CHECK KITING: THE INADEQUACY OF THE UNIFORM COMMERCIAL CODE

Check kiting[1] schemes cause the banking industry to suffer extensive losses each year.[2] In 1982, a check kiting scheme caused the insolvency of the $27,000,000-deposit Hohenwald Bank and Trust Company in Tennessee.[3] That same year, the Mercantile Texas Corporation acquired Lincoln Centre Bank, N.A. after Lincoln Centre sustained extensive losses due to check kiting activities.[4] More recently, the managers of a collection service for professionals kited checks between four financial institutions for one year and caused these institutions to lose more than $2,000,000.[5] In addition, E.F. Hutton & Co. recently pleaded guilty to 2000 counts of mail and wire fraud that involved a check kiting

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1. A check kiting scheme operates as follows:

> The check kiter opens an account at Bank A with a nominal deposit. He then writes a check on that account for a large sum, sueh as $50,000. The check kiter then opens an account at Bank B and deposits the $50,000 check from Bank A in that account. At the time of deposit, the check is not supported by sufficient funds in the account at Bank A. However, Bank B, unaware of this fact, gives the check kiter immediate credit on his account at Bank B. During the several-day period that the check on Bank A is being processed for collection from that bank, the check kiter writes a $50,000 check on his account at Bank B and deposits it into his account at Bank A. At the time of the deposit of that check, Bank A gives the check kiter immediate credit on his account there, and on the basis of that grant of credit pays the original $50,000 check when it is presented for collection.
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> By repeating this scheme, or some variation of it, the check kiter can use the $50,000 credit originally given by Bank B as an interest-free loan for an extended period of time. In effect, the check kiter can take advantage of the several-day period required for the transmittal, processing, and payment of checks from accounts in different banks . . . .

Williams v. United States, 458 U.S. 279, 281 n.1 (1982) (citation omitted). Although this example illustrates the operation of a kite, kiting activities are not limited to new customers. In fact, in many cases, customers with a history of financial stability have kited checks. *See infra* note 5 and accompanying text. *See generally* H. BAILEY, BRADY ON BANK CHECKS § 17.15 (5th ed. 1979, Supp. I 1985 & Supp. II 1986); B. CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS ¶ 41.2 (1981 & Supp. I 1985); J. REITMAN & H. WEISBLAT, CHECKS, DRAFTS AND NOTES § 125.07 (1984); R. SPEIDEL, R. SUMMERS & J. WHITE, COMMERCIAL AND CONSUMER LAW 1411 (3d ed. 1981).

Most banks have taken precautionary measures by programming computers to alert them when there is a substantial volume of large transactions in a short period of time in any given account. This technique, however, is not fail-safe. Banks that process a large number of checks may be unable to screen and check all of the accounts that the computer indicates are active. Furthermore, such shifts in balances may not, in reality, be due to a kite. In any event, these programs do not *prevent* kites.

2. Marshall & Wright, *Taking the Wind Out of the Kite!*, MAG. BANK AD., Apr. 1983, at 62.

3. *Id.*

4. *Id.*

5. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. First Nat'l Bank, 774 F.2d 909, 911-12 (8th Cir. 1985).

operation.[6]

Banks victimized by check kiters have proposed a variety of theories upon which the recovery of losses could be based.[7] Judicial response to these recovery attempts has been confusing. Some courts strictly apply the midnight deadline rule of the Uniform Commercial Code (UCC) to check kiting.[8] Other courts reject this approach and rely on general principles of equity.[9] The resulting inconsistency defeats the purpose of the UCC, which was enacted to ensure uniformity among jurisdictions.[10]

This inconsistency has occurred because the UCC does not provide remedies for check kiting activities. This note proposes an equitably based solution that could serve as the basis for specific changes in the UCC. This note first examines the current, inconsistent judicial approaches to the problem of check kiting.[11] It then analyzes the insufficiency of the UCC provisions currently applied to kiting.[12] Finally, the note proposes the uniform equitable remedy of a proportionate allocation of losses among banks victimized by a check kite.[13] Proportionate allocation of losses, a concept based on equitable principles found in analogous areas of the law,[14] should encourage banks to detect and report kites promptly and thus should promote efficiency as well as result in an equitable allocation of losses.

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6. The following was reported regarding E.F. Hutton's activities:

> [S]everal bank accounts were played off against one another to avoid bouncing any checks and to gain, in effect, interest-free loans. . . . The maneuvers, which took place over a 20-month period beginning in July 1980, involved checks totaling about $10 billion. On some days, Hutton enjoyed $250 million in interest-free loans.

Rudolph, *E.F. Hutton's Simmering Scandal,* TIME, July 22, 1985, at 53. E.F. Hutton planned to compensate the banks involved for their losses. Koepp, *Placing the Blame at E.F. Hutton,* TIME, Sept. 16, 1985, at 54. This note, however, focuses on banking losses from kiters who are judgment proof because of the kiters' financial conditions.

7. *See infra* notes 20-34 and aceompanying text. Additional recovery theories have been advanced. *See* Chrysler Credit Corp. v. First Nat'l Bank & Trust Co., 746 F.2d 200, 203 (3d Cir. 1984) (conversion and fraud theories); Union Bank v. First Nat'l Bank, 621 F.2d 790, 794 (5th Cir. 1980) (warranty liability theory); Omaha Nat'l Bank v. T & T Parts Warehouse, Inc. (*In re* T & T Parts Warehouse, Inc.), 39 Bankr. 399, 401 (Bankr. W.D. Mich. 1984) (constructive trust theory); Barnett Bank v. Capital City First Nat'l Bank, 348 So. 2d 643, 645 (Fla. Ct. App. 1977) (fraud theory); Town & Country State Bank v. First State Bank, 358 N.W.2d 387, 396 (Minn. 1984) (warranty liability theory); Pennsylvania Nat'l Turf Club, Inc. v. Bank of W. Jersey, 158 N.J. Super. 196, 203, 385 A.2d 932, 935 (N.J. Super. Ct. App. Div. 1978) (negligence theory).

8. *See infra* note 36.

9. *See infra* notes 41-46 and accompanying text.

10. *See* U.C.C. § 1-102(2)(c) (1977).

11. *See infra* notes 15-54 and accompanying text.

12. *See infra* notes 55-71 and accompanying text.

13. *See infra* notes 72-81 and accompanying text.

