A Theoretical Analysis of Payment Systems

L. A. Khan

Washburn University

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* Professor of Law, Washburn University. This article is dedicated to hundreds of payment systems students over the years at Washburn University Law School, who assisted with their comments in refining the concepts presented in this Article. The author owes a huge debt to many contemporary scholars, specifically Professors Robert Cooter, Edward Rubin, Peter Alces, Clayton Gillette, and Douglas Whaley, whose combined scholarship informed this study. The faults of the theory presented in this Article, however, belong exclusively to the author.
I. INTRODUCTION

Payment systems have allured great American scholars, such as Joseph Story, Grant Gilmore, William Prosser, and Karl Llewellyn. Although the classical romance for "notes and instruments" has receded, the study of payment systems continues to generate passion and fervency. Professors strive to convey, and students wrestle to master, the elusive language of older payment systems borrowed from defunct times of previous centuries. Professor James White, an eminent scholar of commercial law, analogizes Article 3 of the Uniform Commercial Code (UCC)—the codified law of negotiable instruments—to "a huge machine assembled by a mad inventor and comprised of assorted sprockets, gears, levers, pulleys, and belts." Article 3 is indeed a linguistic maze; it articulates payment precepts in confusingly intertwined phrases. The same party may have three or four technical names, adding

1. In this Article, I define a payment system as a money substitute that the market uses and the law authorizes to make payments for buying goods and services and for borrowing money. See LARRY LAWRENCE, AN INTRODUCTION TO PAYMENT SYSTEMS 3 (1997).
4. Gilmore, Prosser, and Llewellyn were the original academic giants who drafted the Uniform Commercial Code. See Samuel J. M. Donnelly & Mary Ann Donnelly, Commercial Law is a Humanism, 53 SYRACUSE L. REV. 277, 278 (2003).
6. Professor Douglas Whaley, a legend in teaching the teachers of payment systems. He comments on the hazards and the techniques of teaching commercial law. See Douglas J. Whaley, Teaching Law: Thoughts on Retirement, 68 OHIO ST. L.J. 1387, 1398 (2007) (noting that payment systems was known as one of the "dogs" of the curriculum).
7. See, e.g., Carl Felsenfeld & Genci Bilali, The Check Clearing for the 21st Century Act—A Wrong Turn in the Road to Improvement of the U.S. Payments System, 85 NEB. L. REV. 52, 61 (2006) ("[Law] students tend not to take the courses with labels like 'bills and notes,' 'negotiable instruments,' 'commercial paper,' or 'payment systems.'"). Consequently, the bar has little actual or creative knowledge of this area of the law. See id.
9. For example, a person entitled to enforce the instrument could be a holder or a nonholder with the rights of a holder; could be a lawful or wrongful holder; could be in possession; or could not be in possession. The very notion that even a thief of a bearer instrument can be a person entitled to enforce the instrument is baffling. Will any court accept such a daring theory that the thief is a person entitled to enforce the instrument? See U.C.C. § 3-301 (2002).
10. For example, an accommodation party might also be an anomalous indorser and secondary obligor. U.C.C. §§ 3-103(a)(17), 3-205 cmt. 3.
needless strain to clarity and analysis. Even federal courts stumble to use Article 3 definitions correctly.\textsuperscript{11} The federal law containing new payment systems is no less obtuse. Riddled with swarming provisos and exceptions, its long-winded sections sprawl over pages.\textsuperscript{12} Attempts to create a uniform payment code have failed to replace the scattered payment systems.\textsuperscript{13}

While the romance for payment systems is honorable,\textsuperscript{14} clarity demands that payment systems be viewed as a legally regulated industry in which financial institutions provide professional services to transfer monies from account holders to payees. Because, historically, payment systems preceded the emergence of financial institutions, payment systems were seldom viewed as payment services.\textsuperscript{15} Now that the bulk of consumer and business payments are made through financial institutions, payment systems are inseparably tied to financial institutions.\textsuperscript{16} Accordingly, payment systems must be analyzed as payment services that financial institutions provide to consumers, businesses, and other entities.\textsuperscript{17} When a person opens a deposit account with a bank, for example, the bank agrees to provide payment services as per the account holder’s instructions. Similarly, a credit card account is a service account that

\begin{enumerate}
\item The Supreme Court, for example, once used the word “maker” to describe the drawer of the check. Barnhill v. Johnson, 503 U.S. 393, 398 (1992) (citing U.C.C. § 3-104(1)-(2)(b) (1990)). The technical term “maker” is used for a person who undertakes to pay a promissory note, not a check. See U.C.C. § 3-103(a)(5) (2002); \textit{see also} Woodruff v. Miss., 162 U.S. 291, 303 (1896) (using the word maker accurately). More recent cases have also used the word maker inaccurately. \textit{See, e.g.}, U.S. v. Ali, 561 F. Supp. 2d 269, 276 (E.D.N.Y. 2008) (referring to the “maker of the check”).


\item The Uniform New Payments Code (UNPC), drafted by the American Law Institute and the National Conference of Commissioners on Uniform State Laws, was a complete failure because no jurisdiction was willing to adopt it. The UNPC was abandoned. \textit{See Ronald J. Mann, Making Sense of Payments Policy in the Information Age}, 93 GEO. L.J. 633, 634 n.4 (2005).

\item Law professors even quote popular literature to light up the romance of payment systems. \textit{See, e.g.}, Curtis Nyquist, \textit{A Spectrum Theory of Negotiability}, 78 MARQ. L. REV. 897, 898 n.5 (1995) (quoting dialogue in which a character mentions reading \textit{Daniels on Negotiable Instruments}).

\item \textit{See James Steven Rogers, The Myth of Negotiability}, 31 B.C. L. REV. 265, 272 (1990). Needless to say, banks provide numerous services that may or may not be payment services, for example, safe deposits for storing valuables are not payment services.

\item Policy Statement—The Federal Reserve in the Payments System, 55 Fed. Reg. 11,648, at 11,649 (Mar. 29, 1990), \textit{available at} http://www.federalreserve.gov/PaymentSystems/pricing/frpaysys.htm (“The smooth functioning of markets for virtually every good and service is dependent upon the smooth functioning of banking and financial markets, which in turn is dependent upon the integrity of the nation’s payments system.”).

\item Millions of people, however, have little or no access to financial services. \textit{See, e.g.}, Michael S. Barr, \textit{Banking the Poor}, 21 YALE J. ON REG. 121, 123 (2004) (citing Arthur B. Kennickell et al., \textit{Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances}, 86 FED. RES. BULL. 1, 9–11 (2000)) (“[They] lack the most basic financial tool, a bank account.”).
\end{enumerate}
the financial institution operates to pay the cardholder’s payment orders against a revolving loan.\textsuperscript{18}

Checks, credit cards, and debit cards are the devices used to order, receive, and execute payment services.\textsuperscript{19} For centuries, negotiable instruments—promissory notes, bills of exchange, and drafts—served as universal payment devices that needed no financial institution to initiate or complete payments.\textsuperscript{20} Negotiable instruments, sometimes called commercial papers, continue to circulate in national and international markets to pay for goods and services and to transfer monies. Most instruments, however, are now processed through financial institutions.\textsuperscript{21} In the past few decades, credit cards and debit cards have gradually begun competing with, and even replacing, negotiable instruments.\textsuperscript{22} These new payment devices are essentially payment services that the financial institutions extend to millions of natural and juridical persons. Currently made out of plastic, credit cards and debit cards are rapidly turning into electronic numbers while negotiable instruments are still tied to the paper attributes of writing, signature, and possession.\textsuperscript{23} It is only a matter of time,

\textsuperscript{18} As discussed later, the credit card joins two distinct services: lending and payment. See \textit{infra} text accompanying notes 160–61. The same bank that lends revolving credit also agrees to make payments. See Teri Rebecca Daniel, \textit{Improvident Extension of Credit as an Extension of Unconscionability: Discover Bank v. Owens and a Debtor’s Rights Against Credit Card Companies}, 54 CLEV. ST. L. REV. 435, 447–48 (2006).

\textsuperscript{19} Gregory E. Maggs, \textit{New Payment Devices and General Principles of Payment Law}, 72 NOTRE DAME L. REV. 753, 753 (1997). Professor Maggs mentioned what were new payment devices in the late 1990s, including stored-value cards and Ecash. \textit{Id.} at 753–54 These devices seem to have fizzled away. Professor Maggs’s general principles are not the same as the three principles discussed in this Article. In fact, most of the general principles that Professor Maggs mentions are subsumed under the theoretical analysis offered here.

\textsuperscript{20} Rogers, supra note 15. For a historical review of negotiable instruments, see \textit{id.} at 272–90. When banks surfaced in the market, the draft drawn on the bank, called a check, was inducted into negotiable instruments. Khan, supra note 2, at 433; see also JAMES WILLARD HURST, A LEGAL HISTORY OF MONEY IN THE UNITED STATES, 1774–1970, at 47 (1983).

\textsuperscript{21} See generally Geoffrey R. Gerdes et al., \textit{Trends in the Use of Payment Instruments in the United States}, 91 FED. RES. BULL. 180 (2005) (discussing the percentage of payment instruments used in the United States).

\textsuperscript{22} \textit{Id.} In the United States, the use of debit cards grew rapidly from 8.3 billion transactions in 2000 to 15.6 billion transactions in 2003. \textit{Id.} at 183. The number of credit card transactions grew from 15.6 billion in 2000 to 19.0 billion in 2003. \textit{Id.} at 184. The number of checks declined from 41.9 billion in 2000 to 36.6 billion in 2003. \textit{Id.} at 181. However, checks remained the most used payment device in 2003. \textit{Id.}

\textsuperscript{23} A negotiable instrument, for example, must be in writing and must be signed; a person must have possession of a negotiable instrument to obtain the holder status. See U.C.C. §§ 3-103(8), 3-103(12) (2002); see also U.C.C. § 1-201(21) (2001). Although any tangible medium may be used to write, sign, and deliver a negotiable instrument, paper is the most convenient medium used in the market. Contrast this with the use of credit cards on the Internet where the cardholder can buy goods and services by communicating key numbers identifying the card. See RONALD J. MANN, \textit{PAYMENT SYSTEMS AND OTHER FINANCIAL TRANSACTIONS} 260–70 (3rd ed. 2005).
however, before the negotiable instruments law\textsuperscript{24} will transcend the age of paper and permit electronic payments.\textsuperscript{25} And, as is customary, the market will produce even newer payment devices.\textsuperscript{26}

For numerous reasons, including safety and efficiency, the market prefers money substitutes over money\textsuperscript{27} for making payments.\textsuperscript{28} A buyer rarely purchases a house, even of modest value, with the actual transfer of money from the buyer to the seller. Even a payment of a few thousand dollars in Federal Reserve notes, the money of the United States, is prone to risk and suspicion. For most of the twentieth century, the check, and not money, has been the preferred method of making large payments.\textsuperscript{29} Cash transactions were limited to small amounts. The convenience of credit cards, however, has revolutionized payment systems; accordingly, credit cards have extensively substituted the

\textsuperscript{24} Negotiable instruments law includes Articles 3 and 4 of the UCC, Federal Reserve Board regulations, and case law.


\textsuperscript{26} See generally Khan, \textit{supra} note 2, at 397 (explaining the evolution of money and money substitutes).

\textsuperscript{27} Money is defined as a medium of exchange authorized by a government or an intergovernmental organization, such as the European Union. See U.C.C. § 1-201(b)(24) (2001). For the most part, money is territorial. See \textit{id}. The Euro, however, is regional money. Jan Aart Scholte, \textit{Restructuring Contemporary Democracy}, 15 IND. J. GLOBAL LEGAL STUD. 305, 315 (2008). Many consumers simultaneously have both credit card debt and cash in hand. This strategy is justified to meet needs that cannot be charged to the credit card, such as mortgage payments, and to leave liquid assets ready for emergency situations. See Irina A. Telyukova & Randall Wright, \textit{A Model of Money and Credit, with Application to the Credit Card Debt Puzzle}, 75 REV. ECON. STUD. 629, 630 (2008), available at http://moneyrg.googlepages.com/TelyukovaandWright2008.pdf.

\textsuperscript{28} Kahn, \textit{supra} note 2, at 393.

traditional methods of payment. More recently, the widespread access to the internet popularized payments by debit cards and other electronic transfers.

Each payment system owns its separate law. The language, niceties, and concepts of modern negotiable instruments law (NIL), though frequently revised in the past hundred years, continue to carry the burdens of historical anachronism. By contrast, the law of credit cards is new and made in America. Its language is modern and derived from the banking industry. Its concepts absorb the tensions between the rights of credit consumers and those of financial institutions. The law of electronic fund transfers borrows from both negotiable instruments and credit cards, hybridizing the two laws. Sharing common features with others, each payment system nonetheless stands separately in law. In contradistinction to the NIL, electronic payments law (EPL) is primarily federal, codified in the Consumer Credit Protection Act.

30. Credit cards have certain systemic advantages that cardholders exploit to pay for goods and services. First, the payment involves no immediate depletion of cash. Second, users pay no surcharge fee for using credit cards. Third, the interchange fee, the fee that the merchant’s bank pays to the issuer, is passed on to merchants who distribute it to all account holders, including those who pay cash, through higher prices of merchandise. Joshua S. Gans & Stephen P. King, A Theoretical Analysis of Credit Card Regulation 2–3 (Melbourne Bus. Sch., Working Paper No. 2002-11, 2002), available at http://www.mbs.edu/home/jgans/papers/interchange-RBA.pdf.

31. According to the Federal Reserve Board, the number of checks written nationally has been declining since the mid-1990s. Federal Reserve Check Services, http://www.federalreserve.gov/paymentsystems/checkservices/default.htm (last visited Jan. 29, 2009). Accordingly, by 2011, the number of check processing locations will be reduced to only four. Id. Before the decline, Federal Reserve Banks operated forty-five locations. Id.

32. In the nineteenth century, efforts were first made to harmonize the law of negotiable instruments in the United States. Note, The Negotiable Instruments Law, 11 HARV. L. REV. 187, 188 (1897). Modeled after the English Bills of Exchange Act, the Negotiable Instruments Law was enacted in New York, Connecticut, Colorado, and Florida. Id.

33. Credit, in a generic sense, has existed from time immemorial. If credit is defined as deferred payment, credit predates money. See Christopher L. Peterson, Truth, Understanding, and High-Cost Consumer Credit, 55 FLA. L. REV. 807, 808 (2003).

34. See Daniel, supra note 18.


37. Consumer Credit Protection Act (CCPA), 15 U.S.C. §§ 1601–1693r (2006). One might wonder why one payment system is regulated by state law, while the other is regulated by federal law. One answer is that the law of negotiable instruments has traditionally been state law, whereas the law of modern payment systems originated at the federal level. Of course, other explanations are equally valid. For example, the law for credit cards was enacted to regulate a nationwide concern over lending institution practices marketing unsolicited credit cards to vulnerable consumers. See Laurie A. Burlingame, Getting to the Truth of the Matter: Revising the TILA Credit Card Disclosure Scheme to Better Protect Consumers, 61 CONSUMER FIN. L.Q. REP. 308, 312
Striving to simplify, this Article offers a theoretical analysis of payment systems. The analysis does not restructure payment rules that regulate old and new payment devices. Rather, it constructs a common theoretical core of payment systems. The common core brings together payment rules and places them in conceptual folders, called the principles of payment systems. Relying on these principles, the theoretical analysis elucidates how payment rules deviate, sometimes with scant reason, from one payment system to the other. Furthermore, the enormity of payment rules can baffle new learners, leaving an erroneous impression that the study of payment systems is weariful memorization of black letter law. Nothing is further from the truth. The common theoretical core—it has been the author’s teaching experience—animates payment systems like no other area of law, knitting the minutiae of payment rules into an exquisite unity. 38

Stated briefly, the principles of payment systems determine liability. They are derived from statutes, not contracts. They are mandatory, not optional. They allocate loss to various parties involved in payment services. They address questions of fairness and efficiency. They guide legal professionals in resolving payment disputes. They chart a normative path for future payment systems. The theoretical study undertaken in this Article reveals that, despite differing historical origins of payment devices and despite the progression of payment services from tangible to intangible medium, the legal principles of authorization, negligence, and dishonor constitute the common core of payment systems.

First, as Part II suggests, the authorization principle forges a legal relation between authorization and liability, carrying a powerful idea that authorized payments may be lawfully charged against the account holder who authorizes them. This principle is critical to understanding the payment services that financial institutions provide to consumers and businesses. According to the principle, no payment must be made unless it is authorized. And no account holder should be held liable for unauthorized payments. The loss of unauthorized payments, therefore, must fall on financial institutions. 39 These

(2007); see also Arnold S. Rosenberg, Better than Cash? Global Proliferation of Payment Cards and Consumer Protection Policy, 60 CONSUMER FIN. L.Q. REP. 426, 441 (2006) (discussing how credit cards led to the enactment of TILA).

38. Karl Llewellyn argued that the best scholarly enterprise is one that combines truth, beauty, and goodness. Karl N. Llewellyn, On the Good, the True, the Beautiful, in Law, 9 U. CHI. L. REV. 224, 247 (1942). This Article does not quite capture Llewellyn’s unity, but it certainly seeks coherence.

39. The financial institutions may allocate loss among themselves in accordance with the law of warranties. See, e.g., U.C.C. §§ 4-207 to 4-209 (2002) (providing transfer, presentment, encoding, and retention warranties).
norms constitute the bedrock of the authorization principle that governs payment services.

Second, Part III argues that the negligence principle encompasses a simple truth that persons involved in payment services sometimes breach the duty of care attendant to the authorization principle. In such cases, the authorization principle is subordinated to the negligence principle. Suppose an account holder writes a check in a negligent manner so that the amount of the check can be easily raised, say from $10 to $100. A strict application of the authorization principle imposes on the account holder a liability of no more than $10, the amount that the account holder authorized on the check. Under the negligence principle, however, the account holder is liable for the altered amount of $100 because the account holder’s negligence contributed to the alteration of the check. Likewise, if a bank fails to detect a visible alteration on a check due to its negligence and pays the altered amount, the loss falls on the negligent bank and not on the account holder who wrote the check in a careful manner. Hence, the negligence principle allocates loss to the negligent party.

Third, Part IV examines the dishonor principle, which is also a principle of liability. The dishonor principle applies to cases where financial institutions dishonor payments. The principle consists of two distinct parts: rightful dishonor and wrongful dishonor. A financial institution rightfully dishonors forged or altered checks. By contrast, wrongful dishonor occurs when a financial institution dishonors an authorized payment through negligence, mistake, or malice. Placing a dual duty on financial institutions, the dishonor principle requires financial institutions to dishonor unauthorized payments but not to dishonor authorized payments for wrongful reasons. A financial institution is liable to the account holder for damages if the financial institution wrongfully dishonors an authorized payment. In an economy where the maintenance of good credit is a matter of survival for individuals and businesses, dishonored payments generate negative reports with credit bureaus, affecting future borrowing, reputation, and employment. 40

The principles of payment systems serve several distinct purposes. They facilitate the study of payment systems and streamline payment services in a rational and consistent manner. The principles illuminate the advantages and disadvantages of payment systems that consumers need to know in order to choose among the available payment services. In practice, lawyers may turn to these principles to argue cases, particularly if no dispositive rule is available. Most important, the principles guide judges and lawmakers to contextualize payment rules within the framework of principles to reach more disciplined.

40. See, e.g., Ali v. Long Beach Acceptance Corp., No. CV-F-07-1062, 2007 WL 3335015, at *1 (E.D. Cal. Nov. 9, 2007) (consisting of a party arguing that incorrectly reported late payments have resulted in the denial of credit and employment opportunities).
Because principles cautioning efficiency, commencing professionals reinforce current erasing ought recapitulation harmonize Article is explaining a payment application legislative and accordingly, author’s these markets equivalent Clayton Gillette must question the wisdom of treating “functionally equivalent payment devices” differently in both form and substance. Because markets are constantly searching for safer and more efficient payment services, future payment systems would greatly benefit from a rigorous application of these principles.

