AN INTERNATIONAL VIEW OF TRANSACTIONAL BANKING: AN INTERVIEW WITH ARTHUR G. LLOYD*

The Living Law section attempts to bridge the gap between the "official" law as codified and the law as it is actually implemented. For a complete explanation of the theory behind the Living Law section, see Kozolchyk, *Living Law*, 1 Ariz. J. Int'l & Comp. L. 85 (1982); Kozolchyk, *Introduction By The Faculty Advisor*, 2 Ariz. J. Int'l & Comp. L. 3-7 (1984).

The following interview with Arthur G. Lloyd ("AL") was conducted by Boris Kozolchyk ("BK") and the *Arizona Journal of International and Comparative Law* at the University of Arizona College of Law.

Boris Kozolchyk: Could you tell us about your background: How have you married your brief opera career with the law of banking and commercial transactions?.

Arthur Lloyd: I came to Citicorp (then the First National City Bank) in 1970 after spending a number of years in private practice and in a traditional corporate law department. Since joining Citicorp, I have specialized in resolving transactional banking problems. It is true that I once aspired to an operatic career, of which the less said the better. I suppose that a musical bent bespeaks an interest in "harmonization" which is currently a hot topic in comparative commercial law.

BK: Could you describe the operation you direct, as a Citibank Vice President, in charge of one of the most active and influential departments in the country, and probably in the world, in the area of the Uniform Commercial Code ("U.C.C.") Articles 3, 4 and 5? How is it run on a day to day basis? On what specific areas do you concentrate?

AL: I run a department within the Audit Division of Citicorp/Citibank and function as the principal investigator for the corporation. Although my unit is not part of the corporation's legal affairs office, we work closely with that office as well as with line counsel throughout the various business sectors of what is an extremely diverse organization. In the course of any given week, we might deal with various issues such as employee defalcations, legal and practical issues arising out of external and internal fraud as well as actual and potential problems flowing from letter of credit transactions and the various payment systems such as checks, commercial collections and fund transfers.

My staff consists of three lawyers (including myself) and a number of experts in the areas of investigation and bank operations. We do not operate like a traditional law department to the extent that such units replicate the

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functions of outside law firms. Instead, we serve as an adjunct to line counsel and management with a view to containing the risk of loss. A colleague in another bank has referred to this type of operation as a "crisis unit," implying that the operation is independent of the traditional legal and business functions, which should be left to address the more positive agenda of doing deals and making money. Assuming then, that we are a kind of sanitation service, the problems are varied and challenging, running the gamut from forged paper and confidence schemes to splitting hairs over who is a bona fide purchaser of securities or a holder in due course of a negotiable instrument.

The rationale for the development of the department, which is now about twenty-five years old, was to respond to a variety of non-credit losses, many of which would ordinarily be covered by the insurance which all national banks are obliged to maintain. Such insurance policies, which are known as bankers' blanket bonds, typically cover employee dishonesty, forgery, counterfeiting, certain types of larceny, losses from the bank's premises and losses in transit.

Because of the large deductibles necessitated by rising premium costs, banks have been obliged to self-insure a portion of these losses. To the extent we can control the fraud loss risk, we can help keep premiums low as well as avoid having to pay for those losses which fall within the deductible. As a result, we spend a good deal of our time educating line management on how to respond to problems which are likely to arise and to give us early warning so that we may take whatever practical or legal steps which may be required to mitigate our risk. We also assist our auditors in developing and monitoring new controls to help avoid loss.

I should also mention that although operating losses are not ordinarily covered by insurance, they require a responsive and proactive effort that is no less significant than that exerted on insurable type risks.

BK: If it is a problem oriented approach, as opposed to a general counsel approach, how will the U.C.C. Articles 3, 4 and 5 come to you?

AL: The problem will come to us if it involves a potential or actual operating or fraud loss. At present we have a reporting threshold. If a potential loss exceeds an established dollar amount, the matter will come to us.

BK: If it exceeds that sum, you are responsible?

AL: Yes. But we will also handle matters below that threshold figure if invited to do so. This is strictly an administrative device to sort out the more significant problems which require immediate attention.

BK: In your use of U.C.C. Articles 3 and 4,[1] have you found certain sections interchangeable when dealing with particular fact patterns? Don't you find the notion that U.C.C. Article 3 only covers commercial paper

1. Article 3 of the Uniform Commercial Code covers Commercial Paper. Article 4 deals with Bank Deposits and Collections.

before it gets into the banking stream and U.C.C. Article 4 only controls items once they are in the banking stream an overly simplistic one? What is the extent of the interplay between these two Articles? Second, please describe current practice regarding the midnight deadline rule.