14. *See infra* notes 82-86 and accompanying text.

faith, it cannot be considered a holder in due course under the UCC, and recovery is precluded.[21] As stated by Professor O'Malley, "the discovering bank does not qualify as a holder in due course of those checks paid by the second bank after the discovering bank has knowledge of the fraud, and thus, the second bank can recover its payment."[22]

Community Bank v. United States National Bank[23] provides a useful example of this application of the good faith requirement. Community Bank suspected that a customer was engaged in check kiting and decided not to make payment on any checks until the deposits made by that customer had cleared. Community Bank did not, however, inform U.S. National Bank, although it suspected that U.S. National would be affected by the scheme. U.S. National alleged that it should have been informed of Community's suspicions. The Supreme Court of Oregon rejected this claim, finding that Community "was not yet *certain*"[24] of the existence of the kite. On the basis of this finding, the court concluded that "[t]he evidence did not demonstrate bad faith as a matter of law."[25]

The court did not specify whether Community had knowledge of the kiting scheme. The court indicated by its reasoning, however, that

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P.2d 685, 691 (1977) (party may act in bad faith if it "fails to make any inquiry for the purpose of remaining ignorant of facts which [it] believes or fears would disclose a defect in the transaction"); First State Bank & Trust Co. v. George, 519 S.W.2d 198, 203-04 (Tex. Civ. App. 1974) (victim bank could not recover on checks beeause it accepted and deposited them with knowledge of payee's kiting activities). *But see* Toronto-Dominion Bank v. Central Nat'l Bank & Trust Co., 753 F.2d 66, 70 (8th Cir. 1985) (holding that when one bank misses midnight deadline, opposing party's behavior is not relevant "unless that lack of good faith in some way caused [the bank] to breach its return obligation").

21. Absent good faith, a bank cannot recover as a holder in due course on subsequent items. U.C.C. § 3-302 provides:

> (1) A holder in due course is a holder who takes the instrument
> (a) for value; and
> (b) *in good faith*; and
> (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person.
> (2) A payee may be a holder in due course.
> (3) A holder does not become a holder in due course of an instrument:
> (a) by purchase of it at judicial sale or by taking it under legal process; or
> (b) by acquiring it in taking over an estate; or
> (c) by purchasing it as part of a bulk transaction not in regular course of business of the transferor.
> (4) A purchaser of a limited interest can be a holder in due course only to the extent of the interest purchased.

U.C.C. § 3-302 (1977) (emphasis added). A bank could not recover as a mere holder because the drawee bank could raise the defense of fraud. *See* U.C.C. § 3-306(b) (1977) (holder is subject to simple contract defenses). Furthermore, there can be no warranty liability because neither party warrants that sufficient funds are available. *See* U.C.C. § 3-417 (1977) (warranties of presentment).

22. O'Malley, *Common Check Frauds and the Uniform Commercial Code,* 23 RUTGERS L. REV. 189, 194 n.35 (1969).

23. 276 Or. 471, 555 P.2d 435 (1976).

24. *Id.* at 480, 555 P.2d at 440 (emphasis added).

25. *Id.*

had Community in fact possessed knowledge, Community would not have met the good faith requirement and would not have preserved holder in due course status with respect to subsequent checks received from U.S. National. According to this court, then, the UCC imposes on banks a duty to disclose knowledge of check kiting schemes to other involved banks.

Some courts have taken a different approach and have held that when a bank discovers a check kite, it can dishonor checks before the midnight deadline and continue to accept deposits in order to minimize its loss.[26] This course of action destroys the kite and results in losses to the unsuspecting bank that continues to make payment on checks presented to it.

For example, in *Citizens National Bank v. First National Bank*,[27] once First National discovered a check kiting scheme, it promptly returned, unpaid, all checks drawn against its accounts, causing the kite to collapse. Simultaneously, First National accepted deposits to minimize its loss. Citizens National, unaware of the kite, continued to make payment on checks presented to it by First National. Citizens National sued First National in conversion for its resulting loss.[28]

The chancery court sustained First National's demurrer, stating that it failed to "find where [First National] has been charged with doing anything other than acting as a prudent and careful bank should act."[29] The Supreme Court of Mississippi affirmed, concluding:

> [T]hese two banks were competitors in the banking field and ordinarily banks deal with each other at arm's length. The bill does not allege any circumstances or facts that tend to show that a confidential or fiduciary relationship existed between these two banks, neither does it show that there is any requirement in the banking field that one bank notify another of its discovery of a customer kiting checks. In the absence of a fiduciary or confidential relationship, or some other legal duty, *First National Bank had no duty to inform Citizens National Bank* . . . .[30]

The Mississippi Supreme Court stated that Citizens National "could have refused to credit [the customer's] account until the checks cleared"[31] and emphasized that First National "had a legal right to do the things it did for its own protection."[32] The court cited the midnight deadline provision of the UCC, and reasoned that as long as one bank

26. *See infra* notes 28-34 and accompanying text.
27. 347 So. 2d 964 (Miss. 1977).
28. *Id.* at 966.
29. *Id.* at 967 (quoting the unreported Chancery Court decision).
30. *Id.* (emphasis added).
31. *Id.*
32. *Id.* at 969.

returns the check within that deadline, no liability results.[33] The underlying rationale appears to be that strict application of the midnight deadline provision is desirable because it promotes competition among banks.[34]

B. *The Disputed Meaning of Final Payment.*

Additional UCC provisions present further interpretative difficulties in the check kiting context. Specifically, courts differ in applying the midnight deadline to final payment.[35] Some courts strictly interpret the UCC and generally prohibit any recovery by a bank that fails to return a

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33. *Id.* at 967. The court provided three reasons why the payment of a check, absent fraud or misrepresentation, should close the transaction with respect to the bank and the holder:

> First and foremost, to permit a bank to repudiate the payment of a check would destroy the certainty that must pertain to commercial transactions of this nature and would cause uncertainty, delay and annoyance if a bank at some future time could call the payee for the return of the money paid to him on the check. Secondly, there is no privity between the payee or holder of the check and the drawee bank. Finally, the drawee bank always has the means of knowing the status of the depositor's account and is not required to pay the check unless it is satisfied the depositor has sufficient funds to cover the check . . . .

Id. at 968.