The principles of payment systems analyzed in this study are not the author’s invention. They are derived from the law of payment systems. Accordingly, the study validates each principle with specific references to NIL and EPL. This anchoring of principles in law demonstrates their rootedness in legislative will as well as market dynamics. The study exposes that the application of principles to diverse payment services is uneven because a payment service may embrace a principle more vigorously than would another payment service. By exposing such discrepancies, the theoretical analysis invites legal professionals to deliberate whether payment systems must cultivate a more uniform application of the principles. Contrariwise, the theoretical analysis demands that a case be made for the continuation of discordant laws, explaining that a uniform application of the principles across payment services is logistically unwise, legally unjust, and economically inefficient.

Finally, to guide the present and future payment systems, Part V of this Article develops a principled framework and a common vocabulary to harmonize assorted payment services. The principled framework, a succinct recapitulation of the three principles, proposes what the law of payment systems ought to be. The common vocabulary binds diverse payment systems together, erasing conceptual confusion and terminological variations that occupy the current payment laws. The principled framework and the common vocabulary reinforce each other while forging a stable analytical structure that legal professionals may consider in designing the future course of payment systems. Should the proposed framework fail to break ground, it will hopefully commence an instructive conversation of principles that inform the law, logic, efficiency, and economic underpinnings of payment systems.

42. Over the years the author has taught these principles to hundreds of law students, always cautioning them, though, that they ought to be careful in analyzing bar questions in terms of these principles because bar examiners may be looking for more rule-specific answers. But, these principles help organize the study of payment systems in a more manageable way.
II. AUTHORIZATION PRINCIPLE

The authorization principle is the foundation of payment systems. It constitutes the core of negotiable instruments, credit cards, and electronic fund transfers. The authorization principle may be stated in two different ways. Stated positively, the principle is captured in the maxim: authorization imposes liability. This means that an account may be lawfully charged for a payment that the account holder has authorized the financial institution to make. The principle may also be stated negatively in the maxim: no authorization, no liability. This means that the financial institution may not charge an account for a payment that the account holder has not authorized. The two statements, however, emphasize one and the same point—that payment authorization and payment liability are interdependent. They coexist as a matter of law. Jurisprudentially, the authorization principle is the Weberian norm of empowerment that confers upon persons the power to contract payment services with financial institutions.

A. Negotiable Instruments

The NIL—derived from the English common law stretching back hundreds of years, codified in Article 3 of the UCC, and adopted throughout the

43. This principle also applies to wholesale funds transfers governed by Article 4A of the UCC. A payment order "is the authorized order of the person identified as sender if that person authorized the order or is otherwise bound by it under the law of agency." U.C.C. § 4A-202(a) (1989).

44. Max Weber saw the sociology of law as both coercive and empowering. MAX WEBER, ECONOMY AND SOCIETY 730, 667 (Guenther Roth & Claus Wittich eds., Ephraim Fischhoff trans., Bedminster Press 1968). He cited negotiable instruments as one area of law that empowers and enables persons to construct legal relations. Id. at 668. For a discussion of Weber's idea, see Richard Swedberg, The Case for an Economic Sociology of Law, 32 THEORY & SOC'Y 1, 11 (2003).

45. The law of negotiable instruments began to develop in late seventeenth century England and became quite complex and sophisticated in the next two centuries. JAMES STEVEN ROGERS, THE EARLY HISTORY OF THE LAW OF BILLS AND NOTES 152-53 (1995). In England, the law of bills of exchange was codified in 1882, known as the Bills of Exchange Act. The Negotiable Instruments Law, supra note 32. In New York, a similar statute was passed in 1897 as the Negotiable Instruments Law. Frederick K. Beutel, The Development of State Statutes on Negotiable Paper Prior to the Negotiable Instruments Law, 40 COLUM. L. REV. 836, 849 (1940). The National Conference of Commissioners on Uniform State Laws (National Conference of Commissioners) drafted the NIL in 1896, and every American jurisdiction subsequently enacted the NIL. JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE §1, at 2 (5th ed. 2000). The purpose of the NIL was to arrest the chaotic growth of law through diverse and numerous state courts of the Union. The Negotiable Instruments Law, supra note 32, at 187. The common law habit of searching the law in cases rather than in statutes frustrated the "unity of the system" that the drafters of the uniform law intended. WHITE & SUMMERS, supra. In the 1950s, the
University States—is founded upon the authorization principle. Each negotiable instrument has its own unique history. The bill of exchange, known as the draft in the United States, is an ancient instrument that developed centuries ago.

National Conference of Commissioners, under the guidance of Professor William Prosser, revised the NII and drafted a new law. *Id.* at 3; see also Kurt Eggert, *Held Up in Due Course: Codification of Form over Intent in Negotiable Instrument*, 35 CREIGHTON L. REV. 363, 416 (2002) (“The task of reworking the NII was given to Professor William Prosser . . . .”). The new law was enacted in the form of Article 3 of the UCC. *Id.* at 417. In addition to many substantive changes to the NII, the law was renamed the law of commercial papers. U.C.C. § 3-101 (1957). Like the NII, however, the original Article 3 fell short of a uniform interpretation in fifty jurisdictions of the United States. WHITE & SUMMERS, *supra*, § 1, at 4. The case law, using the same provisions of Article 3, was divided on many issues. See, e.g., Robert F. Ballen et al., *Commercial Paper, Bank Deposits and Collections, and Other Payment Systems*, 43 BUS. LAW. 1305, 1339 (1988) (noting that courts were divided on their interpretation of U.C.C. § 3-419). In 1990, Article 3 was revised, changing its name once again. Now, it is called the law of negotiable instruments. U.C.C. § 3-101 (2002).

46. U.C.C. art. 3.


48. The UCC does not mention the authorization principle as such. However, the principle is present throughout Articles 3 and 4. Consider the following: The law recognizes two kinds of instruments—notes and drafts. The note is a promissory note with respect to which the maker undertakes to pay the stated amount, with or without interest, to the bearer or the order of the payee. U.C.C. §§ 3-103(a)(12), 3-104(a), (e). The draft is an order with respect to which the drawer instructs the drawee to pay the amount of the draft to the bearer or to the order of the payee. U.C.C. § 3-104(a), (e). The concepts of undertaking and instructing are related to authorization. Under Article 4, an item when authorized is properly payable. U.C.C. § 4-401(a)(2002).

49. JOSEPH STORY, *COMMENTS ON THE LAW OF BILLS OF EXCHANGE* 5–13 (1853). The law is ancient at least with respect to bills of exchange, and seems to have been developed by the tenth century Middle Eastern commercial community. *Id.* The Italian merchants of Genoa, Lucca, Florence, and Venice were the next to use payment instruments similar to the modern bill of exchange, now known as drafts in the United States. *Id.* at 9, 13; see also JAMES MATLOCK OGDEN, *THE LAW OF NEGOTIABLE INSTRUMENTS* 20 (5th ed. 1947). Gradually, almost all commercial communities began to use bills of exchange to make payments to sellers located in foreign countries. A bill of exchange was a three-party instrument where one party, say in Genoa, ordered another party, say in London, to make payment to a third party. See ROGERS, *supra* note 45, at 35. This arrangement was particularly useful in times when money was measured in gold and silver. Thus, an English merchant who bought spices from India would prefer to pay by means of a bill of exchange rather than taking the risk of “shipping” real money. See *id.* at 35–36. If the English merchant had a foreign agent stationed in India, he would simply order the agent to pay when the seller produced a document (bill of exchange) signed by the English merchant. See OGDEN, *supra*, at 21–22. Of course, the English merchant must also tell the agent when to pay and how much to pay. See Rogers, *supra* note 15, at 285. If the local agent refused to accept the bill of exchange, the seller would ask the English merchant to pay directly or make an alternative arrangement. A merchant would lose credit and credibility if his bills were frequently dishonored by foreign agents. The bill of exchange was also used for payment in domestic transactions and was called an “inland bill of exchange.” ROGERS, *supra* note 45, at 101; see also FREDERICK K. BEUTEL, *NEGOTIABLE INSTRUMENTS LAW* 1391 (7th ed. 1948). If the parties to a bill of exchange
Likewise, the elementary concept of the promissory note has been around from time immemorial. The check came later as banks were organized to manage and lend money. The theoretical analysis of payment systems presented in this paper were well reputed in a trading community, the bill of exchange would circulate as a money substitute. See Rogers, supra note 45, at 112. This negotiation, or no immediate rush to encashment, was possible because merchants had faith that the bill would be paid when presented. See id. For a comprehensive account of the history of bills of exchange in England, see J. Milnes Holden, The History of Negotiable Instruments in English Law 4–65 (1955).

50. See Holden, supra note 49, at 70–73. When gold was frequently used as money, people would often deposit their gold with goldsmiths for fear of loss or theft. See Eggert, supra note 45, at 386 (citing Holden, supra note 49, at 72). On receiving the deposit, the goldsmith would issue notes in the amount of gold deposited. Id. If a depositor wanted to pay a seller, the depositor would offer a goldsmith’s note. See Holden, supra note 49, at 70–73. The seller would accept this method of payment if the seller trusted the goldsmith. See Boris Kozolchyk, Transfer of Personal Property by a Nonowner: Its Failure in Light of Its Past, 61 Tul. L. Rev. 1453, 1493 (1987). The goldsmith’s note may be understood as a “promise by the goldsmith” to pay in gold when the seller presented the note for encashment. See id. at 1492. If the goldsmith enjoyed a good reputation in the community, his notes would circulate as money substitutes. Holden, supra note 49. Again, this negotiation was possible because the people in the community had faith that the goldsmith would pay the note upon presentation. Kozolchyk, supra. An ordinary promissory note is not much different from the goldsmith’s note. Just like the goldsmith’s note, a promissory note is also a “promise to pay a certain sum,” often at a future date. Eggert, supra note 45, at 374. The difference lies in the fact that the maker of a promissory note is most likely an ordinary person, not a goldsmith, borrowing money and promising to pay at a future date, with or without interest. That is why promissory notes were known as “bills of debt.” James Webster Eaton & Frank B. Gilbert, A Treatise on Commercial Paper and the Negotiable Instruments Law 19 (1903) (citing Gerard Malynes, Consuetudo, vel Lex Mercatoria or The Ancient Law-Merchant 71–72 (London, Adam Islip 1622)). Promissory notes containing high interest rates were embodiments of usury. See Rogers, supra note 45, at 70. Some systems, therefore, were initially reluctant to enforce excessive interest promissory notes. Theophilus Parsons, A Treatise on the Law of Promissory Notes and Bills of Exchange 400–01 (1873); see Rogers, supra note 45, at 70–71. In England, even the negotiation of a promissory note was initially beyond the protection of the law. John Barnard Byles, A Treatise on the Law of Bills of Exchange, Promissory Notes, Bank-Notes and Cheques 7 (1899); see also Eggert, supra note 45, at 387 (“[T]he transferability of promissory notes through indorsement was not originally recognized at the common law.”).

51. Khan, supra note 2, at 433. The goldsmith’s note was the early ancestor of the modern check. Holden, supra note 49, at 70–73. The rise of banks was the natural evolution of goldsmiths. Id. The bank, in the modern sense, accepts deposits and allows account holders to write checks. Not too long ago, however, even banks issued notes that freely circulated as money substitutes—a medium of exchange—among traders and ordinary people. See Kahn, supra note 2, at 430. Gradually, checking accounts replaced bank notes. See id. at 433. In fact, the modern check is a functional hybrid of a bank note and a bill of exchange. Just like a bill of exchange, a check is also a three-party instrument. Kenneth D. Ferguson, Does Payment by Check Constitute a Transfer upon Delivery or Payment?, 64 Am. Bankr. L.J. 93, 97 (1990). Yet, there is a difference between the two: A bill of exchange or a draft may or may not be drawn on a bank, whereas a check is always drawn on a bank. See U.C.C. § 3-104(e), (f); Khan, supra note 2, at 433. A check is not a note because the drawee bank does not promise to pay every check drawn on its deposits. U.C.C. § 3-408. The drawee bank pays only if there are sufficient funds in the account on which the check
Article focuses predominantly on drafts since notes are essentially debt rather than payment instruments.\textsuperscript{52} As a general principle, no negotiable instrument can come into lawful existence without authorization. Although the issuer is the first person that authorizes the instrument and launches it into the stream of commerce, the authorization principle is not confined to the issuer’s liability. The principle is a dynamic normative force that governs all operations performed on the instrument, including transfer, accommodation, acceptance, and accord and satisfaction.\textsuperscript{53} When the original payee transfers the instrument to another person, the original payee authorizes the new payee to be the lawful owner of the instrument.\textsuperscript{54} This transfer imposes liability on the original payee to pay to the subsequent payee if the instrument is dishonored.\textsuperscript{55} Likewise, if a payor bank accepts to pay an instrument, the acceptance imposes payment liability on the payor bank.\textsuperscript{56} Each operation performed on the instrument requires authorization. And as a general rule, each authorized operation imposes liability on the operator.\textsuperscript{57}

1. Classical Authorization

The NIL recognizes several ways to authorize a negotiable instrument.\textsuperscript{58} Because negotiable instruments are frequently written on paper, they are tangible entities that can be possessed, transferred, and presented for payment.\textsuperscript{59} Signing the instrument is the classic and the most convenient method of authorization.\textsuperscript{60} The issuer’s signature on the paper instrument authorizes its

\textsuperscript{52} This concept appears to have been accepted for ages. A law review article published in 1893 suggests that an authorized alteration is binding on the drawer. Melville M. Bigelow, \textit{Alteration of Negotiable Instruments}, 7 \textit{Harv. L. Rev.} 1, 7 (1893). In the nineteenth century, consent seems to be the key word in capturing the concept of authorization. \textit{See id.}

\textsuperscript{55} \textit{See U.C.C. §§ 3-401 to 3-402.}

\textsuperscript{56} \textit{See U.C.C. §§ 3-401 to 3-402.}

\textsuperscript{57} The concept of delivery and possession are critical to the issuance and negotiation of instruments; these concepts presuppose the tangibility of instruments. Though paper is not officially required, it is the most convenient tangible medium in which the instrument can be delivered, possessed, and exhibited. \textit{See U.C.C. §§ 3-105(a), 3-201(a), 3-501(b)(2)(i).} However, electronic presentation is authorized. U.C.C. § 3-501 cmt.

\textsuperscript{58} \textit{See U.C.C. § 3-401 cmt. 1.}
More specifically, the maker’s signature on a note binds the maker to pay the stated amount, whereas the drawer’s signature on a draft is required in order for the drawee to pay the amount stated on the instrument. The drawer’s signature does not obligate the drawee to pay the draft, but the drawer’s signature does obligate the drawer to pay the draft in case the drawee dishonors the draft. Regardless of whether the paper instrument is a note or a draft, a signature means authorization, which imposes payment liability on the signer.

The signature, central to the definition of negotiable instruments, is indispensable. An instrument must have a signature. The NIL requires seven elements, including the issuer’s signature, for the lawful construction of a negotiable instrument. Many of the seven elements, if missing from the

61. For an interesting case regarding signature, see La Mar Hosiery Mills, Inc. v. Credit & Commodity Corp., 216 N.Y.S.2d 186, 190 (City Ct. 1961) (“The signature on the telegram in suit, although typed in the office of the telephone company, is therefore defendant’s authorized signature . . . .”).


63. U.C.C. § 3-408.

64. The drawer’s liability is triggered when the drawee dishonors the draft. See U.C.C. § 3-414(b).


66. Article 3 defines an instrument as a promise or an order. See U.C.C. § 3-104(b), (e). Both an order and promise are signed writings. See U.C.C. § 3-103(a)(8), (12).

67. See U.C.C. § 3-104(a) & cmt. 1. A negotiable instrument—either a note or a draft—must be (1) in writing, (2) signed, (3) an unconditional promise or order to pay (4) a fixed sum (5) on demand or at a definite time, (6) either to bearer or to the order of a named payee, and (7) containing no extra undertaking. See id. These elements constitute the negotiability of the instrument. They legally empower the instrument to be negotiable. One purpose of negotiability is to free the instrument from the claims and defenses arising from the underlying transaction that occasioned the issuance of the instrument. See U.C.C. § 3-305 cmt. 1. In contrast to negotiability, negotiation is the mode of transfer from one holder to the next. Benjamin Geva, Forged Check Indorsement Losses Under the UCC: The Role of Policy in the Emergence of Law Merchant from Common Law, 45 WAYNE L. REV. 1733, 1737 n.13 (2000). The law recognizes two main methods of negotiation: one by delivery alone, see Tex. Sw. Med. Supply, Inc. v. Tex. Commerce Bank-Dallas, N.A., No. 05-93-00001-CV, 1994 WL 246169, at *4 (Tex. App. June 2, 1994), and the other by “indorsement and delivery,” Yeskolski v. Crosby, 480 S.E.2d 474, 476 (Va. 1997) (quoting Becker v. Nat’l Bank & Trust Co., 284 S.E.2d 793, 795 (Va. 1981)). Bearer instruments with no named payees are negotiated by delivery alone. Tex. Sw., 1994 WL 246169, at *4; U.C.C. § 3-201(b). Order instruments, where the payee is named on the instrument, are negotiated by the named payee’s indorsement and delivery. Becker, 284 S.E.2d at 795; U.C.C. § 3-201(b).
instrument, are supplied through default rules. For example, if the instrument contains no time of payment, the default rule makes the instrument payable on demand. No default rule, however, supplies a missing signature. If the issuer’s signature is missing, the instrument does not exist as a lawful liability. The strict requirement that the issuer or the representative of the issuer place the signature on the face of the instrument validates the principle of authorization. Note, however, that the NIL does not require a manual signature on every instrument and furnishes ample flexibility with respect to what constitutes a signature.

