank and customer agreed that the authenticity of payment orders would be verified pursuant to a security procedure; (2) the security procedure is commercially reasonable; and (3) the bank proves that it accepted the orders in good faith and in compliance with the security procedure and any written agreement or instruction of the customer. Mich. Comp. Laws § 440.4702(2).

Even if these conditions are satisfied, the risk of loss nevertheless may shift to the bank if "the person committing the fraud did not obtain the confidential information [facilitating the breach of the security procedure] from an agent or former agent of the customer or from a source controlled by the customer source." U.C.C. § 4A-203(1)(b), cmt. 5; Mich. Comp. Laws § 440.4703(1)(b). As Comerica argues in its motion, there can be no dispute in this case that the third-party that caused the wire transfers from Experi-Metal's account on January 22, 2009, obtained Experi-Metal's confidential information from Experi-Metal's Controller, Maslowski. Section 440.4702 therefore is determinative of which party is responsible for the loss at issue in this case and the Court will focus on that section.

Comerica relies on the Services Agreement and Master Agreement to show that Comerica and Experi-Metal agreed that secure token technology would be used to verify the authenticity of payment orders and that this security procedure was commercially reasonable. As an initial matter, although acknowledging that it

agreed to use Comerica's wire transfer service and that it entered into an agreement with respect to NetVision, Experi-Metal argues that it never entered into an agreement with respect to Comerica's TM Connect Web service. Experi-Metal therefore argues that it is not bound by the terms of the Services Agreement or Master Agreement. Experi-Metal also argues that it never identified Maslowski as an authorized user with respect to TM Connect Web.

Comerica establishes, however, that NetVision and TM Connect Web are the same program and that the change from one to the other signified a change in name only. Comerica also establishes that Experi-Metal, including Maslowski, used Comerica's wire transfer service after it became known as TM Connect Web (even if it did not use the service to send wire transfers). Further, when Comerica began using secure token technology, it sent its customers' account administrators a list of the users for their accounts who had been active for the past six months and a secure token for that user. Comerica asked the account administrators to notify Comerica if the registration for any user should be removed. Although the list sent to Experi-Metal's account manager, Allison, identified Maslowski as an authorized user and a secure token was sent for his use, Allison never advised Comerica that Maslowski no longer was authorized to utilize Comerica's wire transfer service with respect to Experi-Metal's account.

Pursuant to the U.C.C., a security procedure is *deemed* reasonable if:

> (*i*) the security procedure was chosen by the customer after the bank offered, and the customer refused, a security procedure that was commercially reasonable for that customer, and (*ii*) the customer expressly agreed in writing 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 chosen by the customer.

MICH. COMP. LAWS § 440.4702(3). Comerica contends that Experi-Metal chose the security procedure after Comerica offered, and Experi-Metal refused, a security procedure that was commercially reasonable for Experi-Metal (i.e. requiring authorization of additional individuals at Experi-Metal before a payment order is processed). Further, Comerica points out that Experi-Metal agreed in the Master Agreement to be bound by any payment order issued in its name that complied with the security agreement. In this Court's view, however, requiring confirmation by additional users simply is an option or element within a security procedure. The "security procedure" is the secure token technology. Furthermore, Comerica informed Experi-Metal of this option when Experi-Metal initially signed on to use Comerica's wire transfer service. At that time, Comerica was using digital certificates for its security procedure.

Nevertheless, when it agreed to use Comerica's wire transfer service, Experi-Metal signed the Service Agreement and, by signing that agreement,

> agree[d] that the Service provided by [Comerica] ... shall be governed by, and acknowledge[d] receipt of the Comerica Treasury Management Services Master Agreement (publication date as set forth below [i.e. August 2002]) ... and any applicable implementation documents and user guides as such documents are amended from time to time.

(Def.'s Mot. Ex. 1.) The Service Agreement and Master Agreement both provide that by using Comerica's wire transfer service, Experi-Metal agreed that the Security Procedures that Comerica utilized (at that time, digital certificate technology) were commercially reasonable.

