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Liability of Intermediary and Beneficiary Banks in Funds Transfer: A Comparative Study of American and German Law

by
Rainer Stockmann*

I. INTRODUCTION

If an intermediary bank negligently fails to properly execute a funds transfer payment, the bank will be liable for consequential damages incurred under German law, but not American law. Two leading cases, both decided in 1982, illustrate the differences in the laws of both countries.

The outcomes in *Evra Corp. v. Swiss Bank Corp.*¹ and *Oberlandesgericht Düsseldorf*² differed completely, despite the similarity of the underlying facts. In the former, the Seventh Circuit Court of Appeals reversed the district court's decision³ under the *Hadley v. Baxendale*⁴ doctrine, and denied *Evra* recovery of consequential damages. In the latter, however, the *Oberlandesgericht Düsseldorf* found for the plaintiff and awarded consequential damages. Following the decisions in *Evra* and *Oberlandesgericht Düsseldorf*, the question of who bears the risk of loss if an intermediary bank fails to execute the originator's payment order properly has been given particular attention in both the United States and the Federal Republic of Germany. Significant questions in the laws of both countries remain unsettled, including: the nature of the cause of action, the responsibility of the originator's bank for the actions of intermediary banks, and the measure of damages.⁵

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1. 522 F. Supp. 820 (N.D. Ill. 1981), *rev'd*, 673 F.2d 951 (7th Cir.), *cert. denied*, 459 U.S. 1017 (1982).

2. DB 1982, 749.

3. 673 F.2d 951 (1982).

4. 9 Exch. 341, 156 Eng. Rep. 145 (Ex. 1854). See *infra* note 154 and accompanying text.

5. See Scott, *Corporate Wire Transfer and the Uniform New Payment Code*, 83 COLUM. L. REV. 1664 (1983).

The relationship of the originator to the intermediary and beneficiary banks is characterized by an absence of privity. The absence of privity creates problems—more so under civil than common law⁶—regarding the nature of actions available, if any, to the originator against intermediary and beneficiary banks. In addition, the problem arises as to who, if anyone, the originator may sue. Two theoretical solutions exist. The originator may sue his own bank, which may be held responsible for the actions of the intermediary and beneficiary banks, or he may directly sue the intermediary or beneficiary bank. Questions of loss allocation, enforcement, and costs are involved. Another question concerns the amount of damages that may be recovered. False negatives⁷ (i.e., failure to pay a payment order or failure to pay it within a designated time) in funds transfer normally lead not to a loss of the face value, but to consequential damages. Should these be excluded or limited in order to avoid imposing an excessive burden on the funds transfer system?

Since funds transfers are often used to execute transborder payments, legal differences are of great practical significance, as was underscored in *First National Bank of Boston v. Chase Manhattan Bank*.⁸ First National Bank of Boston (FNBB) had not timely performed a wire transfer to a shipper hired to carry flour to Yemen. Consequently, the shipper delayed performance and the cargo spoiled by the time it was delivered. The Aix-en-Provence appeals court entered judgment against FNBB for damages in excess of \$1 million. While the appellate court held the shipper primarily liable for the damages, the shipper had gone out of business by the time the French action had commenced. FNBB paid \$1 million and sought contribution and indemnification from the defendants.

Under the U.S. decision in *Evra*, FNBB probably would not have been held liable for the damages incurred. *Evra* underscored the difference that a particular court and particular law can make to the outcome of international funds transfer litigation.⁹ The plaintiff, Evra, sued Swiss Bank in Illinois under Illinois law. Evra conceded that, under Swiss law, Swiss Bank could not be held liable due to the lack of privity between the originator and the intermediary bank.¹⁰ The appellate court ultimately avoided the choice of law question. The court held that since it could find no liability under Illinois law, it would make no difference to the outcome whether Illinois law or Swiss law governed.¹¹

6. Under common law, the absence of privity as a defense in actions for damages in contract is no longer of great importance due to the enactment of warranty statutes and court decisions which have largely extended the right to sue to third parties. See BLACK'S LAW DICTIONARY 1199 (6th ed. 1990).

7. As to the term "false negative," see Cooter & Rubin, *A Theory of Loss Allocation for Consumer Payments*, 66 TEX. L. REV. 63, 86 (1987).

8. 1988 WL 80149 (S.D.N.Y.).

9. 522 F. Supp. 820 (N.D. Ill. 1981), *rev'd*, 673 F.2d 951 (7th Cir.), *cert. denied*, 459 U.S. 1017 (1982).

10. 522 F. Supp. at 827, *conceded in appellate decision*, 673 F.2d at 954.

11. 673 F.2d at 954-55.

In addition, with regard to the lack of uniform legal standards in international payment transactions, an Uncitral code concerning international wire transfer is currently being drafted. In order to be successful, the Uncitral code will have to take into consideration the various approaches of different legal systems.

A. Importance of Payments Made by Funds Transfer and Governing Law

In both the United States and the Federal Republic of Germany, funds transfers are of great importance. In the United States, according to 1980 figures, funds transfers accounted for the movement of \$117 trillion. Since funds transfers are mainly used by banks and corporations, these funds were moved by the relatively small number of 56 million transactions, resulting in an average of \$2 million per transaction. By comparison, the amount transferred by check in 1980 was only \$19 trillion made through 34 billion transactions, with the average check transaction being \$570.¹²

In the Federal Republic of Germany, according to 1985 figures, funds transfer transactions numbered 3.1 billion and moved 10.5 trillion deutsche marks. In contrast to the U.S. figures above, these totals do not include transactions made between banks. Payment by check was made through 700 million transactions involving 3 trillion deutsche marks. Fifty-seven percent of all payment transactions in the Federal Republic of Germany are executed by funds transfers and only twelve percent by check.¹³ These figures show important differences between the payment systems in both countries. In the Federal Republic of Germany, funds transfers are traditionally used to a large extent in consumer transactions,¹⁴ while in the United States they are mainly limited to commercial transactions.

Although funds transfers have existed in the United States since the early days of the 20th century, there is no comprehensive body of law which governs this area.¹⁵ The Electronic Funds Transfer Act (EFTA)¹⁶ is limited

12. Scott, *supra* note 5, at 1664.

13. Möschel, *Dogmatische Strukturen des bargeldlosen Zahlungsverkehrs*, ACP 189-91 (1986).

14. In the Federal Republic of Germany, the first public funds transfer system was offered by the Giro Bank in Hamburg in 1619. In other European countries, such as Italy, such systems were operational even prior to that time. See R. BRANDL & D. BAKER, *THE LAW OF ELECTRONIC FUND TRANSFER SYSTEMS* 25-3 (1980).

15. Until recently, disputes over funds transfers were largely resolved by gentlemen's agreements between the few participants. Bankers contend this type of dispute resolution explains the previous state of American law concerning funds transfers. Today, however, the situation has changed due to the increased number of banks providing such services and the concomitant increase in the amount of money moved by funds transfers. Scott, *supra* note 5, at 1678.

16. 15 U.S.C. §§ 1693-1693r (1988).

to certain consumer transactions¹⁷ and explicitly excludes transfers for consumers by Fedwire, Bank Wire, or similar transfer services.¹⁸ The number of reported cases has only recently increased¹⁹ with the legal issues involved becoming a new subject matter for discussion.²⁰

In addition, private rules of the funds transfer systems, such as Chips or S.W.I.F.T.,²¹ do not purport to govern the relationships between originators of funds transfers and their respective banks.²² These rules are principally concerned with technical issues and the risks and liabilities to be borne by the systems themselves.²³ The same is true for Federal Regulation J of the Federal Reserve System, which governs funds transfers effected through the Federal Reserve Communications System.²⁴ Contracts between banks and their customers, if they exist at all,²⁵ often do not address liability issues.²⁶ If

17. The primary focuses of the EFTA are point of sale transfers, automated teller machine transactions, direct deposits or withdrawal of funds, and transfers initiated by telephone. See EFTA § 903(6).

18. EFTA § 903(6). The application of the EFTA is limited to federal and state financial institutions.

19. Three sets of recently decided cases can be distinguished. One set concerns a bank's liability for false positives, i.e., errors which result in payments made that should not have been made. This category includes, for example, discrepancies between the amount the originator orders to be paid and the amount actually credited to the account of the beneficiary, see *Walker v. Texas Commerce Bank, N.A.*, 635 F. Supp. 678 (S.D. Tex. 1986), or payments fraudulently initiated by unauthorized persons, see *Securities Fund Servs., Inc. v. American Nat'l Bank & Trust Co. of Chicago*, 542 F. Supp. 323 (N.D. Ill. 1982); *Bradford Trust Co. v. Texas Am. Bank-Houston*, 790 F.2d 407 (5th Cir. 1986). The second set of cases concerns a bank's liability for false negatives, i.e., errors which result in a failure to execute a payment order entirely or within a designated time. See *Evra Corp. v. Swiss Bank Corp.*, 522 F. Supp. 820 (N.D. Ill. 1981), *rev'd*, 673 F.2d 951 (7th Cir.), *cert. denied*, 459 U.S. 1017 (1982); *Central Coordinates, Inc. v. Morgan Guar. Trust Co.*, 40 U.C.C. Rep. Serv. (Callaghan) 1340 (N.Y. Sup. Ct. 1985); *Compania Anonima Venezolana de Navegacion v. American Express Int'l Banking Corp.*, 1985 WL 1898 (S.D.N.Y. 1985). For a discussion of the terms "false positives" and "false negatives," see *Cooter & Rubin, supra* note 7, at 86. The third set of cases concerns settlement problems. See *Delbrueck & Co. v. Manufacturers Hanover Trust Co.*, 609 F.2d 1047 (2d Cir.), *aff'g* 464 F. Supp. 989 (S.D.N.Y. 1979).

20. See Scott, *supra* note 5; Tallackson & Vallejo, *International Commercial Wire Transfers: The Lack of Standards*, 11 N.C.J. INT'L L. & COM. REG. 639 (1987); Cooter & Rubin, *supra* note 7, at 63; Jetton, *Evra Corp. v. Swiss Bank Corp.: Consequential Damages for Bank Negligence in Wire Transfers*, 9 RUTGERS COMPUTER & TECH. L.J. 369 (1983); Budnitz, *The Finicky Computer, The Paperless Telex and the Fallible Swiss: Bank Technology and the Law*, 25 B.C.L. REV. 259 (1984); Miller & Scott, *Commercial Paper, Bank Deposits and Collections, and Commercial Electronic Fund Transfers*, 38 BUS. LAW. 1129 (1983).

21. For a description of these systems and the relevant rules, see Scott, *supra* note 5, at 1669-74 and R. BRANDL & D. BAKER, *supra* note 14, at 9-1 to 9-18, 16-1 to 16-49.

22. Scott, *supra* note 5, at 1674.

23. The fact that these rules generally do not bind third parties raises another problem. Under the theory that each bank is an agent of the holder of a collect item, these rules might yet have some significance. See *infra* notes 118-22 and accompanying text. Under section 4-103(2) of the Uniform Commercial Code (U.C.C.), clearing house rules and the like become automatically binding between parties. This is not true for funds transfer rules so far as funds transfers are not governed by the U.C.C. See *infra* notes 64-80 and accompanying text.

24. See the discussion of Regulation J *infra* notes 81-100 and accompanying text.

25. The significant lack of contractual coverage is shown by a Bank Administration Institute survey. BANK ADMINISTRATION INSTITUTE, STUDIES IN FUNDS TRANSFER, OPERATION AND AUTOMATION SURVEY FINDINGS (1982); See also Scott, *supra* note 5, at 1674.

adopted, article 4A of the Uniform Commercial Code (U.C.C.),²⁷ which considers the issues in question,²⁸ will, therefore, play a major role. At present this proposal is before the National Conference of Commissioners on Uniform State Laws and the suggested solutions will be the subject of discussion.

In the Federal Republic of Germany early cases date back to the beginning of this century.²⁹ However, due to the 1982 decision of *OLG Düsseldorf* and other recent decisions, as well as the rapidly increasing technological changes in the Giro system, the legal issues in question have been intensively discussed during the last several years.³⁰ These discussions will influence future court decisions.

B. Terminology

In the United States and the Federal Republic of Germany, there are three kinds of non-cash payment systems in widespread use today: payment by check, payment by credit card, and payment by funds transfer. The first two types of payment systems are debit transfer systems.³¹ In a debit transfer system, the debtor transmits to the creditor an instruction to the debtor's bank to debit his account for credit to the creditor. In the case of payment made by check or credit card, the instruction to the debtor's bank is contained in the check or in the credit card slip.³² Upon receipt, it is the creditor who initiates the debit collection process by presenting the instruction to the debtor's bank either directly or through bank collection channels. Thus, in the debit system, information flows in one direction and the funds flow in the other.³³ The third payment system, the topic of this study, is payment made by credit transfer, or, in the terminology of draft article 4A of the U.C.C.,³⁴

26. According to Scott, *supra* note 5, at 1675, this is explained basically by two factors. First, many corporate customers refuse to accept rules that require them to assume significant risks. In a competitive environment, banks, therefore, prefer not to address the issues and leave the matters to the court in order to retain customers. Second, courts might be reluctant to enforce private contracts between customers and their banks on the grounds of adhesion or unconscionability. This risk is enhanced by the fact that those contracts do not operate within any statutory framework. The effort to procure private agreements, therefore, may not seem worthwhile.

27. In discussing the U.C.C., unless otherwise expressly stated, this study refers to the A.L.I. (Official Text 1987) and the NAT'L CONF. COMMISSIONERS ON UNIFORM ST. LAWS (10th ed.) (with comments).

28. See *infra* notes 179-92 and accompanying text.

29. See, e.g., RGZ DJZ 1911, 1218.

30. Hüffer, *Die Haftung gegenüber dem ersten Auftraggeber im mehrgliedrigen Zahlungsverkehr*, ZHR 151 (1987) 93-117; Möschel, *supra* note 13; Köndgen, *Bankhaftung - Strukturen und Tendenzen*, in *Neue Entwicklungen im Bankhaftungsrecht* 133 (Johannes Köndgen ed. 1987); Schröter, *Bankenhaftung im mehrgliedrigen Zahlungsverkehr*, ZHR 151 (1987) at 118-45.

31. See R. BRANDEL & D. BAKER, *supra* note 14, at 5-38 to 5-41.

32. These payments are governed by article 3 and article 4 of the U.C.C., which generally consider debit systems.

33. Note, *Alternatives to the Present Check-Collecting System*, 20 STAN. L. REV. 571, 580 (1968).

34. See Miller, Ballen, Davenport & Vergari, *Commercial Paper, Bank Deposits and Collections, and Commercial Electronic Fund Transfers*, 42 BUS. LAW. 1269, 1288-90 (1987).

by "funds transfer." In a credit, or funds transfer, system the instruction to pay is given by the debtor directly to his or her bank. Thus, unlike the debit transfer system, it is the debtor who initiates the payment by instructing the bank to debit his account and credit the account of the creditor. The instruction may be given by any means: in writing, by telephone, or via a terminal linked to a bank's computer.³⁵ In a credit transfer system, information and funds flow in the same direction.³⁶ In the United States this kind of payment transaction is commonly referred to as "wire transfer" or "electronic funds transfer."³⁷ Although it is true that in most cases funds transfers involve some kind of electronic transmission, and while it may also be true that the common law developed in cases primarily involving payment orders transmitted by telex, the means of transmission is not a distinctive element³⁸ and has little legal significance. In the Federal Republic of Germany, the most popular funds transfer system is the post office and bank "Giro System."³⁹ For a long time the Giro System was a paper-based system and basically operated by mail.⁴⁰ Thus, the term "wire transfer" is not quite appropriate. The term "electronic funds transfer," in addition to inaccurately describing the possible means of transmission, is somewhat too broad, since it also covers debit transfer systems.⁴¹ Since at the moment no uniform terminology exists, this study adopts the terminology used by draft article 4A of the U.C.C., which will probably govern this area in the future.⁴² However, where it is an accurate description, the term "wire transfer" will be used.

35. See Scott, *supra* note 5, at 1668.

36. See Note, *supra* note 33, at 580.

37. Tallackson & Vallejo, *supra* note 11, at 639; T. QUINN & M. WHITE, QUINN'S UNIFORM COMMERCIAL CODE COMMENTARY AND LAW DIGEST (Cumulative Supplement No. 2, S4-2 1988) [hereinafter U.C.C. DIGEST].

38. This distinction is emphasized for example by U.C.C. DIGEST, *supra* note 37, at S4-4. Although it is acknowledged that electronic means dominate, the exchange of paper may still be important and, therefore, a clear-cut distinction is illusive.

39. A short overview of the Giro System can be found in R. BRANDEL & D. BAKER, *supra* note 14, at 5-38 to 5-44 and Am. Banker, Mar. 16, 17, 18 & 19, 1970. As to the process of electronification, see Möschel, *supra* note 13, at 187, 189-91.