A signature, although a constitutive element of the instrument, is not the only method to authorize an instrument. The authorization may not be apparent from the face of the instrument. It may be contained in a separate agreement or may be located in the nature and purpose of a relationship, such as an agency relationship. A principal may authorize an agent to sign an instrument. The authorization principle holds the principal liable on the instrument although the principal has not signed the instrument. Some principals or represented persons, such as corporations and governments, cannot sign instruments and must rely on human representatives to execute the formality of a signature. In all such cases, the authorization principle imposes liability on the represented person even if the instrument does not mention the represented person. However, if the representative fails to mention the represented person and the representation on the face of the instrument, then the

68. U.C.C. §§ 3-108(a)–(b), 3-109(a)(2)–(3), 3-111.
69. U.C.C. § 3-108(a).
71. U.C.C. § 3-401(b). The concept of electronic signature, although not applicable to paper-based negotiable instruments, is innovative in that it could mean “an electronic sound, symbol, or process” associated with a record. Electronic Signatures in Global and National Commerce Act, 15 U.S.C. § 7006(5).
73. For example, the represented person, such as the principal, may not be identified on the face of the instrument. Yet the represented person is liable. See U.C.C. § 3-402 cmt. 1.
75. Id.
76. U.C.C. § 3-402(a).
77. Corporations and governments are juridical entities and distinguishable from natural persons. See United States v. Scophony Corp. of Am., 333 U.S. 795, 804 (1948). Both corporations and natural persons can act through representatives. However, juridical entities cannot sign instruments because, as juridical entities, they can act only through human agency. See id.
78. U.C.C. § 3-402(a).
representative, by signing the instrument, is personally liable to pay the instrument to a person who takes or pays the instrument in good faith and for value. 79 If a representative is forced to pay the instrument to a lawful payee, the authorization principle empowers the representative to demand full reimbursement from the represented person. 80

The authorization principle allows subsequent ratification of an unauthorized or a forged signature. 81 Generally, a forged signature is void ab initio, and the UCC imposes no obligation on the person whose signature is forged. 82 The authorization principle can remedy this fatal flaw in the legality of an instrument. By owning the forged signature, the issuer whose signature was forged authorizes the instrument. 83 The forged signature itself is not corrected on the instrument. 84 Nor does the issuer imprint a new signature on the instrument. The authorization principle simply effaces the legal ineffectiveness of the forged signature. 85 Likewise, an issuer may authorize another person to sign the issuer’s name. 86 This signature may vary dramatically from the issuer’s customary signature. However, the critical issue is not the incongruity between the two signatures, which might be obvious and must be conceded. The critical issue focuses on the question of whether the issuer authorized the signer to sign the issuer’s name. 87 If the issuer’s authorization is proved, the accuracy of the

79. U.C.C. § 3-402(b)(2).
80. Id.
81. U.C.C. § 3-403(a).
82. See, e.g., id. (providing that a signature is “ineffective” except in limited circumstances). The rule of subsequent ratification applies to any party whose signature on the instrument is forged. See id. Indorsers, anomalous indorsers, acceptors, accommodation parties, drawees, and makers all invoke the authorization principle to subsequently ratify a fraudulent or unauthorized signature. See id. (“An unauthorized signature may be ratified for all purposes of this Article.”).
83. See U.C.C. § 3-403 cmt. 3; U.C.C. § 1-201(41) (2001). Signature includes indorsement. See U.C.C. § 3-401 cmt. 1 (2002). Therefore, even a forged instrument can be ratified.
84. The signer, however, remains criminally liable for ratification because a forged signature does not affect the rights of the state to enforce criminal law. See U.C.C. § 3-403(c) & cmt. 3.
85. See U.C.C. § 3-403 cmt. 3; U.C.C. § 1-201(41) (2001).
86. U.C.C. § 3-402(a) (2002).
87. See, e.g., Carelli v. Hall, 926 P.2d 756, 762 (Mont. 1996) (“Conversely, where an authorized representative signs his own name to an instrument, the representative—rather than the represented person—is personally obligated unless the instrument either names the person represented or shows that the representative signed in a representative capacity.” (citing MONT. CODE ANN. § 30-3-403(2)(a) (1985))). The same analysis applies to the signature of any other party to the instrument, including indorsers, accommodation parties, acceptors, and co-makers. See U.C.C. § 3-419(h).
issuer’s signature is irrelevant for the purpose of the issuer’s liability to pay the instrument.  

2. Prior and Subsequent Liabilities

As noted previously, the authorization principle is not confined to the issuance of instruments.  The principle applies with equal force to other legal operations performed on the instrument, including negotiation, accommodation, acceptance, and accord and satisfaction.  When an instrument is accommodated, for example, no accommodation without authorization is valid.  The capacity in which the instrument is accommodated constitutes an essential part of authorization.  An accommodation party may authorize accommodation as a primary obligation, in which case the accommodation party signs the instrument as a maker.  Accommodation may also be authorized as a secondary obligation, in which case the accommodation party signs the instrument as an anomalous indorser.  Consistent with the authorization principle, accommodation may be authorized to guarantee collection rather than payment.  The authorization principle rationalizes these various capacities of accommodation with varying degrees of liability because no person should be held liable beyond the scope of that person’s authorization.

88. Indeed, the issuer might not even be disclosed. In that case, however, the signer must be the representative of the undisclosed represented person. U.C.C. § 3-402(a). A taker of the instrument may not know the issuer’s exact signature but may know the issuer’s name. Any discrepancy between the name and the signature makes the instrument facially irregular, a circumstance under which the taker may be denied the status of a holder in due course. See U.C.C. §§ 3-302(a)(1), 3-305(a)(1). However, even if the signer signs a name other than the issuer’s name, the issuer is still liable under the authorization principle. Carelli, 926 P.2d at 762 (citing MONT. CODE ANN. § 30-3-403(2)(a)).

89. See supra text accompanying note 53.

90. U.C.C. §§ 3-201(b), 3-311(a), 3-413(a), 3-419(a).

91. U.C.C. § 3-419(a). An accommodation party must sign the instrument. Id. The accommodation party may sign in the capacity of maker, drawer, acceptor, or indorser. U.C.C. § 3-419(b). However, signature is needed to incur liability. Id.

92. Id.

93. Id. Even though accommodation is associated with promissory notes, the concept allows for the accommodation of drafts and even checks. See 7 AM. JUR. PROOF OF FACTS 2D Status as Accommodation Party § 1 (1975) (citing U.C.C. § 3-415(1) (1957); 11 AM. JUR. 2D Bills and Notes § 8 (1975)).

94. U.C.C. §§ 3-205(d), 3-419(c). Anomalous indorsement is the signature of a person who is not the holder of the instrument. U.C.C. § 3-205(d).

95. U.C.C. § 3-419(d).

96. See U.C.C. § 3-419(b).
A new liability incurred on an instrument may not discharge a prior liability. For example, when the original payee indorses a draft and thus authorizes its delivery to the new payee, the original payee incurs the indorser’s liability. The indorser’s liability is thus added to the instrument without subtracting the drawer’s liability. The two liabilities coexist on the same instrument, although in a hierarchical order: The draft’s lawful payee must first present the draft to the drawee for payment. The indorser’s liability, although existent, lays dormant until the drawer and the drawee both dishonor the draft. Upon dishonor, the indorser’s liability may be activated with proper notice. Likewise, the drawer’s liability is also activated upon dishonor. The two activated liabilities allow the lawful payee to enforce the instrument against either obligor.

Not every new liability is an additional liability; a new liability may discharge prior liabilities. If a payor bank authorizes the acceptance of a draft, the acceptance creates the bank’s liability on the instrument. However, this new liability added to the instrument discharges the drawer’s liability. In this case, the two liabilities cannot coexist on the same instrument. If there are any indorsements on the draft, the bank’s acceptance discharges every indorser’s liability contracted on the draft. Thus, acceptance of a draft dissolves prior liabilities and substitutes many liabilities for one. Likewise, when a maker pays a note, all obligations on the note are discharged. If the maker tenders payment on the note but the payee refuses, all obligations except that of the maker are discharged to the extent of the amount of the tender.

97. However, when a drawee accepts a draft, the drawer is discharged. U.C.C. § 3-414(c). The liability of the indorser is also discharged. U.C.C. § 3-415(d).
98. U.C.C. § 3-415(a).
100. See U.C.C. § 3-415(a).
101. U.C.C. § 3-503(a).
102. U.C.C. § 3-414(b).
103. U.C.C. §§ 3-414 to 3-415. The drawer must pay the indorser who paid the draft. U.C.C. § 3-414(b).
104. U.C.C. § 3-409(a).
105. U.C.C. § 3-413(a).
106. U.C.C. § 3-414(c).
107. U.C.C. § 3-415(d).
108. See id.
109. See U.C.C. §§ 3-415(d), 3-603(c). However, an accommodation party that pays the instrument retains the right of reimbursement from the accommodated party. U.C.C. § 3-419(f).
110. U.C.C. § 3-603(b).
3. Properly Payable Doctrine

The properly payable doctrine reinforces the authorization principle. Article 4 of the Uniform Commercial Code presents the properly payable doctrine to define the relationship between the payor bank and its account holder. The doctrine states simply that an authorized payment is properly payable. The accountholder's authorization is evidenced by means of a check, a draft, or a note payable through the payor bank. In authorizing a payment, the accountholder orders the payor bank to pay a specific amount either to the bearer or to the order of a named payee. If the amount of an authorized payment is altered, or if the payment is made to a wrongful payee, the properly payable doctrine is breached. Consequently, the payor bank cannot lawfully charge the accountholder for any unauthorized payment.

The properly payable doctrine clarifies that both the amount of payment and the rightful payee are the essential attributes of an authorized payment.

111. U.C.C. § 4-401(a). In the terminology of Article 3, the payor bank is the drawee bank, and the customer is the drawer. Rusch, supra note 72, at 563 n.10 (citing U.C.C. §§ 4-104(a)(5), 4-105(3) (2002)). Whereas Article 3 uses the concept of "instrument," see U.C.C. § 3-104 (2002), Article 4 uses the concept of "item," see U.C.C. § 4-108 (2002). Item, defined in Article 4, is a broader term than instrument in Article 3, and includes negotiable instruments. See U.C.C. § 4-104(9). Under Article 4, account holder means customer. See U.C.C. § 4-104(5).

112. U.C.C. § 4-401(a). To understand the authorization principle and the concomitant bank liability, payor banks must be distinguished from depositary banks. The item in issue is what defines the status of a bank. The bank where the item in issue is deposited is the depositary bank, and the bank that pays the item is the payor bank. See U.C.C. § 4-105(2)–(3). Payor banks, also known as drawees or drawee banks, have the duty to pay instruments as authorized by their account holders, also known as drawers. See Lawrence Kalevitch, Luck of the Drawer: The Finality of Bank Payments to Holders in Due Course, 105 BANKING L.J. 416, 425 n.21 (1988). The relationship between the accountholder and the payor bank is contractual, established at the time of opening the checking account. A. Brooke Overby, Check Fraud in the Courts After the Revisions to U.C.C. Articles 3 and 4, 57 ALA. L. REV. 351, 362 (2005). Although the contractual relationship between the bank and the accountholder may vary the provisions of Article 4, the parties cannot contract away the bank's mandatory responsibility to process and pay instruments both in good faith and with care. U.C.C. § 4-103(a).

113. See U.C.C. § 4-106(a)–(b). These subsections distinguish items "payable through" a bank from items "payable at" a bank. Id.

114. U.C.C. § 4-401 cmt. 1.

115. Id. However, payor banks may vary their strict liability under the properly payable doctrine by means of a contract with the accountholder. U.C.C. §§ 4-103(a), 4-401(a). Many banks contract out of strict liability. See, e.g., Travelers Cas. & Sur. Co. of Am. v. Wells Fargo Bank, N.A., 374 F.3d 521, 525 (7th Cir. 2004) (citing U.C.C. §§ 4-103(a), 4-401(a) (2002)) (recognizing defendant bank's right to contract out of strict liability).

116. U.C.C. § 4-401 cmt. 1; Subcomm. on Payments, Am. Bar Ass'n, Deterring Check Fraud: The Model Positive Pay Services Agreement and Commentary, 54 BUS. LAW. 637, 674 (1999). However, an authorized payment for more than the amount available in the customer's account is properly payable. U.C.C. § 4-401 cmt. 1.
The signature is a method of authorization, but what is being authorized is the payment of a specific amount of money to the bearer or to the order of the named payee. The authorization principle, therefore, is sensitive not only to the proper method of authorization but also to the contents of authorization—the amount and the payee. The principle is violated when the account holder’s signature is forged, the amount is altered, or the payment is made to a wrongful payee. The payment made to a wrongful payee would frequently involve a forged or missing indorsement of the rightful payee.

a. Beyond Technical Ruses

The authorization principle is no technical ruse opposed to equity and fairness. Nor is the principle applied mechanically to recredit the account holder’s account every time a payment is made over a forged or missing indorsement. Firmly anchored in equity, the authorization principle may overlook forged and missing indorsements to inquire whether the payment is made to the intended payee. If a person whom the drawer intended to pay receives an instrument that evidences payment and “the drawer suffered no damages caused by the improper payment,” the account holder cannot rely on intervening forged or missing indorsements to demand that the payor bank recredit the account holder’s account. No court would allow any such fact-blind interpretation of the properly payable doctrine because it would result in the drawer’s unjust enrichment—a consequence that equity cannot sanction. If the intended payee receives payment, the payment system is not compromised and no party suffers any injury.

117. *Id.* An item containing a forged indorsement is not properly payable. *Id.*


119. See, e.g., Bank One, Columbus, N.A. v. Hochstadt, 515 So. 2d 332, 333 (Fla. Dist. Ct. App. 1987) (entering summary judgment for the bank where the payee—as intended by the drawer—received proceeds of check paid over a missing indorsement).

120. *Ambassador Fin. Servs., Inc.*, 605 N.E.2d at 752.

121. *Id.*


Where the proceeds of a forged check reach the intended payee, there can as a general rule be no cause of action by anyone on the forged endorsement. The payee cannot sue . . . since he has suffered no damage—he has, after all, received the monies intended for him. The drawer [Bankers Trust] may not sue the drawee-payor bank [Bankers Trust] for an improper charge on his account because, again, no damage has
b. Authorization Anomalies

The authorization principle encounters anomalies when thieves possess bearer instruments. According to the NIL, any person in possession of a bearer instrument is a holder.\textsuperscript{124} Thus, a person who finds or steals a bearer instrument is a holder.\textsuperscript{125} To make matters worse, Article 3 introduces the concept of the "person entitled to enforce" (PETE) the instrument and provides that every holder of an instrument is a PETE.\textsuperscript{126} Even a non-holder who has the rights of a holder is a PETE.\textsuperscript{127} The concept of the PETE is useful to the extent that it authorizes payment to a person who enjoys the rights of a holder but who, for a variety of reasons, cannot obtain the technical status of a holder.\textsuperscript{128} For instance, a person who inherits an unindorsed instrument from a deceased payee is a PETE, even if the deceased payee died without indorsing the instrument.\textsuperscript{129} Since a person must possess the instrument in order to assert the rights of a holder, the concept of PETE also covers situations where the payee has lost possession of the instrument but continues to be the rightful payee.\textsuperscript{130} Such a rightful payee, though no longer a holder, is a PETE.\textsuperscript{131}

Although the concept of the PETE clarifies lawful payments to certain rightful payees, it generates an anomaly in the case of thieves—persons who steal and possess bearer instruments. According to the UCC, every holder is a PETE.\textsuperscript{132} This means that a thief in possession of a bearer instrument is the person entitled to enforce the instrument.\textsuperscript{133} That a thief is "entitled" to enforce

been suffered as the funds have been put to their proper use.... Being immune from suit once the payee has received his funds, the payor bank has suffered no damage from the forgery and hence cannot reap undeserved benefits from the collecting bank.

\textit{Id.}

\textsuperscript{124} U.C.C. § 1-201(21) (2001).
\textsuperscript{125} Overby, supra note 112, at 364 n.83 (citing U.C.C. § 3-201 cmt. 1 (2002)).
\textsuperscript{126} U.C.C. § 3-301 (2002).
\textsuperscript{127} Id.
\textsuperscript{128} See, e.g., Timothy R. Zinnecker, Extending Enforcement Rights to Assignees of Lost, Destroyed, or Stolen Negotiable Instruments Under the U.C.C. Article 3: A Proposal for Reform, 50 U. KAN. L. REV. 111, 113 (2001) ("Section 3-301 defines a 'person entitled to enforce' as '(i) the holder of the instrument, (ii) a nonholder in possession of the instrument who has the rights of a holder, or (iii) a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 3-309 or 3-418(d)." (quoting U.C.C. § 3-301 (1990))).
\textsuperscript{129} U.C.C. § 3-301. This is a person who is a nonholder but has the rights of a holder under the laws of inheritance.
\textsuperscript{130} Zinnecker, supra note 128, at 118 (citing U.C.C. § 3-301(iii) (1990)).
\textsuperscript{131} Id.
\textsuperscript{132} U.C.C. § 3-301.
\textsuperscript{133} See id.; Timothy R. Zinnecker, A Literalist Proposes Four Modest Revisions to U.C.C. Article 3, 32 U. RICH. L. REV. 63, 76 n.71 (1998). However, a holder-thief taking an instrument is subject to the property rights in the instrument. U.C.C. § 3-306.
a bearer instrument that he stole is an obvious abuse of the term “entitlement.” It is unlikely that a court will allow a thief to first steal a bearer instrument and then blatantly argue that the thief is entitled to enforce the instrument, forcing the obligor as a matter of law to pay the instrument. The court’s decision not to enforce a bearer instrument in the thief’s hand would be consistent with the authorization principle because no maker of the note or drawer of the draft has authorized that a bearer instrument can be paid to a thief. Likewise, the depository bank may refuse to collect a bearer instrument, and the payor bank may dishonor payment if either bank has reason to believe that the holder of the bearer instrument is in wrongful possession. The payor bank may refuse to pay if the thief, though holder of the bearer instrument, presents the check for over-the-counter payment. This refusal will be consistent with the authorization principle and also litigation-proof because no thief would dare go to the court to claim the rights of a PETE.

A thief, although not entitled to enforce the bearer instrument as a matter of right, may nonetheless succeed in obtaining payment. If the payor bank in good faith pays a bearer instrument to a thief, the drawer is liable on the instrument, and the payor bank may lawfully charge the account holder’s account on which the bearer instrument is drawn. The account holder cannot rely on the

134. See U.C.C. § 3-301.
135. See, e.g., State v. Barrick, 46 P.3d 770, 772–73 (Utah Ct. App. 2002) (citing UTAH CODE ANN. § 76-6-501(1)(b) (1997)) (holding that an unauthorized completion of a bearer negotiable instrument by a finder or thief is a criminal act).
136. The courts often distinguish between ownership of and entitlement to an instrument. Perrino v. Salem, Inc., 243 B.R. 550, 559 (D. Me. 1999) (citing ME. REV. STAT. ANN. tit. 11, § 3-1203 cmt. 1 (1999)); Util. Conservation Servs. v. Elec. & Gas Indus. Ass’n, No. C051047, 2007 WL 1041678, at *7 (Cal. Ct. App. April 9, 2007) (quoting U.C.C. § 3-203 cmt. 1 (2002)). A thief of a bearer paper may be a PETE, but the thief cannot be the owner of a stolen instrument. Perrino, 243 B.R. at 559 (citing tit. 11, § 3-203 cmt. 1 (2002)); Util. Conservation Servs., 2007 WL 1041678, at *7 (quoting U.C.C. § 3-203 cmt. 1 (2002)). However, if the thief negotiates the bearer instrument to a holder in due course, the instrument is properly payable. The drawer cannot assert any real defense available under UCC section 3-305 because none is available. One might also argue that by issuing a bearer instrument, the issuer undertakes a risk that the instrument would be in good faith paid to a holder who has stolen the instrument.
137. If a depository bank takes the instrument in good faith for value, without knowing that the customer has stolen the instrument, the bank is a holder in due course. See U.C.C. §§ 3-302, 4-205(1).
138. A payor bank is not immune to the good faith obligation in making payments. For example, a payor bank may charge a customer’s account according to the original terms of an altered check provided the bank makes the payment in good faith. U.C.C. § 4-401(d). It may therefore be argued that a payment knowingly made to a thief is incompatible with a good faith payment. If the payor bank dishonors a properly payable instrument, the bank runs the risk of wrongful dishonor. U.C.C. § 4-402.
139. Chung v. N.Y. Racing Ass’n, 714 N.Y.S.2d 429, 432 (Dist. Ct. 2000). The court concluded that “[t]he problem with imposing an identity or ownership check requirement on the
authorization principle to demand that the payor bank recredit the account holder’s account. The most articulate expression of this rule may be found in a case that the Air Force Review Board decided in 1961.140

The Board drew a comparison between stolen goods and stolen instruments: “[A] thief cannot pass good title to a chattel even to an innocent purchaser. However, a long recognized exception to this rule concerns money and commercial paper genuine on its face.”141 Commercial necessity validates the exception and places a burden of good faith, and not one of diligence, on the purchaser of a stolen instrument.142 In validating the exception, however, the Board verbalized the rule more broadly than current law warrants. The Board concluded that “the transfer of stolen negotiable paper to a bona fide purchaser for value without notice and before maturity vests in him good title against all the world, including the true owner.”143 The Board’s ruling failed to distinguish between bearer instruments and specified-payee instruments.144 The ruling is correct with respect to bearer instruments but incorrect with respect to instruments payable to the order of specified payee.

