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N.Y.U.C.C. § 4-302: Agreement Between Depositary and Payor Banks Varying Midnight Deadline Rule Binding on Payee

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by permitting evidence of trade custom and past dealings, future courts will be able to more consistently effectuate the intent and expectation of the parties and construe their agreements in accordance with commercial realities.[187]

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N.Y.U.C.C. § 4-302: Agreement between depositary and payor banks varying midnight deadline rule binding on payee

Section 4-302 of the Uniform Commercial Code (Code) imposes a duty upon a payor bank in possession of a demand item[188] to either settle the item or send notice of its dishonor before the midnight deadline.[189] Recognizing the need for commercial flexibility, the Code permits variation of this provision by agreement of all interested parties to the transaction, provided the agreement does not discharge the bank from its obligations of good faith and ordinary care.[190] It is unclear, however, to what extent a depositary

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Stiles Co., 306 N.Y. 288, 289, 118 N.E.2d 104, 105 (1954).

[187] Speaking to the status of arbitration clauses after the enactment of the Code, one commentator observed:

> [I]f the higher threshold for enforceability of arbitration clauses has survived the enactment of the Uniform Commercial Code, the Code's liberalization of contract formation rules may actually increase the risk that a party may find itself bound to a contract lacking . . . a term that he assumed, by virtue of trade, custom or practice, to be a part of his deal.

Collins, *supra* note 185, at 740.

[188] The Code defines an "item" as "any instrument for the payment of money even though it is not negotiable," but not including money or documentary drafts. N.Y.U.C.C. §§ 4-104(1)(g), 4-302 (McKinney 1964).

[189] N.Y.U.C.C. § 4-302(a) (McKinney 1964). Section 4-302(a) provides that "a payor bank . . . is accountable for the amount of a demand item . . . if the bank . . . does not pay or return the item or send notice of dishonor until after its midnight deadline." *Id.* A bank's midnight deadline is deemed to be "midnight on its next banking day following the banking day on which it receives the relevant item or notice or from which the time for taking action commences to run, whichever is later." *Id.* § 4-104(1)(h).

[190] *Id.* § 4-103(1). Federal Reserve regulations, clearinghouse rules and similar enactments have the effect of agreements under § 4-103(1), whether or not all interested parties have specifically assented to their applicability. *Id.* § 4-103(2); *see* H. BAILEY, BRADY ON BANK CHECKS 14-15 (5th ed. 1979). The article 4 provision relating to agreements between parties to a transaction differs somewhat from the general Code provision. Under § 1-201(3), the provisions of the Code may be varied "except that the obligations of good faith, diligence, reasonableness and care . . . may not be disclaimed by agreement." Because § 4-103(1) expressly limits agreements only by the standards of good faith and ordinary care, it has been suggested that "in the area of bank collections, the bank may contract out of duties of diligence and reasonableness to the extent that such duties are not comprehended in the concept of 'ordinary care.' " Leary, *Check Handling Under Article Four of the Uniform Commercial Code*, 49 MARQ. L. REV. 331, 342 (1965). *See generally* J. WHITE & R.

bank's agreement with a payor bank will be binding upon a payee. Recently, in *David Graubart, Inc. v. Bank Leumi Trust Co.*,[191] the Court of Appeals held that a payor bank is not accountable[192] to a payee when, pursuant to an agreement with the depositary bank, the payor bank retains a previously dishonored check beyond the midnight deadline.[193]

David Graubart, Inc. was the payee of a check drawn by the Prins Diamond Company on its account at the Bank Leumi Trust Company. The payee deposited the check in the National Bank of North America, which passed it through clearinghouse channels to the payor bank.[194] When the check was returned by Bank Leumi for insufficient funds, the payee redeposited the check with its bank, which routed it directly to Bank Leumi with instructions that the payor bank was to remit its cashier's check when the item was paid.[195] An "advice to customer" slip was sent by the depositary bank to the payee indicating that credit would be given upon

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SUMMERS, THE LAW UNDER THE UNIFORM COMMERCIAL CODE 552-58 (2d ed. 1980). Where an agreement, otherwise valid under § 4-103(1), serves to disclaim a bank's responsibility for its own negligence, however, it will be nullified by the courts. *See, e.g.*, Sunshine v. Banker's Trust Co., 34 N.Y.2d 404, 410, 314 N.E.2d 860, 863-64, 358 N.Y.S.2d 113, 119 (1974); New York Credit Men's Adjustment Bureau, Inc. v. Manufacturers Hanover Trust Co., 41 App. Div. 2d 912, 913, 343 N.Y.S.2d 538, 540 (1st Dep't 1973) (per curiam).