The United States Court of Appeals for the Ninth Circuit employed similar reasoning in holding that a bank has no duty to *discover* a kite. *See* Mid-Cal Nat'l Bank v. Federal Reserve Bank, 590 F.2d 761 (9th Cir. 1979). Mid-Cal and Stockton Bank were unknowing participants in a check kiting scheme. Mid-Cal discovered the kite, returned the checks to Stockton and subjected Stockton to a $900,000 loss. Stockton alleged that Mid-Cal had a duty to discover the kite. The Ninth Circuit disagreed, stating that "Mid-Cal did not have a special relationship with its depositors such that the bank had a duty to control their conduct for the benefit of Stockton. . . . [T]he Uniform Commercial Code . . . does not create such a relationship." *Id.* at 763.

Although *Mid-Cal* involved the duty to discover a kite and *First Nat'l Bank* involved the duty to report, the Ninth Circuit cited *First Nat'l Bank* and noted that "if a bank . . . cannot be held liable for failing to notify even when it knows of kiting activity, a bank should not be called to account for failing to discover information that, in any event, it was not required to convey." *Id.* at 764.

34. *Cf.* H. BAILEY, *supra* note 1, § 17.16 at 17-13 n.43 (Supp. II 1986) (strict application of midnight deadline rule promotes philosophy of "every man for himself").

35. The relevant UCC provisions include sections 3-418 and 4-213. Section 3-418 provides:

> Except for recovery of bank payments as provided in the Article on Bank Deposits and Collections (Article 4) and except for liability for breach of warranty on presentment under the preceding section, payment or acceptance of any instrument is final in favor of a holder in due course, or a person who has in good faith changed his position in reliance on the payment.

U.C.C. § 3-418 (1977). Section 4-213 provides that final payment occurs when the payor bank has done any of the following, whichever happens first:

> (a) paid the item in cash; or
> (b) settled for the item without reserving a right to revoke the settlement and without having such right under statute, clearing house rule or agreement; or
> (c) completed the process of posting the item to the indicated account of the drawer, maker or other person to be charged therewith; or
> (d) made a provisional settlement for the item and failed to revoke the settlement in the time and manner permitted by statute, clearing house or agreement.
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> Upon a final payment under subparagraphs (b), (c), or (d) the payor bank shall be accountable for the amount of the item.

U.C.C. § 4-213(1) (1977).

check within the midnight deadline.[36] Some commentators,[37] though not all,[38] support this position. Professor Clark asserts that without this "simple rule" of liability, "courts will be forever wrestling with fine fact questions involving reliance, negligence, notice, damages, and the concept of holder in due course."[39] Similarly, Professor Quinn argues that "[i]n situations where no breach of warranty is involved, . . . the bank can *never* recover once the payment becomes final under 3-418."[40]

In opposition to those courts that strictly apply the midnight deadline rule, some courts have used a restitution theory to allow banks to recover after making final payment. Illustrative of this approach is the decision in *National Savings & Trust Co. v. Park Corp.*[41] Although *Park Corp.* does not involve check kiting, it does focus on the "restitution versus midnight deadline" issue.

In *Park Corp.,* a bank officer had instructed an employee to dishonor Park Corporation checks. A series of errors caused the bank to honor a check, resulting in a loss of $74,000. Park Corporation con-

36. The need to promote finality in the check collection process is often cited as a reason for strict interpretation of the midnight deadline rule. Many federal courts have sanctioned a strict interpretation. *See* Starcraft Co. v. C.J. Heck Co., 748 F.2d 982, 987 (5th Cir. 1984); Chrysler Credit Corp. v. First Nat'l Bank & Trust Co., 746 F.2d 200, 201 (3d Cir. 1984); Appliance Buyers Credit Corp. v. Prospect Nat'l Bank, 708 F.2d 290, 293 (7th Cir. 1983); Community Bank v. Federal Reserve Bank, 500 F.2d 282, 285-86 (9th Cir.), *cert. denied,* 419 U.S. 1089 (1974), *modified,* 525 F.2d 690 (9th Cir. 1975); Central Bank & Trust Co. v. General Fin. Corp., 297 F.2d 126, 129 (5th Cir. 1961); Bank Leumi Trust Co. v. Bank of Mid-Jersey, 499 F. Supp. 1022, 1026-27 (D.N.J. 1980), *aff'd without opinion,* 659 F.2d 1065 (3d Cir. 1981); Catalina Yachts v. Old Colony Bank & Trust Co., 497 F. Supp. 1227, 1234 (D. Mass. 1980); Colorado Nat'l Bank v. First Nat'l Bank & Trust, 459 F. Supp. 1366, 1373 (W.D. Mich. 1978); North Carolina Nat'l Bank v. South Carolina Nat'l Bank, 449 F. Supp. 616, 618-20 (D.S.C. 1976), *aff'd,* 573 F.2d 1305 (4th Cir.), *cert. denied,* 439 U.S. 985 (1978).

Some state courts have also strictly interpreted the midnight deadline rule. *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. Security Pac. Nat'l Bank, 23 Cal. App. 3d 638, 643, 100 Cal. Rptr. 438, 441-42 (1972); Rock Island Auction Sales v. Empire Packing Co., 32 Ill. 2d 269, 272, 204 N.E.2d 721, 723 (1965); Raymer v. Bay State Nat'l Bank, 384 Mass. 310, 315, 424 N.E.2d 515, 519 (1981); Town & Country State Bank v. First State Bank, 358 N.W.2d 387, 391 (Minn. 1984); Prestige Motors, Inc. v. Carteret Bank & Trust Co., 183 N.J. Super. 525, 529-30, 444 A.2d 627, 629 (N.J. Super. Ct. Law Div. 1982), *aff'd,* 188 N.J. Super. 610, 458 A.2d 140 (N.J. Super. Ct. App. Div. 1983); Met Frozen Food Corp. v. National Bank, 89 Misc. 2d 1033, 1037, 393 N.Y.S.2d 643, 647 (N.Y. Sup. Ct. 1977); Hamby Co. v. Seminole State Bank, 652 S.W.2d 939, 941 (Tex. 1983); Kirby v. First & Merchants Nat'l Bank, 210 Va. 88, 94, 168 S.E.2d 273, 277 (1969); Northwestern Nat'l Ins. Co. v. Midland Nat'l Bank, 96 Wis. 2d 155, 166, 292 N.W.2d 591, 597 (1980); *see generally* B. CLARK, *supra* note 1, ¶ 3.6[3] (favoring strict interpretation due to its simplicity); J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE U.C.C. § 16-4 (2d ed. 1980) (discussing "final payment" requirements).