A stolen negotiable instrument, payable to the order of a specified payee, does not transfer good title to the thief or to a subsequent transferee.145 If the thief forges the specified payee’s indorsement, the instrument is not properly payable.146 With respect to checks, the account holder may ask the payor bank to recredit the account holder’s account for paying the instrument to the wrongful payee.147 The payor bank would invoke presentment warranties to demand recredit from the banks that collected the instrument with the forged

negotiation of bearer paper is that such a requirement would impede the free negotiability which is the essence of bearer paper.” Id.


141. Id. (citing United States v. Gaines, 9 C.M.R. 854, 856 (A.F.B.R. 1953)).

142. Id. (citing 8 AM. JUR. Bills and Notes § 619 (1937); 10 C.J.S. Bills and Notes § 507 (1937)).

143. Id. The instrument in this case was a bearer instrument at the time of issuance. Id. at 678. The thief, however, added his name to the instrument and then indorsed it. Id. The Board argued that the stolen instrument was indeed a bearer instrument, id., and an innocent purchaser acquired lawful title to the instrument, id. at 679.

144. Id. at 677. The Board did not raise the question whether the thief could pass the title if the thief forged the indorsement of the rightful payee.


146. Subcomm. on Payments, Am. Bar Ass’n, supra note 116.

147. Willier, Inc. v. Hurt, No. 5:06-cv-00547, 2007 WL 4613033, at *8 (S.D. W. Va. Dec. 31, 2007) (“A customer is not liable for the amount of an overdraft if the customer neither signed the item nor benefited from the proceeds of the item.”); see also U.C.C. § 4-401(b) (2002).
indorsement. The loss may eventually fall on the depositary bank that received the instrument from the thief because the thief is unlikely to reimburse the depositary bank. The law defends this allocation of loss on the theory that the one who deals with the wrongdoer, the thief in this case, must suffer the loss. Intriguingly, though, the Board’s ruling is consistent with the international law of negotiable instruments.

B. Electronic Payments

The authorization principle applies to credit cards and electronic fund transfers (electronic payments) as well. In the early period of credit cards,

148. U.C.C. § 4-208(b); see Overby, supra note 112, at 362. A person presenting the check warrants that he is entitled to enforce. U.C.C. § 4-208(a)(1).


150. U.C.C. § 4-207(b). The thief breached the transfer warranty, claiming that the thief was a person entitled to enforce the instrument. See id. § 4-207(a)(1). The depositary bank has an actionable claim against the thief for breach of warranty. Id. § 4-207(c). However, if the thief is insolvent or unavailable, the depositary bank is stuck with the loss. From a policy viewpoint, this loss allocation is fair since the person who deals with the wrongdoer should suffer the loss—a concept embodied in the maxim “know your [i]ndorser.” Gerold Herrmann, Background and Salient Features of the United Nations Convention on International Bills of Exchange and International Promissory Notes, 10 U. PA. J. INT’L BUS. L. 517, 528 (1988).

151. Again, this refers to the maxim, “Know your [i]ndorser.” Herrmann, supra note 150, at 528; Hetherington, supra note 149, at 123 n.190.


153. Federal law, codified as the Consumer Credit Protection Act (CCPA), 15 U.S.C §§ 1601–1693r (2006), regulates credit cards and electronic fund transfers. Subchapter I of the CCPA, known as the Truth in Lending Act (TILA), governs credit cards, id. §§ 1601–1667(f), whereas subchapter VI of the CCPA, known as the Electronic Fund Transfer Act (EFTA), regulates ATM or debit cards and other electronic devices used to authorize a financial institution to debit or credit an account, id. §§ 1693–1693r. The Board of Governors of the Federal Reserve System (Board) has the authority to issue regulations to clarify, supplement, and carry out the purposes of these statutes. Id. § 1604(a). Accordingly, the Board has promulgated Regulation Z to
which originated under the law of contracts, the authorization principle was rarely accepted as the governing norm.\textsuperscript{154} Under most contracts, the cardholder was liable for unauthorized purchases prior to surrendering the card to the issuer.\textsuperscript{155} This oppressive contract rule later evolved into another contract provision that held the cardholder liable for unauthorized uses of the card prior to giving notice to the issuer that the card was lost or stolen.\textsuperscript{156} Even the liability-until-notice rule was incompatible with the authorization principle because the rule held the cardholder liable for unauthorized charges before notice of lost or stolen card was given, avoiding the temporality question of when the cardholder knew that the card had been lost or stolen.\textsuperscript{157}

The federal regulation of credit cards introduced the authorization principle, which overrode the liability-until-surrender and liability-until-notice provisions of contract law. Accordingly, a cardholder\textsuperscript{158} is liable for payments that the cardholder authorizes. Conversely, a cardholder is not liable for payments that the cardholder does not authorize, including the charges made on lost or stolen cards.\textsuperscript{159} Therefore, both versions of the authorization principle—authorization imposes liability and no authorization, no liability—regulate electronic payments.

Note, however, that the credit card is both a payment device and a debt instrument because it combines the functions of payment and borrowing. As a payment device, the credit card serves as a money substitute for the purchase of enforce TILA, 12 C.F.R. § 226.1(b) (2008), and Regulation E to enforce EFTA, id. § 205.1(b). To further clarify the regulations, the Board issues documents called Official Staff Interpretations, which carry considerable weight unless shown to be demonstrably irrational. See Ford Motor Credit Co. v. Milhollin, 444 U.S. 555, 565–67 (1980).


\textsuperscript{155} Magnolia Petrol. Co. v. McMillan, 168 S.W.2d 881, 881 (Tex. Civ. App. 1943). In the 1940s, the cardholder was responsible for all purchases made by the use of the card prior to the surrender of the card to the issuer. Id.

\textsuperscript{156} Credit Cards: Distributing Fraud Loss, 77 YALE L.J. 1418, 1420 (1968).

\textsuperscript{157} See, e.g., Allied Stores of N.Y., Inc. v. Funderburke, 277 N.Y.S.2d 8, 11–12 (Civ. Ct. 1967) (holding that the cardholder is not liable without knowing the loss or theft of card).

\textsuperscript{158} Both the TILA and the EFTA define the term “card” broadly. Under TILA, card means “any card, plate, coupon book or other device existing for the purpose of obtaining money, property, labor, or services.” 15 U.S.C. § 1602(k) (2006). Under EFTA, card means “a card, code, or other means of access to a consumer’s account for the purpose of initiating electronic fund transfers.” § 1693(a)(1). The term “cardholder” is defined under TILA, § 1602(m), but not under EFTA. Because both statutes employ card, this Article uses cardholder to mean any consumer who uses credit cards and electronic fund transfers available under TILA and EFTA, respectively.

\textsuperscript{159} The law does impose a maximum penalty of $50 for unauthorized charges until notice is given. 15 U.S.C. § 1643(a)(1)(B) (2006).
goods and services. As a lending device, the credit card provides the cardholder with the option either to pay off the entire bill every month without suffering financial charges or to pay the required minimum amount and incur substantial financial charges on the unpaid charges. The law seems to promote credit cards as a payment device that consumers should prefer. The market also furnishes what has been called credit card goodies, such as cash back rewards, discounts, rebates, and airline mileage points. These promotions are invitations to debt. They are lending strategies that have little to do with the credit card as a payment device. The following discussion explores important nuances of the authorization principle as applied to electronic payments.

The EPL creates several structural constraints to fortify the authorization principle with respect to electronic payments. First, financial institutions cannot issue credit or debit cards without a person’s consent. This consent constraint is designed to prevent predatory lending practices and electronic fund transfer abuses. In all cases, therefore, a card must be an accepted card, which means that the cardholder has authorized the issuance of the card either to the cardholder or to another person to use. The unsolicited issuance of credit cards is a breach of the authorization principle, as it induces persons to use what can be a risky method of payment. The practice also harms lenders because unscreened cardholders may engage in fraud and carry a higher risk of

160. See Gillian Garcia, Credit Cards: An Interdisciplinary Survey, 6 J. CONSUMER RES. 327, 327 (1980). The rich use the credit card as a payment device whereas the poor use it primarily for the available credit. Id. at 329.

161. Only affluent cardholders are able to pay off the entire monthly bill. Adam J. Levitin, Priceless? The Social Costs of Credit Card Merchant Restraints, 45 HARV. J. ON LEGIS. 1, 35 (2008). Levitin examines cognitive biases that enter into the dynamics of credit cards. Id. at 18–42.

162. Adam J. Levitin, Payment Wars: The Merchant-Bank Struggle for Control of Payment Systems, 12 STAN. J.L. BUS. & FIN. 425, 435 (2007) (citing Damon Darlin, Gift Horse to Consider: Credit Cards that Reward, N.Y. TIMES, Dec. 31, 2005, at C1). High rewards credit cards charge higher interchange fees from merchants, thus slashing merchants’ profits Id. at 43. Merchants, however, have no way of telling from the face of the card whether the card carries a higher interchange fee. Id. at 435–36.


164. Here the phrase “debit card” includes electronic transfer of funds.


166. See generally Comment, Unsolicited Merchandise: State and Federal Remedies for a Consumer Problem, 1970 DUKE L.J. 991 (1970) (discussing how unsolicited goods were pestering consumers in the 1960s and 1970s, and regulation was needed to protect consumers against these practices).

167. § 1602(t). But see § 1693i(b) (establishing that unsolicited debit cards can be issued under certain defined circumstances).

nonpayment. Of course, a person is free not to use an unsolicited card. However, given the human propensity to use readily available credit, unsolicited credit cards can land cardholders in excessive debt beyond their paying capacity. Unsolicted debit cards may be hazardous even to the operation of deposit accounts, particularly if the cardholder is unfamiliar with proper uses of electronic fund transfers.

Second, each card transaction requires the cardholder’s specific authorization. In most cases, the cardholder must sign the credit card slip that the merchant generates at the time of sale of goods and services. By signing the slip, the cardholder authorizes the issuer to credit the merchant’s account in the approved amount and accordingly to charge the cardholder. Internet transactions require entering the cardholder’s name and the billing address. Furthermore, the cardholder must provide the card number, expiration date, and special digits provided on the card in order to authorize the amount charged to the card. These logistical entries in credit card transactions affirm that the use

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169. Alya Guseva & Akos Ronas-Tas, Uncertainty, Risk, and Trust: Russian and American Credit Cards Markets Compared, 66 AM. SOC. REV. 623, 624 (2001) (noting that American banks suffered serious losses in the 1950s and 1960s when they mass mailed unsolicited credit cards without any prescreening for fraud and risk of nonpayment). The expansion of credit cards is related to the credit score of the cardholder. See Kathleen W. Johnson, Recent Developments in the Credit Card Market and the Financial Obligations Ratio, 91 FED. RES. BULL. 473, 475 (2005), available at http://www.federalreserve.gov/pubs/bulletin/2005/autumn05_lead.pdf. The market has designed a system under which cardholders with poor credit ratings pay higher interest rates. Id. This risk-based pricing has increased the availability of credit cards for low income households. Id.


171. See, e.g., United States v. Price, 763 F.2d 640, 643 (4th Cir. 1985) (holding that credit card sales slips carry express representations concerning account numbers, account owners, and purchase amounts). When charging small amounts to credit cards, merchants may suspend the signature requirement. Richard A. Epstein & Thomas P. Brown, Cybersecurity in the Payment Card Industry, 75 U. CHI. L. REV. 203, 210–11 (2008). This suspension promotes efficiency. The absence of the signature requirement is still consistent with the authorization principle in that, absent fraud, the swiping of the card for paying a charge is evidence of authorization. Thus, the suspension of the signature requirement does not discard the principle of authorization but makes the process of authorization easier. See id. (noting that speed is part of modern transactions and the suspension of the signature requirement promotes speedy transactions).

172. Although credit card slips are still generated and signed, the clearance and settlement of payment is done electronically. Financial institutions have replaced the previous method of depositing credit card slips in the merchant’s bank with automated payment processing. See Gerdes, supra note 21, at 182. Credit card payments are now completely electronic. See id.

173. The three-digit security code located on the back of the card lets the merchant know that the person ordering merchandise has physical possession of the card. See 3-Digit Security
of the card is not accidental but deliberate and authorized. These entries are not fraud proof, nor do they provide conclusive evidence that the cardholder, and not an unauthorized user, has entered the required information. Absent fraud, however, these entries evidence the cardholder’s authorization for the amount charged to the card account. Even in repeated uses of a credit card for the same merchant, the cardholder must enter the amount and special digits to authorize a new transaction. In the case of debit cards, the cardholder must use a personal identification number (PIN) to authorize any transfer of funds. The combined use of the card and the PIN ensures authorization. The authorization to charge an amount on the debit card with the use of the PIN is more credible since the PIN, unlike the card identification number, is closely held private information that only the cardholder supposedly possesses.

The authorization principle, embodied in EPL, allows a cardholder to authorize another person to use the card. Corporations, businesses, universities, and even ordinary persons may obtain cards for employees, officers, agents, representatives, and family members. Even though the cardholder is liable for the amounts charged to the account, the authorized card users may lawfully charge the cardholder’s account. Even though some merchants require the cardholder’s identification before charging the account, EPL permits the cardholder to authorize another person to use the card. In

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177. See id.

178. See, e.g., United States v. Ragosta, 970 F.2d 1085, 1087 (2nd Cir. 1999) (noting that, typically, the bank customer is the only person who knows the PIN).


180. The definition of a cardholder allows flexibility under which a person may agree to charge the card issuer to pay obligations arising from the issuance of a credit card to another person. See 15 U.S.C. § 1602(m) (2006); see also id. § 1645 (discussing a similar provision for business credit cards issued to ten or more employees).

181. See, e.g., Martin v. Am. Express, Inc., 361 So. 2d 597, 599 (Ala. Civ. App. 1978) (holding that a cardholder who “voluntarily permits the use of his (or her) credit card by another person” authorizes the use of a card).

182. See, e.g., Mary Elizabeth Matthews, Credit Cards—Authorized and Unauthorized Use, 13 ANN. REV. BANKING L. 233, 238 (1994) (explaining that merchants enter into specific contracts with merchant banks regarding the verification procedures of the use of credit cards).

183. 12 C.F.R. § 226.12(a)(2) n.21.
fact, for credit cards, the law allows a much broader scope of authorization in that the card bearer may have the cardholder’s “actual, implied, or apparent” authorization to use the card.\(^{184}\) In electronic fund transfers, however, the law requires that the card bearer have the cardholder’s actual authority.\(^{185}\) When a cardholder delivers the PIN information to a card bearer, the information delivery constitutes actual authorization; accordingly, the bank may lawfully charge the cardholder’s account for amounts the card bearer has charged.\(^{186}\)

The authorization principle is no mere formality. It is anchored in information-based operational guidance. Therefore, consumers of payment services need to have the critical information about transaction costs of using different payment devices. Cash payments impose the least transaction costs;\(^{187}\) however, carrying cash is potentially risky. Among money-substitutes, payments by check or electronic transfers also impose minimal transaction costs, even though account holders may incur fees for maintaining deposit accounts.\(^{188}\) However, the use of credit cards may impose substantial transaction costs on cardholders.\(^{189}\) The authorization principle, therefore, demands that lenders disclose credit terms so that cardholders use payment services on the basis of informed consent.\(^{190}\) A meaningful disclosure of credit terms includes information about the annual percentage rate, finance charge determination, minimum periodic payments, late payment penalties, grace period, and methods for correcting billing errors.\(^{191}\) The authorization principle loses meaning when


\(^{185}\) See id. § 1693a(11).

\(^{186}\) See id. § 1963(a)(11)(A) (providing that a cardholder who grants actual authority to third party is liable for third party’s transactions until the card issuer has notice that such cardholder has revoked such authority). However, a bank must investigate unauthorized transfers that a cardholder claims even though the ATM card and the PIN remained in possession of the cardholder during the period of unauthorized transfers. Wilson v. Harris N.A., No. 06 C 5840, 2007 WL 2608521, at *2 (N.D. Ill. Sept 4, 2007).


\(^{188}\) U.C.C. Article 4A, Prefatory Note (1989) (stating that a transfer of many millions of dollars can be made for a price of a few dollars).

\(^{189}\) See, e.g., Benjamin Klein et al., Competition in Two-Sided Markets: The Antitrust Economics Card Interchange Fees, 73 ANTITRUST L.J. 571, 591 (2006) (listing fees commonly imposed on cardholders, including finance charges and per-transaction fees).


cardholders use credit cards with a biased knowledge of credit terms. The cardholder’s liability may be adjusted, even discharged, in cases where the creditors deliberately or deceptively withheld disclosure of material credit terms.

Electronic payments between businesses or financial institutions, known as wire transfers, are covered under Article 4A of the UCC. Although the law of wire transfers shares features with other payment systems, it is nonetheless unique. Despite this uniqueness, the authorization principle is the foundation of Article 4A. Ordinarily, the customer authorizes the payment order for any transfer of funds. The receiving bank verifies the authenticity of the payment order pursuant to security procedures. If the security procedure verifies a payment order to be authentic, even an unauthorized order is effective. In giving effect to an unauthorized order, the rule appears to conflict with the authorization principle. Upon further examination, however, we find that the security procedure must be a “commercially reasonable method of providing security against unauthorized payment orders.” A prudent customer will not open an “authorized account” with a bank unless the customer is satisfied with the security procedure. By opening an authorized account, the customer

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195. See, e.g., U.C.C. § 4A-202(a) (1989) (“A payment order received by the receiving bank is the authorized order of the person identified as send if that person authorized the order . . . ”). The very title of this section is “Authorized and Verified Payment Orders.” U.C.C. § 4A-202. What is a commercially reasonable security procedure is a question of law. U.C.C. § 4A-202(c). Yet, “the wishes of the customer expressed to the bank” is a factor in determining the reasonableness of the security procedure. Id. Furthermore, the customer may choose a security procedure other than the one the bank offers. Id. Most important, the customer agrees in writing to be bound even by unauthorized payment orders in compliance with the security procedure that the customer chooses. Id. A reasoning of these rules clarifies that a customer’s acceptance or choice of a security procedure, critical to wire transfers, is part of the authorization principle as applied to payment orders under Article 4A.

197. Id.
198. Id.
199. Id.
200. U.C.C. § 4A-105(1), (3).
accepts—and authorizes—the bank’s commercially reasonable security procedure as a method of verification of payment orders. In other words, the customer authorizes the security procedure as a method of verification of the customer’s payment orders. Accordingly, the customer is liable when the security procedure verifies an unauthorized payment order.\textsuperscript{201} The authorization principle is not only order-specific, but it is also embedded in the security procedure that the customer has elected to complete its payment orders.\textsuperscript{202}

C. No Authorization, No Liability

As noted above, the authorization principle imposes payment liability.\textsuperscript{203} The negative implication of the principle—no authorization, no liability—is also valid but to a lesser extent, as explained in Part III. The negative implication of the principle, however, is explicitly recognized in the law of payment systems. The NIL declares that an unauthorized signature, except that of the signer, is ineffective.\textsuperscript{204} Thus, a person—be it the drawer, maker, indorser, accommodation party, or any other party—is not liable on the instrument if the person’s signature is unauthorized.\textsuperscript{205} A person\textsuperscript{206} may interpose a real defense to payment if the person’s authorization is inherently defective.\textsuperscript{207} Signatures obtained under duress or under fraudulent inducement that muddied the character of the instrument or its essential terms are examples of inherently flawed authorizations that cannot create a lawful obligation to pay

\textsuperscript{201} U.C.C. § 4A-202(b).
\textsuperscript{202} U.C.C. § 4A-203 cmt. 1. Thus, the authorization principle in the conventional sense of a principal authorizing its agent is not helpful. The wire transfer is not comparable to payment by a check. Wire transfers may be executed on the basis of a message received on a computer screen. The identity of a person sending the message may be not apparent or even determinable. As such, the authorization of a named person is not always applicable to wire transfer orders. In wire transfers, the receiving bank relies on the security procedure. And a payment order is authorized if it passes the security procedure. \textit{Id.}

\textsuperscript{203} See supra text accompanying notes 43-44.
\textsuperscript{204} U.C.C. § 3-401(a), 3-403(a) (2002).
\textsuperscript{205} U.C.C. § 3-401. However, a represented person is liable on the instrument even though that person does not sign the instrument. U.C.C. § 3-402(a).