40. See R. BRANDEL & D. BAKER, *supra* note 14, at 5-42.

41. See HAWKLAND, LEARY & ALDERMAN, U.C.C. SERIES (ARTICLE 4) § 4-101:16 [hereinafter HAWKLAND].

42. The following example of the "Prefatory Note of Article 4A - Funds Transfers" may illustrate the transaction in issue and the terminology used. X, a debtor, wants to pay an obligation owed to Y. Instead of delivering to Y a negotiable instrument such as a check or some other writing such as a credit card slip that enables Y to obtain payment from a bank, X transmits an instruction to X's bank to credit a sum of money to the bank account of Y. In most cases X's bank and Y's bank are different banks. X's bank may carry out X's instruction by instructing Y's bank to credit Y's account in the amount that X requested. In article 4A terminology, X is the "originator" of the transaction by which payment from X to Y will be effected. The instruction that X issues to its bank is a "payment order." X is the "sender" of the payment order and X's bank is the "receiver" of X's order. X's bank is also known as the "originator's bank." Y is the "beneficiary" of X's order. When X's bank issues an instruction to Y's bank to carry out X's payment order, X's bank "executes" X's order. The instruction of X's bank to Y's bank is also a payment order. With respect to that order, X's bank is the sender, Y's bank is the receiver, and Y is the beneficiary. Y's bank is the bank that will pay Y, the beneficiary, and is known as the "beneficiary's bank." The entire series of transactions by which X pays Y is known as the "funds

II.
AMERICAN LAW

A. Statutory and Regulatory Provisions

1. Uniform Commercial Code

The Uniform Commercial Code could be the natural source of law to answer the questions regarding to what extent banks are liable in the area of funds transfers and how liability is structured. However, article 4 of the U.C.C. applies primarily to bank deposits and collections and faces unique problems in a credit transfer context. Nevertheless, the reasoning of the U.C.C. has been applied by analogy and, thus, serves as the theoretical basis for court rulings in the area of funds transfer.

a. Bank Liability

The analysis of article 4's system of liability in the area of bank deposits and collections shows that although banks may not disclaim their liability for failure to exercise ordinary care, their liability is limited. The measure of damages is generally the amount of the item handled. Consequential damages are excluded, except in the case of bad faith or wrongful dishonor of an item. Whether, and under which circumstances, other damages such as punitive damages may be sought is controversial.

Section 4-103(1) of the U.C.C. states that "no agreement can disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care or can limit the measure of damages for such lack or failure." Section 4-103(1) thus acknowledges that under article 4, banks are subject to the general obligation of good faith and the exercise of ordinary care. The section further excludes the possibility of disclaiming these duties. The term "good faith" is defined in section 1-201 of the U.C.C. as "honesty in fact in the conduct or transaction concerned." What constitutes ordinary care or lack of it is not defined. Pursuant to the official comment, this term is used with its normal tort meaning and not in any special sense relating to bank collections.⁴³ The question of what the exercise of ordinary care may consist is explicitly left open to the parties' agreement by section 4-103(1), which further provides that "the parties may by agreement determine the standards by which such responsibility is to be measured if such standards are not manifestly unreasonable." Of course, only the assenting parties are bound by such agreements, and, in a complex collecting chain involving the payor bank and several collecting banks, it is highly unlikely that all interested parties have explicitly agreed.⁴⁴ Therefore, section 4-103(2) provides that Federal Reserve

transfer." In more complex transactions, there are one or more additional banks known as "intermediary banks" between X's bank and Y's bank.

43. U.C.C. § 4-103 comment 4 (1978).

44. Parties not explicitly assenting to such agreements may, however, become bound by adoption, ratification, estoppel or the like. Owners of items, in addition, may become bound to

regulations and operating letters, clearing house rules, and the like, have the effect of agreements under section 4-103(1) whether or not specifically assented to by all parties interested in items handled.

Having spelled out the basic principles of bank liability in part 1, article 4, parts 2, 3, and 4 provide for the special responsibilities of the collecting and payor banks. These provisions lead to notably different results for each type of bank, some of which are relevant to the problems involved in funds transfer. Section 4-202(1) indicates situations in which collecting banks must use ordinary care. For example, they must use ordinary care in presenting an item. Furthermore, they must notify its transferor of any loss or delay in transit within a reasonable time after discovery thereof, specifically before the midnight deadline following receipt of an item, notice, or payment.⁴⁵ Similar responsibilities are set forth in section 4-302 for the payor bank.

If banks do not comply with these duties, including acting in a timely manner, they become liable for damages. However, the amount of damages which can be recovered is limited. Section 4-103(5) provides that:

[T]he measure of damages for failure to exercise ordinary care in handling an item is the amount of the item reduced by an amount which could not have been realized by the use of ordinary care, and where there is bad faith it includes other damages, if any, suffered by the party as a proximate consequence.

Some decisions suggest that section 4-103(5), absent bad faith, allows only the recovery of direct damages,⁴⁶ and thus, generally excludes consequential damages. On the other hand, there is authority that section 4-103(5), read literally, could include consequential damages up to the amount of the item if there is no loss of principal.⁴⁷

The recovery of consequential damages is allowed in the case of bad faith, yet by providing for "other damages, if any, suffered by the party as a proximate consequence," section 4-103(5) suggests that only actual damages

such agreements on the principle that collecting banks act as their agents and, therefore, have authority to enter into binding agreements with respect to items handled. *See* Federal Reserve Bank of Richmond v. Malloy, 264 U.S. 160, 164 (1924); *see also infra* notes 118-22 and accompanying text.

45. U.C.C. section 4-202(2).

46. *Evra Corp. v. Swiss Bank Corp.*, 673 F.2d 951, 955 (7th Cir.) cert. denied 459 U.S. 1017 (1982); *Central Coordinates, Inc. v. Morgan Guar. Trust Co.*, 40 U.C.C. Rep. Serv. (Callaghan) 1340, 1342 (N.Y. Sup. Ct. 1985). As to the disputed question of whether prejudgment interests can be awarded, see *HAWKLAND*, *supra* note 41, § 4-103:08.

47. Miller & Ballen, *Commercial Paper, Bank Deposits and Collections, and Commercial Electronic Fund Transfers*, 41 BUS. L.W. 1399, 1413 n.42 (1986); Miller & Scott, *supra* note 20, at 1135 n.23. This seems doubtful because the language of section 4-103(5) properly construed suggests that consequential damages are generally excluded. Subsection 5 makes clear that the measure of damages is the amount of the item reduced by an amount which could not have been realized even by the use of ordinary care. The immediate context of these concepts shows that in subsection 5 only the loss of the principal is considered. This analysis is further supported in that "other damages," which can be recovered in the case of bad faith, can only mean damages beyond the loss of principal, i.e., damages other than direct damages.

may be sought. Punitive damages, which are not "damages suffered," are excluded.⁴⁸

Section 4-103(5) applies to both collecting and payor banks.⁴⁹ Article 4 sets forth special rules regarding the latter, although no general standard for measuring damages is provided. One such special provision, found in section 4-302, states that in the case where the payor bank misses its midnight deadline, it becomes accountable for the amount of the item. This provision has been construed to mean that the payor bank is liable to the customer for the full amount of the item, regardless of whether the amount could have been realized by the use of ordinary care at all.⁵⁰ This exempts the customer from the limitation set forth in section 4-103(5). More important is section 4-402. It pierces article 4's general principle that banks are liable only up to the amount of the item handled and, in doing so, establishes the possibility of collecting consequential damages. It provides that a payor bank is liable to its customer for damages proximately caused by the wrongful dishonor of an item. What consequential damages are "proximate" is a question of fact to be determined in each case.

Section 4-402 does not purport to specify whether the underlying theory of liability is tort or contract.⁵¹ Therefore, some split in authority exists as to whether consequential damages are subjected to the foreseeability requirement under *Hadley v. Baxendale*,⁵² applicable primarily to contract theories.⁵³ Section 4-402 uses the language "damages proximately caused." The accompanying official comment expressly states that it is not attempting to specify any theory. It makes a strong argument that consequential damages may be awarded whether or not they were foreseeable by the payor's bank, and regardless of whether the claim sounds in contract or tort.

Section 4-402 explicitly limits the recoverable damages to actual damages proved when the dishonor occurs through mistake.⁵⁴ In that case, therefore, recovery of punitive damages and damages for pain and suffering are excluded. In addition, section 4-402 rejects the so-called "trader rule" which provided for the award of substantial damages without proof that damages had occurred. This rule was based on the ground that where the dishonored item had been drawn by a merchant, trader, or fiduciary, he was defamed in

48. See HAWKLAND, *supra* note 41, § 4-103:10.

49. *Id.*

50. See F. MILLER & A. HARRELL, THE LAW OF MODERN PAYMENT SYSTEMS AND NOTES 237 (1985); HAWKLAND, *supra* note 41, § 4-302:05.

51. UCC § 4-402 comment 2 (1978).

52. 9 Exch. 341, 156 Eng. Rep. 145 (Ex. 1854).

53. The *Hadley* doctrine was applied by the court in *Bank of Louisville Royale v. Sims*, 435 S.W.2d 57 (Ky. 1968), but rejected by *Kendall Yacht Corp. v. United Cal. Bank*, 50 Cal. App. 3d 949, 123 Cal. Rptr. 848 (1975). See also HAWKLAND, *supra* note 41, § 4-402:08.

54. As to the question what is to be considered "mistake," see F. MILLER & A. HARRELL, *supra* note 50, at 254-55. See also HAWKLAND, *supra* note 41, § 4-402:05.

his business, trade, or profession by a reflection on his credit.⁵⁵ Controversy exists as to whether, where the dishonor is not caused by mistake, other than actual damages can be awarded⁵⁶ and as to whether the trader rule survives.⁵⁷ These questions seem to depend upon how the general liability provisions of the U.C.C. are to be construed. Section 1-106 provides that neither consequential, special, nor penal damages may be had except as specially provided for in the U.C.C. or by other rules of law. Since article 4 does not provide for such damages, the question arises as to whether another rule of law exists and whether under section 1-103 applicable state law has been displaced by section 4-402. Since section 4-402 adopts no theory of liability and covers mistaken and deliberate dishonor, it is arguable that it displaces any such damages.⁵⁸

b. New York Rule v. Massachusetts Rule

The U.C.C. takes the approach that each bank is an agent or subagent of the item's owner, a concept illustrated by the "Massachusetts collection rule." Under the Massachusetts rule as adopted by the U.C.C., upon failure of an intermediary bank, the owner of an item on principle has a cause of action only against the intermediary bank. As to the payor bank, article 4 provides in some cases for a privity requirement.

At common law two different rules existed concerning the liability of intermediary banks.⁵⁹ Under the "New York collection rule," the owner could only sue the initial collecting bank, which was subjected to liability for the actions of the subsequent banks in the collection chain.⁶⁰ According to this rule, the initial bank, in the absence of statute or contract to the contrary, undertook to collect the paper as an independent contractor and was itself responsible to the owner for the fault of its own agents. Under this theory, there was no privity between the owner and the intermediary bank, and hence no relationship between the owner and the intermediary bank existed out of

55. See U.C.C. § 4-402 comment 3 (1978); F. MILLER & A. HARRELL, *supra* note 50, at 256.

56. Punitive damages have been awarded under the U.C.C. in *Farmers & Merchants State Bank of Krum v. Ferguson*, 617 S.W. 2d 918 (Tex. 1981) and *Northshore Bank v. Palmer*, 525 S.W.2d 718 (Tex. Civ. App. 1975), but denied in *Kendall Yacht Corp. v. United Cal. Bank*, 50 Cal. App. 3d 949, 123 Cal. Rptr. 848 (1975).

57. *Raymer v. Bay State Nat'l Bank*, 384 Mass. 310, 424 N.E.2d 515 (1981), stands for the proposition that § 4-402 has completely abolished the "trader rule." See also F. MILLER & A. HARRELL, *supra* note 50, at 256; HAWKLAND, *supra* note 41, § 4-402:09; Davenport, *Wrongful Dishonor: UCC Section 4-402 and the Trader Rule*, 56 N.Y.U. L. REV. 1117 (1981).

58. F. MILLER & A. HARRELL, *supra* note 50, at 255 n.54, 256; HAWKLAND, *supra* note 41, § 4-402:09.

59. See, e.g., *Federal Reserve Bank of Richmond v. Malloy*, 264 U.S. 160, 164 (1924). As to the history of both rules, see Scott, *The Risk Fixers*, 91 HARV. L. REV. 737, 762-64 (1978).

60. The New York Rule had been adopted by the federal courts. See *Federal Reserve Bank of Richmond*, 264 U.S. at 160; *California Nat'l Bank of Sacramento v. Utah Nat'l Bank*, 190 F. 318 (8th Cir. 1911); *Smith v. National Bank of D.O. Mills & Co.*, 191 F. 226 (N.D. Cal. 1911); *City of Douglas v. Federal Reserve Bank of Dallas*, 2 F.2d 818 (5th Cir. 1924).

which a cause of action for failure to perform could be maintained. The intermediary banks were merely agents of the initial bank.⁶¹

By contrast, under the Massachusetts rule, the initial bank was only liable for negligence in selecting a responsible and properly qualified intermediary bank and giving proper instructions to that bank. Under this rule the injured owner had to directly pursue the intermediary bank. The theory underlying this cause of action was that the initial bank had implied authority to employ subagents for the collection who thereupon became the agents of the owner of the paper. An intermediary bank is not the agent of the initial bank but of the owner of the paper only, and is directly responsible to him for its failure.⁶²

Article 4 reflects the Massachusetts Rule by providing in section 4-201 that unless a contrary intent clearly appears, the bank is an agent or subagent of the owner of the item.⁶³ Furthermore, section 4-202(3) provides that "a bank is not liable for the insolvency, neglect, misconduct, mistake or default of another bank or person or for loss or destruction of an item in transit or in the possession of others."⁶⁴ Under the U.C.C., therefore, in the case of a failure of an intermediary bank, the owner of an item has a cause of action only against the intermediary bank, provided the initial bank has used ordinary care in selecting and giving proper instruction to it. Suing the intermediary bank may result in some difficulties for the owner of the item, e.g., the intermediary bank may be located some distance from the owner and it may be difficult to find out which of possibly numerous intermediary banks has failed. On the other hand, this rule avoids a complex chain of suits and brings the suit against the party who ultimately bears the loss. The payor's bank is directly liable to the owner of the item in the event that it misses its midnight deadline, pursuant to section 4-302. In the case of wrongful dishonor, section 4-302 allows recovery only by those who have an account or other contractual arrangement with the bank, thereby creating some privity requirement.⁶⁵ The U.C.C. prevents the holder of the item who has no direct contract with the bank from recovering his losses.⁶⁶

61. See *City of Douglas*, 2 F.2d at 818; *First Nat'l Bank v. Federal Reserve Bank*, 6 F.2d 339, 341 (8th Cir. 1925).

62. *First Nat'l Bank*, 6 F.2d at 345.

63. The primary meaning of this provision is to determine whether a bank is a purchaser of an item or merely an agent for collection. See U.C.C. § 4-201 comment 1 (1978). However, relating § 4-201 to § 4-202(3) shows that article 4 intended to follow the underlying theory of the Massachusetts rule.

64. See U.C.C. § 4-202 comment 4 (1978).

65. F. MILLER & A. HARRELL, *supra* note 50, at 256.

66. *Id.* This creates some dichotomy, for example, where the drawer, shortly after the item was presented, goes into bankruptcy, but at the moment of presentation is able to comply with his financial obligations. If the bank in this case fails to give timely notice of dishonor, the holder of the item may sue the payor bank for the amount of the item independent of whether or not he could have realized the amount of the item if the bank had complied with its duties. If the bank instead wrongfully fails to honor the item, but gives timely notice under the U.C.C. provisions, the payor bank is not liable to the holder of the item but only to its customer. It is difficult to see

c. *Application to Funds Transfer*

Although courts have denied the direct applicability of the U.C.C., they have considered the language of the U.C.C. and have applied certain provisions by analogy.⁶⁷ Article 4 of the U.C.C. applies to bank deposits and collections. Historically, the U.C.C. contemplated a paper-based payment system; typically, this meant payment by check or another negotiable instrument. In determining whether article 4 applied, part of the discussion focused on the fact that payment orders were often transmitted electronically. Hence, the distinction was drawn between a paper-based and an electronic-based payment system, the operative element being in one a piece of paper and in the other an electronic impulse.⁶⁸ The issue seemed to be whether, in the case of funds transfers effected by wire or other electronic means, the banks were handling an "item" pursuant to section 4-102(2).⁶⁹ "Item" is defined in section 4-104(1)(g) as "any instrument for the payment of money even though it is not negotiable but does not include money." Thus, the question seemed to concern whether an electronic message was an instrument for payment. "Instrument" is defined in section 9-105 as "any other writing which evidences a right to the payment of money." In fact, some commentators have argued that electronic messages or their representation as magnetic impulses on computer tape may be considered "writing," and thus an "item" could include funds transfer by electronic means.⁷⁰ Some states have adopted non-standard amendments to section 4-104(1)(g) which incorporate this concept.⁷¹

As mentioned above, a payment order may be transmitted by any means, including first class mail. In the case of a funds transfer made by telex, there can be no doubt that the "electronic message" is expressed in writing. In

why in one case the holder has a direct claim against the payor's bank and in the other he does not.

67. See *Evra Corp. v. Swiss Bank Corp.*, 522 F. Supp. 820, 827-28 (N.D. Ill. 1981), *rev'd*, 673 F.2d 951 (7th Cir.), *cert. denied*, 459 U.S. 1017 (1982); *Securities Fund Servs. Inc. v. American Nat'l Bank & Trust Co. of Chicago*, 542 F. Supp. 323, 326-27 (N.D. Ill. 1982); *Central Coordinates, Inc. v. Morgan Guar. Trust Co.*, 40 U.C.C. Rep. Serv. (Callaghan) 1340, 1342 (N.Y. Sup. Ct. 1985); *Bradford Trust Co. v. Texas Am. Bank-Houston*, 790 F.2d 407, 409 (5th Cir. 1986).