[191] 48 N.Y.2d 554, 399 N.E.2d 930, 423 N.Y.S.2d 899 (1979), *rev'g*, 66 App. Div. 2d 659, 410 N.Y.S.2d 823 (1st Dep't 1978).

[192] "Accountability" under § 4-302, *see* note 189 *supra*, is synonymous with liability. Rock Island Auction Sales v. Empire Packing Co., 32 Ill. 2d 269, 204 N.E.2d 721 (1965). The *Rock Island* court suggested that the term was used to distinguish a payee's damages under § 4-302 from those incurred as a result of provisional settlements between banks in the collection process. 204 N.E.2d at 723. It has been contended, however, that "accountability" implies a greater degree of responsibility: While failure to return an item within the specified time limits renders the payor bank liable for the face amount of the item, Met Frozen Food Corp. v. National Bank, 89 Misc. 2d 1033, 1038, 393 N.Y.S.2d 643, 647 (Sup. Ct. Nassau County 1977); *see* United States v. Loskocinski, 403 F. Supp. 75 (E.D.N.Y. 1975), the measure of damages imposed on a collecting bank for its failure to exercise ordinary care in the handling of an item is the "amount of the item reduced by an amount which could not have been realized by the use of ordinary care," N.Y.U.C.C. § 4-103(5) (McKinney 1964).

[193] 48 N.Y.2d at 561, 399 N.E.2d at 934, 423 N.Y.S.2d at 903-04.

[194] *Id.* at 557, 399 N.E.2d at 932, 423 N.Y.S.2d at 901. A clearinghouse is an association of banks which facilitates the transferral of checks and the settling of balances due among members. The association is the fiduciary representative of member banks. *See* 8 MICHIE, BANKS AND BANKING 331 & nn.1 & 2 (1971).

[195] 48 N.Y.2d at 557, 399 N.E.2d at 932, 423 N.Y.S.2d at 901. Direct resubmission of checks by a collecting bank to a payor bank, bypassing clearinghouse channels, is a permissible method of presentment under the Code. N.Y.U.C.C. § 4-204(2)(a) (McKinney 1964). The practice has been deemed "justified by the need for speed, the general responsibility of banks, Federal Deposit Insurance protection and other reasons." *Id.* Official Comment 2.

payment.[196] When the drawer failed to deposit sufficient funds within seven banking days, Bank Leumi returned the check to the depositary bank as "uncollectible."[197] During this period, however, the drawer made an assignment for the benefit of creditors, thereby precluding the payee from obtaining payment on the instrument.[198] The payee brought suit against the payor bank, alleging that its failure to return the resubmitted check to the depositary bank within the midnight deadline rendered the payor bank accountable. The trial court denied both parties' motions for summary judgment,[199] and the plaintiff appealed. The Appellate Division, First Department, affirmed, holding that factual questions existed whether the actions of the payor bank were customary in the banking community and whether direct resubmission of the previously dishonored check with the "advice to customer" slip constituted an agreement to set aside the midnight deadline rule.[200]

On appeal, the Court of Appeals reversed and granted summary judgment for the defendant, holding that a payee has no cause of action against a payor bank that relies on the apparent authority of the depositary bank.[201] Judge Fuchsberg, writing for a unanimous Court, reasoned that the payor bank's conformance with the terms of its agreement with the depositary bank would relieve it of accountability under section 4-302 if the assent of the payee and the reasonableness of the agreement could be established.[202] The Court found the requisite assent of the payee from

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[196] 48 N.Y.2d at 557, 399 N.E.2d at 932, 423 N.Y.S.2d at 901.