\textsuperscript{206} Article 3 uses the word “obligor” to prescribe real defenses. See U.C.C. § 3-305(a). This is inaccurate drafting since the word obligor implies that the person is obligated but for a defense. In the context of personal defenses, the word obligor is accurate. However, this word is confusing—indeed inaccurate—when used in the context of real defenses. A person who has real defenses against payment is not an obligor in any sense of the word.

\textsuperscript{207} The NIL presents two distinct types of defenses—real and personal. Real defenses are available against all payees regardless of their status as holders in due course. U.C.C. § 3-305(a)(1). Personal defenses are unavailable against holders in due course. U.C.C. § 3-305(a)(2). For an explanation of the distinction between real and personal defenses, see Gillette, supra note 41, at 238-39.
the instrument. Inherently flawed authorization is no authorization at all—it is void ab initio.

The EPL evidences the negative implication of the authorization principle. A cardholder is not liable for unauthorized charges although the law charges a minimal amount for unauthorized charges if the cardholder fails to report the loss of the card in a timely manner. This penalty does not weaken the authorization principle, nor should it be seen as an exception to the principle. Though the law is drafted in terms of the cardholder’s obligation for unauthorized charges, the law is geared more toward imposing a penalty for not reporting the loss of the card rather than creating an exception to the authorization principle. Lenders, and not cardholders, suffer huge losses when stolen and lost cards are unlawfully charged. This shift of loss from cardholders to lenders is consistent with the authorization principle because cardholders do not authorize payments on stolen and lost cards.

Under agency principles, a cardholder may authorize another person to use the card for buying goods and services. The card bearer may sign his own name or the name of the cardholder to authorize a particular transaction. That the card bearer has forged the signature of the cardholder to authorize a transaction poses no difficulty in charging the cardholder’s credit account. “Where a cardholder voluntarily and knowingly allows another to use his card and that person subsequently misuses the card,” courts in most jurisdictions have held that the agent had apparent authority to lawfully charge the cardholder’s account.

208. See U.C.C. § 3-305(a)(1)(ii)-(iii).
211. See Gilbert M. Schroeder, Claims Under Financial Institution Bonds for Losses Due to Credit Card Chargebacks, BRIEF, Summer 2004, at 24, 24–25; see also 15 U.S.C. §§ 1643, 1693g (establishing that the cardholder is liable for unauthorized charges or transfers). Because both sections cap liability, the law serves more as an incentive to report the loss or theft of the card. See MANN, supra note 23, at 149–50.
212. Gillette & Walt, supra note 176, at 505–08.
213. 15 U.S.C. § 1602(o); see also Permobil, Inc. v. Am. Express Travel Related Servs. Co., 571 F. Supp. 2d 825, 828 (M.D. Tenn. 2008) (reporting that the company obtained credit cards for its employees with the name of the company and the authorized employee’s name on each employee card).
The cardholder may authorize a merchant to charge the card for future fixed or variable liabilities. Until the cardholder revokes authorization, the merchant may charge the card according to the terms of authorization. The authorization principle, however, needs clarification when a cardholder instructs a merchant not to charge the card over a certain limit. This scenario may arise when a cardholder authorizes another person to use the card but advises the merchant not to allow the card bearer to charge the card over a certain amount. Here, restrictive authorization extended to the merchant competes with apparent authority given to the card bearer. The merchant may refuse to accept such restrictive authorization, but if the merchant accepts the restriction, the authorization principle binds the merchant not to charge the cardholder over the authorized amount. The restrictive authorization communicated to the merchant subsumes the apparent authority of the card bearer. The enforcement of the restriction may be cumbersome and may even impose prohibitive enforcement costs on the merchant. But the cardholder cannot be subjected to charges over the authorized amount. The merchant can disallow the card bearer to charge over the specified amount. If the merchant fails to enforce the restriction, however, the cardholder is not liable for charges over the authorized amount.

employee’s charges outside the scope of the business trip); Walker Bank & Trust Co. v. Jones, 672 P.2d 73, 76 (Utah 1983) (holding wife liable for husband’s charges despite wife’s notification to the bank that her husband was no longer an authorized user); Mastercard v. Town of Newport, 396 N.W.2d 345, 348 (Wis. Ct. App. 1986) (holding the town liable for town clerk’s personal charges).

216. For example, the EFTA allows preauthorized electronic fund transfers that are “authorized in advance to recur at substantially regular intervals.” 15 U.S.C. § 1693a(9) (2007).

217. See, e.g., Steiger, 666 A.2d at 479 (“Where a credit cardholder . . . voluntarily permits the use of his or her credit card by another person, the cardholder has authorized the use of that card and is thereby responsible for any charges as a result of that use, even if he or she requested that the other person not charge over a certain amount or make charges on it for specified purposes.” (citing Standard Oil Co. v. Steele, 489 N.E.2d 842, 844 (Ohio Mun. Ct. 1985)).

218. See, e.g., Towers World Airways v. PHII Aviation Sys. Inc., 933 F.2d 174, 177 (2d Cir. 1991) (“Unlike express or implied authority, however, apparent authority exists entirely apart from the principal’s manifestations of consent to the agent. Rather, the cardholder, as principal, creates apparent authority through words or conduct that, reasonably interpreted by a third party from whom the card bearer makes purchases, indicate that the card user acts with the cardholder’s consent.”).

219. Courts, however, are reluctant to place restrictive liability on card issuers even if the cardholder gives notice of restriction. Towers World Airways, 933 F.2d at 179 (rejecting the placing of an unrealistic burden on the card issuer to convey to numerous merchants whatever limitations the cardholder has placed on the card user’s authority).
III. NEGLIGENCE PRINCIPLE

The negligence principle is the second principle of the theoretical code of payment systems. Ordinarily, alterations and forged signatures impose no liability on the purported obligor, as these actions are contrary to the authorization principle.220 An instrument that carries an alteration or a forged signature is not properly payable and may be lawfully dishonored.221 However, the authorization principle ceases to determine the liability of a party whose negligence substantially contributes to alteration or a forged signature.222 The negligent party is denied the benefits of the authorization principle and is held liable under the negligence principle.223 For instance, a drawer whose failure to exercise ordinary care substantially contributes to altering the amount of the check from $10 to $10,000 cannot rely on the authorization principle to assert that the drawer is liable only for $10.224 The negligent drawer is accountable for the full, altered amount of $10,000, which the payor bank has paid in good faith and without notice of the alteration.225 Hence, the negligence principle is essentially a loss allocation criterion.

The exercise of care in legal transactions is a cardinal principle of the legal system. The breach of a duty of care—negligence—is actionable and carries legal consequences. As in many other areas of law,226 the negligence principle is an essential part of payment systems law. In its simplest formulation, the

221. Id.
222. U.C.C. § 3-406(a) (2002).
223. The negligence principle is distinguishable from the concept of negligence in tort. This distinction is critical. The tort negligence theory is confined to losses suffered to persons or property. See, e.g., Sovereign Bank v. BJ's Wholesale Club, Inc., 533 F.3d 162, 175 (3d Cir. 2008) ("The Economic Loss Doctrine provides that no cause of action exists for negligence that results solely in economic damages unaccompanied by physical or property damage."). This caution is also flagged in Article 3. See U.C.C. § 3-406 cmt. 1.
224. U.C.C. § 3-406 cmt. 3. Article 3 defines alteration as an "unauthorized" change that may modify the obligation of a party. U.C.C. § 3-407(a). Thus, alteration is conceptually antithetical to the authorization principle. Under some circumstances, however, when the party's negligent conduct causes the alteration, the negligence principle—and not the authorization principle—should control the determination of liability. U.C.C. § 3-407 cmt. 2 (stating that the party that left the instrument incomplete is liable when the instrument is completed, though without authorization).
225. Id. The rule was first articulated in a nineteenth century common law case, Young v. Grote, (1827) 130 Eng. Rep. 764 (K.B.).
negligence principle requires persons to issue, transfer, debit, and credit payment orders with care. If a person processing a payment device does so negligently, the person is liable for the loss attributable to negligent conduct. In enforcing the negligence principle in payment systems, the law may in some cases require proof of negligent conduct before assigning loss to the negligent person, while in other cases the law may presume negligence and accordingly allocate the loss.

The following discussion demonstrates that the negligence principle is not evenly applied to payment devices. The negligence principle's application to negotiable instruments is pervasive and robust. The principle's application to the law of credit cards is disguised. The principle is noticeably present in electronic fund transfers, but its application is not as vigorous as it is with negotiable instruments. These varying applications of the negligence principle raise a policy question—whether the principle should be more evenly applied to payment devices.

A. General Negligence

1. Negotiable Instruments

The NIL defines "general negligence" as a "failure to exercise ordinary care" that "substantially contributes to alteration or forged signature on an instrument." General negligence is thus associated with two wrongs: alteration and forged signature. In most cases, the wrong of alteration involves an unauthorized change in the amount of money to be paid on the instrument. However, any unauthorized change that modifies a party's liability constitutes alteration. The wrong of forged signature includes the purported signature of maker, drawer, drawee, indorser, accommodation party, or any

227. The phrase "payment order" is not used as defined in UCC section 4A-103(a)(1). I use the phrase in a more generic sense to include any order to a financial institution to debit or credit an account.
228. Professor Robert Cooter must be credited for making the distinction between general negligence and presumptive negligence. See Robert D. Cooter & Edward L. Rubin, A Theory of Loss Allocation for Consumer Payments, 66 TEX. L. REV. 63, 64 (1987). The UCC presumes negligence in sections 3-405(b) (employer liability) and 3-404 (liability for instruments issued to impostors and fictitious payees).
229. Article 3 does not use the expression general negligence. This phrase, however, is analytically useful in distinguishing different manifestations of negligence recognized in the law. See Cooter & Rubin, supra note 228.
230. U.C.C. § 3-406(a).
231. Id. This section deals only with forged signature and alteration.
232. U.C.C. § 3-407(a).
other party to the instrument. The liability arising from general negligence is not confined to the issuer of the instrument but applies to all parties that may process the instrument. As such, the negligence principle is thoroughly interwoven with all parties to, and processes of, negotiable instruments. A more detailed discussion of general negligence—highlighting the logistics of ordinary care and substantial contribution—will assist in later determining whether the negligence principle is, or ought to be, applied to electronic payments.

General negligence stems from a party’s failure to exercise ordinary care. The statutory standard of care prescribed to assess the negligent conduct is party specific. The standard of care raises two important questions: Where is the party located? And what type of business does the party do? Answers to these questions determine whether the party has engaged in statutorily negligent conduct. The location of the party is critical because the prescribed standard of care is not national or universal in scope. No one standard of care governs all localities in which instruments are issued, negotiated, or paid. Parties located in metropolitan areas may observe a standard of care that might be too oppressive for parties located in small towns. Furthermore, the standard of care may vary from business to business. A party is judged for negligence according to the reasonable commercial standards with respect to the business in which the party is engaged. Hence the failure to exercise ordinary care consists of the combined norms of commercial standards prevailing in the party’s locality and business.

General negligence also requires that the negligent conduct “substantially contribute” to the alteration or forged signature. The substantial contribution test is not as stringent as the “direct and proximate cause” test. The causation of a wrong can be highly complex and even indeterminate in that no legal jargon can definitively capture the calculus of contributions that eventually

233. See U.C.C. § 3-103(a)(8).
234. See U.C.C. § 3-406(a). Although the language of the section refers to preclusion of a negligent party from asserting alteration or forgery against a person who in good faith pays the instrument or takes it for value or collection, the preclusion is designed to shift the loss to the negligent party. Because failure to exercise ordinary care is negligence, section 3-406 incorporates liability imposing general negligence and not mere preclusion. For the use of the concept of negligence that contributes to alteration, see U.C.C. § 3-406 cmt. 1. This concept of negligence in payment systems, however, must not be confused with negligence in tort. Id.
235. See U.C.C. § 3-103(a)(7), (9).
236. See U.C.C. § 3-103(a)(9) (establishing that the standard of care is the observance of reasonable commercial standards prevailing in the area in which the person is located).
237. For example, banks engaged in the automated processing of instruments are not required to examine the instruments provided the practice complies with the standard of ordinary care. See id.
238. U.C.C. § 3-406(a).
239. U.C.C. § 3-406 cmt. 2.
produce an alteration or a forged signature. The law holds a party liable on the instrument if the party’s negligent conduct is a substantial factor in the chain of events that produced a wrong. 240

Comparative negligence adds to the uncertainty of fact-based litigation. 241 The NIL allows a negligent party to show that another party has also been negligent in processing or paying the instrument. 242 It is hard to imagine that a party charged with general negligence would roll over and accept liability. More likely, the allegedly negligent party would not only contest the charges of negligence but would also plead the plaintiff’s negligence. This double-headed—and possibly poly-headed—pleading of general negligence turns the case into an expensive contest of facts. 243 The cost of litigation multiplies as each allegedly negligent party defends its contribution to the loss. In addition to increasing the cost of litigation, the outcome of a fact-based negligence case is hard to predict. 244 The risk of losing a case, after incurring substantial transaction costs, 245 makes little sense if the contested amount of the instrument is smaller than the transaction costs.

The logistics of ordinary care, substantial contribution, and comparative fault are all heavily fact-based legal concepts. The litigants will incur substantial transaction costs in gathering and in disputing facts to establish or deny a party’s breach of ordinary care. 246 This is so because the establishment of actionable negligent conduct would require gathering facts about commercial standards in the party’s locality as well as in the party’s business. 247 Furthermore, though easier to satisfy than the direct and proximate cause test, the fact-based substantial contribution test adds cost to litigation as well.

240. U.C.C. § 3-406(a). The law leaves it to the court and the jury to determine the negligent conduct that caused alteration. U.C.C. § 3-406(a) cmt. 1.

241. See, e.g., Overby, supra note 112, at 371 (examining the impact of comparative negligence on litigation and arguing that banks have been able to shift the loss of forged checks to account holders with greater ease).

242. UCC sections 3-404(d), 3-405(b), 3-406(b), and 4-406(e) all allow for the concept of comparative negligence, which potentially minimizes the account holder’s liability by showing that the bank failed to exercise ordinary care in paying instruments or items.

243. One way to reduce litigation costs is to stipulate facts. See, e.g., Sipl v. Sentry Indem. Co., 431 N.W.2d 685, 688 (Wis. Ct. App. 1988) (“It is, of course, entirely proper for parties to avoid litigation costs by stipulating to uncontested facts—or by agreeing not to contest some facts they might dispute.”).

244. WHITE & SUMMERS, supra note 45, § 16-3, at 74 (commenting that comparative negligence invites the plaintiff to roll the dice with the jury).

245. Used here, transaction costs include attorney’s fees, court fees, and other expenses incurred to prosecute or to defend a case.

246. Ordinary care is a standard defined in terms of specific business and locality in which the business is located. U.C.C. § 3-103(9). In the case of businesses, this standard is fact-specific. Id. cmt. 5. In case of banks, the law seems to allow automated means. Id.

247. See supra text accompanying notes 236–37.
No empirical studies are available to demonstrate whether comparative negligence inducted in the NIL sponsors or suppresses litigation. Professional wisdom, however, reveals that litigation costs associated with a poly-headed negligence case, plus the risk of an uncertain outcome, may persuade parties to settle the case and split the loss.\(^{248}\) Of course, some cases may still be litigated and the losing party may have to pay expenses, including the attorney’s fees, to the winner. But in many cases, parties would choose to split the loss in a fair proportion rather than incur litigation costs for an uncertain outcome.\(^ {249}\)

To nudge parties toward settlement and fair apportionment of loss, courts must not allow summary judgment to circumvent allegedly negligent conduct.\(^ {250}\) Payor banks, however, have been successful in obtaining summary judgment through the observance of reasonable commercial standards\(^ {251}\)—a trend that defeats the \textit{raison d’être} of comparative negligence.\(^ {252}\) To obtain summary judgment more readily, payor banks may establish little care as ordinary care so that negligence charges fail to assert a triable issue of fact.\(^ {253}\) For example, payor banks have adopted “bulk processing of checks, which does not include sight review for signature verification”\(^ {254}\) as ordinary care.\(^ {255}\) Under this standard of care, account holders are out of luck in asserting comparative negligence against banks for bypassing forged or fraudulent signatures. Payor banks may adopt a no sight review procedure to avoid check processing costs, since signature verification consumes resources. Fairness demands, however,


\(^{249}\) Commentators offer various economic models to rationalize and propose settlements. See, e.g., David Rosenberg & Steven Shavell, \textit{A Simple Proposal to Halve Litigation Costs}, 91 \textit{Va. L. Rev.} 1721, 1721 (2005) (proposing the awarding of double damages in cases that reach trial).


\(^{252}\) Comparative negligence does not presuppose that all parties involved in an injury share fault. However, a party may not avoid fault by adopting an unacceptable standard of care. Banks should not be allowed to avoid liability by adopting an automation process that cannot detect fraud or alteration.

\(^{253}\) See Overby, \textit{supra} note 112, at 379–80. The banks may adopt a no-sight review procedure provided they are prepared to share a reasonable portion of the loss.

\(^{254}\) Espresso Roma Corp., 124 Cal. Rptr. 2d at 554.

\(^{255}\) Id.
that payor banks pay a fair portion of the loss if its no sight review procedure fails to catch the drawer’s forged signature for which the negligent drawer is partly responsible.

2. Electronic Payments

In vivid contrast to negotiable instruments, the EPL imposes no general negligence liability on cardholders, card bearers, merchants, or card issuers. Regardless of the unauthorized amount charged to the card, the law imposes a minimal penalty on cardholders if they fail to report loss or theft of the card.\textsuperscript{256} The cardholder suffers no damages if the cardholder’s general negligence produces unauthorized charges.\textsuperscript{257} If Congress were to reform the EPL in the image of the NIL, the cardholder would be liable if the cardholder’s failure to exercise ordinary care substantially contributed to fraudulent charges. If the merchant and the card issuer were also negligent in processing and paying fraudulent charges, the loss would be allocated under the comparative negligence analysis.

Furthermore, under the force of general negligence, the cardholder would be liable for charges even on stolen and lost cards. The question would turn on whether the cardholder’s failure to exercise ordinary care substantially contributed to the loss or theft of the card. In its present form, the EPL imposes no duty of care to safeguard credit and debit cards, even though most cardholders panic if their cards are lost or stolen—often under the mistaken notion that they will be liable for all charges made on the lost or stolen cards. Even the more informed cardholders, who know that the law caps the maximum liability for unauthorized charges at $50,\textsuperscript{258} carefully protect their cards and make little delay in reporting any loss or theft of the card. This natural instinct to protect cards and report their loss or theft indicates a firmly rooted dynamic of care in human behavior. A reformed EPL imposing a duty of care in safekeeping cards would be in harmony with natural behavior.

The absence of general negligence liability in the EPL does not mean that negligent losses are nonexistent or rare with respect to credit cards and electronic fund transfers. Lending institutions suffer annual losses due to unauthorized charges on lost and stolen credit cards.\textsuperscript{259} However, the system is

\textsuperscript{256} See infra notes 312, 318 and accompanying text.