68. See U.C.C. DIGEST, *supra* note 37, at S4-4.

69. See *Scott, Wire Transfer*, *supra* note 5, at 1664; *Clark, An Item is an Item is an Item: Article 4 of the U.C.C. and the Electronic Age*, 25 Bus. L.W. 109, 111-12 (1969); *Central Coordinates, Inc. v. Morgan Guar. Trust Co.*, 40 U.C.C. Rep. Serv. (Callaghan) 1340 (N.Y. Sup. Ct. 1985). But see *Evra Corp. v. Swiss Bank Corp.*, 673 F.2d 951, 955 (7th Cir.); *Houston Contracting Corp. v. Chase Manhattan Bank, N.A.*, 539 F. Supp. 247 (S.D.N.Y. 1982) (holding that an unsigned telex was an "item" under article 4 but not a "demand item" and therefore not subject to § 4-302).

70. *Clark, supra* note 69, at 111-12.

71. In Georgia, § 4-109(1)(g) was amended to add that "item shall also include any stored electronic message unit for the payment of money." GA. CODE ANN. § 109A-4-104(g) (1982). In Florida, § 4-104(g) was changed to provide that "item means any instrument or electronically recorded, stored, or transmitted message for the payment of money even though it is not negotiable." FLA. STAT. ANN. § 674.104(1)(g) (West 1975).

Evra, one possibility was that the telex incorporating the payment order was lost by Swiss Bank. Hence, one may argue that the real issue was not "whether the language of section 4-102(2) could be stretched to include electronic fund transfers,"⁷² as the court stated, but whether the telex was an "item" pursuant to section 4-102(2).⁷³ From this perspective, there was no need to stretch the language of the U.C.C. in the actual case. The *Evra* court left this question open and did not apply article 4 on the grounds that the "electronic funds transfer" was not contemplated by the draftsmen.⁷⁴ Losing a piece of paper, however, has nothing to do with the electronic age, and one may ask what difference it makes whether a bank loses a telex or a check, the latter case being without a doubt contemplated by the draftsmen.

Thus, at least in some instances, article 4 could apply to funds transfers. However, one important difference between the payment system in question and the payment transaction contemplated by article 4 is the distinction between debit and credit transfer principles. Article 4 refers to debit transfer systems, such as systems where the payee places an instrument into the collection process which results in a debit to the payor. In contrast to this, funds transfer is a credit transfer, where the payor, not the payee, transmits an instruction to the payee's bank in order to credit a sum of money to the payee's bank account.⁷⁵ It is difficult to apply article 4 to funds transfer because of this structural difference between credit and debit transfer systems.⁷⁶ This may explain part of the reason why the rules of article 4 were not held applicable to the *Evra* wire transfer.

In deciding wire transfer cases, the courts have generally found common law principles, rather than article 4, applicable. *Delbrueck & Co. v. Manufacturers Hanover Trust Co.*⁷⁷ was the first case which dealt with this question. The issue was determining the latest time at which a wire transfer made through Chips⁷⁸ to the German bank house, Herstatt, could be revoked. The Second Circuit court of appeals held that "[t]he Uniform Commercial Code . . . is not applicable to this case because the U.C.C. does not specifically address the problems of electronic funds transfer."⁷⁹ Both the district and appellate courts in *Evra* referred to the *Delbrueck* holding.

In *Central Coordinates, Inc. v. Morgan Guaranty Trust Co.*,⁸⁰ facts very similar to those in *Evra* were involved. A wire transfer order was sent via Fedwire to the defendant, an intermediary bank, for credit to Alexander

72. 673 F.2d at 955.

73. Miller & Scott, *supra* note 20, at 1133.

74. 673 F.2d at 955.

75. See *supra* notes 31-34 and accompanying text.

76. As to specific questions which would arise out of the application of U.C.C. Article 4 see J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* 646 (2d ed. 1980).

77. 609 F.2d 1047 (2d Cir. 1979), *aff'd*, 464 F. Supp. 989 (S.D.N.Y. 1979).

78. See *supra* note 21 and accompanying text.

79. 609 F.2d at 1051.

80. 40 U.C.C. Rep. Serv. (Callaghan) 1340 (N.Y. Sup. Ct. 1985).

Maillis, a customer of Barclay's Bank. The payment was to preserve an option to acquire certain stock. The defendant credited the funds to Barclay's account, but did not give instructions to Barclay's Bank to credit Maillis' account. As a result, the option lapsed and plaintiff alleged losses of \$485,500. The court discussed at some length whether section 4-104(1)(g) regarded electronic transfers as "items," and had doubts as to whether the U.C.C. applied. Eventually, in deciding the case, the court left this question open.⁸¹

Both *Bradford Trust Company v. Texas American Bank-Houston*⁸² and *Walker v. Texas Commerce Bank, N.A.*,⁸³ relied exclusively on *Delbrueck* and *Evra*. In accordance with *Evra*, the arguments were made that the U.C.C. did not specifically address the problem of liability for electronic transfers of funds and that such transfers were not in the contemplation of the U.C.C. draftsmen.⁸⁴

2. Regulation J

In contrast to article 4, courts did not draw analogies to Regulation J, which governs bank liability in the area of funds transfer via Fedwire.⁸⁵ Funds transfers are often executed through the Federal Reserve Communications System, owned and operated by the twelve Federal Reserve Banks. The system, commonly referred to as Fedwire, provides both communication services and settlement services.⁸⁶ Not only member banks, but also non-member banks, other financial institutions, businesses, and consumers may request a member bank to send funds through the Federal Reserve System. The above-mentioned case of *Central Coordinates, Inc. v. Morgan Guaranty Trust Co.*⁸⁷ gives an illustrative, rather complex, example of a payment transaction involving Fedwire. In that case, plaintiff, the originator of the funds transfer, instructed his bank, Union Chelsea National Bank ("Chelsea"), to transfer funds to the account of Alexander Maillis, the beneficiary, at Barclay's Bank International, the beneficiary's bank. Chelsea used Fedwire to send the funds to Morgan Guaranty, Barclay's correspondent bank, with the instruction to credit the account of Barclay's for ultimate credit to the account of the beneficiary. Both Chelsea and Morgan Guaranty, the intermediary bank, were members of the Federal Reserve Bank system and thus

81. *Id.* at 1342.

82. 790 F.2d 407 (5th Cir. 1986).

83. 635 F. Supp. 678 (S.D. Tex. 1986).

84. 790 F.2d at 409; 635 F. Supp. at 681.

85. See *supra* notes 22-23 and accompanying text.

86. In 1983, 38 million transactions valued at \$84 trillion were handled on this network. See Tallackson & Vallejo, *supra* note 37, at 639 n.1. However, most of these transactions did not involve funds transfers on behalf of bank customers, but rather transfers resulting from the purchase and sale of federal funds and transfers in order to settle correspondent bank balances. See R. BRANDL & D. BAKER, *supra* note 14, at 11-7.

87. 40 U.C.C. Rep. Serv. (Callaghan) 1340 (N.Y. Sup. Ct. 1985); see *supra* notes 65-66 and accompanying text.

maintained balances at the same Federal Reserve Bank or at different Federal Reserve Banks. Settlement between these banks occurred by debiting and crediting the respective accounts with the Federal Reserve Banks. Settlement between Morgan Guaranty and Barclay's then occurred by crediting Barclay's account, which was held at Morgan Guaranty. Chelsea could not send the funds directly to Barclay's because there was no correspondent relationship with Chelsea, and Barclay's was not a member of the Federal Reserve Bank system.⁸⁸

Subpart B - Wire Transfers of Funds of Regulation J⁸⁹ addresses important aspects of the issues in question in funds transfers via Fedwire. However, the application of subpart B of Regulation J is limited. Obviously, it only applies to funds transfers effected via Fedwire and not through other means of funds transfer such as Bankwire II or simple Telex messages between correspondent banks. In addition, Regulation J is limited to "transferor" and "transferee" who are defined to be member banks and certain others that maintain or use accounts with a Federal Reserve Bank.⁹⁰ Its basic purpose is to define the rights and obligations of the Federal Reserve Banks. No attempt was made to specify the liabilities of other parties.⁹¹ Nevertheless, some general guidance may be drawn from these rules, since they govern the status of the Federal Reserve Banks as intermediary banks in the transactions in question. In addition, Regulation J was subject to substantial modifications recently, which point out tendencies in the development of the law.

Section 210.38 of Regulation J provides that a Federal Reserve Bank shall not have or assume any responsibility except to its immediate transferor. Thus, the originator of a funds transfer who is injured by a Federal Reserve Bank's failure to exercise ordinary care cannot bring an action against the Federal Reserve Bank. Regulation J follows the above-discussed New York Rule.⁹² In funds transfers, the Federal Reserve Banks act only as agents of the immediate transferor and are not agents for any other party in the transaction.⁹³ Section 210.6(a) of Subpart A - Collection of Check and Other Items By Federal Reserve Banks follows the same rule. Thus, these provisions are in apparent contradiction with section 4-201(a) of the U.C.C., which, as discussed above, has adopted the Massachusetts Rule,⁹⁴ providing

88. See Central Coordinates, 40 U.C.C. Rep. Serv. (Callaghan) 1340, 1341 (N.Y. Sup. Ct. 1985).

89. 12 C.F.R. §§ 210.25-38 (1988).

90. 12 C.F.R. § 210.26(f)-(g) (1988).

91. See Scott, *supra* note 5, at 1664.

92. See *supra* notes 54-56 and accompanying text.

93. See 51 Fed. Reg. 21,740 (1985); B. CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS § 4-58 (rev. ed. Supp. 1988).

94. See *supra* note 61 and accompanying text.

for direct actions of the owner of items against collecting banks.⁹⁵ With respect to this antinomy, the Board of Governors of the Federal Reserve System (the "Board") has amended section 210.6(a) by deleting the New York Rule. Effective January 1, 1990, the Federal Reserve Banks will be subject to suits by the same parties that can bring actions under the U.C.C. provision against collecting banks.⁹⁶ Although courts, in deciding questions of liability in funds transfers, have generally drawn an analogy to the U.C.C. provision and have held that intermediary banks are agents of the originator,⁹⁷ the Board did not change section 210.38. Thus, future originators of funds transfers effected by Fedwire will not be allowed to bring direct suits against Federal Reserve Banks, which therefore will be treated differently than other intermediary banks. With respect to the change in section 210.6, there appears to be no explanation for this inconsistency between the rules of Regulation J governing check collection and funds transfers and the provision of Regulation J and common law.

Until August 1986 section 210.38 subpart B - Wire Transfers of Funds of Regulation J, provided that the Federal Reserve Banks were liable for all losses proximately caused by the banks' lack of good faith or failure to exercise ordinary care. This provision included the possibility for recovery of consequential damages.⁹⁸

Presumably with regard to the development of the common law in wire transfers, which applied the *Hadley v. Baxendale* doctrine,⁹⁹ the Board in 1985 proposed to amend Regulation J to limit a Federal Reserve Bank's liability "to damages that are directly and immediately attributable to the mis-handling and to make it clear that a Reserve Bank will not be liable for consequential damages."¹⁰⁰ This amendment was adopted and section 210.38 now provides that a Federal Reserve Bank's liability for a failure to credit the amount of a transfer item caused by the failure to exercise ordinary care or act in good faith is limited to damages that are attributable directly and immediately to the failure to credit. However, liability does not include damages that are attributable to the consequences of the failure to credit, even if such consequences were foreseeable at the time of such failure. Interestingly enough, of the thirty-eight comments received on the proposal of this amendment, thirteen (thirty-four percent) were opposed. They contended that the adoption of the amendment would give an advantage to the Federal Reserve Banks resulting from the exercise of regulatory authority rather than

95. Section 210.6(a) has been upheld by several courts. See, e.g., *Childs v. Federal Reserve Bank of Dallas*, 719 F.2d 812 (5th Cir. 1983), *reh'g denied*, 724 F.2d 127 (5th Cir. 1984). It was held that this Federal Reserve Board regulation takes precedence over state law if they are inconsistent.

96. See 51 Fed. Reg. 21,741 (1985).

97. See *infra* note 124 and accompanying text.

98. See R. BRANDEL & D. BAKER, *supra* note 14, at 16-4; Scott, *supra* note 5, at 1669-70.

99. 9 Exch. 341, 156 Eng. Rep. 145 (Ex. 1854); See *infra* notes 150-69 and accompanying text.

100. 51 Fed. Reg. 21,744 (1985).

from the competitive merits of the Fedwire service since contractual arrangements could not provide to private sector institutions the same level of security that a federal regulation would provide to the Federal Reserve Banks.¹⁰¹ Although acknowledging this argument, the Board did not believe it was sufficient reason to leave Regulation J unchanged. The Board held that the concept adopted was desirable for the industry as a whole and that to the extent that private institutions transmitting wire transfers on behalf of customers could not protect themselves by private agreements, state legislatures should intervene. The Board believed that it could best induce these changes by taking the lead and adopting its proposal.¹⁰²

Although addressing certain issues of funds transfer explicitly, courts have rarely referred to Regulation J in order to answer the questions raised.¹⁰³ Especially as to the question of whether the originator has a direct claim against an intermediary bank, the courts have exclusively referred to the U.C.C. provisions by analogy, without taking into consideration the existing legislative approach.¹⁰⁴

B. Common Law

I. *Evra Corp. v. Swiss Bank Corp.*

*Evra Corp. v. Swiss Bank Corp.*¹⁰⁵ is the leading U.S. decision concerning an intermediary bank's failure to transfer funds properly. In *Evra*, the plaintiff brought an action against Swiss Bank Corporation ("Swiss Bank") for the failure to promptly transmit a \$27,040.62 payment order, resulting in the cancellation of a charter. The plaintiff sought to recover \$2.1 million in consequential damages consisting of the lost profits from a subcharter of the vessel.¹⁰⁶ *Evra* has been heavily relied upon by subsequent cases in this area. Perhaps more important for the future, it also has been relied upon to support provisions of the draft of the Uniform New Payments Code¹⁰⁷ and the subsequent draft of article 4A of the U.C.C.¹⁰⁸

101. See *id.*

102. See *id.* at 21,741.

103. A rare example is *Central Coordinates, Inc. v. Morgan Guar. Trust Co.*, 40 U.C.C. Rep. Serv. (Callaghan) 1340, 1344-45 (N.Y. Sup. Ct. 1985), which, consistent with the purpose and the language of Regulation J, held that this regulation did not address questions of liability of the transferee as to the originators of a funds transfer.

104. See *supra* note 67.

105. 522 F. Supp. 820 (N.D. Ill. 1981), *rev'd*, 673 F.2d 951 (7th Cir.), *cert. denied*, 459 U.S. 1017 (1982).

106. 673 F.2d. 951. As to the German system of courts, see generally N. HORN, H. KOTZ & H. LESER, *GERMAN PRIVATE & COMMERCIAL LAW: AN INTRODUCTION* 29-32 (1982); 1 E.J. COHN, *MANUAL OF GERMAN LAW* 36-38 (2d ed. 1968).

107. At Section 101 purpose no. 2 and Section 411 purpose no. 8 Uniform New Payment Code (Permanent Editorial Board for the Uniform Commercial Code, Draft No. 3, June 2, 1983) [UNPC]; see Scott, *supra* note 5, at 1678; R. BRANDEL & D. BAKER, *supra* note 14, at 10-16 to 10-28; HAWKLAND, *supra* note 41, § 4-101:25-26.

108. See *infra* notes 189-90 and accompanying text.

In *Evra*, Hyman-Michaels Company, the predecessor-in-interest to the *Eyra* Corporation, made payments due under its charter with the Pandora Shipping Corporation by wire transfer.¹⁰⁹ The payments were originated through Hyman-Michaels Company's bank, Continental Illinois National Bank and Trust Company of Chicago ("Continental"). According to Hyman-Michaels and Swiss Bank, and uncontroverted by Continental, it knew the background of the wire transfer at issue.¹¹⁰ The transfer procedure was usually as follows: Continental would debit its customer account and then send a telex to its London office for retransmission to its correspondent Swiss Bank in Geneva. Swiss Bank then advised the Bank de Paris to credit the amount to the account of Pandora Shipping Corporation.¹¹¹ Continental in Chicago settled by crediting Swiss Bank's account and Swiss Bank settled by crediting the Banque de Paris account.¹¹² In each instance a charter payment was made, Continental sent an advice of debit to Hyman-Michaels.¹¹³ Hyman-Michaels made the payment orders a few days in advance of the payment due date, and payments were made on time until the payment due at 9 p.m. Geneva time on April 27, 1973.¹¹⁴ In order to execute that payment, Hyman-Michaels telephoned Continental on the morning of April 25, 1973 and requested that Continental make a wire transfer in the amount of \$27,040.62. Continental forwarded the payment order by telex to its London office on the same afternoon, which was nighttime in England. Continental issued its standard advice form, confirming that the Hyman-Michaels account had been debited and that Continental would execute the wire transfer. Hyman-Michaels received it at or before 8:30 a.m. on April 27, 1973. Early in the morning, London time, on April 26, Continental London, in accord with the instruction it had received from Chicago, attempted to telex the payment order to Swiss Bank's general telex number, but it was busy. The London office then diverted the telex message to another number, that of a machine in Swiss Bank's foreign exchange department, which it had used in

109. *Evra*, 673 F.2d at 953.

110. See *Jetton*, *supra* note 20, at 379 n.45. Hyman-Michaels described its relationship with Continental as follows: Continental was Hyman-Michaels' primary bank, providing to Hyman-Michaels a line of credit in excess of \$5 million as well as a full range of banking services. Continental sought and received from Hyman-Michaels detailed information about each and every phase of Hyman-Michaels' business, including the specifics of Hyman-Michaels' various charters; charter rates and expected profitability of each vessel under charter, market rates for the shipping industry, and the expiration dates of each charter. Hyman-Michaels had to obtain Continental's approval before entering into new charters. *Evra*, 673 F.2d at 953.

111. *Evra*, 522 F. Supp. at 823; 673 F.2d at 952.