[197] *Id.*

[198] *Id.*

[199] *Id.* at 558, 399 N.E.2d at 933, 423 N.Y.S.2d at 902.

[200] 66 App. Div. 2d at 660, 410 N.Y.S.2d at 825.

[201] 48 N.Y.2d at 558, 399 N.E.2d at 933, 423 N.Y.S.2d at 902. The Court of Appeals reversed the lower court's finding that there was a triable question of fact whether the holding of previously dishonored checks by a payor bank was a customary banking practice. *Id.* at 559, 399 N.E.2d at 933, 423 N.Y.S.2d at 902. In support of its crossmotion for summary judgment, the defendant-payor bank submitted an affadavit of its assistant vice president asserting that, based upon his personal knowledge of banking practice, the retention of previously dishonored checks beyond the midnight deadline was an industry custom. In reply, counsel for the payee submitted an affirmation contesting the existence of such a commercial usage. This affirmation was held to be insufficient to raise a question of fact since it was not based on personal knowledge of the facts. *Id.; see* CPLR 3212(b) (1970); 4 WK&M ¶ 3212.09, at 32-167. Moreover, since all relevant dates were conceded for the purposes of summary judgment, there were no factual issues to be presented to the jury. 48 N.Y.2d at 559, 399 N.E.2d at 933, 423 N.Y.S.2d at 902.

[202] 48 N.Y.2d at 561-62, 399 N.E.2d at 935, 423 N.Y.S.2d at 904. Section 4-108 of the Code permits a collecting bank to extend the Code's time limits for up to an additional banking day without the consent of an interested person in order to secure payment.

the agency relationship created between a payee and its depositary bank upon presentment of an item for collection.[203] Furthermore, the Court concluded, the interbank agreement was reasonable since there was no specific evidence of bad faith or lack of ordinary care[204] and the agreement did not violate the underlying purpose of the midnight deadline.[205]

It is submitted that the *Leumi* Court has unduly expanded the Code-created agency relationship arising from the presentment of a check. Under the Code, a depositary bank has actual authority to enter into agreements embodying customary collection practices.[206]

N.Y.U.C.C. § 4-108(1) (McKinney 1964). This provision was unavailable to the *Leumi* defendants, however, since delays by a payor bank are excused only if "caused by interruption of communication facilities, suspension of payments by another bank, war, emergency conditions, or other circumstances beyond the control of the bank provided it exercises such diligence as the circumstances require." *Id.* § 4-102(2).

[203] 48 N.Y.2d at 561, 399 N.E.2d at 934, 423 N.Y.S.2d at 903; *see* note 206 and accompanying text *infra*. The *Leumi* Court determined that Leaderbrand v. Central State Bank, 202 Kan. 450, 450 P.2d 1 (1969), cited by the defendant, was "unavailing." 48 N.Y.2d at 559-60, 399 N.E.2d at 933, 423 N.Y.S.2d at 902-03. In *Leaderbrand*, the court reasoned that since § 3-511(4) of the Code excused further notice of dishonor where "drafts" were once dishonored by "nonacceptance," the same rule was applicable to the dishonor of checks by "nonpayment." 450 P.2d at 8-9. Therefore, no notice of dishonor was required where an item had been previously returned for insufficient funds. *Id.* The Court in *Leumi* rejected this conclusion, finding that "[s]ince it would be futile to present for payment a draft that has been dishonored by nonacceptance . . . such presentment and further notice are excused as superfluous. In contrast, a *demand* item such as a check may eventually be paid if resubmitted at a time when the drawer's account has an adequate balance." 48 N.Y.2d at 559-60, 399 N.E.2d at 933, 423 N.Y.S.2d at 903 (emphasis in original).

[204] 48 N.Y.2d at 562, 399 N.E.2d at 935, 423 N.Y.S.2d at 904. The Court refused to imply bad faith or lack of ordinary care and dismissed any presumption of collusion between the drawer and payor bank from the mere fact that, at the time of the assignment for the benefit of creditors, the drawer was indebted to Leumi. *Id.*

[205] *Id.* at 563, 399 N.E.2d at 935-36, 423 N.Y.S.2d at 905. The purpose of the midnight deadline is to promptly firm up provisional credits received by intermediary banks. *See* N.Y.U.C.C. § 4-213 & Official Comment 9 (McKinney 1964). Because the depositary bank had forwarded the check directly to the payor bank, thus obviating the need for provisional credits, the *Leumi* Court reasoned that the purpose of the midnight deadline rule was not violated. 48 N.Y.2d at 563, 399 N.E.2d at 935-36, 423 N.Y.S.2d at 905.