Paragraph 3 of the Services Agreement states that Comerica offers "[c]ommercially reasonable security procedures ... to each customer that is authorized to send Fund[ ] Transfers" and the "Customer agrees that the selected Security Procedures are commercially reasonable for the type of entries which Customer may transmit to the Bank ..." Similarly, Experi-Metal agreed in the Master Agreement that "[b]y utilizing the Service and employing the Security Procedure, ... the Security Procedure is commercially reasonable for the type, size and volume of transactions [Experi-Metal] will conduct using the Service." Further, in the Master Agreement Comerica "reserve[d] the right to change, implement or require new and/or additional Security Procedures or features thereof by giving oral or written notice to Customer" and Experi-Metal agreed that its "use of the Service after [Comerica] provides notice of any such described changes, will be deemed [Experi-Metal]'s acceptance of the new Security Procedure."

While Experi-Metal establishes that it did not send any wire transfers after Comerica instituted the secure token technology, it did continue to receive funds through the service. Experi-Metal also accessed TM Connect Web using the secure token technology to access its accounts and perform other tasks. Moreover, the Master Agreement provides that, if a customer does not agree to changes in the service after Comerica provides the customer written notice of those changes, the customer must discontinue use of the service and follow the procedures set forth in the agreement— i.e. sending written notification of termination to Comerica— to effectuate its termination of the agreement. Experi-Metal never complied with these requirements.

Whether the security procedure that Comerica employed for its wire transfer service was commercially reasonable is a question of law. MICH. COMP. LAWS § 440.4702(c). Based on the plain and unambiguous terms of the Service Agreement and Master Agreement, the Court finds as a matter of law that Comerica's secure token technology was commercially reasonable. Experi-Metal agreed that this security procedure was commercially reasonable. While Experi-Metal provides a contrary opinion from its expert, Lance James, such parol evidence is not effective to contradict the plain language of the Service Agreement and Master Agreement. Nevertheless, the January 2009 unauthorized wire transfer orders from Experi-Metal's account are not effective as orders of Experi-Metal *unless the bank proves* that it accepted the payment order in good faith and in compliance with the security procedure and any written agreement or instruction of the customer restricting acceptance of payment orders issued in the name of the customer." MICH. COMP. LAWS § 440.4702(2).

As noted earlier, there is a genuine issue of fact with regard to whether Maslowski was authorized to initiate wire transfer orders using Comerica's online service as of January 2009. For this reason, the Court finds a genuine issue of fact with respect to whether Comerica complied with the security procedure when it accepted the wire transfer orders initiated with Maslowski's user information on January 22. The Court also finds a genuine issue of material fact with respect to whether Comerica acted in "good faith."

Article 4A of the U.C.C. defines "good faith" as "honesty in fact *and* the observance of reasonable commercial standards of fair dealing." MICH. COMP. LAWS § 440.4605(1)(f). The same definition appears in other articles of the U.C.C. *See, e.g.,* U.C.C. §§ 1-201, 3-103. With respect to the second half of the definition, the Comment to U.C.C. § 1-201 explains:

> Although fair dealing is a broad term that must be defined in context, it is clear that it is concerned with the fairness of conduct rather than the care with which an act is performed. Failure to exercise ordinary care in conducting a transaction is an entirely different concept than failure to deal fairly in conducting the transaction.

Id. Neither the Sixth Circuit nor Michigan courts have elaborated on the meaning of the phrase "the observance of reasonable commercial standards of fair dealing."

The Third Circuit has explained that "good faith," as defined in the U.C.C., "has both a subjective prong— 'honesty in fact'— and an objective prong— observance of 'reasonable standards of fair dealing.'" *In re Jersey Tractor Trailer Training, Inc.*, 580 F.3d 147, 156 (3d Cir. 2009); *see also* U.C.C. § 1-203, cmt. 20. The court also adopted the following two-part test established by the Maine Supreme Court for evaluating the second component: "First, whether the conduct ... comported with industry or 'commercial' standards applicable to the transactions and, second, whether those standards were reasonable standards intended to result in fair dealing." *In re Jersey Tractor Trailer Training, Inc.*, 580 F.3d at 157 (citing *Maine Family Fed. Credit v. Sun Life Assurance Co. of Canada*, 727 A.2d 335, 343 (Me. 1999)).