112. See *Miller & Scott*, *supra* note 20, at 1131.

113. *Evra*, 522 F. Supp. at 824.

114. *Id.* By contrast, the court of appeals found that since the installment was due April 27 and payment was due in advance, the payment "arguably" was due by the close of business on April 26. 673 F.2d at 953.

the past when the general number was engaged. The London office had received a clear copy of the message on its telex machine¹¹⁵ and the machine at Swiss Bank acknowledged a successful receipt of the transmission.¹¹⁶

Swiss Bank, however, took no action in response to the telex, and no transfer of funds was made to the account of the vessel's owner. The district court found that Swiss Bank either lost the April 26, 1973 telex message, or failed to have paper in its machine at the time the message was being received.¹¹⁷ The receiving machine was not equipped to make duplicate copies of messages. As a result, if a person took the single copy of the message and then lost it, there was no backup copy. The telex machine in the foreign exchange office of Swiss Bank had no system for logging messages or ensuring that they were acted upon and no procedure for checking the paper supply. The telex machine would continue to receive messages and would communicate receipt of the message to the receiver even when it had run out of paper.¹¹⁸ Hyman-Michaels first learned that the payment had not been made at 8:30 a.m. Chicago time, on Friday, April 27, 1973, by a telex message from the owner of the Pandora canceling the charter. Hyman-Michaels immediately instructed Continental by telephone to keep trying to effect payment, and confirmed this instruction by a letter dated April 28. It also contacted the owner's representative on the morning of April 27 to tell him that payment had been made. Continental, after having investigated what had happened to the payment, tried to execute the funds transfer at about 6:00 p.m. Geneva time by giving Swiss Bank the telex code and payment instructions over the telephone. This was not successful because Swiss Bank said it was too late in the day. No further action was taken on Monday, April 30, except a search for the lost telex message. On May 1, Swiss Bank suggested to Continental that it retransmit the payment order, which Continental did the same afternoon. Swiss Bank attempted to execute the payment order on May 2 to the account of the Pandora's owner at the Banque de Paris, but the payment was refused.¹¹⁹ An arbitration panel was convened and the arbitrators held that the owner was entitled to withdraw the vessel from the charter. The arbitrators' decision was confirmed by a federal district court in New York.¹²⁰

2. *Theories Under Evra and Following Cases*

The *Evra* plaintiff, Hyman-Michaels, sued the intermediary bank in contract and tort, claiming breach of contract, breach of fiduciary duty, and negligence. After having decided that Illinois law governed rather than Swiss law and that the Illinois U.C.C. did not apply, the district court decided in

115. *Evra*, 522 F. Supp. at 825.

116. *Evra*, 673 F.2d at 953.

117. *Evra*, 522 F. Supp. at 825.

118. *Id.*

119. *Evra*, 673 F.2d at 954.

120. *Id.*

favor of Hyman-Michaels on two claims, holding that Swiss Bank had breached its contractual duty of care and had been negligent.

The district court upheld the claim for breach of contractual duty of care on the grounds that a contract existed between Continental and Hyman-Michaels establishing a duty of care to transmit the wire transfer payment accurately and in a timely manner,¹²¹ and that the intermediary bank owed the plaintiff that same duty.¹²² The district court drew an analogy to article 4 of the U.C.C. where, under section 4-201, it is presumed that prior to final settlement each collecting bank becomes an agent of the owner of the item.¹²³ It found that in the case of a wire transfer the intermediary bank was in the same position as the intermediary collecting bank and thus became an agent of the originator of the transaction until such time as the transaction was completed. Since Swiss Bank was held to be the agent of the plaintiff, owing the plaintiff the same duty of care that the originator's bank owed the plaintiff, Swiss Bank breached the duty to transmit the wire transfer accurately and in a timely manner. Although Hyman-Michaels also filed suit against Continental, neither the district court nor the Seventh Circuit on appeal discussed whether Continental could have been held vicariously liable for Swiss Bank's breach of duty. This possibility was not necessarily excluded if Swiss Bank was Hyman-Michaels' agent.¹²⁴ However, both decisions impliedly followed the rule of section 402-2(3) of the U.C.C. excluding bank liability for the actions of subsequent banks in the collection chain. Both courts held that all Continental undertook to do was to transmit a telex message to Swiss Bank and that it did so without breaching any contract with Hyman-Michaels.¹²⁵ Both courts thus applied the Massachusetts Rule to funds transfer, without discussing the New York Rule.¹²⁶

The district court did not uphold the claim under a fiduciary duty theory.¹²⁷ Relying on *People ex rel. Barrett v. Central Republic Trust Co.*,¹²⁸ the court stated that "a fiduciary relationship exists only when confidence is reposed on one side and there is a resulting superiority and influence on the other side."¹²⁹ Obviously the defendant did not exercise any superiority or influence over Hyman-Michaels. Accordingly, the court found that Swiss Bank did not breach any fiduciary duty.

Both the district court and the court of appeals found Swiss Bank negligent.¹³⁰ The district court stated that upholding a negligence action under Illinois law required the existence of a duty owed to plaintiff by defendant, a

121. Evra, 522 F. Supp. at 829.

122. *Id.* at 827.

123. See *supra* notes 58-61 and accompanying text.

124. See *Shrewsbury v. Dupont Nat'l Bank*, 10 F.2d 632, 635 (D.C. Cir. 1925).

125. Evra, 673 F.2d at 960.

126. See *supra* notes 54-56 and accompanying text.

127. Evra, 522 F. Supp. at 829.

128. 300 Ill. App. 297, 302-03, 20 N.E.2d 999, 1001-02 (1939).

129. Evra, 522 F. Supp. at 829.

130. Evra, 522 F. Supp. at 829; 673 F.2d at 957.

breach of that duty, and an injury proximately caused thereby. The existence of such a duty is a question of law, and in determining whether it exists, it must be found that the occurrence involved was reasonably foreseeable.¹³¹ Other factors to be considered in determining whether a legal duty exists are the likelihood of injury, the magnitude of the burden of guarding against it, and the consequences of placing that burden on the defendant.¹³² The court found that Swiss Bank owed Hyman-Michaels a duty of care to maintain a system of receiving and disposing of telex messages upon which plaintiff could rely and that it was reasonably foreseeable to Swiss Bank that the negligent maintenance of its foreign exchange telex machines could result in substantial damages. The court found that defendant breached its duty of care in two regards. First, it was negligent in using a telex machine which continued to receive messages regardless of whether the content of the message was being recorded. Second, Swiss Bank was also negligent in failing to institute a system for logging messages to insure that diverted messages were not lost or mishandled.¹³³

In the view of the court, setting up these safety procedures using safe equipment would have involved minimal costs vis-à-vis the potential losses involved. The court, furthermore, held that the negligence and carelessness of Swiss Bank proximately caused the loss suffered by Hyman-Michaels.¹³⁴

That the originator may directly sue an intermediary bank was reaffirmed by two cases in which the facts were almost identical: *Securities Fund Services, Inc. v. American National Bank and Trust Co. of Chicago*¹³⁵ and *Bradford Trust Co. v. Texas American Bank-Houston*.¹³⁶ The same theories underlying *Evra* were applied, and others were added. In *Securities Fund Services*, an impostor ordered Securities Fund Services (SFS) to redeem \$2 million worth of shares held by John Bushman as trustee, and to transfer the proceeds of the liquidation to an account at the American National Bank and Trust Company of Chicago (ANB) designated "John Bushman, Trustee//204471."¹³⁷ SFS instructed New England Merchants National Bank (NEMNB) to make the transfer, which transmitted the order to ANB. Although Bushman had no account with ANB, the funds were credited to the specified account number, which was held for Gerald Haberkorn. No notification was given and no inquiry made about the discrepancy. "Haberkorn had previously agreed to sell approximately \$2 million dollars worth of diamonds and jewels to two individuals who promised to pay by wiring funds

131. *Cunis v. Brennan*, 56 Ill. 2d 372, 376-77, 308 N.E.2d 617, 619 (1974).

132. *Cross v. Chicago Hous. Auth.*, 74 Ill. App. 3d 921, 925, 393 N.E.2d 580, 583 (1979).

133. *Evra*, 522 F. Supp. at 829. The court characterized Swiss Bank's lack of safety procedures as a "cavalier attitude towards major transactions by a sophisticated international bank" which was shocking.

134. *Id.*

135. 542 F. Supp. 323 (N.D. Ill. 1982).

136. 790 F.2d 407 (5th Cir. 1986).

137. 542 F. Supp. at 325.

to Haberkorn's account at ANB.¹³⁸ After the funds were credited to Haberkorn's account, he delivered the merchandise.

SFS, upon discovery of the fraud, reissued the previously redeemed shares to Bushman and sued ANB in order to recover damages. SFS contended that ANB caused the loss by crediting an account in which the name and number given in the instruction did not match. Upon ANB's motion to dismiss, the court allowed certain counts to stand.¹³⁹ The court followed the reasoning in *Evrà* with respect to the analogy drawn to the agency status of intermediary banks set forth in article 4 of the U.C.C. It held that defendant ANB was an agent of the originator and that under the facts alleged had breached its duty of care. However, defendant in that case was a beneficiary bank having a contractual relationship with the holder of the account to which the funds were credited. The court simply referred to the defendant as being a collecting bank, and thus did not see the differences between credit and debit transfers. Arguably, the beneficiary bank is only an agent of its customer¹⁴⁰ and not at the same time an agent of the originator, because in receiving the money it acts in the first place on behalf of its customer.¹⁴¹

The court also upheld a negligence theory. It found that ANB owed the plaintiff a duty of care in handling the wire transfer under section 4-203, since SFS, by analogy to section 4-104(e),¹⁴² could be deemed to be a customer of ANB.¹⁴³ The court held that the loss of the transferred funds was the reasonably foreseeable result of a credit made where the name on the payment order differed from the name of the account the funds were credited to, and that, therefore, the defendant breached its duty by failing to inform the plaintiff or the plaintiff's bank, NEMNB, that the name and account number on the payment order did not coincide.¹⁴⁴

However, in *Securities Fund Services*, the court added another theory under which the originator directly might hold an intermediary bank liable for the loss incurred. It found that SFS had adequately pleaded its status as third-party beneficiary¹⁴⁵ to a contract entered into between NEMNB and

138. *Id.*

139. The court dismissed the bailment, conversion, and estoppel counts. 542 F. Supp. at 326.

140. As to the agency status of the beneficiary bank towards the holder of the account, see *Delbrueck & Co. v. Manufacturers Hanover Trust Co.*, 609 F.2d 1047, 1051-52 (2d Cir.), *aff'd* 464 F. Supp. 989 (S.D.N.Y. 1979).

141. Arguably, one could draw an analogy to the rules of article 4 of the U.C.C. governing the status of a payor bank. Only the collecting banks are agents of the holder of the item, and acting in the holder's interest. The agency status is not set forth for the payor bank, which basically acts on behalf of the payor in fulfilling the payor's obligation towards the payee. See *MILLER & HARRELL, supra* note 50. By contrast, the court argued that SFS could be deemed a "customer" pursuant to § 4-104(e) of the U.C.C., because ANB was acting as a collecting bank for SFS. Taking into consideration the above reasoning, it is difficult to draw this analogy.

142. As to the question whether this analogy is justified see *supra* note 141 and accompanying text.

143. 542 F. Supp. at 327.

144. *Id.* at 327.

145. See *Miller, Ballen & Scott, Commercial Paper, Bank Deposits and Collections, and Commercial Electronic Fund Transfers*, 39 BUS. LAW. 1329, 1333 (1984).

ANB. The general rule regarding a third party's right to sue for breach of a contract between two other parties was announced by the Illinois Supreme Court in *Carson Pirie Scott & Co. v. Parrett*.¹⁴⁶ According to that case, if a contract is made for the benefit of the third party, the third party may sue for the breach. The test to be applied is whether the benefit to the third party is direct or is only incidental. The question of whether the benefit to a third party is direct or incidental, and thus whether the third party may sue or not, depends upon the intent of the parties and is to be determined within the language of the contract in a case-by-case analysis.¹⁴⁷ In *Securities Fund Services*, the court found that the benefit to SFS was the interest in properly transferring the funds so as to avoid any loss by SFS¹⁴⁸ and that SFS did not need to be named within the contract between NEMNB and ANB,¹⁴⁹ since it was evident that SFS fell within the group designated to benefit from the contract.¹⁵⁰ In failing to properly credit the funds as directed by NEMNB, ANB had breached its contract. The court thus impliedly found that in funds transfers, account numbers did not control inconsistent names.¹⁵¹ The third-party beneficiary theory was also applied in *Central Coordinates, Inc. v. Morgan Guaranty Trust Co.*¹⁵² However, it is worth noting that this analysis is not consistent with the finding that ANB was the agent of SFS under the analogy drawn between ANB's status and the status of a collecting bank under the U.C.C. Pursuant to the U.C.C. provisions, no contractual relationship exists between collecting banks as to the execution of the payment order. The collecting banks involved in the collecting chain are mere agents of the holders of the item and responsible only to them.¹⁵³

3. Damages

Whereas the district court held that Hyman-Michaels was entitled to recover the full amount of \$2.1 million on lost profits, the claim eventually was rejected by the court of appeals under the *Hadley v. Baxendale*¹⁵⁴ doctrine. Four defenses were raised by Swiss Bank in order to exclude partially

146. 346 Ill. 252, 178 N.E. 498 (1931).

147. *Securities Fund Servs., Inc. v. American Nat'l Bank & Trust Co. of Chicago*, 542 F. Supp. at 329 (citing *Midwest Concrete Prods. Co. v. LaSalle Nat'l Bank*, 94 Ill. App. 3d 394, 418 N.E.2d 988, 990 (1981); *Kravitz v. Lake County*, 62 Ill. App. 3d 101, 379 N.E.2d 126, 128 (1978)).

148. 542 F. Supp. at 329.

149. It is sufficient that the third-party beneficiary is otherwise described or designated. *Candlewick Lake Util. Co. v. Quinones*, 82 Ill. App. 3d 98, 402 N.E.2d 369 (1980); *Gothberg v. Nemerovski*, 58 Ill. App. 2d 372, 208 N.E.2d 12 (1965).

150. 542 F. Supp. at 329.

151. Section 3-118(c) of the U.C.C. provides that "words control figures except that if the words are ambiguous figures control." An analogy to this provision probably would have compelled a different result. See *Miller, Ballen, Davenport & Vergari*, *supra* note 34, at 1290.

152. 40 U.C.C. Rep. Serv. (Callaghan) 1340, 1343 (N.Y. Sup. Ct. 1985). For a summary of the facts, see *supra* notes 76-77 and accompanying text.

153. See *supra* notes 58-59 and accompanying text.

154. 9 Exch. 341, 156 Eng. Rep. 145 (Ex. 1854).

or completely accountability for consequential damages: (1) the plaintiff's contributory negligence, (2) the plaintiff's failure to mitigate the consequences of the lost telex, (3) a contractual exculpatory clause, and (4) the lack of foreseeability of the amount of damages involved. The district court rejected all four arguments and held Hyman-Michaels entitled to the full amount.

On appeal the case turned on the question as to whether the *Hadley v. Baxendale* doctrine could bar Hyman-Michaels from recovering consequential damages. *Hadley v. Baxendale* is the leading common law case on liability for consequential damages caused by failure or delay in carrying out a commercial undertaking. In *Hadley*, the plaintiff's mill was stopped when the main crankshaft by which the mill was worked broke. It was necessary to send the shaft as a pattern for a new one to the manufacturer. Defendant, a common carrier, was hired to transport the shaft. By defendant's neglect, delivery of the shaft was delayed. The plaintiff sued for lost profits during the additional time the mill was shut down because of defendant's delay. The court found that the plaintiff could not recover the lost profits it was seeking because "in the great multitude of cases of millers sending off broken shafts to third persons by a carrier under ordinary circumstances, such consequences would not, in all probability, have occurred; and these special circumstances were here never communicated by the plaintiffs to the defendants."

The court found special circumstances in the fact that the defendant did not know that the mill depended on the broken shaft to operate and that delay would cause additional damages. The court hypothesized that, for example, the miller might have had a spare shaft and that, had it known the special circumstances, the carrier might have had special terms provided for in the contract.

The precursors to *Evra* were the old telegraph cases.¹⁵⁵ They accepted the *Hadley v. Baxendale* doctrine, but were divided as to the circumstances under which the telegraph companies had enough notice about the risk involved in order to collect consequential damages.¹⁵⁶ In deciding *Evra* three Illinois cases were of special importance. In *Siegel v. Western Union Telegraph Co.*,¹⁵⁷ the plaintiff attempted to wire to a friend \$200 to bet on a horse. Because of Western Union's failure the money did not arrive until several hours after the race had taken place. The horse on which the plaintiff had

155. See *Postal Telegraph Co. v. Lathrop*, 131 Ill. 575, 23 N.E. 583 (1890); *Providence-Washington Ins. Co. v. Western Union Tel. Co.*, 247 Ill. 84, 93 N.E. 134 (1910); *Morris v. Western Union Tel. Co.*, 24 Ariz. 12, 206 P. 580 (1922); *Kerr S.S. Co. v. Radio Corp.*, 245 N.Y. 284, 157 N.E. 140, *cert. denied*, 275 U.S. 557 (1927); *Siegel v. Western Union Tel. Co.*, 312 Ill. App. 86, 37 N.E.2d 868 (1941); *Taggart v. Western Union Tel. Co.*, 179 Misc. 121, 37 N.Y.S.2d 662 (N.Y. Sup. Ct. 1942); *Baker v. Western Union Tel. Co.*, 180 Tenn. 403, 175 S.W.2d 544 (1943).