37. B. CLARK, *supra* note 1, ¶ 3.6[3].

38. D. EPSTEIN & J. MARTIN, BASIC U.C.C. TEACHING MATERIALS 514 (2d ed. 1983).

39. B. CLARK, *supra* note 1, ¶ 3.6[3], at 3-40.

40. T. QUINN, QUINN'S U.C.C. COMMENTARY AND LAW DIGEST, ¶ 3-418[A][2], at 3-232 (1978) (emphasis added).

41. 722 F.2d 1303 (6th Cir. 1983), *cert. denied,* 466 U.S. 939 (1984).

tended that the bank had made final payment on the check,[42] an argument the court found to have a "certain appeal."[43] Recognizing that "opinion on the matter is by no means uniform,"[44] the court held that restitution was an available remedy notwithstanding the midnight deadline provision.[45] The court explained its position as follows:

> An examination of the comments to section 3-418 makes clear both that this section was intended to apply to "the payment of overdrafts, or any other payment made in error as to the state of the drawer's account," . . . and that restitutionary recovery was to be denied only when the payee had relied on the payment. . . .
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> . . . The purpose of section 4-213 is "to determine *when* settlement for an item or other action with respect to it constitutes final payment." . . . Section 4-213 determines *when* the final payment rule of section 3-418 comes into effect, not *what* that rule is supposed to mean.[46]

This same argument was made in *Town & Country State Bank v. First State Bank*.[47] The plaintiff-banks seeking recovery of kiting losses argued that:

> "[F]inal payment" under section 4-213 only fixes the *time* at which final payment occurs, *i.e.*, when notice, stop payment orders, legal process and set-off will not prevent the payment of an instrument. . . . [O]ne must look to Article 3 of the Code, specifically section 3-418, to determine the *effect* of final payment.[48]

Unlike the court in *Park Corp.*, however, the court in *Town & Country State Bank* rejected the argument that restitution was available notwithstanding the midnight deadline provision.[49] The court did acknowledge,

42. Park Corporation relied on sections 3-418 and 4-213. *Id.* at 1305.

43. *Id.* The court noted that Professor White had argued in his treatise that no restitution should be available. This treatise, the court reasoned, "is generally considered the leading authority on commercial transactions." *Id.* at 1305. Professor White, it should be mentioned, has since changed his position. *See infra* notes 51-53 and accompanying text.

44. *Park Corp.*, 722 F.2d at 1305.

45. *Id.* at 1306.

46. *Id.* (quoting U.C.C. § 3-418 comment 2 (1977), and U.C.C. § 4-213 comment 1 (1977)).

47. 358 N.W.2d 387 (Minn. 1984).

48. *Id.* at 394.

49. *Id.* at 395. The court stated that "to say that the final payment provisions of Article 4 are only given effect under the dictates of section 3-418 would render those actions of Article 4 virtually meaningless." *Id.* Professor Lawrence has likewise criticized the use of Article 3 in situations that the provision does not specifically address. He asserts that:

> Article 3 has been treated as though its rules contained an answer for virtually every commercial paper question. Each rule has been interpreted broadly. Often, when no answer has been readily apparent, any rule has been applied whose terms possibly could be interpreted to cover the situation, even when it was fairly clear that the situation did not fall within the intended coverage of the rule.

Lawrence, *Misconceptions about Article 3 of the Uniform Commercial Code: A Suggested Methodology and Proposed Revisions,* 62 N.C.L. REV. 115, 122 (1983). *See also* Lawrence, *Making Cashier's Checks and Other Bank Checks Cost-Effective: A Plea for Revision of Articles 3 and 4 of the Uniform* however, that the UCC was ambiguous on the point and that support could be found for both positions.[50]

Indeed, even Professor White has wrestled with the question of restitution. White originally contended that no restitution was available under the UCC.[51] Following the publication of a student note criticizing this approach,[52] White changed his position and now contends that section 4-213 does not preclude restitution.[53] A few courts have discussed

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Commercial Code, 64 MINN. L. REV. 275, 340 (1980) ("Articles 3 and 4 fail to offer the comprehensive framework that the modern business community needs.").

50. *Town & Country State Bank,* 358 N.W.2d at 393-95. A number of courts and commentators have discussed the possibility of restitutionary recovery. *See, e.g.,* Blake v. Woodford Bank & Trust Co., 555 S.W.2d 589, 593-601 (Ky. Ct. App. 1977); Bryan v. Citizens Nat'l Bank, 628 S.W.2d 761, 761-64 (Tex. 1982); D. EPSTEIN & J. MARTIN, *supra* note 38, at 514; Note, *Commercial Paper and Forgery: Broader Liability for Banks?,* 1980 U. ILL. L.F. 813, 830-36.

One case that allowed recovery on that basis was Bank Leumi Trust Co. v. Bally's Park Place, Inc., 528 F. Supp. 349 (S.D.N.Y. 1981). Bally's was a gambling casino. Brinker paid a $60,000 debt owed to Bally's by check. *Id.* at 351. Later that month, Brinker died. Bally's contacted Brinker's estate to try to collect the $60,000; the estate, however, was unable to pay. Nevertheless, Bally's submitted the check to the bank in an attempt to recover the money. *Id.* at 352. Through a series of errors, the bank failed to return the check before the midnight deadline. *Id.* at 353.

Although the bank failed to act in a timely fashion, the court allowed recovery. Asserting that the UCC did not replace the common law, the court said:

> Bally's reliance upon the New York U.C.C. §§ 3-418, 4-301 and 4-302 is misplaced. These sections of the U.C.C. apply to interbank settlement procedures, and not to subsequent actions for restitution. A contrary reading of §§ 3-418, 4-301 and 4-302 would be inconsistent with § 1-103 which retains the common law governing mistake. It would lead to the unintended result of allowing a payee, unjustly, to retain moneys improperly obtained.

Id. at 354.

In Demos v. Lyons, 155 N.J. Super. 489, 376 A.2d 1352 (N.J. Super. Ct. Law Div. 1977), the bank, in an effort to avoid embarrassing the customer, elected to pay a check presented on the customer's account even though the account contained insufficient funds. The court held that restitution was an available remedy, stating:

> As a rule of law, "payment is final" refers to the common law principle that one cannot recover back money paid, simply because of a change of mind. Its rationale is repose. Establishing the finality of a payment tends to assure stability in people's affairs. However, the law may compel restitution where there are competing considerations—such as fraud, duress and mistake—favoring the payor. When these considerations are raised, the evidence must be examined and equities balanced.