[206] *See* N.Y.U.C.C. § 4-201(1) (McKinney 1964). Section 4-201(1) provides that "[u]nless a contrary intent clearly appears and prior to the time that a settlement given by a collecting bank for an item is or becomes final . . . the bank is an agent or sub-agent of the owner of the item . . . ." *Id.* Under common-law agency principles, the actual authority of an agent to bind his principal may be created expressly or implied by conduct on the part of the principal that reasonably leads the agent to believe that he is authorized to act. RESTATEMENT (SECOND) OF AGENCY § 7, Comment c (1958). The New York courts have consistently held that to effectuate the authority conferred on an agent, the agent has implied authority to act in accordance with the customs and practices of the particular industry or trade. *See, e.g.*, Peter Pan Mfg. Corp. v. Lady Royal Mfg. Co., 272 App. Div. 418, 71 N.Y.S. 97 (1st Dep't 1947); Standard Oil Co. v. Siraco, 226 App. Div. 266, 235 N.Y.S. 1 (3d Dep't

Where a custom is found to exist, the payee's assent to the interbank agreement may be implied under general agency principles.[207] In suggesting that the depositary bank has apparent authority to bind the payee to even noncustomary banking practices merely by virtue of the bank-customer relationship, however, the *Leumi* Court has effectively discharged the payor bank from any duty under section 4-301 unless bad faith or a lack of ordinary care is shown.

It is suggested that a depositary bank's liability for exceeding its actual authority should not affect a payee's direct rights against a payor bank.[208] Where a particular banking practice does not rise to the level of a commercial usage, the payee should not be deemed to have impliedly consented to such an interbank agreement, and the strict rule of accountability should apply.[209] By cloaking the depositary bank with apparent authority, the *Leumi* Court has removed the payor bank's burden of proving that the modifying agreement embodied a commercial usage, since the depositary bank's authority may be predicated solely on the payee's voluntary establishment of banking relations. Notwithstanding the need for flexibility in the collection process, an extension of this approach to cases where a trade usage cannot be established appears to be an unintended curtailment of a payee's article-four rights.

Thomas M. Cerabino

1929); *accord,* Demarco v. Edens, 390 F.2d 836, 844 (2d Cir. 1968); RESTATEMENT (SECOND) OF AGENCY § 36 (1958).

[207] *See* note 206 *supra.*

[208] The availability of remedies against the depositary bank for violation of an article 4 provision under general agency principles was not intended to limit payor bank accountability under § 4-302. Accountability of a payor bank for the retention of a demand item beyond the midnight deadline is not dependent on agency principles; it is expressly created in § 4-302 as a direct right of the payee against the payor bank. N.Y.U.C.C. § 4-201, Official Comment 4 (McKinney 1964).

[209] One rationale for permitting suspension of the midnight deadline by an agreement evincing a commercial usage is that such a practice allows parties to "advantage themselves of the 'wisdom born of accumulated experience.' " 48 N.Y.2d at 560, 399 N.E.2d at 934, 423 N.Y.S.2d at 903 (quoting Banker's Trust Co. v. J.V. Dowler & Co., 47 N.Y.2d 128, 134, 390 N.E.2d 766, 769, 417 N.Y.S.2d 47, 51 (1979)). It is clear, however, that such indirect agreements must be applied discriminately. The comments to § 4-103 of the Code provide:

> Direct agreements between a bank and its customer would ordinarily be used in the area of bank-customer relationships . . . . The new statutory sanction for indirect agreements binding remote parties applies principally . . . [where] the use of direct agreements is impracticable and in which the indirect agreement has heretofore had neither legislative sanction nor judicial approval.

N.Y.U.C.C. § 4-103, commentary at 518 (McKinney 1964).