156. In 1934 the liability of telegraph companies was limited by the Federal Communications Act and therefore older cases became largely obsolete. Scott, *supra* note 5, at 1677 n.64 & 1694 n.159.

157. 312 Ill. App. 86, 37 N.E.2d 868 (1941).

intended to bet won, and the plaintiff sued for the lost profits. Since the instruction given to Western Union did not disclose the purpose of the payment, defendant was not held liable under the *Hadley* rule because it lacked sufficient notice.

In *Postal Telegraph Cable Co. v. Lathrop*¹⁵⁸ a coffee dealer sent a telegram to its broker directing him to buy 1000 bags of coffee. This message was negligently changed to 2000 bags, and because the price fell the dealer sustained an extra loss for which he sued the telegraph company. The court held that the defendant had enough notice under *Hadley v. Baxendale* in order to make it liable for the consequential damages sought. The defendant knew from the plain language of the message that it was transmitting buy and sell orders in a fluctuating market and that mistakes could result in large losses.¹⁵⁹

In *Providence-Washington Insurance Co. v. Western Union Telegraph Co.*,¹⁶⁰ the telegraph company failed to promptly deliver a telegram from an insurance company canceling a fire insurance policy. During the delay, there was a fire and the insurance company was liable on the policy. The Illinois Supreme Court awarded consequential damages under the *Hadley* rule, holding that sufficient notice had been provided. The risk involved by a delay was disclosed to defendant from the face of the telegram.¹⁶¹

The *Hadley* rule was formulated in the section 351 of Restatement (Second) of Contracts (the "Restatement")¹⁶² as follows:

- (1) Damages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made.
- (2) Loss may be foreseeable as a probable result of a breach because it follows from the breach
 - (a) in the ordinary course of events, or
 - (b) as a result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know.

In *Evra*, the district court found that Swiss Bank could reasonably foresee that failure to act promptly upon receipt of the telex message could result in substantial damages to a customer of the bank. According to the court, the fact that Hyman-Michaels was transferring funds by wire rather than through the mail was sufficient to alert Swiss Bank to the importance of the

158. 131 Ill. 575, 23 N.E. 583 (1890).

159. *Id.* at 585-86, 23 N.E. at 585.

160. 247 Ill. 84, 93 N.E. 134 (1910).

161. *Id.* at 90, 93 N.E. at 136. In addition, the court stated:

While the weight of authority is that telegraph companies are not common carriers, and therefore insurers of the correct and prompt transmission and delivery of messages, it is held that they exercise a quasi public employment, with duties analogous to those of common carriers, and are required to use a high degree of care and still in the correct and prompt transmission of messages.

162. Restatement (Second) of Contracts § 351 (1981).

transaction.¹⁶³ The court thus applied an objective standard and did not require actual notice of special circumstances as a prerequisite for awarding consequential damages. Instead, it held sufficient general foreseeability, found in the fact that ordinarily companies transfer funds to pay debts, and that late payment may result in penalties, such as late charges, repossession, eviction, loss of an option, and withdrawal of a charter.¹⁶⁴ Thus, in the terminology of the Restatement, the court considered the consequential damages sought as a probable result in the ordinary course of events.¹⁶⁵

In contrast, Judge Posner, writing the opinion for the court of appeals, imposed a test of "specific" foreseeability.¹⁶⁶ The bank would have had specific foreseeability if it had known when payment was due, what the terms of the charter were, that these terms had turned out to be extremely favorable, and how at once "precious and fragile" Hyman-Michaels' contract was.¹⁶⁷ The court held that these circumstances were too far removed from Swiss Bank's practical range of knowledge to influence the standard under which it handled incoming telexes in the foreign department. Thus, in the terminology of the Restatement (Second), in contrast to the district court, the court of appeals considered the loss involved to be a result of special circumstances beyond the ordinary course of events that the party in breach had reason to know.¹⁶⁸

The question arose as to whether the contract law principle of *Hadley v. Baxendale* could apply to the negligence of Swiss Bank. In *Kerr Steamship Co. v. Radio Corporation*,¹⁶⁹ Chief Justice Cardozo drew a line between a tort claim unrelated to the contract and a tort claim arising out of contractual duties. He held that in the latter case the measure of the damages should not depend on the form of action.¹⁷⁰ Like Cardozo, the court of appeals, while acknowledging that contract liability is strict while tort liability is not, applied the *Hadley* rule to the negligence claim.¹⁷¹ The court also pointed out that in *Siegel v. Western Union Telegraph Co.*¹⁷² the defendant had not merely broken its contract to deliver the plaintiff's money in a timely manner, but had negligently misdirected the money order.¹⁷³ In addition, the court of appeals held that "Swiss Bank was not required to take precautions or insure

163. Evra, 522 F. Supp. 820, 833 (N.D. Ill. 1981), *rev'd*, 673 F.2d 951 (7th Cir.), *cert. denied*, 459 U.S. 1017 (1982).

164. See *Budnitz*, *supra* note 20, at 290.

165. Restatement (Second) of Contracts § 351(2)(a) (1981).

166. Evra, 673 F.2d at 956.

167. *Id.*

168. Restatement (Second) of Contracts § 351 (2)(b) (1981).

169. 245 N.Y. 284, 157 N.E. 140 (1927).

170. 245 N.Y. at 292, 157 N.E. at 142-43. The court found authority for its opinion in *Primrose v. Western Union Telegraph Co.*, 154 U.S. 1 (1894); *Western Union Telegraph Co. v. Hall*, 287 F. 297 (4th Cir. 1923); *Fitch v. Tel. Co.*, 150 Mo. App. 149 (1910); and *Newsome v. Western Union Telegraph Co.*, 153 N.C. 126 (1910).

171. Evra, 673 F.2d at 956.

172. 312 Ill. App. 86, 37 N.E.2d 868 (1941).

173. Evra, 673 F.2d at 957.

against a harm that it could not measure but that was known with precision to Hyman-Michaels, which could by the exercise of common prudence have averted it completely.”¹⁷⁴ The court linked the contract law principle of *Hadley v. Baxendale* to the tort law principle that the amount of care a person ought to take is a function of the probability and magnitude of the harm that may occur if he does not take care.¹⁷⁵

The Seventh Circuit denied *Evra* consequential damages for two other reasons, the first of which may be as important to the relationship between intermediary and beneficiary banks and the originator of a funds transfer as the application of the special notice requirement under the *Hadley v. Baxendale* doctrine. First, in contrast to the district court, the Seventh Circuit held that Hyman-Michaels was obliged to monitor the payment transaction and, thus, was contributorily negligent in waiting until what was arguably the last day before payment was due to instruct its bank to transfer the funds.¹⁷⁶ Second, the court held that Hyman-Michaels acted imprudently when it failed to make a second payment immediately after it was notified that the Pandora’s owner had not received payment, and thus had failed to mitigate and avoid damages.¹⁷⁷ Interestingly enough, the court again found the rationale for its holding in the “animating principle” of *Hadley v. Baxendale* “that the costs of the untoward consequences of a course of dealings should be borne by that party who was able to avert the consequences at least cost and failed to do so.”¹⁷⁸

The holding of the Seventh Circuit could have been limited to the special facts of this case: a payment order diverted into the communication system of a bank department which did not deal with funds transfer. Some language in the opinion suggests that this was one of the main reasons why the court believed the actual circumstances were too far removed from Swiss Bank’s knowledge.¹⁷⁹ However, *Evra* generally was read in a broader sense,¹⁸⁰ and the requirement of special foreseeability for awarding consequential damages in funds transfers was confirmed by New York courts in two recent cases: *Central Coordinates, Inc. v. Morgan Guaranty Trust Co.*¹⁸¹ and *Compania Anonima Venezolana de Navegacion v. American Express International Banking Corp.*¹⁸²

174. *Id.* at 958.

175. See Scott, *supra* note 5, at 1695; Miller & Scott, *supra* note 20, at 1134.

176. *Evra*, 673 F.2d at 957.

177. *Id.*

178. *Id.* According to Judge Posner, the economic rationale of the *Hadley v. Baxendale* principle is that it induces the party with knowledge of the risk either to take any appropriate precautions or if it wants to shift the risk of loss to the other party, to disclose the risk and to pay him to assume it. R. POSNER, ECONOMIC ANALYSIS OF LAW 120 (2d ed. 1977). Thus, incentives are generated to deal with the risk in the most efficient way. *Id.*

179. See *Evra*, 673 F.2d at 958.

180. See Miller & Scott, *supra* note 20, at 1933-35; Scott, *supra* note 5, at 1695; Budnitz, *supra* note 20, at 290-92; Jetton, *supra* note 20, at 384-95.

181. 40 U.C.C. Rep. Serv. (Callaghan) 1340 (N.Y. Sup. Ct. 1985).

182. 1985 WL 1898.

C. Draft Statutory Rules — U.C.C. Article 4A — Funds Transfer

The draft's primary focus is to cover payment transactions between businesses or financial institutions, which today in the United States are the main participants in funds transfers. Such payment transactions are commonly referred to as "wholesale wire transfers." Draft article 4A is not limited to commercial transactions,¹⁸³ but applies to all funds transfers which are not covered by the Electronic Fund Transfer Act of 1978 (EFTA).¹⁸⁴ The EFTA is limited to certain consumer transactions¹⁸⁵ and explicitly excludes customer transfers by Fedwire, Bank Wire, or similar transfer services.¹⁸⁶ In the future, article 4A may play an important role in consumer transactions provided that funds transfers become more popular in this area.¹⁸⁷

As to bank liability, the draft of article 4A, rather than providing general rules, approaches typical situations and gives specific and detailed solutions for each case. For example, some of the issues addressed are: erroneous execution of payment orders (section 4A-302), misdescription of beneficiary (section 4A-305), and liability for late or improper execution or failure to execute payment order (section 4A-306). Thus, in contrast to article 4, the draft does not explicitly subject the parties involved in the funds transfer to a general duty of care and does not set forth a general standard for such a duty. In principle, a bank's liability arises upon acceptance of the payment order. Draft section 4A-210 provides that prior to acceptance, the receiving bank incurs no liability regarding the order with respect to either the sender or the beneficiary of the order or any party to the funds transfer, except as otherwise provided in article 4A.¹⁸⁸ More importantly, for the issues in question, section 4A-210 provides that after acceptance, a receiving bank, in principle, is not the agent of the sender of the payment order, of the beneficiary of the order, or of any other party to the funds transfer. Thus, the draft does not follow the Massachusetts Rule, adopted by article 4, which provides that banks in the collecting chain are agents of the originator,¹⁸⁹ and contrasts with the common law which also holds the receiving bank an agent of the

183. See U.C.C. § 4A-108 (draft rules).

184. 15 U.S.C. §§ 1693-1693r (1988).

185. Primary focuses of the EFTA are point of sale transfers, automated teller machine transactions, direct deposits or withdrawals of funds, and transfers initiated by telephone. See EFTA § 903(6). However, the EFTA is not limited to such transfers but applies on principle to all "electronic fund transfers" defined as any transfer of funds, other than a transaction originated by check, draft or similar paper instrument, which is initiated through an electronic terminal, telephonic instrument, or computer or magnetic tape so as to order, instruct, or authorize a financial institution to debit or credit an account. See EFTA § 903(6).

186. EFTA § 903(6). In addition, the application of the EFTA is limited to both federal and state financial institutions.

187. For general information concerning the development of consumer-oriented funds transfer systems, such as Giro Systems, see R. BRANDL & D. BAKER, *supra* note 14, at 5-37 to 5-44.

188. Such exceptions are stated in § 4A-207(2)(c) and § 4A-208(2) of the U.C.C. These sections hold receiving banks liable for interest in certain cases concerning the late receipt of rejections of payment orders by senders.

189. See *supra* notes 56-57 and accompanying text.

originator.¹⁹⁰ In addition, the common law holds the beneficiary's bank an agent of the beneficiary.¹⁹¹ The draft also does not follow the New York Rule, adopted by Regulation J, whereupon the Federal Reserve Banks are agents of the immediate transferor.¹⁹² The approach of the draft is unique to the existing legal system. The underlying theory is that each party to a funds transfer has an independent contractual relationship with the immediate sender. Thus, neither bank is responsible for the acts of the other as to the originator. In addition, the originator no longer has a direct claim against an intermediary or beneficiary bank under the theory that those are his or her agents. At best, the originator only has a claim under a third-party beneficiary theory. Nevertheless, the draft provides that in the case of a breach of the specified obligations set forth by article 4A, intermediary and beneficiary banks are directly liable to the originator. This cause of action would originate in statutory law.

There is an exception to the concept that no agency relationship exists between banks. Draft section 4A-206 provides that if a payment order addressed to a receiving bank is transmitted to a funds transfer system or other communications system for transmittal to the subsequent bank, the transmitting system is considered an agent of the sender for the purpose of transmitting the payment order to the subsequent bank. Thus, if the receiving bank is the originator's bank, it becomes vicariously liable to the originator for errors in the funds transfer system. The liability of the funds transfer is not governed by draft article 4A. Instead, it is incorporated in the law of contract, a funds transfer system rule, and other applicable law.¹⁹³ "Funds transfer systems" is defined in section 4A-105(1)(d) as a wire transfer network, an automated clearing house or another communication system of a clearing house, or other association of banks through which a payment order by a bank may be transmitted to the bank to which the order is addressed. The term does not include the Federal Reserve wire transfer network (Fedwire). The exclusion of the latter seems to generate some inconsistency with subpart B - Wire Transfer of Regulation J. As discussed above,¹⁹⁴ this regulation has adopted the New York Rule and holds a Federal Reserve Bank liable only to the immediately preceding sender via status of an agent for the latter. Thus, on the one hand Regulation J provides for the same structure as section 4A-206, and, therefore, banks employing Fedwire for customers' funds transfers should be liable for mistakes of their agents. On the other hand, draft article 4A does not consider Fedwire a "funds transfer system" and, therefore, does

190. See *supra* notes 118-22 and accompanying text.

191. See *Delbrueck & Co. v. Manufacturers Hanover Trust Co.*, 612 F.2d 1047, 1051 (2d Cir. 1979), *aff'd* 464 F. Supp. 989 (S.D.N.Y. 1979).

192. See *supra* notes 54-56 and accompanying text.

193. See U.C.C. § 4A-206 comment (draft rules).

194. See *supra* notes 88-90 and accompanying text.

not provide for bank liability for the mistaken actions of Fedwire. Interestingly enough, the June 1, 1988 Draft of section 4A-105(1)(c) expressly included Fedwire in the definition of "funds transfer system." However, unless Regulation J is amended to conform to article 4A, this inconsistency will most likely be addressed through section 4A-107, which provides that Regulations of the Board of Governors of the Federal Reserve System and operating circulars of the Federal Reserve Banks supersede any inconsistent provision of draft article 4A to the extent of the inconsistency. Therefore, it must also be assumed that under article 4A Fedwire is an agent of the originators' banks with the consequence that banks employing Fedwire are responsible to the originator of a funds transfer for mistakes caused by it, although this is not provided for under draft article 4A.

Bank liability for false negatives are determined by section 4A-302 and section 4A-306 of the draft. Section 4A-302, entitled "Manner of Execution of Payment Order," sets forth the obligations of the receiving banks. Section 4A-306, entitled "Liability for Late or Improper Execution or Failure to Execute Payment Order," provides for remedies if the obligations of receiving banks are breached.

Section 4A-306 essentially establishes two obligations of receiving banks. First, the receiving bank is obliged to issue a payment order that complies with the sender's order and to follow the sender's instruction concerning (i) any intermediary bank or funds transfer system to be used in carrying out the funds transfer, and (ii) the means by which payment orders are to be transmitted in the funds transfer. Second, if the sender's instruction states that the funds transfer is to be carried out "by wire" or as a "wire transfer" or otherwise indicates that the funds transfer is to be carried out by the most expeditious means, the receiving bank is obliged to transmit its payment order by telephonic or electronic communication and to instruct any intermediary bank accordingly. If the sender's instruction states a payment date, the receiving bank is obliged to transmit its payment order at a time and by means reasonably necessary to allow payment to the beneficiary on the payment date or as soon thereafter as is feasible.

Pursuant to section 4A-306, the damages recoverable for a bank's failure to comply with its obligations are limited to a great extent. In the case of a mere delay pursuant to section 4A-306(1), the bank must pay interest lost as a result of the noncomplying execution to either the originator or the beneficiary. Subsection (2) governs cases involving more than a mere delay. When the execution of a payment order by a receiving bank in breach of the obligations mentioned above results in (i) noncompletion of the funds transfer, (ii) failure to use an intermediary bank designated by the originator, or (iii) issuance of a payment order that does not comply with the terms of the payment order of the originator concerning amount or beneficiary, the bank is obliged to compensate the originator for its expenses in the funds transfer and for incidental expenses and interest losses resulting from the improper

execution. In addition, reasonable attorney's fees are recoverable when demand for compensation under sections 4A-306(1) or 4A-306(2) is made and refused before an action is brought on the claim. Both subsections expressly exclude recovery of further damages, except as provided in an agreement pursuant to sections 4A-306(3) and 4A-306(4). According to the latter provisions, additional damages, including consequential damages, are recoverable to the extent provided for in an express written agreement of the receiving bank. Thus, the bargaining power of the originator determines whether consequential damages are recoverable under article 4A.