\textsuperscript{257} Mark E. Budnitz, Commentary, Technology as the Driver of Payment System Rules: Will Consumers Be Provided Seatbelts and Air Bags?, 83 CHI.-KENT L. REV. 909, 922 (2008).

\textsuperscript{258} 15 U.S.C. § 1643(a) (2006) (stating that liability is capped at $50); id. § 1693g(a) (stating that liability is capped at $50 if the cardholder reports the loss or theft of the card within two business days after consumer learns of the loss or theft).

not designed to determine whether the individual cardholder substantially contributed to loss or theft of the card. The financial institutions aggregate losses and pass them on to cardholders under the guise of interest rates and fees.\footnote{260} At the systemic level, therefore, it would be inaccurate to say that cardholders are not liable for general negligence with respect to electronic payments. Congress has not formally adopted the general negligence principle into the EPL, but the law allows financial institutions to hold cardholders liable as a group for losses. Because no data on negligence is gathered or shared with the public, financial institutions can pass all losses on to cardholders, regardless of whether cardholders’ general negligence substantially contributes to lost or stolen cards.

The allocation of losses resulting from negligence can be person-specific or group-specific. Compare the NIL with the EPL: The NIL is person-specific, as it holds each negligent party to the instrument accountable for the loss, whereas the EPL is group-specific, as it allows lenders to distribute general negligence losses to consumers of credit. Hence, the law may choose between fairness and systemic efficiency in order to distribute losses. Fairness allocates losses on the basis of fault, whereas systemic efficiency bypasses fault and distributes losses to the users of the system.

Under the EPL, the lender’s liability is somewhat analogous to the manufacturer’s strict liability when selling a dangerous product.\footnote{261} The manufacturer pays the injured consumer of the product under strict liability—regardless of the consumer’s fault—and passes on lawsuit and settlement losses to consumers by raising the price of the product.\footnote{262} For the EPL, a similar dynamic is at work. Under strict liability, the lender assumes all risk of loss and theft of cards. The individual cardholder is not liable for general negligence that contributes to loss or theft of the card. By an invisible hand, however, the lender passes negligence losses on to consumers of credit. Under the law of products liability, corrective efficiency compensates the injured consumer without regard

\footnote{260} See, e.g., Jim Hawkins, Renting the Good Life, 49 WM. & MARY L. REV. 2041, 2085 (2008) (noting that merchants bundle the credit card transaction costs into goods and services and pass these costs on to buyers) (citing Levitin, supra note 161, at 3).

\footnote{261} See generally William L. Prosser, The Assault upon the Citadel (Strict Liability to the Consumer), 69 YALE L.J. 1099 (1960). Prosser was one of the original champions of strict liability for defective products.

to fault.\textsuperscript{263} Under the EPL, the principle of corrective efficiency explains why no individual cardholder, even if at fault, is saddled with a monetary penalty. Both laws ignore individual fault and distribute aggregate losses to an entire group of consumers.

\hspace{1cm} \textit{B. Presumed Negligence}

In addition to general negligence, payment systems presume negligence under certain circumstances and hold the negligent person liable for unauthorized payments. Presumed negligence is a species of negligence that needs no proof. It speaks for itself—a manifestation of res ipsa loquitur—as in the famous “case of a collision between two trains upon the same line, and both being the property and under the management of the same Company.”\textsuperscript{264} Presumed negligence is inferred from a set of circumstances. It may also be established as a matter of law.

Economically, presumed negligence adopts the cheapest cost avoider rule that clarifies conduct, guarantees efficiency, and allocates risk of unauthorized payment services to the person best situated to avoid the loss with minimal cost. The cheapest cost avoider rule would require the party that can prevent or minimize loss at the lowest cost overall to undertake the requisite action.\textsuperscript{265} The party that violates the cheapest cost avoider rule is presumed negligent and therefore liable for the loss.\textsuperscript{266} Presumed negligence is therefore a more efficient

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\textsuperscript{263} It appears to me, however, that corrective efficiency is a better description because manufacturers pass on the losses to consumers of the product. Justice rarely recommends the passing of the loss to someone else; efficiency is famed for doing so.


\textsuperscript{265} In preventing environmental pollution, the cheapest cost avoider rule (or principle) would modify the absolute application of “the polluter pays” rule. See DIETER SCHMIDTCHEN ET AL., CTR. FOR THE STUDY OF LAW & ECON., THE INTERNALISATION OF EXTERNAL COSTS IN TRANSPORT: FROM THE POLLUTER PAYS TO THE CHEAPEST COST AVOIDER PRINCIPLE (2007), available at http://www.iru.org/index/cms-filesystem-action?file=PPP/en_CCAP_Study_full.pdf.

\textsuperscript{266} David L. Mengle, \textit{Legal and Regulatory Reform in Electronic Payments: An Evaluation of Payment Finality Rules, in The U.S. Payment System: Efficiency, Risk, and the Role of the Federal Reserve} 145, 155 (David B. Humphrey ed., 1990) (arguing that assigning losses to the cheapest cost avoider result in minimum costs); see also Ada Long-Crooom, \textit{Unauthorized and Forged Indorsements: A Glitch in Revised Article 3 of the Uniform Commercial
and more cost effective rule than general negligence, which imposes transaction costs to establish negligent conduct.

The following discussion demonstrates that the law of negotiable instruments and electronic fund transfers relies on both presumed negligence and the attendant cheapest cost avoider rule to shift loss, under certain prescribed circumstances, from financial institutions to account holders. However, the law of credit cards does not fully recognize presumed negligence, and therefore, it appears to violate the cheapest cost avoider rule.

1. **Negotiable Instruments and Electronic Fund Transfers**

The NIL and EFTA employ presumed negligence in two distinct cases: employee fraud and the account holder’s duty to discover and report unauthorized payments. In each case, the account holder who occupies the cheapest cost position to avoid loss but fails to act bears the loss.

a. **Employee Fraud**

The NIL relies on presumed negligence to shift loss from banks to account holders. Employee fraud is a recurrent source of loss that the NIL may transfer to employers on the basis of presumed negligence. Even a modest business may entrust a special employee—known as a cashier, treasurer, or accountant—to process negotiable instruments. These entrusted employees are authorized to sign outgoing checks drawn on the business account to pay off creditors. Businesses may also authorize these employees to indorse and deposit incoming checks in the business account. The employees entrusted with checks occupy a strategic position to embezzle funds. They may divert incoming and outgoing checks to their personal account. They may issue

*Code, 37 SANTA CLARA L. REV. 349, 349–52 (1997) (explaining how certain loss allocation rules violate the cheapest cost avoider rule).*


268. WHITE & SUMMERS, *supra* note 45, § 16-4, at 78.

269. In all such cases, the employees would forge the signature of the creditor or fraudulently indorse the signature of the employer. The NIL provides a technical solution by creating a legal fiction that all fraudulent or forged indorsements made by an entrusted employee
checks to fictitious creditors and to nonexistent employees while depositing them into their own accounts. Businesses lose billions of dollars due to variant strains of employee fraud.  

If there was no negligence principle, the employer could invoke the authorization principle to assert that banks could not lawfully collect or pay checks with the employee’s fraudulent indorsement. Technically, a check with a forged indorsement is not a properly payable item. Accordingly, the employer should be able to plead conversion of incoming checks wrongfully paid to the fraudulent employee. Similarly, the employer should be able to argue that company checks issued to fictitious creditors or to nonexistent employees lack the employer’s authorization and are not properly payable. Likewise, company checks issued to legitimate creditors should not be properly payable if the fraudulent employee forged the creditors’ indorsements and diverted the funds. These arguments are consistent with the authorization principle and would, under a pure theory of authorization, shift the loss to banks that collect forged checks for, or pay to, the fraudulent employee. The arguments derived from the pure authorization principle, however, fail under presumed negligence. The authorization principle ceases to function as a principle of liability when the account holder engages in presumed negligence. An employer whose trusted employee issues unauthorized drafts or fraudulently indorses incoming drafts has no actionable remedy against banks because the employer was presumably negligent in trusting the untrustworthy employee. An employer cannot hire a crook and then externalize the crook-initiated losses to the market. The employer must be vigilant in hiring employees responsible for processing negotiable instruments and must have procedures in place to supervise the activities of such employees. If entrusted employees commit check fraud, the employer is presumed negligent in hiring and in supervising the employees. Presumed negligence would not allow employers to shift the loss to the market in such cases. The bank does not have to prove that the business was negligent in hiring or supervising the disloyal employee. No such burden is placed on banks. The bank, however, must show that the employer entrust the

are “effective.” U.C.C. §§ 3-404(b)(2), 3-405(b) (2002). This fiction relieves banks from charges of conversion and breach of warranties.

272. Here, “forged check” means both checks with forged indorsements as well as checks with the drawer’s fraudulent signature. There are around 500 million checks forged annually. See National Check Fraud Center, supra note 267. This loss, however, is not all due to employee fraud.
273. U.C.C. § 3-404 cmt. 2 (discussing cases where corporate treasurer or other entrusted officers stole outgoing checks); U.C.C. § 3-405 cmt. 3 (discussing cases where employee entrusted with incoming checks stole them).
274. WHITE & SUMMERS, supra note 45, § 16-4, at 78.
employee to indorse incoming drafts, or that the employer empowered the employee to issue outgoing drafts. 275

The allocation of loss to businesses for employee fraud is fair and efficient. It is fair because employers who hire deceitful employees must accept responsibility for the employees’ acts. It is efficient because employers can improve hiring practices with minimal costs to screen out dishonest employees and can bond employees entrusted with negotiable instruments. For a small premium, employers can also insure against fraud. 276 If the burden of employee fraud is shifted to merchants or banks, stiff criminal laws may have to be enacted to deter fraud. However, no criminal law can reverse the loss of money. The allocation of loss must still be determined. It would be unfair and inefficient to turn the responsibility of employee fraud over to the market or to the banking industry. It would be unfair because merchants and banks would pay for the dubious hiring practices of businesses. It would be inefficient because merchants and banks would spend huge resources in terms of transaction costs to detect and abort payment frauds committed in the privacy of business.

The EFTA includes no provisions addressing employee fraud. Any such provisions are beyond the scope of EFTA because electronic fund transfers, as defined by the EFTA, are confined to natural persons, called consumers. 277 Even natural persons making business electronic payments do not fall under the EFTA, for the law is limited to consumer accounts established primarily for personal, family, or household purposes. 278 Juridical persons, such as corporations, making electronic payments for business purposes are, therefore, excluded from the EFTA. 279

275. U.C.C. §§ 3-404, 3-405(b). The fraudulent indorsement must be made by an employee entrusted with the instrument. U.C.C. § 3-405(b).


278. § 1693a(2).

279. Wire transfers between businesses or financial institutions, regulated under Article 4A of the UCC, seem to function under the principle of presumed negligence, as the following analysis shows. In maintaining the security procedure for the verification of payment orders, banks are required to train its employees in the security procedure. U.C.C. 4A-203 cmt. 3 (1989). The trained employee handling payment orders “test[s]” whether the payment order complies with various steps of the security procedure. Id. If the employee responsible for the payment order breaches the security procedure or does not carefully handle the payment order, “the bank is responsible for the acts of these employees.” Id. Furthermore, the bank is responsible if it did not comply with the customer’s instructions—regarding the authorized account from which funds can be transferred or the list of authorized beneficiaries of payment orders—which the customer has furnished the bank. Id. If the bank, in processing payment orders, fails to comply with security procedures or otherwise violates the customer’s written instructions, the bank will be presumed negligent and be held liable.
Despite the narrow scope of the EFTA, a concept analogous to employee fraud may be read into the EFTA law. The EFTA allows a consumer to authorize another person to make electronic fund transfers in the consumer’s account.\textsuperscript{280} This authorization is evident when the authorized person is furnished with the card, code, or other means of access to the consumer’s account.\textsuperscript{281} This type of authorization, however, is subject to termination.\textsuperscript{282} The consumer must notify the relevant financial institution that electronic fund transfers by such other person are no longer authorized.\textsuperscript{283} If the consumer terminates the authority of such other person to make electronic fund transfers in the consumer’s account but fails to provide the notice of termination to the financial institution, the consumer’s conduct falls under presumed negligence.\textsuperscript{284} The consumer is held responsible for all electronic fund transfers that the person equipped with the card or the code has made after the termination of authorization.\textsuperscript{285}

\textit{b. Duty to Discover and Report}

Presumed negligence imposes a duty on account holders to discover and report alterations and forged checks to the payor bank within a prescribed period after receiving the periodic account statement.\textsuperscript{286} Negligence is presumed if the account holder fails to discover and report unauthorized payments and, consequently, the account holder is held responsible for the loss.\textsuperscript{287} The bank is saddled with no burden to prove the account holder’s negligence in not discovering and reporting alterations and forgeries. The mere failure to report reasonably discoverable unauthorized payments within the prescribed period shifts the loss to the account holder, provided the payor bank itself has not been negligent.\textsuperscript{288} Thus, presumed negligence overrides the authorization principle,

\begin{itemize}
\item \textsuperscript{280} § 1693a(11).
\item \textsuperscript{281} § 1693a(11)(A).
\item \textsuperscript{282} Id.
\item \textsuperscript{283} Id.
\item \textsuperscript{284} Id. The consumer’s failure to notify the financial institution may be viewed as presumed negligence.
\item \textsuperscript{285} Id. § 1693g(a).
\item \textsuperscript{286} U.C.C. § 4-406(e) (2002). This section requires that the account holder exercise reasonable promptness in examining the statement. A period of thirty days has been fixed for reporting unauthorized payments made by the same wrongdoer. U.C.C. § 4-406(d)(2).
\item \textsuperscript{287} The duty to discover unauthorized payments is not absolute, but is based on reasonableness. If unauthorized payments cannot be reasonably discovered, the account holder breaches no duty. U.C.C. § 4-406(c). What constitutes reasonable discovery is a question of fact and is decided on a case-by-case basis. U.C.C. § 4-406 cmt. 1.
\item \textsuperscript{288} Again, the NIL adopts comparative negligence. See supra text accompanying notes 241–45. However, the account holder must prove the bank’s negligence, that is, the breach of
\end{itemize}
precluding the account holder’s argument that alterations and forgeries constitute unauthorized payments.

Similar to the NIL, the EFTA imposes a duty to discover and report unauthorized transfers to the relevant financial institution.\textsuperscript{289} The EFTA gives the consumer a prescribed period to examine the periodic account statement and to report unauthorized transfers or account errors.\textsuperscript{290} If the consumer fails to report, the consumer is liable for the losses that the financial institution would not have otherwise suffered.\textsuperscript{291} Deviating from the NIL, however, the EFTA places the burden on the financial institution to show that the disputed transfers were unauthorized.\textsuperscript{292} Most important, the consumer liability for not reporting unauthorized transfers could exceed the $500 limit set for not reporting the loss or theft of a card.\textsuperscript{293} Though the law is unclear,\textsuperscript{294} the consumer’s liability under EFTA appears to be similar to that of the account holder’s unlimited liability under the NIL.\textsuperscript{295}

No theoretical basis exists for imposing unlimited liability on account holders under the NIL but only fixed liability on account holders under the EFTA. In each case, the account holder has failed to discover and report unauthorized payments apparent on the periodic account statement. In each case, presumed negligence is similar. In each case, it might be the same person operating the same account, using exclusively paper payments for one billing ordinary care as practiced by banks in the relevant locality. See U.C.C. §§ 3-103, 4-406(e) (explaining that the definition of ordinary care is local).


\textsuperscript{290} § 1693f(a). The consumer must report errors within sixty days after the financial institution has transmitted the statement. Id.

\textsuperscript{291} Id.

\textsuperscript{292} Id. § 1693g(b).

\textsuperscript{293} Id. Under 15 U.S.C. § 1693f, if the consumer fails to report unauthorized transfers within sixty days, the liability could be unlimited, at least up to the amount of the account. See Gail Hillebrand, Before the Grand Rethinking: Five Things to Do with Payments Law and Ten Principles to Guide New Payment Products and New Payments Law, 83 CHIL.-KENT L. REV. 769, 776 (2008).

\textsuperscript{294} There seems to be some incompatibility between § 1693f and § 1693g because the former section places a maximum liability of $500, whereas the latter seems to place an unlimited liability. A pro-consumer court, however, may interpret § 1693g to override § 1693f, though no case has raised or resolved the incompatibility. One court came close to upholding § 1693g, but the court failed to take into account § 1693f. See Heritage Bank v. Lovett, 613 N.W.2d 652, 654 (Iowa 2000) ("[T]he loss was increased as a result of a delay by the depositor in reporting either a stolen ATM card or an unauthorized entry on a statement that the bank has sent to the depositor. Even in such instances, however, the bank may not debit the depositor’s account for more than $500.” (emphasis added)).

\textsuperscript{295} See Peters v. Riggs Nat’l Bank N.A., 942 A.2d 1163, 1172 n.9 (D.C. 2008) (comparing EFTA liability with liability for using checks). The analysis in Peters is inadequate because the court did not discuss the possible conflict between § 1683f and § 1693g.
period and exclusively electronic fund transfers for the next. But the person's liability for presumed negligence would vary from one billing period to the next. This differential outcome seems iniquitous and arbitrary.

Despite having no theoretical justification, a practical argument may shore up uneven loss allocation under the two payment systems. Since both consumers and businesses make payments under the NIL, the amount of money transferred by means of drafts can be large.296 A single business draft can transfer millions of dollars. By contrast, electronic transfers in consumer accounts are relatively small in amount.297 Many consumer accounts may not even transfer $500 in a single billing period. The banking system can absorb losses beyond the deductible $500 cap in consumer accounts. But a parallel $500 cap under the NIL—where millions of dollars are transferred in business accounts each day—would drain huge resources from the banking industry.

If consumer protection is a desirable goal, as it assuredly is, negotiable instruments can be harmonized with electronic payments by creating a liability cap of $500 per periodic statement for consumer accounts maintained for personal, family, or household purposes—regardless of whether funds are transferred electronically or by means of paper devices. This cap for presumed negligence would be unavailable for business accounts. In addition to the liability cap, the duty to discover and report unauthorized payments could also be harmonized by providing similar standards of discovery, a prescribed period for such discovery, and the same burden of proof.

Suppose, on the other hand, the law, policy, or market aims at substituting paper fund transfers with electronic fund transfers. The existing incentives tilting in favor of electronic transfer would eventually convince rational consumers that they should transfer funds electronically. Electronic transfers confer the benefits of limited liability for presumed negligence, shift the burden of proof to financial institutions, and arguably bypass the unlimited liability under the NIL. Regardless of these advantages, not all consumers have the transfer skills and the electronic access needed to complete electronic transfers.298 In its present form, therefore, the law of electronic fund transfers favors computer savvy consumers who also know the comparative benefits of payment systems and therefore elect electronic fund transfers over paper fund transfers to minimize liability.

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298. See Barr, supra note 17, at 123.
2. Credit Cards

Presumed negligence has an anemic presence in the law of credit cards. Presumed negligence offers guidance when a cardholder authorizes another person to charge the card, but the person exceeds the use limit that the cardholder has fixed.299 The law holds the cardholder responsible for all charges that a person makes with the cardholder’s actual, implied, or apparent authority.300 As discussed in Part II.C, few courts discharge the liability of a cardholder who voluntarily delivers the card to a nominated person but places a limit on the person’s use.301 Merchants and financial institutions cannot be encumbered with the burden of supervising nominated card bearers for use limits. The cardholder breaches the care principle when the cardholder delivers the card to an untrustworthy person who does not observe use limits that the cardholder has established. Therefore, regardless of both use limits and the authorization principle, presumed negligence provides a legally defensible basis to allocate losses to the cardholder for charges that the nominated card bearer has made.