Id. at 1355. The court noted that if section 4-213 deprived a payor bank of restitution, a payee could coerce or defraud the bank into making final payment, yet be permitted to keep the money obtained through fraud. *Id.* at 1357. After determining that restitution was an available remedy, the court declined to grant it in this case. *Id.* at 1357.

51. J. WHITE & R. SUMMERS, *supra* note 36, § 16-2, at 613-18.

52. Note, *Commercial Paper and Forgery: Broader Liability for Banks?,* 1980 U. ILL. L.F. 813. This note argues that "[a]s a matter of statutory construction, the White and Summers position is untenable. The traditional use of the term 'final payment' does not support the argument that final payment precludes restitution. Under pre-Code law . . . [t]he right of a bank to obtain restitution for mistaken payment . . . was never questioned." *Id.* at 830.

53. D. EPSTEIN & J. MARTIN, *supra* note 38, at 514. Professor White explained that "[t]o read such trenchant criticism of one's carefully constructed argument is painful, made yet more painful by the realization that it comes from the pen of a callow youth and worse, by the knowledge that he is right." *Id.*

White's change of position.[54]

II. THE NECESSITY OF ADDITIONAL LEGISLATION

The differing interpretations of the UCC have resulted in inconsistencies regarding recovery of losses due to check kiting schemes. Each theory discussed above inadequately addresses the problem of kiting. Accordingly, the UCC should be amended to specifically address check kiting and to provide for a uniform and equitable recovery standard.

A. *Inadequacy of Current Loss Allocation Approaches.*

Neither of the judicial approaches discussed above is optimal. The *First National Bank* court indicated that a rule allowing one bank to knowingly shift its losses to the other bank is justified because no fiduciary relationship exists between the two banks.[55] Equity, however, should not require a fiduciary relationship in order to justly allocate losses. On the other hand, there is no good reason why a bank that does discover a kite should not be able to protect itself against known losses. In those jurisdictions that impose a good faith duty to inform other banks of discovered kites, however, the discovering bank forfeits its holder in due course status as to later checks if it attempts to minimize its loss by concealing the kite.[56] Thus, neither approach is wholly satisfactory.

B. *Inapplicability of the Midnight Deadline.*

The UCC's midnight deadline provision by its terms applies to isolated transactions. The provision expressly applies when "*an item* is presented" for payment.[57] A check kite is *not* an isolated or single transaction; rather, it involves a series of transactions.[58] One might attempt to divide a kite into independent transactions based on when a check is presented for payment. Such a division, however, would be highly artificial given the nature of the kite. A kite requires at least two transactions within a short period of time between two banks having an ongoing relationship. Courts that strictly apply the midnight deadline provision to the series of transactions that constitute the kiting scheme ignore this fact

54. National Sav. & Trust Co. v. Park Corp., 722 F.2d 1303, 1306 (6th Cir. 1983), *cert. denied,* 466 U.S. 939 (1984) (accepting White's new position); Town & Country State Bank v. First State Bank, 358 N.W.2d 387, 394 n.7 (Minn. 1984) (discussing but rejecting White's new position).

55. Citizens Nat'l Bank v. First Nat'l Bank, 347 So. 2d 964, 967 (Miss. 1977). *See supra* notes 27-32 and accompanying text.

56. *See supra* notes 20-25 and accompanying text.

57. U.C.C. § 4-302 (1977) (emphasis added).

58. *See supra* note 1.

and consequently misapply the UCC.[59] The faulty analysis results in an inequitable outcome because it allows the entire burden of the kiting loss to be shifted to one bank.

C. *Kiting and the Intent of the UCC.*

United States banks processed approximately forty billion checks during 1985.[60] Although some banks do not,[61] most banks immediately extend credit on checks deposited. Thus, the customer incurs no delay with respect to the availability of the deposited funds. Each time a bank extends credit to a customer, the possibility exists that the customer may engage in kiting. Although the majority of customers do not engage in kiting, those who do can cause substantial losses.[62]

Although banks might foreclose the possibility of loss by not extending credit immediately, it would be commercially impractical for them to do so.[63] If a bank were to place a hold on each check presented until it had knowledge that the account contained sufficient funds, the convenience of checking accounts would be destroyed, and all transactions would be unnecessarily and significantly delayed. Such delay would defeat a major purpose underlying the availability of checking acounts.[64] Under the UCC, the policy thrust "is for speed and facility at

59. Professor Lawrence has sharply criticized the overly broad scope of Article 3. *See supra* note 49 and accompanying text; *see also supra* notes 55-58 and accompanying text.

60. *Statements to Congress,* 71 FED. RESERVE BULL. 937, 937 (1985) (statement by Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System).

61. *See, e.g.,* Rapp v. Dime Sav. Bank of New York, 64 A.D.2d 964, 408 N.Y.S.2d 540 (1978) (bank may place hold on checks deposited until they have been paid), *aff'd,* 48 N.Y.2d 658, 396 N.E.2d 740, 421 N.Y.S.2d 347 (1979).

62. *See supra* notes 1-6 and accompanying text.

63. Banks can, theoretically, take precautions when processing checks. Such precautions, however, are commercially inefficient. An analogy can be made to precautions taken to limit forgery. With respect to such precautions, one court has stated: "A single branch of a large bank . . . may handle several thousand instruments bearing third party endorsements in a single day. Considering this burden, it would be commercially unreasonable to expect payor banks to undertake foolproof efforts to verify ostensibly valid endorsements." Cooper v. Union Bank, 9 Cal. 3d 371, 385-86, 507 P.2d 609, 620, 107 Cal. Rptr. 1, 12 (1973).

Like the cost of eliminating kites, "the cost of checking signatures exceeds the dollar amount of forged checks which are an insignificant percentage of all checks processed." R. JORDAN & W. WARREN, COMMERCIAL LAW 559 (1983).

64. The UCC focuses on efficiency in banking transactions. *See* Bowling Green, Inc. v. State St. Bank & Trust Co., 425 F.2d 81, 84 (1st Cir. 1970) ("Article 4 establishes a comprehensive scheme for simplifying and expediting bank collections."). If banks held checks until they were assured of sufficient funds, this aim would be defeated. Professor Malcolm asserts that the provisions of Article 4 were drafted "to recognize the tremendous, machine-like, flow nature of the bank collection process and facilitate the smooth functioning of this process rather than throw irritants or blockages in its path." Malcolm, *How Bank Collection Works—Article 4 of the Uniform Commercial Code,* 11 How. L.J. 71, 75 (1965).