In the case of default of an express agreement, however, banks are widely exempted from any liability for consequential damages. The underlying rationale for these rules is the assumption that imposition of consequential damages on a bank for commission of an error is not justified, because the success of the wholesale wire transfer industry has largely been based on its ability to effect payment at low cost and great speed¹⁹⁵ and both aspects of the modern wire transfer system would be adversely affected by a rule that imposed on banks liability for consequential damages. The draft relies on the following statement of a banking industry amicus brief in *Evra*: "Whether banks can continue to make EFT services available on a widespread basis, by charging reasonable rates, depends on whether they can do so without incurring unlimited consequential risks. Certainly, no bank would handle for \$3.25 a transaction entailing potential liability in the millions of dollars."¹⁹⁶ Excluding consequential damages even in the case of foreseeability, the draft limits bank liability to an even greater extent than suggested by *Evra*. The draft statutory rules reject *Evra* on the grounds that no practical solution to the problem of bank liability for consequential damages is provided, largely due to the difficulty of defining what information would be required to give a bank adequate notice of special circumstances. In addition, the draft assumes that the *Evra* rule is not operationally feasible as to intermediary banks, because notice of special circumstances to the originator's bank would not bind intermediary banks. Moreover, it seems impractical for the originator's bank to transmit the respective notice to intermediary banks in the funds transfer. In order to obtain a simple solution, the draft places the burden of risk for consequential damages entirely on the originator. The assumption that the originator is in the best position to avoid any loss by issuing a payment order in time to allow monitoring of the transaction justifies such a rule.

195. See U.C.C. § 4A-306 comment (Draft Rules).

196. *Id.*

III.
GERMAN LAW

A. The Approach of Jurisdiction—OLG Düsseldorf DB 1982, 749

1. Factual Background

OLG Düsseldorf DB 1982,749 gave the originator of a funds transfer a direct claim against an intermediary bank under a third-party beneficiary theory.¹⁹⁷ The decision followed the Federal Supreme Court's 1977 holding¹⁹⁸ which gave the bank's customer a direct claim against intermediary banks in the area of preauthorized debit transfers on the same grounds. Thus, *OLG Düsseldorf* DB 1982,749 decided the issue of whether the Federal Supreme Court's construction of the law also applied in the area of funds transfer.

In *OLG Düsseldorf* DB 1982,749, the plaintiff acquired an interest in a limited partnership near the end of 1978. The contribution to be made was DM 100,000 in cash. The purpose of the investment was to obtain tax benefits as a result of the partnership's 1978 losses. On December 28, 1978, the plaintiff instructed his bank by telephone to transfer part of the contribution in the amount of DM 30,000 to the account of the partnership held at the S. AG, the beneficiary's bank. Plaintiff drew the attention of his bank to the fact that the amount had to be credited to the beneficiary's account by December 31, 1978 in order to be eligible for substantial tax benefits. The originator's bank, by means of a rapid giro, transmitted to the defendant, a central giro institution, the payment order the same day via telex. The defendant transferred the funds the same day to the beneficiary's bank but omitted the name and the account number of the beneficiary. As a result, the transferred funds were credited to the "miscellaneous" account of the beneficiary bank. The clerk of the beneficiary bank telephoned the originator's bank to inquire about the beneficiary, but the beneficiary's identity or account number could not be ascertained. Thus, the funds were retransferred to the central giro institution.

On January 15, 1979, the defendant again transferred the funds and the payment order to the beneficiary bank, indicating this time the name and the account number of the beneficiary. Due to the missing capital contribution in 1978, however, the plaintiff obtained no tax benefits in that year. He alleged lost tax savings of DM 19,604 and claimed damages. Since the exact amount of damages depended upon the future earnings of the limited partnership, and

197. See Hüffer, *supra* note 30, at 100. OLG Düsseldorf DB 1982, 749 was followed by OLG Frankfurt WM 1984, 726.

198. BGHZ 69,82 = NJW 1977, 1916. Prior to BGHZ 69,82 the Federal Supreme Court gave only the originator's bank a claim against intermediary banks in order to recover damages of its customer. See BGHZ 27, 241, 247; BGH NJW 1969, 320; BGH WM 1976, 904, 907. The customer had to compel his bank to pursue this claim or to compel an assignment of the existing rights. Although this seems formal, it made sense because rights and counterrights stayed within the original contractual relationships and the dogmatic system of contract law, especially the privity requirement, was kept intact. See Hüffer, *supra* note 30, at 104-05.

thus could not be computed by the last day of the trial, the plaintiff brought an action for declaratory judgment establishing that he was entitled to full compensation by the defendant.¹⁹⁹ The court entered judgment accordingly.

2. Theories

a. Intermediary Banks as Agents

The court did not hold the intermediary bank an agent of the originator or of the originator's bank. Applying the law of contracts set forth in the German Civil Code, the court in *OLG Düsseldorf DB 1982,749* first analyzed the contractual relationships between the parties. In accordance with the prevailing doctrine,²⁰⁰ the court held that respective independent contracts as to the funds transfer exist between the originator, the originator's bank, the intermediary bank (central giro institution), and the beneficiary's bank.²⁰¹

The court expressly stated that no bank in the funds transfer chain was an agent of the originator or of another bank, on the grounds that each bank was acting in its own name and on its own behalf and was crediting the funds to be transferred to the accounts of the respective parties out of its own means.²⁰² The court qualified these "giro contracts" as contracts of service which have as their object the taking care of a matter pursuant to section 675 BGB.²⁰³ This type of contract is subject to the provisions of section 662 BGB et seq. which govern the legal concept of "mandate." Mandate is a gratuitous contract by which one party undertakes to do something on behalf of the other without receiving any consideration.²⁰⁴ Under German law this contract is fully binding, and although the mandatory receives no consideration, he is responsible even for slight negligence. The mandatory is not necessarily granted any power of attorney.²⁰⁵ Thus, the single payment orders within the bank-customer or bank-bank giro relationship are instructions pursuant to section 665 BGB, which provides that

a mandatory is entitled to deviate from the instructions of his mandator if, under the circumstances, he can assume that the mandator would approve of the deviation if he had knowledge of the state of affairs. Before making the deviation the mandatory shall give notice to the mandator and await his decision, unless there is danger in delay.

The court, in *OLG Düsseldorf DB 1982,749*, in accordance with the prevailing doctrine,²⁰⁶ held that the originator's bank's contractual obligation

199. OLG Düsseldorf DB 1982, 749.

200. See, e.g., C.W. CANARIS, BANKVERTRAGSRECHT, nn. 390-91 (2d ed. 1981); A. BAUMBACH & K. DUDEK, HANDELSGESETZBUCH, Anh I 406 2 (24th ed. 1980).

201. OLG Düsseldorf DB 1982, 749.

202. *Id.*

203. BÜRGERLICHES GESETZBUCH (German Civil Code) of August 18, 1896 (RGBl. S. 195).

204. Section 662 BGB.

205. Cf. E. J. COHN, *supra* note 106, at 289.

206. C.W. CANARIS, *supra* note 200, at nn. 233-34; Schröter, *supra* note 30, at 120; Hüffer, *supra* note 30, at 95; RGZ 105, 50; BGH 4, 244, 248.

did not extend to crediting the funds to the beneficiary's account, but merely to transmitting the payment order to the intermediary or beneficiary bank.²⁰⁷ As a consequence, originators' banks are not vicariously liable for any fault of intermediary or beneficiary banks, but only for their own fault in not selecting responsible and properly qualified intermediary banks.²⁰⁸ Thus, in funds transfers, section 278 BGB, which states that "[a] debtor is responsible for the fault of his legal representative and of persons whom he employs in performing his obligation, to the same extent as he is for his own fault," does not apply.

b. *Third-Party Beneficiary*

The court found a contractual relationship between the originator and the intermediary bank under a third-party beneficiary theory. However, the court held that the originator could not be deemed a third-party beneficiary under a genuine third-party beneficiary contract pursuant to section 328 BGB because the bank's customer lacked the prerequisite contractual right to make direct claims regarding the performance of the funds transfer against intermediary or beneficiary banks. Thus, no direct contractual relationship between the originator and parties other than the originator's bank existed. The originator, therefore, could not demand performance from an intermediary bank and had no cause of action against the latter for breach of the contract relating to the funds transfer entered into between the originator's bank and the intermediary bank.²⁰⁹

OLG Düsseldorf DB 1982,749 upheld a direct claim of plaintiff against defendant. The court held that defendant owed plaintiff certain duties of care in protecting his financial interests and that plaintiff was a third-party beneficiary as to those duties.²¹⁰ The theory of a third-party beneficiary contract as to the duty of care, distinguished from a third party beneficiary contract as to performance, is not provided for by the German Civil Code, but was established earlier by the jurisdiction of the Supreme Court of the German Reich²¹¹ and the Federal Supreme Court.²¹² The theory of a duty of care was established to close certain gaps left open by tort law which, in the opinion of the courts, provided inadequate protection for third parties not in privity with the creditor who were damaged by the defective performance of contractual obligations.²¹³ In general, contract law liability is broader since not only property and personal damages but also economic damages, which

207. OLG Düsseldorf DB 1982, 749.

208. OLG Düsseldorf DB 1982, 749; *supra* note 198.

209. OLG Düsseldorf DB 1982, 749.

210. *Id.* at 750.

211. See RGZ 91, 24; 102, 232; 127, 222; BGH 49,353; BGH 56, 273.

212. BGH 49,353; 56, 273

213. PALANDT-HEINRICH, *infra* note 216.

do not result from the injury to property or person, are recoverable.²¹⁴ Thus, in the area of funds transfer involving false negatives, the theory of the third-party beneficiary contract provides for the recovery of economic losses which would not be covered by tort law.

In addition, different rules regarding the burden of proof²¹⁵ and vicarious liability²¹⁶ make liability in contract law easier to establish. For example, under the provisions of the German Civil Code alone it may have made a substantial difference whether a tenant, who was a party to the lease agreement, or his wife or children who were not, were injured through the landlord's fault in not keeping the premise free of defects.²¹⁷ Under the presupposition that the lessor knew that the premise was to be occupied by the tenant's family, the courts held that the liability of the lessor should be the same vis-à-vis all occupants. In order to overcome the lack of privity, the courts implied a third-party beneficiary contract into the lease agreement.²¹⁸ The implied extension of the contractual duty of care to certain third persons who were not parties to the contract was based on the general contract principle of section 242 BGB under which all parties to a contract are subject to the requirements of good faith.²¹⁹

In order to limit the extent of contractual liability to third parties, only a very restricted circle of persons were initially deemed to be implied third-party beneficiaries to the duty of care. Basically, the duty of care was extended only to such persons to whom a party to a contract was responsible for special care,²²⁰ i.e., family members or employees.²²¹ In addition, the other party must have had reason to foresee that such persons legitimately would

214. On the other hand, contract law, as opposed to delict law, does not provide for damages for pain and suffering. Thus, in certain circumstances, the law of delict provides for extended relief. See § 847 BGB. However, the problems of proving a claim and establishing vicarious liability remain and, in many cases, plaintiff will be better off seeking relief on a contract theory even if damages for pain and suffering cannot be awarded.

215. See § 282 BGB.

216. Section 278 BGB. See 1 E. COHN, MANUAL OF GERMAN LAW 222-23 (2d ed. 1968); § 831 BGB; see also N. HORN, H. KOTZ & H. LESER, GERMAN PRIVATE AND COMMERCIAL LAW: AN INTRODUCTION, 160 (1982). See generally PALANDT-HEINRICH, KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH § 328 (3)(a) (50th ed. 1991).

217. This obligation is set forth in § 537 BGB.

218. See RGZ 127, 218.

219. See PALANDT-HEINRICH, *supra* note 216, at § 328 (3)(b); Larenz, section 17 II; OLG Düsseldorf DB 1983, 749. In controversy, courts have also held that the extension of the duty of care is to be derived from the construction of the contract. RG 127,222, BGH 56,273.

220. BGHZ 51,96; 56, 273; BGH NJW 70, 40.

221. See, e.g., RGZ 127, 218. A tenant had contracted with a repair firm for the repair of a gas water heater. The contractor was careless. As a result, the heater exploded and injured the tenant's charwoman. The charwoman could sue the contractor under a contract theory on the grounds that the contractor, in not properly repairing the heater, had breached the duty of care owed to her under a third-party beneficiary contract, derived from the repair contract. As a result, the contractor could not exculpate himself for the faults of his employees under the tort provision of § 831 BGB, but became unconditionally liable under the contract provision of § 278 BGB.

come into contact with the performance of the subject matter of the contract.²²² The limitation restricting third-party duty-of-care beneficiaries was gradually lifted and the contractual duty of care was extended to those persons for whose benefit the contract was entered into.²²³

In the area of banking law, and more specifically in the area of preauthorized debit transfers, the Federal Supreme Court has held that the requirement that only those third parties for whom one party had to take special care could be integrated into the contractual duty of care was too narrow in the case of mass transactions provided for and offered by financial institutions.²²⁴ The court's reasoning was that bank customers could generally rely on careful execution of payment transactions, but at the same time could not influence the inherent procedural risk of such transactions, which instead could be reasonably minimized by the banks. The intermediary and beneficiary banks involved in the execution of a payment transaction should also know that the customers' banks were not only acting in their own best interest but also in the interest of their respective customers. Thus, under the obligation of good faith pursuant to section 242 BGB, banks' customers were held to be third-party beneficiaries of the duty of care under implied third-party beneficiary contracts.²²⁵

OLG Düsseldorf followed this ruling in the area of funds transfer, holding that the interests of the parties involved in mass transactions were equivalent to parties in preauthorized debit transfers.²²⁶ The court held that the intermediary bank owed the originator the duty of care to accurately describe the beneficiary and the beneficiary's account on the payment order to be retransmitted to the beneficiary's bank. The court stated that the bank's failure was due to the technique and procedure applied by the bank for which the bank exclusively carried the risk. In omitting both the name and the account number on the payment order, defendant had breached this duty of care as to plaintiff and was liable for damages.²²⁷

3. Damages

OLG Düsseldorf DB 1982,749 awarded plaintiff damages. The court decided that damages were not excluded by the general banking conditions employed between the originator's bank and the defendant. It also decided that there was no comparative negligence on the part of the originator's bank or the originator, and that damages were not excluded because defendant could not foresee the actual loss of tax benefits on the part of plaintiff.

222. BGHZ 49, 354; 75, 323; WPM 84, 1234.

223. See PALANDT-HEINRICH, *supra* note 216, § 328 (3)(d)(bb).

224. BGHZ 69, 82.

225. BGHZ 69, 82, 86, 88.

226. OLG Düsseldorf DB 1982, 750.

227. *Id.*

a. Exclusion of Damages by Banking Conditions

In the Federal Republic of Germany, general banking conditions regulate, to a large extent, the relationship between banks and between banks and their customers. Two sets of rules exist which provide for very similar conditions: the General Conditions of the Public Banking Institutes²²⁸ and the General Conditions for Private Banks.²²⁹ These banking conditions are private rules included in the contractual relationships of the parties, in accordance with the requirements of general contract law, i.e., basically by acceptance.²³⁰ Since April 1, 1977 such standard business conditions have been controlled by an apposite statute,²³¹ which provides for an invalidation of clauses that deviate too much from the balanced model of the dispositive law.²³²

Section 16 of the General Conditions of the Public Banking Institutes, which were operative between the defendant and the originator's bank, and section 7 of the General Conditions for Private Banks provide that the customer is obligated to give the bank in each case special notice if, out of delay or failure to execute a commission, damages can arise which extend the loss of interest. If the customer complies with this obligation, the bank is liable for fault. If the customer fails to give notice, the bank is liable only for serious default, and where the commission involves a commercial transaction, the bank is liable only for lost interest.

The court in *OLG Düsseldorf* DB 1982,749 did not discuss the fairness of limiting bank liability in the absence of special notice under the Standard Form Contract Act, but did hold section 16 of the General Conditions of the Public Banking Institutes valid.²³³ In accordance with the prevailing opinion,²³⁴ the court applied section 16, which was part of the contract between the originator's bank and the defendant, to the contractual relationship between plaintiff and defendant, which resulted from the third-party duty-of-

228. Allgemeine Geschäftsbedingungen der Spar-, Girokassen und Kommunalbanken (version April 1st 1977), text published in BAUMBACH/HEFERMEHL, WECHSELGESETZ UND SCHECKGESETZ 608-31 (13th ed. 1980).

229. Allgemeine Geschäftsbedingungen der privaten Kreditinstitute, published in BAUMBACH/HEFERMEHL, *supra* note 228, at 571-89.

230. See N. HORN, H. KOTZ & H. LESER, *supra* note 216, at 29-32, 76-77; E. COHN, *supra* note 216, at 36-38.

231. Standard Form Contract Act (Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen) of December 9th 1976 [AGBG] (BGBI I, 3317) altered by Act of March 29, 1983 (BGBI I, 377) [hereinafter Standard Form Contract Act].

232. See N. HORN, H. KOTZ & H. LESER, *supra* note 216, at 66.

233. The validity of the clause was questioned by OLG Frankfurt WM 1984, 726, 728, referred to C.W. CANARIS, *supra* note 200, at n. 31. The issue was not decided because the bank was held to have acted with serious default.

234. BGHZ 56, 269, 272, 273; BGH NJW 76, 1843, 1844. See also PALANDT-HEINRICH, *supra* note 216, § 328 (3)(e)(bb); Hüffer, *supra* note 30, at 114.

care beneficiary contract. As the defendant's liability resulted from its contract with the originator's bank, the rights of plaintiff could not exceed those of the originator's bank from whom plaintiff derived his rights.²³⁵

Thus, the question arose in *OLG Düsseldorf* DB 1982,749 whether defendant was put on notice about the possibility of damages exceeding loss of interest. The court put emphasis on the fact that the originator's bank had executed the funds transfer by the means of a "rapid giro." It held that notice of the risk of damages exceeding the loss of interest could be inferred by the employment of that device, since the rapid giro was typically used for urgent payment transactions where time was of the essence. The court also reasoned that large payment transactions at the end of the year were particularly likely to be urgent.²³⁶

b. Comparative Negligence

As for comparative negligence, section 254(1) BGB provides that if any fault of the injured party has contributed to causing the damage, the obligation to compensate the injured party and the extent of the compensation to be made depends upon the circumstances, especially upon how far the injury has been caused predominantly by the one or the other party.