Unlike electronic fund transfers, credit cards are not confined to natural persons for personal, family, or household purposes. Organizations and businesses can also be cardholders. Credit cards are more like negotiable instruments that can be used for both consumer and business purposes. Despite this similarity with negotiable instruments, the law of credit cards carries no provisions for employee fraud. Under the NIL, as discussed above, the employer takes the loss if the entrusted employee obtains payments by making forged or fraudulent indorsements on instruments.302 The law of credit cards does impose liability on the employer for charges made by an employee who has actual, implied, or apparent authority to use the card.303 This source of liability, however, flows from the authorization principle and not from presumed negligence.

One could argue that the vast agency doctrine of actual, implied, and apparent authority functions similar to the doctrine of presumed negligence.304

299. The use limit is distinguishable from the credit limit. Credit limit on a card is set by the issuer whereas use limit is set by the cardholder. Card issuers have mechanisms in place to monitor that the cardholder does not exceed the credit limit so that a charge over the credit limit will not be approved.
301. See supra text accompanying notes 209–11.
302. See supra Part III.B.1.a.
Even if the employer has granted no actual authority to an employee to use the company card, the employer is nonetheless liable for credit card charges that the employee may make under the umbrella of apparent authority. Unlike actual and implied authority, “apparent authority exists entirely apart from the principal’s manifestations of consent to the agent.” When the employer voluntarily delivers the card to the employee for making certain charges, merchants may believe that the employee has the apparent authority to charge the card for additional purchases as well. The company cannot be allowed to externalize its employee-caused losses to merchants or to financial institutions.

This outcome, though perfectly defensible under the agency precept of apparent authority, can be articulated with equal force under the principle of presumed negligence by arguing that the delivery of a company card to a dishonest employee is a breach of ordinary care. Therefore, the employer must suffer credit card losses that its dishonest employee causes without actual or implied authority. Policy also dictates that it would be more efficient for employers to screen which employees can be trusted with company cards than for the market to second-guess whether the employee holding the company card lacks the authority to use the card at all or lacks the authority to use it beyond a certain limit. The market cannot micromanage the uses of company cards by the company’s employees. To minimize losses, employers can obtain insurance to guard against disloyal employees who would misuse company credit cards.

The law of credit cards imposes no duty on cardholders to discover and report unauthorized charges. The law does furnish a method to report billing errors within a prescribed period after the cardholder receives the periodic account statement. If the billing error occurred as asserted, the card issuer removes the disputed amount and related charges from the cardholder’s account. By implication, the cardholder is responsible for billing errors if the cardholder fails to provide to the card issuer a written notice of such errors within the prescribed period. If unauthorized charges were to be included in the definition of billing errors, the law of credit cards would be similar to that of negotiable instruments. Just as account holders are precluded from contesting alterations and forged checks after the expiration of the prescribed period, the credit cardholders should be under a similar obligation of presumed negligence.

308. WHITE & SUMMERS, supra note 45, § 16-4, at 78.
309. See supra text accompanying note 276.
312. § 1666(a).
313. U.C.C. § 4-406(d) (2002).
However, the question remains whether unauthorized charges shown on the periodic statement of a credit card account constitute billing errors and are therefore subject to the duty of discovery and reporting.\textsuperscript{314} No explicit text in any statute or federal regulation so provides. The courts differ. One federal court of appeals relied on the duty to discover and report under the NIL\textsuperscript{315} to hold, on the basis of analogy, that "[a] cardholder’s failure to examine credit card statements that would reveal fraudulent use of the card constitutes a negligent omission that creates apparent authority for charges that would otherwise be considered unauthorized under the [law of credit card]."\textsuperscript{316} Another federal court of appeals held that "there is no need for a court to look to [the NIL] to resolve the risk allocation and public policy issues regarding credit card fraud."\textsuperscript{317} The credit cardholder is under no duty to discover and report unauthorized charges under the rules of billing errors. The cardholder’s failure to examine periodic statements results in the loss of the opportunity to correct billing errors, "not that [the cardholder] forfeits protections against liability for unauthorized use."\textsuperscript{318} However, when a cardholder continues to make repeated payments in full for fraudulent charges made by the same employee, the cardholder leads the card issuer to believe that the employee has the authority to use the card.\textsuperscript{319}

If the doctrine of presumed negligence is applied to the law of credit cards, the duty to discover and to report is a more straightforward legal basis to allocate loss to the cardholder for unauthorized payments. This approach embraces a uniform standard of presumed negligence for all payment systems. Moreover, it makes economic sense in that the cardholder incurs minimal costs in discovering unauthorized payments in periodic account statements and reporting them to the issuer. Lawmakers should declare that an unauthorized charge on a credit card is a billing error that must be reported to the creditor—the card issuer—within the prescribed period. Accordingly, the failure to report will result in allocating the loss to the cardholder. For purposes of consumer protection, the loss may be capped at a fixed amount, such as $500, thus equalizing the law of credit cards with that of electronic fund transfers.

\textsuperscript{315} U.C.C. § 4-406(c).
\textsuperscript{316} Minskoff v. Am. Express Travel Related Servs. Co., 98 F.3d 703, 709–10 (2d Cir. 1996).
\textsuperscript{318} Id. at 893.
\textsuperscript{319} Id.
IV. WRONGFUL DISHONOR PRINCIPLE

The principle of wrongful dishonor is the third principle of liability. Whereas the authorization and negligence principles apply to all parties to payment orders, the principle of wrongful dishonor applies exclusively to financial institutions that decline payment orders.\(^{320}\) Wrongful dishonor is tied to the authorization principle. When a bank does not pay a properly payable payment order, the wrongful dishonor repudiates the customer’s authorization. Wrongful dishonor may also be derived from the torts of negligence and defamation in that a wrongful dishonor, frequently originating from the bank’s negligence, defames the customer.\(^{321}\) Regardless of the theoretical justification of the wrongful dishonor principle, a financial institution that wrongfully turns down an authorized payment order must pay damages to the aggrieved party.\(^{322}\) This is the essence of the wrongful dishonor principle.

Distinguish, however, between lawful and wrongful dishonor. A financial institution may lawfully turn down a payment order for a variety of reasons, including where there is insufficiency of funds in the relevant account;\(^{323}\) the payment order appears to have been altered or forged;\(^{324}\) the payee fails to provide proper identification;\(^{325}\) the account holder has placed a stop payment order subsequent to the authorization of payment;\(^{326}\) or the financial institution is placed under bankruptcy.\(^{327}\) The financial institution suffers no damages for any lawful dishonor of payment orders. Wrongful dishonor occurs when a payment order is properly payable, but the financial institution refuses to make the payment.\(^{328}\) Wrongful dishonor imposes liability on the financial institution.

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\(^{320}\) See, e.g., 15 U.S.C. § 1693h (2006) (placing the liability on financial institutions); U.C.C. § 4-402 (placing the liability on payor bank).


\(^{322}\) The wrongful dishonor remedy is available only to customers and not to payees or holders. Before the enactment of the NIL, courts were divided over the wrongful dishonor liability owed to holders. See Michael D. Sabbath, Drawee Bank’s Liability for Wrongful Dishonor: A Proposed Checkholder Cause of Action, 58 ST. JOHN’S L. REV. 318, 328–29 (1984) (citing Cox v. National Bank, 100 U.S. 704, 712 (1879); Swope v. Ross, 40 Pa. 186, 188 (1881); B. CLARK & A. SQUILLANTE, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS 28 (1970) (proposing that the wrongful dishonor remedy be available to payees/holders).

\(^{323}\) U.C.C. § 4-402(c), § 4-402 cmt. 4.

\(^{324}\) U.C.C. § 4-401 cmt. 1.

\(^{325}\) Banks may adopt this policy for over-the-counter payments of orders papers, that is, checks issued to payees named on the check. See, e.g., Messing v. Bank of Am., N.A., 821 A.2d 22, 26 (Md. 2003) (discussing that the bank asked for identification).

\(^{326}\) U.C.C. § 4-403(a).

\(^{327}\) U.C.C. § 4-216.

\(^{328}\) U.C.C. § 4-402(a).
The following discussion contrasts the application of the wrongful dishonor principle to negotiable instruments, electronic fund transfers, and credit card transactions.

A. Negotiable Instruments and Electronic Fund Transfers

Both the NIL and the EFTA explicitly recognize the wrongful dishonor principle. However, the rules of the two systems are not the same. The variation in rules, as discussed below, is to a large extent unwarranted. The variation presupposes certain market conditions that may no longer be relevant. Part of the variation comes from the fact that negotiable instruments are paper devices, whereas electronic fund transfers are electronic orders. The medium of a payment order, whether paper or electronic, imposes its own logistical concerns in that paper-based checks may be displaced and computers may fail to process electronic orders. Yet the liability for wrongful dishonor need not vary according to the medium containing the payment order.

Regardless of the choice of medium, an account holder’s authorized payment order must not be rejected for wrongful reasons. This point, however, is delicate and needs explanation. As a general rule, a payor bank is under no obligation to honor every payment order. No unqualified obligation to honor payment orders is placed on the payor bank since the bank may have valid reasons to dishonor payments. Yet the obligation comes into existence when a properly payable payment order is presented to the payor bank. The key trigger is the “properly payable” part of the payment order. The account holder’s unassailable authorization is the first requirement of a properly payable payment order. Furthermore, the order is free of faults, such as alteration and forgery, and the account holder has sufficient credit with the bank to make the payment. When all these conditions coalesce, a properly payable payment order cannot be lawfully dishonored. If the transaction is authorized, the payor bank is liable for wrongful dishonor. To this extent, the NIL and the EFTA

330. § 1693(h)(a); U.C.C. § 4-402. UCC Article 4A, however, does not seem to recognize the concept of wrongful dishonor. It is conceivable though, that under specific circumstances—where the customer suffers losses due to wrongful dishonor of a payment order made under UCC section 4A-202—the customer may be entitled to damages. I have not been able to find a case where a court has awarded damages for the wrongful dishonor of a payment order under UCC Article 4A.
331. See supra text accompanying notes 323–27.
332. A stop payment order takes away the account holder’s authorization, and the payment order is no longer properly payable. See U.C.C. § 4-403.
333. Sufficient credit includes any draft facility that the account holder has contracted with the payor bank.
334. § 1693(h)(a); U.C.C. § 4-402.
are in agreement. However, they carry different rules for providing damages to the aggrieved party.

The NIL and the EFTA both require that damages be proximately caused by the wrongful dishonor of a payment order.\textsuperscript{335} Proximate causation is a natural and continuous sequence of events under which a prior event produces a subsequent event, and the subsequent event would not have occurred but for the prior event.\textsuperscript{336} The sequence is continuous when no other independent cause intervenes to direct or affect the chain of causation.\textsuperscript{337} An account holder who suffers arrest or prosecution for the wrongful dishonor of a payment order may show proximate causation between the events. Proximate causation in each case of wrongful dishonor is a question of fact.\textsuperscript{338} For example, it was a question of fact for the jury to determine whether the wrongful dishonor of numerous checks of a motor dealership proximately caused, as claimed, negative business effects to the extent that the employee morale dropped, good salespeople quit, parts suppliers called for cash payments on delivery, and lenders raised interest rates—all of these effects compounding the dealership's financial woes.\textsuperscript{339}

The measure of damages for wrongful dishonor, however, varies under the two payment systems. The NIL requires the account holder to prove actual damages;\textsuperscript{340} therefore, damages per se are unavailable. The proof requirement has rejected the common law action for "slander of credit"—under which traders could recover substantial damages for wrongful dishonor without showing any actual harm.\textsuperscript{341} Now all account holders, consumers and businesses alike, must prove actual injury to demand monetary compensation.\textsuperscript{342} Compared to the NIL, the EFTA is textually generous as it allows for all damages proximately caused by the wrongful dishonor and does not demand that damages be actual or proved.\textsuperscript{343} The EFTA's textual generosity, however, is

\textsuperscript{335} 15 U.S.C. § 1693h; U.C.C. § 4-402(b).
\textsuperscript{337} Id.
\textsuperscript{338} U.C.C. § 4-402 cmt. 3. The determination of proximate causation is left to the jury given the unique nature of inquiry in each case. Derdiarian v. Felix Contracting Corp., 414 N.E.2d 666, 668 (N.Y. 1980).
\textsuperscript{340} U.C.C. § 4-402(b).
\textsuperscript{342} See Wasp Oil, Inc. v. Ark. Oil & Gas, Inc., 658 S.W.2d 397, 402 (Ark. 1983) (holding that speculative and conjectural damages may not be allowed but "recovery will not be denied merely because the damages cannot be determined with exactness" (citations omitted)). Mental suffering can be compensated under the NIL, however, mental injury must be proved.
elusive. Because the EFTA is not common law, it cannot be presumed to offer damages per se.\textsuperscript{344} For all damages, the EFTA requires proximate causation between the wrongful dishonor and the injury.\textsuperscript{345} Damages per se, by definition, have nothing to do with proximate causation.\textsuperscript{346} Damages are simply presumed. However, the EFTA text refrains from demanding that the actual damages be proved.\textsuperscript{347} This omission does not mean that the EFTA allows damages per se. Consistency demands that, under both payment systems, the plaintiff prove proximately caused damages to obtain compensatory relief.\textsuperscript{348}

The EFTA provides specified exceptions under which the wrongful dishonor is not compensated. Some of these exceptions are similar to the ones available under the NIL.\textsuperscript{349} Others are not. Under the EFTA, for example, a bank is not liable for damages if an act of God or a technical malfunction causes the wrongful dishonor.\textsuperscript{350} Given that bank processes are automated for checks as well as for electronic transfers, the technical malfunction defense\textsuperscript{351} should be available for all payment orders. Likewise, an act of God defense for the wrongful dishonor should be available to financial institutions whether the

\begin{itemize}
\item \textsuperscript{344} Because damages per se were available to merchants and traders, the EFTA cannot offer such damages. See U.C.C. § 4-402 cmt. 1 (stating that the trader rule has been abolished). Note that the EFTA is confined to consumer transfers and does not apply to business transfers that are regulated under UCC Article 4A.
\item \textsuperscript{345} § 1693h(a).
\item \textsuperscript{346} See, e.g., Maietta Constr., Inc. v. Wainwright, 847 A.2d 1169, 1174 (Me. 2004) (discussing that damages per se are not the same as actual damages).
\item \textsuperscript{347} § 1693h(a).
\item \textsuperscript{348} The NIL allows punitive damages when wrongful dishonor is malicious and willful. See Twin City Bank v. Isaacs, 672 S.W.2d 651, 653–54 (Ark. 1984). Likewise, punitive damages should be awarded under the EFTA if electronic fund transfers were dishonored out of oppression, malice, or any similar motive. The purpose of punitive damages is to warn financial institutions that proper payment orders must not be dishonored out of spite against the account holder. Interpersonal vindictiveness should have no place under any payment system, whether it is cash-based or credit-based, or whether payments orders are processed through a tangible or an intangible medium. See generally Anthony J. Sebok, \textit{Punitive Damages: From Myth to Theory}, 92 IOWA L. REV. 957, 1009 (2007) (arguing that one purpose of punitive damages is to deter insulting and humiliating behavior).
\item \textsuperscript{349} Insufficiency of funds, payment orders exceeding an established credit limit (overdraft), judicial encumbrances, or administrative encumbrances on the account are valid bases to dishonor payment orders. See § 1693h(a) (stating that transfers are subject to legal processes and other encumbrances); U.C.C. § 4-303(a) (stating that payments are subject to legal process, setoff, and stop payment orders).
\item \textsuperscript{350} § 1693h(b)(1)-(2). These defenses presuppose that the bank’s conduct and automated processes are in line with the ordinary care practiced in the banking industry. See § 1693h(c) (removing the bona fide error defense when “the maintenance of procedures reasonably adopted to avoid such error” were not present).
\item \textsuperscript{351} § 1693h(b)(2) (providing a defense when the “failure to act resulted from a technical malfunction which was known to the customer”). This defense may be denied to a bank that has failed to maintain an automation system compliant with the industry standards.
\end{itemize}
payment order is initiated electronically or by means of paper. Such systemization of defenses will yield a more rational, efficient, and just law of wrongful dishonor.

B. Credit Cards

In 1971, the Supreme Court of South Carolina declared that it knew of “no case dealing with the wrongful dishonor of a credit card . . . . Nor has any case been cited or come to our attention which deals with the respective rights, duties and liabilities of the parties.”352 The court, however, “refrain[ed] from deciding [this] question of novel impression.”353 In 1984, a federal court expressed sympathy toward a cardholder whose credit card, upon the issuer’s instruction, was confiscated and destroyed when the cardholder tried to pay for a wedding anniversary dinner.354 However the federal court did not embrace the concept of wrongful dishonor.355 The federal law of credit cards that Congress legislated during the period between these two cases is silent on the wrongful dishonor of credit cards. As of the writing of this Article, no state or federal case raises or resolves the question of wrongful dishonor of credit cards.

As noted previously, not every dishonor of a payment order is wrongful.356 A card issuer may dishonor a payment order when the cardholder has exceeded an established credit limit, the order appears to be unauthorized, the electronic terminal has insufficient cash to complete the transaction, or the cardholder has defaulted in paying previous charges.357 Likewise, the dishonor of credit card orders is excusable if an act of God or a technical malfunction prevents the completion of the order.358 To avoid wrongful dishonor liability, however, card issuers must maintain a customary technical infrastructure and take necessary preventive measures against the foreseeable forces of nature.

A card issuer wrongfully dishonors a credit card charge when the charge is properly payable. A properly payable charge means that the cardholder or the authorized card bearer has used the card for a lawful purpose to order payment within the credit limit set for the card.359 The wrongful dishonor may be charge-

353. Id.
354. Gray v. Am. Express Co., 743 F.2d 10, 13 (D.C. Cir. 1984). The plaintiff in this case was a lawyer determined to seek a remedy against wrongful dishonor. The court praised the plaintiff for his tenacity “beyond the professional custom” to resist the abusive and lengthy discovery process of a resourceful card issuer. Id. at 20.
355. Id.
356. See supra text accompanying notes 349–51.
358. § 1693h(b).
specific or card-specific. When a properly payable charge is dishonored without cancellation of the card, the wrongful dishonor is charge-specific. When the issuer cancels the card depriving the cardholder of the credit facility, the wrongful dishonor is card-specific. The card-specific wrongful dishonor may create serious consequential injury to the cardholder, as it completely precludes the cardholder from using the contractual credit. In some cases, the charge-specific wrongful dishonor may result in serious monetary, mental, and reputational injury.