In response to Comerica's motion, Experi-Metal argues "that reasonable commercial standards of fair dealing would not entail allowing forty-seven (47) fraudulent wire transfers to be initiated from [its] bank account, particularly with respect to a customer which had made only two wire transfers in the prior two years, with those transfers being made in 2007."[6] Experi-Metal appears to also argue that, had Comerica been acting in good faith, it would have been alerted to the fraudulent nature of the wire transfers based on the unusual destinations where the money was being directed (such as Moscow, Estonia, and China), particularly in light of Experi-Metal's limited prior wire transfer activity. Experi-Metal further argues that Comerica did not engage in reasonable commercial standards of fair dealing when it allowed the initiation of forty-six (46) additional fraudulent wire transfers after the activity in Experi-Metal's account was detected, Ling at Comerica contacted Allison at Experi-Metal, and Allison instructed Ling that Comerica should not honor any further transfers.

As emphasized earlier, Comerica has the burden of proving that it accepted the wire transfer orders in good faith and in compliance with commercially reasonable security procedures and any instruction by Experi-Metal restricting acceptance of payment orders issued in the company's name. MICH. COMP. LAWS § 440.4702(2). Comerica states in its reply brief: "Had Comerica been acting in *bad* faith, it would not have called Experi-Metal [in response to the atypical number of transfers being made on January 22, 2009]." Comerica, however, provides no evidence to rebut Experi-Metal's claim that the bank should have questioned the transfer orders

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6. As part of its argument that Comerica did not act in good faith, Experi-Metal contends that Comerica could have instituted additional security procedures which would have enabled it to detect unusual activity in customers' accounts. In this Court's view, this argument is relevant to whether Comerica's security procedure was commercially reasonable and not the good faith issue. Experi-Metal also argues that Comerica cannot show that it acted in compliance with an agreed upon security procedure or written agreement or instruction of Experi-Metal because there was no agreement between the parties with respect to the TMC Web wire transfer service and because Maslowski was not authorized as a user with respect to that service. As indicated earlier, those arguments lack merit.

more quickly in light of Experi-Metal's minimal prior wire transfer activity and the destinations of the payments. Notably, as set forth in Section II above, the fraudulent wire transfer orders began at 7:30 a.m. and forty-seven transfers were made before Comerica contacted Experi-Metal at 10:50 a.m.

As to the forty-one additional transfers that occurred from that point until 2:02 p.m., the U.C.C. provides that a bank must be given a "reasonable opportunity to act" in response to a customer's instruction. MICH. COMP. LAWS § 440.4702(2). Nevertheless, Comerica fails to present evidence from which this Court can conclude that it could not reasonably have stopped the transfers before it did. Comerica claims that "though it was physically impossible to instantly stop the transfers, it did so as quickly as it could, initiating this process immediately after talking to Experi-Metal." Comerica, however, offers no evidence to support this statement. While it cites to Ling's affidavit, Ling only states that after being informed that Experi-Metal had not initiated the wire transfers, she "immediately emailed the wire transfer room and asked that all wires be recalled and future wires stopped."

The Court therefore finds a genuine issue of material fact with respect to whether Comerica accepted the wire transfer orders in Experi-Metal's name on January 22, 2009 in "good faith."

REGULATION E

12 C.F.R. pt. 1005

§ 1005.1 – *Authority and purpose.*

(a) ***AUTHORITY***. The regulation in this part, known as Regulation E, is issued by the Bureau of Consumer Financial Protection (Bureau) pursuant to the Electronic Fund Transfer Act (15 U.S.C. 1693 *et seq.*).

(b) ***PURPOSE***. This part carries out the purposes of the Electronic Fund Transfer Act, which establishes the basic rights, liabilities, and responsibilities of consumers who use electronic fund transfer and remittance transfer services and of financial institutions or other persons that offer these services. The primary objective of the act and this part is the protection of individual consumers engaging in electronic fund transfers and remittance transfers.

§ 1005.2 – *Definitions.*

Except as otherwise provided in subpart B, for purposes of this part, the following definitions apply:

(a)

(1) "Access device" means a card, code, or other means of access to a consumer's account, or any combination thereof, that may be used by the consumer to initiate electronic fund transfers.