Professor Brady likewise emphasizes the effectiveness of present banking practices:

some expense to exact checks and balances."[65] Thus, if banks were to hold checks until they were assured of sufficient funds, the efficiency contemplated by the UCC would be defeated and market transactions would be significantly affected.[66]

Not only would a significant delay occur in market transactions, but the administrative burden placed on banks would be substantial. Given the large number of checks that a typical bank processes,[67] the cost of ensuring that each check was covered by sufficient funds would affect the market demand for the bank's services and significantly increase the cost of processing checks.[68]

The social benefit of these precautions simply would not be worth the cost in both time and money. Such precautions are not and should

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> The story of the phenomenal growth of the bank check as a medium of exchange may be read in the statistics, which tell in billions of dollars the amount which, in the form of checks, passes through the clearinghouses of this country every day. No one can doubt that the bank check now performs a very important function in the commerce of the country and performs it with great efficiency.

H. BAILEY, *supra* note 1, § 1.1 at 1-3 (1979). This "great efficiency" would surely cease if banks refused to credit accounts until checks were paid.

65. R. JORDAN & W. WARREN, *supra* note 63, at 582.

66. Walter Malcolm, a member of the Permanent Editorial Board of the Uniform Commercial Code, describes the bank collection process as follows:

> Reflection upon the bank collection process indicates that here we have a vast, machine-like, volume operation with literally tremendous numbers of items and dollars and which might well be likened to the bloodstream of our economy. We have a steady flow of items and dollars that perform a vital and essential function. So long as the flow continues we are almost completely unaware that it is taking place, just as we are substantially unaware of the flow of the blood through our bodies. But produce a stoppage of this flow for a week or even for a day as, for example, during the bank holiday in 1933 and conditions approaching chaos would strike our economy almost instantly; or produce a minor stoppage or obstruction at some stage in this operation and the confusion and irritation which would result would be amazing.

Malcolm, *supra* note 64, at 74.

67. *See* Leary & High, *The Place of EFT and Check Truncation in Corporate Payment Systems,* 5 DEL. J. CORP. L. 1, 6 n.31 (1980). Leary and High provide an example that illustrates the immenseness of the volume of checks processed each year:

> A very large California bank has informed the authors that three years ago it handled about two billion checks. In the process it moved about ten tons of paper every working day. One branch alone has produced for it daily a stack of computer printouts six feet high. The bank transported some of the paper 800 miles overnight, requiring a fleet of nine aircraft which flew more than a million miles over eleven routes from the Mexican Border to the Oregon state line. It also used more than 500 courier vans and cars to move the materials between branches and airports, covering 471 routes and tallying over 740,000 miles per month.

Id.

68. Were banks to hold deposited checks until final payment, administrative costs—such as costs incurred in responding to customers' inquiries into whether their checks had cleared—would increase sharply. Furthermore, customer convenience would be significantly reduced. Customer convenience is a significant factor in market demand. *See* Canner & Kurtz, *Service Charges as a Source of Bank Income and Their Impact on Consumers,* 71 FED. RESERVE BULL. 609, 610 (1984) ("Regardless of income, only a small fraction of consumers rank service charges ahead of *convenience, [and] availability of many services* . . . when asked to list such reasons in order of importance to them in their selection of a primary financial institution.") (emphasis added).

not be a part of the routine operation of a bank.[69] The Federal Reserve Board has recognized this and has voiced opposition to legislation that would require the delayed availability of deposited checks.[70] Furthermore, several states, including New York and California, have passed laws limiting the ability of state-chartered banks to delay the extension of credit to their depositors.[71]

III. A UNIFORM EQUITABLE REMEDY

The preceding two sections sought to demonstrate the need for change. Not only have courts experienced difficulties in applying the existing provisions of the UCC, but they have yet to advance an interpretation that yields an equitable and efficient result. An amendment to the UCC is therefore needed to promote uniformity and fairness. The most equitable and efficient solution would be one that provides for a proportionate allocation of losses among banks.

A. *An Examination of Alternative Approaches.*

The diagram below illustrates a hypothetical kiting scheme. For the sake of simplicity, the hypothetical involves only two banks, Banks A and B.[72] Both banks extend immediate credit to the kiter. Bank A then discovers the kite. The kiter, however, has already written a check to a third party, who qualifies as a holder in due course.[73] It shall be assumed that the kiter is judgment proof.[74] The question to be resolved, then, is how to allocate the $100,000 loss between the two banks.

The following diagram depicts the series of transactions that constitute the kite. Events 1 through 5 explain the collapse of the kite. Four possible approaches to allocating the losses are then presented. The first approach, based on the above-described no duty theory, allows the discovering bank to escape all liability by accepting deposits and returning

69. It has been noted that "[c]ommercial reasonableness is perhaps the most significant and innovative of the [UCC] admonitory concepts." A. SCHWARTZ & R. SCOTT, COMMERCIAL TRANSACTIONS, PRINCIPLES AND POLICIES 4 (1982). One can persuasively argue that such extensive precautions would not be commercially reasonable because of the significant burdens that would be imposed on both banks and customers.

70. *Statements to Congress,* 71 FED. RESERVE BULL. 937, 940 (1985).

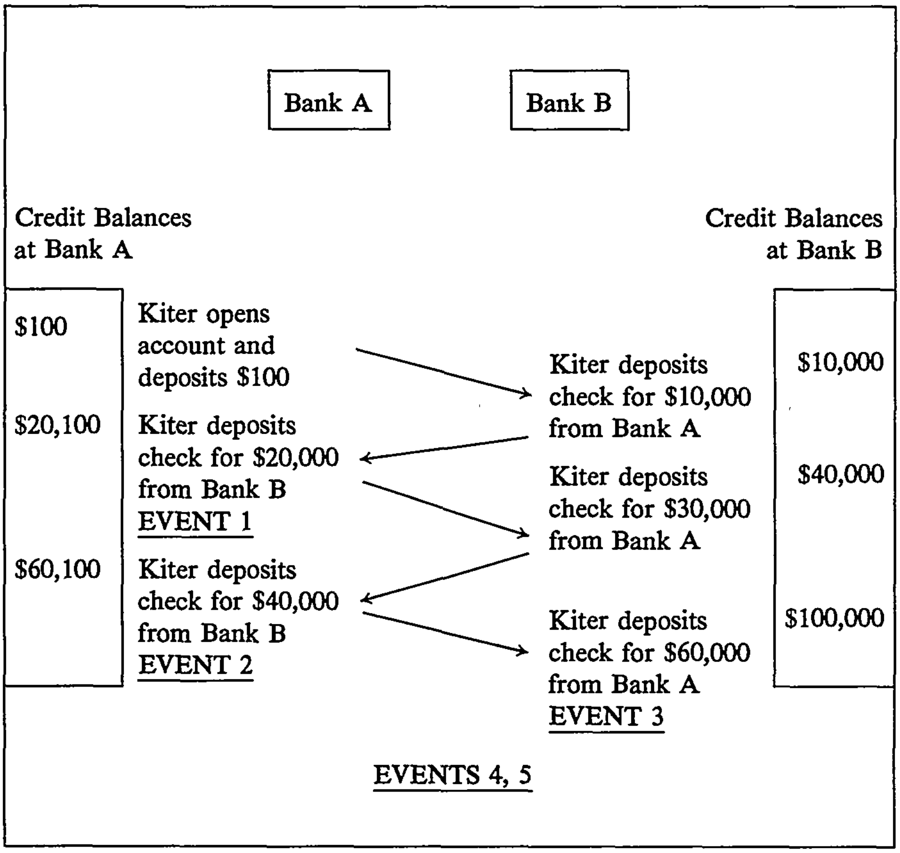
71. *Id.* at 937.