It is unclear why the law of credit cards excludes the concept of wrongful dishonor. One argument in support of exclusion draws from the distinction between what could be termed "my money" and "[their] money." 360 The money in an account holder's checking account is my money, whereas the credit in a cardholder's account is their money, that is, the lender's money. 361 Therefore, when a bank dishonors a payment order drawn on my money, the bank is liable for wrongful dishonor. However, no action is allowed when the lender refuses to comply with a payment order out of their money. 362 Since a credit card draws on their money and not my money, the argument goes, the law of credit cards rightfully excludes the wrongful dishonor principle. 363

The distinction between my money and their money is deceptive. It misconceives the relationship between the account holder and the bank. Money kept in safe deposits in banks must not be confused with money deposited with banks in checking or other accounts. 364 Safe deposits offer a storage facility for keeping valuables, including jewelry and cash. The bank acts as the bailee that

361. Id.
362. See id.
363. During the last several years, some students in my payment systems classes have made this argument to defend the absence of the wrongful dishonor principle in the law of credit cards.
364. See FREDRICK POLLOCK & FREDRIC WILLIAM MAITLAND, THE HISTORY OF ENGLISH LAW 151 (1898) (demonstrating that "money has no ear-mark"). In the 18th century in the United States, a legal confusion persisted regarding bank liability for deposits of specie. Khan, supra note 2, at 412 n.92. The depositors viewed the bank as a warehouse for keeping gold and silver coins and wanted to draw out the same coins they had deposited. Id. Notably, Alexander Hamilton, the Secretary of Treasury, believed that the specie deposited in a bank was the customer's earmarked property. Id. Banks resisted this view of liability, which is anchored in the law of bailment. They preferred the legal doctrine under which depositors were the bank's creditors. This view, which ultimately prevailed, changed the notion of money as earmarked property. Id. In Thompson v. Riggs, 72 U.S. 663 (1866), the United States Supreme Court upheld the view that, when customers deposit money in the bank, "the title to the money passes to the bank and the latter becomes the debtor of the [customer] to that amount." Id. at 680. This footnote is adapted from a footnote in another article that I authored. Ali Khan, The Evolution of Money: A Story of Constitutional Nullification, 67 U. CIN. L. REV. 393, 412 n.92 (1999).
must return the specified items.\textsuperscript{365} However, when the account holder deposits funds in a checking or savings account, the account holder is entitled to an amount equal to the amount deposited. With respect to accounts, the bank is not a bailee but a debtor.\textsuperscript{366} The account holder is the creditor. When a bank extends a line of credit to an account holder, whether in the form of an overdraft facility in a checking account or revolving credit in a credit card account, the bank obligates itself to comply with the account holder’s authorized payment orders. Thus, no meaningful distinction separates an overdraft account from a credit account. In both cases, the bank lends money to the account holder and may have undertaken a contractual obligation to pay authorized orders.\textsuperscript{367}

Even if the bank offers no overdraft facility, the distinction between a checking account and a credit card account is inconsequential for purposes of wrongful dishonor. By extending a contract-based line of credit, the card issuer creates market expectations that the issuer will pay the cardholder’s authorized charges. The cardholder uses the card in contractual reliance that the authorized charges will not be dishonored. The cardholder’s lawful uses of the credit card, therefore, cannot be arbitrarily dismissed without notice or good reason. If the credit card charge is properly payable, no good reason distinguishes the account holder’s reliance on a checking account from the cardholder’s reliance on a credit card account to pay for goods and services.

Consistent with the NIL and the EFTA, the law of credit cards may require that the plaintiff’s injury be proximately caused by the wrongful dishonor of a credit card charge or a card cancellation. The cardholder may yet be saddled with the burden of proof for actual damages. Still, damages per se for the wrongful cancellation of the credit card may not be granted. Though the proof requirement places a formidable burden on cardholders, many of whom have modest means of income and cannot afford to litigate against resourceful banks, consistency requires that the cardholder shoulder the burden of proof of actual damages.\textsuperscript{368} Consumer protection laws, however, may exempt consumers from the burden of proof requirement and shift the burden to card issuers. This shifting of the burden of proof would require banks to establish that the wrongful dishonor was not the proximate cause of the cardholder’s injury. Businesses, on the other hand, need not be exempted from the burden of proof. This bifurcation in the placement of the burden of proof is consistent with the notion of fairness and the meaningful realization of consumer rights.

\textsuperscript{366} Thompson, 72 U.S. at 680.
\textsuperscript{367} See, e.g., Bank of Am. v. Jarczyk, 268 B.R. 17, 22 (W.D.N.Y. 2001) (finding a unilateral contract where the issuing bank’s performance of the contract is reimbursement to the merchant).
\textsuperscript{368} This proposal is consistent with 15 U.S.C. § 1693h(a) and UCC section 4-402.
V. PRINCIPLED FRAMEWORK

This Part interweaves the application of the three principles discussed above into a coherent whole. In doing so, it offers a principled framework that lawmakers, judges, and other legal professionals may consult in legislating payment rules, deciding payment disputes, and determining the future evolution of payment services. In addition to reforming payment laws in the United States, the proposed framework offers a universal model that other jurisdictions may also use to regularize national payment systems. Markedly, an international payment system can be realized in light of the framework discussed below.

A. Account Orders

Regardless of the type of payment system, an account order is central to payment transactions. An account order instructs a financial institution to debit or to credit a specified amount in a designated account. An account order is either a credit order or a debit order. An account order is a credit order when the order adds credit to the account; it is a debit order when the order subtracts credit from the account. The designated account may be a conventional credit account, such as a checking account or a credit card account. It could be an ad hoc account, such as a letter of credit account, opened for making a limited number of debit orders. An ad hoc account is almost always terminated on a definite expiration date. By contrast, the conventional account is a revolving account—undergoing credit and debit transactions—which the account holder continues to use for an indefinite period. An account, conventional or ad hoc, must have sufficient credit at the time the bank receives a debit order. However, a credit order that adds available funds to the account may undergo fewer restrictions.

Generally, a debit order involves three parties. The account holder that initiates the debit order is the first party, the payee is the second, and the payor bank the third. More parties may be involved if an intermediary financial

369. The account order may pay periodic bills, receive cash from a checking or savings account, or transfer funds to another person or account.
371. Depositing a paycheck in a checking account, for example, is a credit order.
372. Withdrawing cash from a checking account, for example, is a debit order.
373. A certificate of deposit comes under the definition of an ad hoc account.
374. The payments made to the credit card account replenish the credit for future use whereas payments made to the checking account replenish the credit for future withdrawals or payments.
375. See Effros, supra note 370.
institution—such as the depository bank in the case of checks, or the merchant’s bank in the case of credit card charges—processes the debit order.\textsuperscript{376} When an account holder withdraws funds, the debit order involves only two parties: the account holder and the payor bank. In most cases, a credit order may involve only the account holder and the bank. The person adding credit to the account may be a third party, such as the account holder’s employer, who may electronically transfer funds to the account holder’s account. In all cases, an account order, whether debit or credit, involves the bank where the account holder maintains the designated account.\textsuperscript{377}

Theoretically, account orders are medium-neutral. An account holder may initiate an account order with a paper instrument, such as a check or a deposit slip. An account holder may also initiate and process the order electronically or by any other method. The methods of receiving credit and debit account orders must be left to the market that constantly searches for accuracy, speed, and efficiency. A technologically advanced jurisdiction, in which account holders use the Internet, may allow electronic fund transfers. Another jurisdiction may prefer a tangible medium, such as paper, for processing account orders. Some account holders may prefer one medium over the other. Convenience and market conditions demand that account holders be given multiple methods of initiating account orders. To some extent, however, the automation for processing account orders is inevitable regardless of the medium by which the account holder initiates the order.\textsuperscript{378}

The market may provide incentives—or disincentives—to discriminate against certain types of payment services. For example, the market may impose a surcharge for the use of credit cards, consequently making credit card transactions expensive.\textsuperscript{379} Some merchants may not accept checks. The market may embrace electronic transfers as the preferred method of payment. Ideally,
the law should not intervene to subvert or inhibit competition between diverse payment services and should let the market sort out the competition in a fair and open manner. However, the law must intervene to curb abuses and predatory practices associated with payment services.\textsuperscript{380}

B. Authorization Principle

Account orders are subject to the authorization principle. Debit orders must specifically comply with the authorization principle.\textsuperscript{381} As a general principle, an unauthorized debit order is not properly payable.\textsuperscript{382} Authorization implies that the debit order is not forged or altered.\textsuperscript{385} If the debit order is altered, the account holder is liable for the original amount.\textsuperscript{384} In the absence of negligence, the account holder is not liable for forged or fraudulent debit orders.\textsuperscript{385} An account holder may authorize an agent, employee, or any other representative to initiate debit orders.\textsuperscript{386} Such orders are binding on the account holder.\textsuperscript{387} Accordingly, an account holder company is liable for debit orders that an authorized employee charges to the account. An account holder may at any time ratify an otherwise unauthorized account order.\textsuperscript{388}

A debit order may be authorized by any means, including signature, code, personal identification number, or any other method acceptable to the bank. Signature, as a classical method of authorization, presupposes a tangible medium to convey the account order, though the invention of the digital signature has freed the concept from the tangible medium.\textsuperscript{389} Since account orders are not tied to the tangible medium, they may be initiated in any acceptable medium. Technology may offer new methods of initiating and

\textsuperscript{380} Christopher L. Peterson, Federalism and Predatory Lending: Unmasking the Deregulatory Agenda, 78 TEMP. L. REV. 1, 5 (2005) (noting that all levels of government activated controls when predatory lending practices create a major crisis, such as subprime lending in home mortgaging).

\textsuperscript{381} Credit orders may require authorization to prevent criminal liability. See 15 U.S.C. § 1644(a) (2006) (providing penalties for fraudulent use of credit cards, including lost or stolen cards). For example, a charity may need to know the identity of the depositor to avoid criminal sanctions under the national security laws. In most cases, however, depositing funds in an account does not require preauthorization of the account holder.

\textsuperscript{382} U.C.C. § 3-403(a).

\textsuperscript{383} See U.C.C. § 1-201(b)(41) (1989).

\textsuperscript{384} U.C.C. § 3-407(c) (2002).

\textsuperscript{385} U.C.C. § 3-403(a).

\textsuperscript{386} See U.C.C. § 3-402(a).

\textsuperscript{387} Id.

\textsuperscript{388} U.C.C. § 3-403(a).

\textsuperscript{389} Kalama M. Lui-Kwan, Recent Developments in Digital Signature Legislation and Electronic Commerce, 14 BERKELEY TECH. L.J. 463, 464 (1999) (noting that a digital signature suffices to verify the identity of the cardholder).
verifying the account holder’s authorization. Financial institutions are unlikely to accept a risk-prone or inefficient method of authorization. More specifically, account holders will not accept a cumbersome or time-consuming method of authorization. The law may need to continuously evaluate new methods of authorization to find one that the market prefers, while also offering appropriate regulation in order to streamline market expectations.

The authorization principle allocates losses to financial institutions by making them liable for unauthorized orders. Financial institutions are liable for paying fraudulent and forged checks, unauthorized electronic fund transfers, and credit card charges debited to stolen and lost credit cards. Banks may insure these losses. They may also transfer some of these losses to account holders by way of fees that financial institutions charge for processing debit orders, maintaining accounts, making late payments, and charging higher interests on loans. While financial institutions distribute losses caused by the authorization principle to account holders through indirect means, no account holder is responsible for losses that unauthorized payments cause in a specific account. In this sense, the authorization principle is communitarian, in that it allows financial institutions to allocate aggregated losses to the community of account holders. If losses exceed what the community of account holders will tolerate in a competitive market, the account holders may require the financial institution to absorb all or part of the losses.

C. Negligence Principle

While authorization imposes liability is a valid principle with respect to account orders, the negative implication of the authorization principle—no authorization, no liability—is subject to the negligence principle. Ordinarily, a person is not liable for an account order unless the person authorizes the order. However, the negligence principle intervenes to impose liability on the person whose negligence substantially contributes to the execution of a forged, fraudulent, or altered account order. Theoretically, this negligence principle applies to all account orders regardless of the payment system from which they originate. More specifically, the negligence principle would apply to negotiable

390. Banks frequently obtain a banker’s blanket bond or similar insurance that protects them against losses from employee fraud, forgery, and criminal acts such as robbery and burglary. Some states require banks to obtain insurance coverage. See Susan Koehler Sullivan & Teresa Jones, The Question of Causation in Loan Loss Cases, 11 FIDELITY L.J. 89, 101–02 (2005).

391. Allocation of Losses from Check Forgeries Under the Law of Negotiable Instruments and the Uniform Commercial Code, 62 YALE L.J. 417, 436–39 (1953). Although this Article does not discuss loss allocation in the case of credit and debit cards, the analysis is sound for loss allocation in all payment systems.

392. U.C.C. § 4-401(a) (2002).
instruments, credit card charges, and electronic fund transfers. Needless to say, no person is liable for a forged, fraudulent, altered, or erroneous account order if the person exercised ordinary care in initiating, processing, or executing the account order. In the absence of negligence, no authorization, no liability is a golden guideline.

The negligence principle requires that the account holder discover and report any forged, fraudulent, altered, or erroneous debit or credit orders reflected in the periodic statement that the bank sends to the account holder. The law may require a reasonable statutory period within which the account holder must discover and report problematic entries. The account holder is liable for debit orders and accepts the accuracy of credit orders if the account holder fails to discover and report forgeries, alterations, mistakes, errors, and other discrepancies in the statement. This application of the negligence principle, consistent with the cheapest cost avoidance norm, may be enforced regardless of payment devices used to access the account.

Extending the negligence principle to employers, the principled framework requires that any account order, debit or credit, that an employee originates imposes liability on the employer. The framework operates on the rebuttable presumption that the employee originating the account order has the requisite authority. This simple rule makes good economic sense because it does not externalize fraud that is committed within a business. Otherwise, businesses will have no incentive to screen and supervise employees who process account orders. The internalization of employee-sponsored payment losses persuades businesses to practice care in hiring employees, supervising their activities related to accounts, and bonding high risk employees. This allocation of loss safeguards financial institutions from adopting cumbersome processing filters to do the impossible task of separating good employees from bad employees.

As a general principle, the framework allocates losses to the negligent account holder. Just as negligence is person-specific, so follows the allocation of loss. Each negligent account holder is liable for its own negligent losses.

393. The banking industry cannot be allowed to adopt a standard of care that excludes banks from detecting forged signatures and alterations. Under such a minimalist standard of care, the risk of forgery and alteration automatically shifts to account holders.

394. This standard of care is fair and efficient for it shifts the lost to the cheapest cost avoider, the account holder. See supra text accompanying notes 258–60. The duty to discover and report may be imposed on all account holders regardless of payment devices used to operate the account. The $50 limit, as in credit cards and electronic transfers, should not apply to minimize liability under this standard of care.

395. This proposed rule dispenses with the concept of entrusted employee or the employee with actual, apparent, or implied authority. The employer must be liable for employee fraud. The banks, however, cannot close their eyes if a fiduciary is blatantly committing fraud or diverting company funds to a private account. See U.C.C. § 3-307 (2002) (explaining the circumstances where banks are on notice for a breach of fiduciary duty).
Hence, the framework’s negligence loss allocation is markedly different from the law of credit cards discussed above, which aggregates losses and distributes them to the community of cardholders in the form of higher interest rates.\footnote{396} The framework would require that the law of credit cards be reviewed to shift the loss to the negligent cardholder. For both efficiency and consumer protection purposes, however, the law may introduce the concept of “reverse deductible”\footnote{397}—creating a cardholder who is liable for negligent losses above a prescribed amount.\footnote{398}

Currently, the law of credit cards does not fully enforce this proposed framework’s loss allocation of the negligence principle. Credit cardholders know or should know that they are not liable for the negligent safekeeping of credit cards. If a card is lost or stolen, the law does not inquire whether the cardholder’s negligence caused the card to be lost or stolen. Any charges made to the lost or stolen credit card are unauthorized charges, regardless of the cardholder’s contributory negligence.\footnote{399} This impunity creates a false impression that no credit cardholder is liable for negligence, even though in practice, the negligent losses are aggregated and distributed to the entire community of negligent, as well as non-negligent, cardholders. Consequently, the current law subsidizes negligent cardholders and penalizes non-negligent cardholders, who all share the negligent losses.

D. Wrongful Dishonor Principle

The principled framework embraces the wrongful dishonor principle for all payment systems. The principle exercises lawful pressure on financial institutions to honor authorized account orders. Orderly and timely payments are critical for the efficient functioning of financial markets. Furthermore, debit

\footnote{396} See supra text accompanying note 389.
\footnote{397} This idea, though beyond the scope of this Article, needs further development. Reverse deductible would shift a limited loss (for example, $50) per periodic statement to financial institutions. If negligent losses exceed the deductible, the consumer–account holder would forfeit the deductible and be held liable for the entire amount. The financial institutions may distribute the reverse deductible losses to the community of account holders in the guise of fees and interest rates. The reverse deductible rule is efficient, while it eliminates the transaction costs of enforcing minor negligent losses against the cardholder. It also encourages cardholders to take better care of credit cards and to safeguard them from being lost or stolen. The reverse deductible is unavailable to the cardholder if the loss is intentional, collusive, or fraudulent.
\footnote{398} This proposal does not weaken the duty to discover and report errors in the periodic statement. The bank may have good reasons to sue a cardholder whose negligence causes substantial losses, although the losses have been duly discovered and reported.
\footnote{399} 15 U.S.C. § 1643(a) (2006) (stating that the maximum liability is capped at $50).
orders serve as the medium of exchange for the sale of goods and services. When authorized payments are dishonored, the market of goods and services is subject to disruption. Most important, as discussed previously, the wrongful dishonor of account orders may stain the account holder’s credit, resulting in consequential damages.

Recognizing the efficiency of the wrongful dishonor principle, the proposed framework extends the principle to credit card payments. Accordingly, a financial institution would be liable for actual damages proximately caused by the wrongful dishonor of a credit card charge, let alone wrongful termination of a credit card. If a cardholder has not exceeded the credit limit and has been diligent in paying the bills, there exists no lawful excuse for the card issuer to decline a lawful charge or to arbitrarily terminate the credit facility. The financial institutions may be allowed certain defenses, such as an act of God or a technical malfunction. On the other hand, the principled framework imposes punitive damages on the credit card issuer if the wrongful dishonor is oppressive or malicious, thus bringing credit cards transactions to a level playing field with negotiable instruments and electronic fund transfers.

VI. CONCLUSION

The three principles of authorization, negligence, and wrongful dishonor constitute a normative theoretical model of payment services, regardless of the devices—checks, credit cards, or electronic transfers—by which these services are accessed. Most fundamentally, the authorization principle mandates that financial institutions provide payment services in accordance with the account holder’s authorization. Reciprocally, the account holder is liable for amounts that the bank pays in accordance with authorized instructions. The negligence principle creates exceptions to the authorization principle by holding the

400. Khan, supra note 2, at 441–42 (describing the movement of money through the intangible medium). I often wonder if money is becoming mere accounting under which numbers are moved from one account to another.

401. See supra Part IV.B. No law yet exists for the wrongful dishonor of credit card authorizations.

402. See supra text accompanying note 350.

403. Punitive damages must be available to prevent malicious discrimination against a cardholder. If an issuer bank wrongfully and maliciously cancels a credit card, the bank must be held liable for punitive damages. As a result, the principled framework extends the rule of punitive damages already available for malicious nonpayment of checks. See, e.g., Maxan Curtain Mfg. Corp. v. Chem. Bank, 646 N.Y.S.2d 701, 702 (App. Div. 1996) (permitting punitive damages where plaintiff alleged that the bank’s vice president “maliciously ordered a bank employee to dishonor the plaintiff’s checks despite the fact that the plaintiff had sufficient funds in its checking account”). If a financial institution terminates a credit card for factors such as race, religion, national origin, or language, the ease for punitive damages garners more strength.
negligent party liable for unauthorized payments if the party's negligence substantially contributes to the loss. The negligence loss is distributed on the basis of comparative fault. Conversely, in the case of businesses, the employer's negligence is presumed and loss shifts to the employer if the bank makes a good faith payment, and the employee has ordered a fraudulent deposit using the company's authorization setup. This allocation of loss to employers is consistent with the cheapest cost avoider rule, since employers are best situated to supervise disloyal employees. Finally, the principle of wrongful dishonor holds banks liable for the nonpayment of properly payable orders. This principle promotes an efficient and timely transfer of value, greasing the wheel of commerce so that merchants can receive prompt payments for goods and services that they sell to account holders or their authorized representatives. On the basis of these principles, this Article highlights for consumers and businesses the comparative advantages and disadvantages of using checks, credit cards, and electronic payments. Ultimately, the Article recommends a number of legal reforms to bring diverse payment systems in harmony with the efficiency and fairness of the principled framework presented in this Article.