Pursuant to section 254(2), "[t]his applies also even if the fault of the injured party consisted only in an omission to call the attention of the debtor to the danger of unusually high damage which the debtor neither knew nor should have known, or in an omission to avert or mitigate the damage."²³⁷

In an early funds transfer case, the Supreme Court of the Reich applied section 254(2) to reduce the recoverable amount of damages by fifty percent.²³⁸ In that case, the originator had to pay RM 380 to the patent office in order to reserve his patent rights. Because of the bank's default, the funds did not arrive in time at the patent office and the originator lost his patent. He sued the bank for RM 180,000 damages, the alleged value of the patent. The court held that the plaintiff had been obligated to give the bank notice about the importance of the transaction. The court rejected plaintiff's argument that he could have relied on the confirmation received from his bank that the funds transfer had been executed and thus, because on his part there was no further action required, there was no room for the application of section 254 BGB. The court reasoned that the bank, knowing the danger of the unusually high damage, might have handled the funds transfer more carefully and might have established monitoring procedures to ensure the crediting of the funds to the beneficiary's account. The court held that in absence of any notice, it was the duty of plaintiff to monitor whether the funds had arrived in time at the patent office and that the only meaning of the confirmation was

235. OLG Düsseldorf DB 1982, 750.

236. *Id.*

237. I. FORRESTER, S. GOREN & H.M. ILGEN, THE GERMAN CIVIL CODE 42 (1975).

238. RG DJZ 1911, 1218.

that defendant had done what it was obligated to undertake, but not that the funds were actually credited to the beneficiary's account.²³⁹

Both the literature and the courts have generally recognized comparative negligence on the part of the originator who fails to provide notice about the risk of unusually high damages.²⁴⁰ Under the theory of comparative negligence, the courts have generally reduced the recoverable amount by fifty to seventy percent.²⁴¹ The general banking conditions as to the notice requirement, instead of providing for a flexible apportioning of the liability between customer and bank, exclude any liability in the case in which a customer fails to provide special notice.

OLG Düsseldorf examined the comparative negligence issue and stated that plaintiff was responsible not only for his own actions and omissions, but also as a third-party beneficiary for the actions and omissions of the originator's bank from which his rights as to the intermediary bank were derived.²⁴² However, the court did not find that the originator or the originator's bank contributed to causing the damages incurred. The court reasoned that the means of the funds transfer was a rapid giro²⁴³ and that the originator's bank had complied with the principles of funds transfers applicable between banks.²⁴⁴

c. *Foreseeability of Damages*

The third question at issue in *OLG Düsseldorf* DB 1982,749 was whether the recovery of actual damages was excluded because the loss of tax profits was not foreseeable by defendant. In German contract law, liability generally arises from fault.²⁴⁵ One prerequisite for a finding of fault is the foreseeability that damages may arise out of certain behavior.²⁴⁶ According to German law, however, the requirement of foreseeability does not extend to the actual damages caused by misbehavior. It is sufficient that the party to a contract is aware that non-compliance with contractual or legal duties in general may cause damages to the other party.²⁴⁷ Thus, German law does not have an analogous rule to the *Hadley v. Baxendale* principle which limits liability to damages which were actually foreseeable at the time the contract was formed. Pursuant to German law, once the party has breached a contractual duty, it is obliged to compensate for all damages for the culpable behavior for which "adequate cause" existed. Damages are "adequately

239. RG DJZ 1911, 1219.

240. Hüffer, *supra* note 30, at 113; C.W. CANARIS, *supra* note 200, at n.347.

241. Möschel, *supra* note 13, at 210; Hellner, *Rechtsprobleme des Zahlungsverkehrs unter Berücksichtigung der höchstrichterlichen Rechtsprechung*, ZHR 145 (1981), 109, 129.

242. OLG Düsseldorf DB 1982, 750. See also BGH NJW 75, 867; Hüffer, *supra* note 30, at 112; PALANDT-HEINRICH, *supra* note 216, at § 328 (3)(e)(bb).

243. See Hüffer, *supra* note 30, at 111.

244. OLG Düsseldorf DB 1982, 750.

245. See N. HORN, H. KOTZ & H. LESER, *supra* note 216, at 112.

246. BGHZ 39, 285; PALANDT-HEINRICH, *supra* note 216, at § 276 (4)(B)(c).

247. RGZ 136, 10, 148, 165; BGH NJW 53, 542.

caused" when the damage would not have arisen had the misbehavior not occurred and such misbehavior was "apt in general to lead to the result which occurred, taking things as they normally happen and ignoring very peculiar and improbable turns of event."²⁴⁸ This rule cannot be explained by mere logic but leaves to the court the possibility of value judgments.²⁴⁹ Broad liability exists under the rule of adequate causation, and only extremely unlikely events are exempted from compensation.

Given this well-settled rule, the Oberlandesgericht Düsseldorf rejected defendant's argument that the actual fact situation was not foreseeable by simply stating that there is no such foreseeability requirement for awarding damages once it was established that defendant had breached its duties by culpable behavior.²⁵⁰

B. Proposals from the Literature

In the literature two positions exist that contest how the principles of contract law are construed and applied in funds transfer cases by *OLG Düsseldorf* and the prevailing doctrine. Köndgen has advocated the idea that originators' banks are vicariously liable for intermediary banks and Möschel has developed the theory that direct contractual relationships exist between all parties of the funds transfer system.

With their contributions the two scholars aim at both influencing the courts to change the construction of the law in future decisions and influencing the legislature to change the statutory rules.

1. Vicarious Liability of the Originator's Bank for Intermediary Banks

The starting point of the prevailing doctrine, that the contractual obligation of the originator's bank is limited to the transmittal of the payment order to an intermediary or beneficiary bank, has been contested recently by Köndgen.²⁵¹ According to Köndgen, the customer's expectation in a funds transfer transaction is not limited to the originator bank's transmittal of the payment order to an intermediary bank; but the consumer also expects that the originator's bank will take care to see that the payment order is finally transmitted to the beneficiary bank.²⁵² Köndgen views the funds transfer payment system as a uniform product offered by banks to their customers produced by a division of labor throughout the banking industry, just as other industrial products are produced: by division of labor without anyone taking into consideration the fact that the consumer is not buying a uniform product

248. RGZ 158, 34, 168, 88, 169, 88; BGHZ 3, 261. See also PALANDT-HEINRICH, *supra* note 216, preliminary statements to § 249 (5)(c)(aa).

249. See N. HORN, H. KOTZ & H. LESER, *supra* note 216, at 151.

250. OLG Düsseldorf DB 1982, 750.

251. Köndgen, *supra* note 30, at 146-51.

252. *Id.* at 146.

from one producer.²⁵³ He holds that the nature of the contractual relationship in the prevailing doctrine, i.e., that bank "services" in funds transfer transactions relate only to the transmittal of the payment order, is mere fiction, because for this kind of service, in reality, there would exist no market.²⁵⁴ Köndgen feels that, since the obligation of the originator's bank in a funds transfer would also comprise the transmittal of the payment order to the beneficiary bank, intermediary banks are employed by originator's banks in the performance of their obligation. As a consequence, section 278 BGB would apply, making an originator's bank vicariously liable for the fault of an intermediary bank to the same extent as for its own fault.

Köndgen's view solves the dogmatic problems and allocates the liability with the customer's bank. This facilitates the customer's assertion of damages because the originator's bank is held responsible and the customer is exempted from the burden of investigating which of the possibly numerous intermediary banks has failed. On the other hand, the proposed solution generates higher transaction costs because originator's banks may seek recovery over intermediary banks, which finally have to bear the loss.

Köndgen maintains that the funds transfer system could bear these additional costs, since overall the advantages of applying section 278 BGB would prevail over the disadvantages. In addition, he suggests that higher transaction costs could be avoided by inter-bank agreements dividing liability on a flat-rate basis, thereby avoiding expensive actions for recourse.²⁵⁵ In the Federal Republic of Germany, working examples for such agreements can be found between auto insurers.²⁵⁶

2. Direct Contract Claims Against Intermediary and Beneficiary Banks

Another proposal comes from Möschel²⁵⁷ who suggests that direct contractual relationships between the originator, the intermediary banks and the beneficiary banks exist. According to Möschel, funds transfers in the Federal Republic of Germany are executed by a compound system of the banking industry.²⁵⁸ Therefore, he reasons, a customer who uses the funds transfer system becomes a member of it and, thus, becomes contractually linked to all of the system's bankmembers. Möschel explains these extensive contractual relationships by an until now unknown juridical concept which he named

253. *Id.* at 147.

254. *Id.* at 148.

255. *Id.* at 151.

256. H. BECKER, *KRAFTVERKEHRS-HAFTPFlicht-SCHADEN*, 372-77 (17 ed. 1989); J. PROLSS & A. MARTIN, *VERSICHERUNGSVERTRAGS GESETZ, KOMMENTAR ZUM VVG*, 462-71 (24 ed. 1988).

257. Möschel, *supra* note 13, at 211-33.

258. *Id.* at 222.

“netcontract.”²⁵⁹ This concept is animated by the fact that payment transactions are mass transactions which increasingly use electronic data processing. Möschel raises the question of whether, in today’s world, the traditional rules of formation of contracts are still adequate,²⁶⁰ since these rules are based on the declaration of intentions by the parties forming offer and acceptance. Möschel’s concept departs from traditional contract rules and links contractual relationships to the mere factual situations, as opposed to declaration of intentions. Möschel’s departure from traditional contract principles has led to the rejection of his proposal by the great majority of commentators.²⁶¹

IV. COMPARISON AND ANALYSIS

A. Thesis

The application of the *Hadley v. Baxendale*²⁶² doctrine to liability questions in funds transfer creates inconsistencies between the liability for consequential damages of originator banks and intermediary banks which cannot easily be founded upon a rational basis.

In *Evra*,²⁶³ Continental, the originator’s bank, had specific notice of the risks involved, but absent negligence, was not held liable. Swiss Bank, the intermediary bank, was negligent but not held liable because it lacked sufficient notice. As a consequence of the application of the *Hadley* rule, intermediary banks are exempted from liability for consequential damages since as a matter of fact the required specific notice will not be passed along the funds transfer chain. Thus, an originator may hope that if a mistake arises, it is his own bank that is negligent, because only then can the originator potentially recover consequential damages.²⁶⁴ Therefore, under common law it is mere chance that determines whether the customer or the banking system bears the loss, or, in other words, whether the risk is spread among all customers instead of remaining with the originator.

If article 4A of the U.C.C. is adopted in its present version, the recovery of consequential damages will be excluded for both originators’ and intermediary banks. Moreover, banks’ liability will be limited to lost interest in cases of false negatives. Thus, loss resulting from banks’ negligence is, as a matter

259. *Id.* at 211.

260. *Id.* at 234-35.

261. See Hüffer, *supra* note 30, at 108; C.W. CANARIS, *supra* note 200, at 393; Köndgen, *supra* note 30, at 114; Schröter, *supra* note 30, at 126.

262. 9 Exch. 341, 156 Eng. Rep. 145 (Ex. 1854).

263. 522 F. Supp. 820 (N.D. Ill. 1981), *rev’d*, 673 F.2d 951 (7th Cir.), *cert. denied*, 459 U.S. 1017 (1982).

264. See *Compania Anonima Venezolana de Navegacion v. American Express Int’l Banking Corp.*, 1985 WL 1898. The court distinguished this case from *Evra*, 673 F.2d 951 and *Central Coordinates, Inc. v. Morgan Guar. Trust Co.*, 40 U.C.C. Rep. Serv. (Callaghan) 1340 (N.Y. Sup. Ct. 1985), mainly on the ground that AMEX, which was the originator’s bank, had special knowledge of all the circumstances involved in the funds transfer.

of principle, not spread, but remains with the originator. These rules will give little incentive for banks to improve their reliability standards and therefore may impact the overall efficiency of the funds transfer system.

These problems of American law may be resolved using approaches developed in German law. Also, in American law the foreseeability of consequential damages could be inferred by the means used for the payment transaction and originator banks could be held liable for not passing specific notice to intermediary banks. The goal to eliminate the feared excessive burden of the financial system could be achieved by adopting comparative negligence concepts or by setting a limit for the amount of damages which can be recovered. In any case, the liability system in funds transfer should differentiate between consumer and commercial transactions.

B. American and German Law Compared

This study has shown on the one hand notable similarities and, on the other, notable differences between the approaches of American and German law as to intermediary and beneficiary banks' liability in funds transfers.

Although the applied theories are different in principle, both legal systems presently give the originator of a funds transfer a direct cause of action against intermediary and beneficiary banks. The discussion about bank liability in the Federal Republic of Germany centered on that issue, i.e., whether to allow such direct claims. Emphasis was put on the dogmatic structure of the liability. Of course, this discussion was not a mere end in itself but, as Hüffer pointed out,²⁶⁵ the underlying ground was an opposition to the unlimited extension of bank liability. In German law these limits are established by way of the privity concept. This fact makes it understandable why in German law the extension of contractual liability to third parties is an important issue, and what may appear at first sight as merely dogmatic questions are actually of great interest. Since Anglo-American tort concepts, when compared to the German concepts of tort law, are very broad, the discussion of those issues was of minor interest in the United States. Instead, emphasis was placed on the question of whether consequential damages could be awarded.

Refraining from the consideration of the private banking conditions which are applied in the Federal Republic of Germany, it is on the topic of consequential damages that one can find the most striking differences between the two nations' laws. These differences are not specific to funds transfers, but, rather, reflect for the most part discrepancies in general concepts. Under the German Civil Code, all damages adequately caused by fault are recoverable. There is no special foreseeability requirement which can be compared to the common law *Hadley v. Baxendale* doctrine.

In the United States it was especially on the application of the *Hadley v. Baxendale* doctrine that fierce criticism has been raised against the Seventh

265. Huffer, *supra* note 20, at 97.

Circuit's decision in *Evra*. It was argued that even under the existing law and precedents, Hyman-Michaels was entitled to consequential damages because under the *Hadley* rule Swiss Bank had sufficient notice under the rationale of *Postal Telegraph Co. v. Lathrop*²⁶⁶ and *Providence-Washington Ins. Co. v. Western Union Tel. Co.*²⁶⁷ to be held liable.²⁶⁸ Prior telex messages and the telex message in question disclosed that the funds transfer pertained to a business transaction and that plaintiff was paying the Pandora Shipping Company for the hire of a motor vessel.²⁶⁹ Prices of the charter market were fluctuating enormously and it was customary in the market that contract terms be strictly enforced. Since normally payments are made because they are due, Swiss Bank could have assumed that delay or nonexecution of the payment order would involve substantial damages. Also that plaintiff failed to mitigate damages was held to be not fully convincing on the facts of the case.²⁷⁰

However, more important for modern banking relationships than the intrinsic critique of *Evra* based on the analysis of the correct interpretation of the facts and application of the law would have been the question of whether it makes sense to apply the rule in *Hadley v. Baxendale* to modern funds transfer. Chief Justice Cardozo had earlier stated in *Kerr S.S. Co. v. Radio Corp.*:

We are not unmindful of the force of the plaintiff's assault upon the rule in *Hadley v. Baxendale* in its application to the relation between telegraph carrier and customer. The truth seems to be that neither the clerk who receives the message over the counter nor the operator who transmits it nor any other employee gives or is expected to give any thought to the sense of what he is receiving or transmitting. This imparts to the whole doctrine as to the need for notice an air of unreality.²⁷¹

This is even more true in today's modern funds transfers, which involve mass-transaction situations where the parties do not engage in individualized contemplation of the consequences of a breach and a subsequent tailoring of a transaction.²⁷² In addition, in such mass-transaction situations personal communication in business transactions is increasingly replaced by electronic means which leave no possibility for "specific notice." Thus, reliance on the interpretation of the *Hadley* rule in Great Britain²⁷³ has called for an objective interpretation, which focuses on a certain degree of probability of the

266. 131 Ill. 575, 23 N.E. 583 (1880).

267. 247 Ill. 84, 93 N.E. 134 (1910).

268. See Jetton, *supra* note 20, at 401.

269. *Evra Corp. v. Swiss Bank Corp.*, 522 F. Supp. 820 (N.D. Ill. 1981), *rev'd*, 673 F.2d 951 (7th Cir.), *cert. denied*, 459 U.S. 1017 (1982).

270. Miller & Scott, *supra* note 20, at 1136.

271. 245 N.Y. 284, 291, 157 N.E. 190, *cert. denied*, 275 U.S. 557 (1927).

272. See Danzig, *Hadley v. Baxendale: A Study in the Industrialization of the Law*, 4 J. LEGAL STUD. 249, 279 (1978).

273. The Heron II, 3 All E.R. 686 (1967). The standard set forth in this decision was whether the defendant ought to have realized that the kind of consequential damages in question was "not unlikely" to result from a breach of contract causing delay in delivery. "Not unlikely" denoted a degree of probability. *Id.* at 689.

consequential damages involved and no longer on the actual knowledge of special circumstances.²⁷⁴

Moreover, the Seventh Circuit's opinion in *Evra* did not take into consideration the specific positions and functions of intermediary banks in funds transfers. Remaining within the reasoning of the *Hadley* rule, it is worth pointing out that it is virtually impossible for the originator to communicate directly to intermediary banks the importance and special circumstances of the funds to be transferred, if only because the originator often does not know which intermediary banks are involved in a complex transaction. In addition, attempting such communication would be beyond any expectation of the parties concerned. Thus, the business practice is that the prudent originator usually informs the bank about the urgency of a payment and relies on that bank and on the mechanism of the payment system. In *Evra*, Continental, the originator's bank, had specific notice of the risks involved, but absent negligence was not held liable. Swiss Bank, the intermediary bank, was negligent but not held liable because it lacked sufficient notice. It was thus mere chance which determined whether *Evra* or *Continental* had to bear the loss, or in other words, whether the risk was spread among all bank customers instead of remaining with the originator.