72. A kite often involves more than two banks. A kiter may kite principally between two banks but also involve one or more additional banks, drawing checks of much lesser sums from these "peripheral" banks.

73. For a discussion of the concept of holder in due course, *see supra* note 21 and accompanying text.

74. Kiters are often judgment proof. The kiter never initially possesses the money deposited in the various bank accounts, but "creates" it by means of the kite. *See supra* note 1. E.F. Hutton, however, was not judgment proof. *See supra* note 6.

checks presented to it unpaid.[75] The second approach, based on the good faith theory, prohibits the discovering bank from using its knowledge of the kite to evade losses.[76] The third approach, based on an equal allocation theory, requires all involved banks to allocate the losses equally.[77] Finally, the fourth approach, based on a proportionate allocation theory, requires the banks to divide the losses according to their exposure to them.



Event 1:
Bank A discovers the kite.

Event 2:
Bank A accepts the $40,000 check drawn on kiter's account at Bank B, which Bank B pays.

75. *See supra* notes 27-32 and accompanying text.

76. *See supra* notes 20-25 and accompanying text.

77. Although no court has yet applied an equal allocation theory, it is a plausible approach given the fact that each bank is an innocent victim.

Event 3:

The kiter deposits the check for $60,000 drawn on Bank A in Bank B's account.

Event 4:

The kiter writes a check for $100,000 to a third party who qualifies as a holder in due course.

Event 5:

Bank A dishonors the $60,000 check drawn against Bank A's account.

Result: The collapse of the kite and a $100,000 loss that the court must allocate.

ALLOCATION OF LOSS UNDER EACH APPROACH:[78]

Approaches	Bank A	Bank B
(1) No Duty	$0	−$100,000
(2) Good Faith	−$60,000	−$ 40,000
(3) Equal Allocation	−$50,000	−$ 50,000
(4) Proportionate Allocation	−$40,000	−$ 60,000

B. *Justification for Proportionate Allocation.*

A rule of loss allocation ideally should give the bank an incentive to discover the kite and an incentive to report it quickly. Of the four approaches outlined above, only the proportionate allocation provides both of these incentives.

1. *Incentive to Discover.* Prompt discovery of a kite minimizes the losses of all involved banks. Obviously, if a kite is allowed to continue, the amounts involved become greater. Early detection of a kite should therefore be encouraged and rewarded. The no duty approach does provide an incentive to the extent that the bank is allowed to accept deposits, return unpaid checks drawn on it, and shift the loss to the other participating banks. Yet this approach, which allows the discovering

78. Under the no duty approach, Bank A can return all checks presented to it—even those presented to it after it learns of the kite—as long as it acts before the midnight deadline. Bank B, unaware of the kite, therefore, suffers the entire $100,000 loss. Under the good faith approach, Bank A cannot escape liability on the $60,000 check because it had knowledge of the kite when it took the check. Accordingly, Bank A suffers a $60,000 loss and Bank B suffers a $40,000 loss. Under the equal allocation theory, the total loss is simply divided between the banks. Thus, each bank suffers a loss of $50,000. Finally, under the proportionate allocation theory, Bank A is given an advantage because it discovered the kite, but the losses are not completely shifted to Bank B. Bank A escapes liability on the last check dishonored (Event 5, the check drawn for $60,000). Thus, Bank A is liable for $40,000 of the total loss, and Bank B sustains the remaining $60,000 loss. Had Bank A not discovered the kite, however, the $60,000 would have been added into the total of Bank A's liability.

bank to shift the total loss to the other, unsuspecting bank, is inequitable and may force banks to take unreasonable precautionary measures to protect themselves.[79] The second approach, the good faith approach, provides no direct incentive to discover; in fact it penalizes the bank that returns checks and accepts deposits in order to minimize its loss.

Similarly, equal allocation fails to provide an advantage to the discovering bank; the losses will be equally allocated regardless of who detects the kite. The proportionate allocation approach, however, does provide an incentive to the first to discover the kite because it allows the discovering bank to escape liability on the last check (Event 5, the check drawn for $60,000). Had Bank A not discovered the kite, the $60,000 would have been added to the total of Bank A's liability. Because Bank A discovered the kite, it is not held liable for this last check. The proportionate allocation approach, unlike the good faith and no duty approaches, thus provides an incentive that is equitable and reasonable.[80]

2. *Incentive to Report.* The second desired goal is to provide an incentive to report the discovery promptly and thus to facilitate the termination of the kite. The no duty approach, by allowing the discovering bank to benefit so long as the other banks do not have knowledge of the kite, encourages silence. This approach therefore provides an incentive to *discover* but not an incentive to *report* the discovery. The good faith approach marginally encourages banks to report the discovery because the potential liability of all banks increases as the kite progresses. The good faith approach, however, provides no reward to the bank that reports the kite.[81]

Similarly, an equal allocation theory fails to provide any advantage to the reporting bank, except for the general benefit that results from terminating the kite. Because all losses are equally divided, it is irrelevant which bank discovers or reports the kite.[82] Proportionate alloca-

79. Although inequitable, this approach does promote finality in commercial transactions. *See supra* note 39 and accompanying text.

80. To continue the kite, each deposit must involve a larger amount of money than the previous one; the amounts must continually increase to "cover" the previous deposits made. If the final check could have been written for a lesser amount, such as $10, a proportionate division would not be the most appropriate remedy because any incentive to discover would be minimal.