(2) An access device becomes an "accepted access device" when the consumer:

(i) Requests and receives, or signs, or uses (or authorizes another to use) the access device to transfer money between accounts or to obtain money, property, or services;

(ii) Requests validation of an access device issued on an unsolicited basis; or

(iii) Receives an access device in renewal of, or in substitution for, an accepted access device from either the financial institution that initially issued the device or a successor.

(b)

(1) "Account" means a demand deposit (checking), savings, or other consumer asset account (other than an occasional or incidental credit balance in a credit plan) held directly or indirectly by a financial institution and established primarily for personal, family, or household purposes.

(2) The term does not include an account held by a financial institution under a bona fide trust agreement. ...

(m) "Unauthorized electronic fund transfer" means an electronic fund transfer from a consumer's account initiated by a person other than the consumer without actual authority to initiate the transfer and from which the consumer receives no benefit. The term does not include an electronic fund transfer initiated:

(1) By a person who was furnished the access device to the consumer's account by the consumer, unless the consumer has notified the financial institution that transfers by that person are no longer authorized;

(2) With fraudulent intent by the consumer or any person acting in concert with the consumer; or

(3) By the financial institution or its employee.

Official interpretation of 2(a) Access Device

1. ***EXAMPLES***. The term "access device" includes debit cards, personal identification numbers (PINs), telephone transfer and telephone bill payment codes, and other means that may be used by a consumer to initiate an electronic fund transfer (EFT) to or from a consumer account. The term does not include magnetic tape or other devices used internally by a financial institution to initiate electronic transfers.
2. ***CHECKS USED TO CAPTURE INFORMATION***. The term "access device" does not include a check or draft used to capture the Magnetic Ink Character Recognition (MICR) encoding to initiate a one-time automated clearinghouse (ACH) debit. For example, if a consumer authorizes a one-time ACH debit from the consumer's account using a blank, partially completed, or fully completed and signed check for the merchant to capture the routing, account, and serial numbers to initiate the debit, the check is not an access device. (Although the check is not an access device under Regulation E, the transaction is nonetheless covered by the regulation. See comment 3(b)(1)-1.v.)

Official Interpretation of 2(m) Unauthorized Electronic Fund Transfer

1. ***TRANSFER BY INSTITUTION'S EMPLOYEE***. A consumer has no liability for erroneous or fraudulent transfers initiated by an employee of a financial institution.
2. ***AUTHORITY***. If a consumer furnishes an access device and grants authority to make transfers to a person (such as a family member or co-worker) who exceeds the authority given, the consumer is fully liable for the transfers unless the consumer has notified the financial institution that transfers by that person are no longer authorized.
3. ***ACCESS DEVICE OBTAINED THROUGH ROBBERY OR FRAUD***. An unauthorized EFT includes a transfer initiated by a person who obtained the access device from the consumer through fraud or robbery.

4. ***FORCED INITIATION***. An EFT at an ATM is an unauthorized transfer if the consumer has been induced by force to initiate the transfer.
5. ***REVERSAL OF DIRECT DEPOSITS***. The reversal of a direct deposit made in error is not an unauthorized EFT when it involves:
   i. A credit made to the wrong consumer's account;
   ii. A duplicate credit made to a consumer's account; or
   iii. A credit in the wrong amount (for example, when the amount credited to the consumer's account differs from the amount in the transmittal instructions).

§ 1005.3 – *Coverage. ...*

(b) ***ELECTRONIC FUND TRANSFER*** —

(1) ***DEFINITION***. The term "electronic fund transfer" means any transfer of funds that is initiated through an electronic terminal, telephone, computer, or magnetic tape for the purpose of ordering, instructing, or authorizing a financial institution to debit or credit a consumer's account. The term includes, but is not limited to:

(i) Point-of-sale transfers;

(ii) Automated teller machine transfers;

(iii) Direct deposits or withdrawals of funds;

(iv) Transfers initiated by telephone; and

(v) Transfers resulting from debit card transactions, whether or not initiated through an electronic terminal. ...

(c) ***EXCLUSIONS FROM COVERAGE***. The term "electronic fund transfer" does not include:

(1) ***CHECKS***. Any transfer of funds originated by check, draft, or similar paper instrument; or any payment made by check, draft, or similar paper instrument at an electronic terminal. ...