Thus, the issue confronting the court in *Evra* was how to structure the legal responsibilities in a mass transaction where performance typically involved several parties that had no actual business relationships with each other.²⁷⁵ Specifically, the issues were whether in a transfer chain it should suffice that the originator put only his own bank on notice, and whether, as a legal consequence, the originator's bank should be held liable for the mistakes of subsequent banks on the ground that only the originator's bank realistically had the opportunity to inform the intermediary banks as to the importance of the transaction. Thus, the threshold inquiry by the *Evra* court should have been made with respect to whether the New York Rule, rather than the Massachusetts Rule, should apply.²⁷⁶ That is, whether intermediary banks should be held to be the agents of the originator's bank in executing the funds transfer. Under the court's assumption that each bank in a transfer chain is an agent of the originator, the next question in *Evra* should have been whether it was the duty of the originator's bank to inform the intermediary bank on behalf of its customer. Assuming such a duty existed, *Continental*, which did not transmit the notice of the special circumstances involved in the funds transfer, would have breached the duty. *Continental*, therefore, could

274. See Jetton, *supra* note 20, at 384; G. GILMORE, THE DEATH OF CONTRACT 84 (1974).

275. Neither *Hadley v. Baxendale*, 9 Exch. 341, 156 Eng. Rep. 145 (Ex. 1854), nor the telegraph cases involved negligence of intermediaries. They all involved two-party situations where, at least in theory, the parties were able to bargain in a face-to-face transaction.

276. See *supra* notes 54-57 and accompanying text.

have been held liable for its own action. In turn, Hyman-Michaels, the originator, could have been barred from the recovery of damages from the intermediary bank, Swiss Bank, which was adjudged to be negligent. In contrast to this line of reasoning, the only duty which Continental legally owed to Swiss Bank was transmission of the telex message and that Continental had satisfied its obligations under such duty.²⁷⁷ As a consequence, the decision created inconsistencies between the respective liabilities of originators' banks and intermediary banks which cannot easily be justified on any rational basis.

Apart from these considerations, the underlying motivation of the Seventh Circuit may have been its unwillingness to burden the banking system with the risk of extraordinary losses. After having conceded the air of unreality of the *Hadley v. Baxendale* doctrine, Chief Justice Cardozo in *Kerr S.S. Co. v. Radio Corp.* continued:

The doctrine, however, has prevailed for years so many that it is tantamount to a rule of property. The companies have regulated their rates upon the basis of its continuance. They have omitted precautions that they might have thought it necessary to adopt if the hazard of the business was to be indefinitely increased.²⁷⁸

In fact, *Evra* can be read as a case establishing to what standard of care and technology banks are held by the law and to what extent customers may rely on the accuracy of bank services. In deciding that a customer was obliged to monitor important payment transactions, Judge Posner implicitly held that customers may not assume routine banking transactions to be entirely reliable and, as a result, the failure of banks to operate with technology and procedures that comply with reasonable standards, at least in certain respects, will not result in substantial liability. It has thus been observed that the approach of the Seventh Circuit provides little incentive for banks to provide for more than minimal procedural standards and none for reliable technology.²⁷⁹

The argument made in the United States, that liability for damages must be kept within a certain ratio to the actual earnings received from a contract, is, on principle, of no importance in German law. The way one analyzes this issue is not by looking at the concrete transaction, but by looking at all of the income created by banks with the profitable services of funds transfers.²⁸⁰ This leads to the conviction that the risk of loss can be spread, whereas allocating all the risk to the originator may result in unbearable financial consequences to him.²⁸¹ In addition, there is consensus among the courts that the bank customer should be able to rely on a functioning system which works without avoidable errors,²⁸² and that on principle banks have to bear the loss,

277. *Evra*, 673 F.2d at 960.

278. 245 N.Y. 284, 157 N.E. 140, *cert. denied*, 275 U.S. 557 (1927).

279. For a pointed critique, see Budnitz, *supra* note 20, at 292.

280. In 1985 the estimated revenue of the banking industry from non-cash payment transactions was DM 18 billion, which was one percent of the gross national product. See Möschel, *supra* note 13, at 190.

281. See C.W. CANARIS, *supra* note 200, at n.331; OLG Frankfurt NJW 1983, 1681, 1682.

282. See *supra* notes 217-20 and accompanying text.

including consequential damages, caused by their fault, because they are in the best position to minimize the procedural and technical risks of the transactions in question. Of course, what is considered to be "fault" is based upon the standard of the duty of care to which banks are held. In mass-transactions, the duty of care may be defined differently than in person-to-person relationships and will be influenced by economic considerations.²⁸³ Also, in the Federal Republic of Germany, a well known cost-benefit argument made by the banking industry is that if standards in mass transactions are set too high, consumers cannot be served efficiently on a low cost basis.²⁸⁴ It is worth noting that these arguments do not aim to exclude any liability for consequential damages in the case of fault. The discussion centers more on the question of what standard of care should be applied to banks, i.e., what should be considered fault. Courts and commentators are generally reluctant to follow this argument, probably on the grounds that it may be better tailored to protect bank profits than customer interests.²⁸⁵

Compared with the discussion in the United States, and especially with the proposed solutions of draft article 4A of the U.C.C., this somewhat different approach may result in part from a different legal climate surrounding the award of damages. Only actual damages, which must be proven by plaintiff, are recoverable. Punitive damages and damages *per se* are unknown to German law, and damages for pain and suffering are strictly limited to tort law. In addition, the losing party, as a matter of law, must reimburse the winning party's attorney's fees. On the other hand, loss imposition costs are relatively low compared with those found in the United States due to the fact that attorney's fees are fixed by statute at a relatively low level, and due to differences between the two countries' civil procedures which allow litigation to proceed in Germany over a relatively short time period, even if the matters are complex. Interestingly enough, the amount of damages for which recovery is sought in German cases is less than in the analogous American cases, where the cost of litigating complex factual matters may deter all claims save for the most disastrous injuries or the most extravagant amounts.²⁸⁶ However, it must be acknowledged that this impression is gained without statistical background and thus any effort to explain it is rather speculative.

In contrast to common law, and even more so to the proposed draft article 4A of the U.C.C., general German contract law does not exempt banks from liability in the cases at issue. Parties may agree on disclaimers, but boiler-plate disclaimers, which are the only practical way to accomplish this goal in the mass-transactions, are limited by the Standard Form Contract

283. See Möschel, *supra* note 13, at 205-11 as to the problem whether in funds transfer the account number or the name of the beneficiary should control. There are strong arguments that, currently, cost effective automated processing of funds transfers in the Federal Republic of Germany is only possible if the account numbers control.

284. *Id.* at 209.

285. See C.W. CANARIS, *supra* note 200, at n.331.

286. Cooter & Rubin, *supra* note 7, at 112.

Act. In consumer transactions, liability for serious fault cannot be excluded pursuant to section 11(7) AGBG.²⁸⁷ This prohibition also applies to the exclusion or the stipulation of a cap for consequential damages.²⁸⁸ Whether bank liability in commercial transactions can be restricted beyond these limits set forth by section 11 (7) AGBG is at issue and has not yet been definitely decided.²⁸⁹ The key point to this question will be whether such disclaimers deviate too much from the balanced model of the dispositive law.

However, under German law, bank liability is not without limits. Pursuant to section 254 (2) BGB, the originator is obligated to give the bank notice if there is a risk of unusually high damages about which the bank neither knows nor should know. Under the comparative negligence theory of section 254 BGB, German law is similar to the common law *Hadley v. Baxendale* doctrine. The results, however, are different. Under *Hadley v. Baxendale*, consequential damages are completely excluded in the case of lack of notice; under section 254 BGB the respective responsibility of each party is to be weighed by the courts and the recoverable damages are to be reduced accordingly. Since section 254 BGB imposes a general duty on the bank's customer to prevent damages from arising or to mitigate them once they are incurred, this provision gives incentives to both banks and customers to do their best to avoid incurring damages. In addition, a notice requirement even more similar to the *Hadley v. Baxendale* doctrine is set forth in the general banking provisions. However, pursuant to those provisions, lack of notice in consumer transactions does not lead to a complete forfeiture of recovery damages in cases of serious fault.²⁹⁰ Different results may be achieved in commercial transactions where noncompliance with the notice requirement may lead to bank liability limited to lost interest.

Under German law, as under American law, these notice requirements refer not only to the originator's bank but also to any subsequent bank. Therefore, if the intermediary bank or beneficiary bank has no notice of the unusual risk involved in the funds transfer, its liability in consumer transactions is at least reduced and in commercial transactions it may be exempted from any liability, except for lost interest. Although not yet decided by the courts, general considerations lead to the conclusion that under German law this does not require the originator to give notice about special circumstances to all banks involved. Once the originator has given notice to the originator's bank, it is the latter's duty to pass this information along the funds transfer chain. If the originator's bank does not comply with this duty, it becomes responsible for the amount which is not recoverable from the intermediary or beneficiary bank because of its failure to do so. However, following OLG

287. Standard Form Contract Act, *supra* note 231.

288. PALANDT-HEINRICH, *supra* note 216, AGBG 11(7).

289. See PALANDT-HEINRICH, *supra* note 216; AGBG 9(6).

290. "Serious fault" is analogous to gross negligence in tort law.

Düsseldorf, questions regarding the notice requirements may be in part obsolete, because in many important and urgent funds transfers, originators will use the special device of the rapid giro, which implies and thus discloses to all parties involved the importance of the transaction.

The differences between the two nations' laws discussed above may become even greater in the future if draft article 4A of the U.C.C. is adopted in its present form. If so, in the case of false negatives, lost interest may be the only recoverable damages under American law, independent of whether consumer or commercial transactions are involved and independent of the degree of negligence found.

C. Proposed Solution

The striking inconsistency created by the application of the *Hadley v. Baxendale* doctrine to liability questions in funds transfers is that it might depend upon mere chance whether the originator's loss is spread or whether he bears the loss, since notice is normally given by the careful originator only to the originator's bank. Thus, as a matter of fact, if loss occurs through the intermediary bank's negligence no damages can be recovered. This inconsistency could be avoided by adopting the view that it is the implied duty of the originator's bank to pass the notice along the funds transfer chain. In addition, as suggested by the holding of *OLG Düsseldorf* regarding the rapid giro device, the common law should take into consideration whether in certain cases the foreseeability of consequential damages can be inferred from the means used in a funds transfer. This, however, would call for a more objective interpretation of the *Hadley v. Baxendale* doctrine, which would better coincide with the reality of modern mass transactions where the parties do not engage in individualized contemplation of the consequences of a breach of contract and the subsequent tailoring of a transaction. It is worth pointing out that this more objective interpretation is also called for by the fact that today, due to increased specialization, many services are rendered by a division of labor whose extent was unknown at the time *Hadley v. Baxendale* was decided.²⁹¹

Draft article 4A of the U.C.C. avoids most of the problems stemming from the application of the *Hadley v. Baxendale* rule to funds transfers by awarding only lost interest and no further consequential damages, independent of whether notice of the importance of the transaction was given. Enforcement problems, therefore, do not exist. As a matter of possible future statutory law, any loss exceeding lost interest remains with the originator

291. In fact, *Hadley v. Baxendale*, 9 Exch. 341, 156 Eng. Rep. 145 (Ex. 1854), involved only a two-party relationship as opposed to a complex funds transfer chain. In *Evra*, 673 F.2d 951 (7th Cir.), cert. denied, 459 U.S. 1017 (1982), the court thus might have asked whether the *Hadley v. Baxendale* doctrine was literally transferable to the multi-party situation involved.

who has to take precautions. Although it remains a possibility that the parties of a funds transfer could change this statutory allocation of loss by express written agreement, in the majority of cases the statutory default rules of draft article 4A of the U.C.C. will apply and, therefore, be of decisive importance.

This solution is rather opposed to the concept of German law, which tries to hold bank services to a certain standard by imposing liability that extends to any consequential damages. Thus, in principle, liability is not limited to lost interest. Even in the case where special notice was given, the proposed solution of draft article 4A of the U.C.C. puts the burden of monitoring the transaction on the originator. German law, however, imposes this burden on the banking system even in commercial transactions. The solution of the draft is also opposed to the common law, which in principle allows recovery of consequential damages provided they are foreseeable.

Viewing only the draft article 4A of the U.C.C. provisions regarding bank liability in cases of false negatives, there is little incentive for banks to improve their reliability standards.²⁹² In addition, the burden of monitoring payment transactions may involve high costs on the part of the customer. Thus, although consistent with the exemption from liability provided for by article 4 of the U.C.C. and Regulation J, the proposal may not be an overall efficient solution and may be overly solicitous of the stability of the financial system. However, the concern that unpredictable consequential damages may impose an excessive burden on the system is a serious one. But eliminating this feared excessive burden and stabilizing the financial system could be achieved as well by adopting comparative negligence concepts and by setting a limit on the amount of damages that can be recovered. However, it has to be noted that different loss imposition costs in the United States could set limits to the efficient adoption of this more flexible approach.

The German giro system demonstrates the effective use of funds transfers in consumer payment transactions. In the future, this payment system may become more popular with consumers in the United States, and responding to higher demand, bank services which are more accessible to consumers may be offered. The proposed liability system of draft article 4A of the U.C.C. does not distinguish between commercial and consumer transactions. However, one arguably may justify the exemption of liability in commercial transactions by the assumption that the originator is in the best position to avoid any loss by issuing a payment order in time to allow monitoring of the transaction. This is no longer true in the case of consumer transactions. Thus, the draft article 4A of the U.C.C., at least for the latter transactions,

292. However, in cases of false positives, draft article 4A of the U.C.C. imposes the risk of loss up to the face value of the transaction on the banking system. It is therefore arguable that the proposed liability system of article 4A as a whole meets the requirement of holding banks up to a certain standard. On the other hand, avoiding loss caused by false positives may require precautions other than those for avoiding loss for false negatives.

should broaden bank liability and shift the risk of loss, to a certain extent, to the banking system in order to avoid unbearable consequences for consumers. In this area, the differentiation provided for by the General Banking Conditions employed by the German banking industry could give some guidance.

V.
CONCLUSION

Both legal systems give the originator of a funds transfer a direct cause of action against intermediary and beneficiary banks. However, under American law the recovery of consequential damages, resulting from the improper execution of payment orders by intermediary or beneficiary banks, is *de facto* excluded by the *Evra* court's application of the *Hadley v. Baxendale* rule. This application has created inconsistencies between the liability of originators' banks on one hand, and intermediary and beneficiary banks on the other hand, which cannot easily be founded upon a rational basis. Under common law it is mere chance that determines whether the risk remains with the originator.

If article 4A of the U.C.C. is adopted in its present form, the recovery of consequential damages will be excluded for both the originator's bank and intermediary bank. Bank liability will be limited to lost interest. The risk of loss will always be with the customer. Thus, the funds transfer system will be protected from liability risks for extraordinary losses even more so under article 4A than under the common law rule of *Hadley v. Baxendale*. This protection from liability may result in lowering the efficiency of the funds transfer system, since there is little incentive for banks to improve their reliability standards.

Under German law loss resulting from the bank's fault is spread.²⁹³ The limitation of bank liability by imposing a notice requirement on bank customers is also known in the German legal system. The application of this concept, however, is more flexible than in the United States. In particular, German law takes into consideration the degree of the bank's fault. As a result, in the case of serious fault, which was assumed in *Evra*, banks rarely are exempted from any liability because of actions or omissions on the part of the customer. These rules provide incentives for both the bank customer and the bank to exercise care and to use reliable technical systems and procedures, thus enhancing the bank's efficiency and the efficiency of the entire payment system. Since both parties are motivated to take precautions, these rules create incentives for loss reduction on both sides. They further provide incentives for the parties to avoid the "paradox of compensation" or "moral

293. For a discussion of the economic analysis of loss allocation in payment transactions and the principles of loss spreading, loss reduction, and loss imposition, see Cooter & Rubin, *supra* note 7, at 70-84.

hazard.”²⁹⁴ It has not been observed that these rules generate negative impacts on the banking system and customer services. On the other hand, the outcome of liability cases depends on the discretion of the courts as they weigh the respective responsibilities of the parties. This generates certain loss imposition costs, which given the relatively cheap and quick German procedural system, are acceptable for the parties and for the system as a whole.

With regard to the difference in both nations’ laws, the outcome of liability suits in international payment transactions will differ according to the location of the bank at fault and the applicable law. Thus, no predictable liability system exists in international funds transfer on which the originator could rely.

The inconsistencies of the common law could be resolved using approaches developed in German law. More objective standards could apply to the foreseeability requirement by inferring the foreseeability of damages from the means used for a payment transaction. Originators’ banks, moreover, could be held liable for not passing specific notice of the importance of a payment transaction to intermediary banks. The goal of eliminating the feared excessive burden of the financial system could be achieved by adopting comparative negligence concepts or by setting a limit for the amount of damages which could be recovered. In any case, the liability system in funds transfer should differentiate between consumer and commercial transactions in order to protect consumers from unbearable consequences.

294. See Cooter & Rubin, *supra* note 7, at 74; Möschel, *supra* note 13, at 209.