81. Although the good faith approach prohibits the discovering bank from using the discovery to its advantage, it provides no further guidance with respect to loss allocation.

82. One could argue that even though the equal allocation approach fails to provide incentives to discover and report, it is the most equitable approach in light of the unsuspecting status of each bank. This argument, however, addresses neither the true nature of a check kite nor its effect on banks. As the diagram illustrates, banks affected by a kite do not necessarily sustain equal losses. If an equal allocation standard were implemented, Bank B, after being presented with checks totaling $40,000, would be held liable for $50,000. This disparity may be significantly larger in different circumstances. Furthermore, a kite may involve a number of "peripheral" banks. Under the equal

tion, however, does provide an incentive to report the kite. The discovering bank will be encouraged to report the kite not only because it will share in the general benefits that result from stopping the kite, but also because it will be exempt from any liability on the last check it returns: the last check reduces exposure and thereby allocates the losses.[83] Therefore, the fourth approach, proportionate allocation of losses, is the only approach that provides incentives to both discover and report check kiting.[84]

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allocation approach, these banks would inequitably sustain losses disproportionate to their actual exposure.

83. The consequences of lost interest provide an additional justification for a proportionate allocation of losses. Aside from the loss of principal ($100,000 in the example provided), banks lose money they would normally receive as interest. When the banks victimized by the kite extend credit to the kiter, they are in effect providing the kiter with interest-free "loans." Under the proportionate allocation approach, the interest loss would be allocated based on the amount of credit each bank granted. Therefore, the loss suffered through interest-free "loans" automatically falls in accordance with each bank's exposure.

84. The no duty approach to kiting situations can be viewed as analogous to the prisoner's dilemma: both parties would benefit from cooperation, but each party has an incentive based on self-interest not to cooperate. *See* J. VON NEUMANN & O. MORGENSTERN, THEORY OF GAMES AND ECONOMIC BEHAVIOR (1947); *see also* PARADOXES OF RATIONALITY AND COOPERATION: PRISONER'S DILEMMA AND NEWCOMB'S PROBLEM (R. Campbell & L. Sowden eds. 1985); A. RAPOPORT, M. GUYER & D. GORDON, THE 2 X 2 GAME (1976); M. DAVIS, GAME THEORY: A NON-TECHNICAL INTRODUCTION (1973).

The prisoner's dilemma occurs when two prisoners, accomplices in a crime, have been discovered committing the criminal act:

> The district attorney interviews each separately, saying, "I have enough on both of you to send you to jail for a year. But if you *alone* will confess to the 10-year crime, I'll make a deal with you: you'll get off with a 3-month sentence, while your partner will serve 10 years. But if you *both* confess, you'll both get 5 years. . . .
>
> [S]uppose [A] doesn't confess and, unknown to [him], [B] does confess. [A], stands to get 10 years! Better than *that* is to confess and get no worse than 5 years. [B] is in the same dilemma: if only he knew what [A] is thinking, or what [A] thinks [B] thinks [A] is thinking. . . . The important result here is that when both prisoners act selfishly by confessing, they both end up . . . with long prison terms. Only when they act collusively or altruistically will they end up . . . with short prison terms.

P. SAMUELSON, ECONOMICS 556 (12th ed. 1985).

Applied to a kiting scheme, both banks should be eager to report the kite, because it is advantageous to both to eliminate it as quickly as possible. But if one bank discovers the kite first, it can shift the loss to the other bank and thereby further its own interests. If neither bank reports the kite, the penalty becomes progressively worse for both banks because the amounts involved increase over time.

Therefore, the "no duty" approach results in a situation analogous to the prisoner's dilemma because a cooperative outcome is most advantageous to both banks, yet both banks have an incentive to cheat. A proportionate allocation theory solves this problem by providing both the incentive to discover and the incentive to report without the need to cheat. The proportionate allocation theory provides both incentives because it gives an advantage to the discovering bank by not adding liability on the last check returned to the discovering bank's losses.

C. *Analogous Approaches in Other Areas of the Law.*

The concept of proportionate allocation of losses has been applied in other areas of the law. One such area is that of bankruptcy. For example, unsecured creditors in a liquidation proceeding must share proportionately the losses incurred.[85] The Bankruptcy Code provides that where funds are inadequate to pay in full the claims of a particular class of creditors, "payment on claims . . . shall be made pro rata among [the] claimants."[86]

Section 2-615 of the UCC[87] applies a similar principle in a different context. This provision provides that when impracticability affects a seller's capacity to fulfill his contractual obligations, the seller "must allocate production and deliveries among his customers . . . in any manner which is fair and reasonable."[88] Each customer incurs losses, but the losses incurred are commensurate with the losses sustained by other similarly situated customers.[89]

These same equitable principles should apply with equal force to banks victimized by check kiting schemes. Like the unsecured creditor in the bankruptcy context, the bank victimized by a check kiting scheme stands to sustain significant pecuniary loss due to its credit-extending nature. And like the customer in the section 2-615 context, the bank is one of several similarly situated innocent parties. As in these analogous contexts, the most equitable and reasonable way to allocate the loss resulting from check kiting is the proportionate allocation method.

IV. CONCLUSION

Because sufficient funds rarely exist to replace losses that result from check kiting schemes, the question of equitable loss allocation frequently arises. The UCC inadequately addresses this question. Courts have inconsistently applied various provisions of the UCC, such as the good faith requirement and the midnight deadline rule, and have developed competing theories regarding how losses should be allocated.

The proportionate allocation scheme proposed in this note provides banks an economic incentive to discover and report kites, and allows for

85. 11 U.S.C. § 726(b) (1982).

86. *Id.*

87. U.C.C. § 2-615 (1977).

88. U.C.C. § 2-615(b) (1977).

89. In addition, section 9-315(2) of the UCC provides that when a priority interest in commingled or processed goods is contested, and more than one security interest has attached to the goods, the interests "rank equally according to the *ratio* that the cost of the goods to which each interest originally attached bears to the cost of the total product or mass." U.C.C. § 9-315(2) (1977) (emphasis added). Thus, this section also requires that competing interests be proportionately allocated.

an equitable allocation of losses on a pro rata basis based on each bank's exposure to loss. This scheme is based on principles of loss allocation adopted in other areas of the law. An amendment to the UCC addressing check kiting and incorporating these principles is necessary to achieve uniformity, fairness, and efficiency.

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