(3) ***WIRE OR OTHER SIMILAR TRANSFERS***. Any transfer of funds through Fedwire or through a similar wire transfer system that is used primarily for transfers between financial institutions or between businesses. ...

§ 1005.6 – *Liability of consumer for unauthorized transfers.*

(a) ***CONDITIONS FOR LIABILITY.*** A consumer may be held liable, within the limitations described in paragraph (b) of this section, for an unauthorized electronic fund transfer involving the consumer's account only if the financial institution has provided [various required disclosures]. If the unauthorized transfer involved an access device, it must be an accepted access device and the financial institution must have provided a means to identify the consumer to whom it was issued.

(b) ***LIMITATIONS ON AMOUNT OF LIABILITY***. A consumer's liability for an unauthorized electronic fund transfer or a series of related unauthorized transfers shall be determined as follows:

(1) ***TIMELY NOTICE GIVEN***. If the consumer notifies the financial institution within two business days after learning of the loss or theft of the access device, the consumer's liability shall not exceed the lesser of

$50 or the amount of unauthorized transfers that occur before notice to the financial institution.

(2) ***TIMELY NOTICE NOT GIVEN.*** If the consumer fails to notify the financial institution within two business days after learning of the loss or theft of the access device, the consumer's liability shall not exceed the lesser of $500 or the sum of:

(i) $50 or the amount of unauthorized transfers that occur within the two business days, whichever is less; and

(ii) The amount of unauthorized transfers that occur after the close of two business days and before notice to the institution, provided the institution establishes that these transfers would not have occurred had the consumer notified the institution within that two-day period.

(3) ***PERIODIC STATEMENT; TIMELY NOTICE NOT GIVEN.*** A consumer must report an unauthorized electronic fund transfer that appears on a periodic statement within 60 days of the financial institution's transmittal of the statement to avoid liability for subsequent transfers. If the consumer fails to do so, the consumer's liability shall not exceed the amount of the unauthorized transfers that occur after the close of the 60 days and before notice to the institution, and that the institution establishes would not have occurred had the consumer notified the institution within the 60-day period. When an access device is involved in the unauthorized transfer, the consumer may be liable for other amounts set forth in paragraphs (b)(1) or (b)(2) of this section, as applicable.

Official interpretation of 6(a) Conditions for Liability

1. ***MEANS OF IDENTIFICATION.*** A financial institution may use various means for identifying the consumer to whom the access device is issued, including but not limited to:
   i. Electronic or mechanical confirmation (such as a PIN).
   ii. Comparison of the consumer's signature, fingerprint, or photograph.

NOTES

1. Regulation E is one of a family of regulations that protect consumers from responsibility for unauthorized transfers or charges when they use modern payment systems. Regulation E deals with transfers from accounts at banks and other financial institutions, including ATMs and debit-card transactions. Regulation Z provides similar protections for credit-card transactions. Regulation CC deals with checks and other deposits; one of its key features is to limit the amount of time it takes for a check to "clear," i.e., between when a consumer deposits a check at their own bank and when the funds actually reach their account from the bank on which the check was drawn. Note that these regulations only apply to consumer transactions. As seen in *Experi-Metal*, the protections for businesses and other entities are different and weaker, mostly because they are assumed to be more sophisticated and better able to protect themselves.
2. Does Regulation E apply to payments made using a digital-wallet app like Venmo, PayPal, or Cash?

3. Many stores sell pre-loaded gift cards. To buy one, you pay up front for the value of the card (e.g., $25 or $100) and the cashier then activates the card by marking it as available for use. The recipient can then use the card much like a credit or debit card to pay for goods and services up to the purchased value of the card. Some of these cards are offered by major payment-card networks, like Visa and American Express, and can be used anywhere those payment cards are accepted. Others are tied to a specific merchant, like Target or Applebee's, and can be used only at that merchant. What should happen if the recipient of a gift card discovers that a fraudster copied the number off the card in the store and has already spent it? If their roommate took the card out of their wallet and used it? If the issuer freezes the card and refuses to accept it? Should they be redeemable for cash? Should it matter which type of card they are?