AL: The U.C.C. as applied, is significantly different from how it is likely to be perceived by a person looking at it from an academic vantage point. There is a dynamic running through the statute which moves quickly from Article 3 to Article 4 and sometimes outside the U.C.C. into common law or trade custom and usage in the banking industry. The U.C.C. contemplates reference to supplementary sources such as the common law, equity and the law merchant, which makes it a living document and one that needs little revision until the system it governs is overtaken by events.[2] For example, the advent of high speed fund transfer mechanisms, which were not foreseen in the late 1940's and 1950's require a response which is being addressed by proposed U.C.C. Article 4A.[3]

The concept of variation by agreement or clearing house rules embodied in U.C.C. § 4-103 is even a more ingenious device which has permitted the commercial law of Lord Mansfield's eighteenth century to remain viable in today's high speed market place.[4] Although the statutory language may not be sufficient to cover every contingency, U.C.C. § 4-103 permits us to respond creatively to those situations and contract out of a potential liability. I previously mentioned the vacuum left in the U.C.C. with regard to electronic funds transfers. This has given rise to occasional disputes between banks and their customers known as the name/number discrepancy. Customer X has been fraudulently induced to deliver an electronic instruction to its bank to debit its account and credit "ABC Automotive, Account No. 3456"

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2. U.C.C. § 1-103 provides:
> Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

3. *See* National Conference of Commissioners on Uniform State Laws, Discussion Draft, Uniform Commercial Code, Article 4A Funds Transfers, February 1989 (hereinafter, "Discussion Draft").

4. U.C.C. §§ 4-103 provides in pertinent part:
> (1) The effect of this article may be varied by agreement except that no agreement can disclaim a bank's responsibility for its own lack of good faith or failure to exercise care...
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> (2) Federal Reserve regulations and operating letters, clearing house rules, and the like, have the effect of agreements under subsection (1), whether or not specifically assented by all parties interested in items handled...
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> (3) Action or non-action approved by this Article or pursuant to Federal Reserve regulations or operating letters constitutes the exercise of ordinary care and, in the absence of special instructions, action or non-action consistent with clearing house rules and the like or with a general banking usage not disapproved by this Article, prima facie constitutes the exercise of ordinary care...

in the amount of $500,000. ABC Automotive is a well-known manufacturing company. The bank's electronic process causes the funds to be credited immediately to Account No. 3456, but the proper name of the account is "ABC Autos", a sole proprietorship on the brink of insolvency. Delighted at his good fortune, the recipient takes the money and runs, while the bank and its customer are left pointing fingers at each other. Who is liable? Should the customer have exercised greater care in drafting its instruction? Does the bank have a duty to compare the name and number on each of the thousands of transfer instructions it receives daily? At this point neither the statute nor the courts have given much guidance,[5] and pending the enactment of U.C.C. Article 4A, which would permit a bank to ignore the name on such an instruction,[6] banks should look to U.C.C. § 4-103 if they seek to avoid a controversy on this issue.

Although it may be difficult from a marketing standpoint to modify an existing account agreement with a valuable customer, certainly new account agreements can be drafted to provide that a bank is entitled to rely on the account number given in an instruction received from a customer and that in the interest of efficiency, it may ignore the name contained in the advice.

The interplay between U.C.C. Articles 3 and 4, which you suggest in your question is particularly evident in the concepts of negligence embodied in § 3-406 and § 4-406 of the U.C.C. Banks rely heavily on U.C.C. § 4-406 to refute untimely claims by customers while customers often turn the section to their own advantage where banks have been negligent in verifying signatures. In recent years, U.C.C. § 4-406, which was formerly used to defend against claims involving checks on which spaces had been left in the amount or name designations in such a way as to facilitate a forgery, is now being used to establish the customer's lack of care in controlling his checkbook or supervising his employees, as for example, where a bookkeeper has forged the drawer's signature.

Similarly, the concept of finality of payment, found in U.C.C. § 3-418, and the notions of timeliness in Part 5 of Article 3 of the U.C.C. are basic to the time-driven provisions of U.C.C. Article 4, which leads to the part of your question on the midnight deadline.

Here again, we go back to U.C.C. § 4-103, which makes the statutory deadline subject to change by clearing house rules. According to the U.C.C. rule, returned checks must be paid or dishonored timely, that is, by midnight of the day following receipt. But because that time is not convenient for most clearing houses, there is usually a 10:00 or 11:00 p.m. deadline which becomes the "midnight" deadline because a clearing house rule has declared it to be so.

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5. *But see* Bradford Trust Co. v. Texas American Bank, 790 F.2d 407 (5th Cir. 1986); Securities Funds Services, Inc. v. American Nat'l Bank & Trust Co., 542 F.Supp. 323 (N.D. Ill. 1982).

6. Discussion Draft, § 4A-305(2).

BK: What are the most important clearing houses in the country today which set such standards?

AL: The Federal Reserve Bank is, of course, our most important clearing house because it operates on a nationwide basis in the various districts and handles the greatest volume of checks. In the private sector, clearing house associations in the major cities, such as New York and Chicago have developed similar rules tailored to their own needs for the rapid clearance of cash items. Under the federal system, the Federal Reserve Board established a framework of general regulations which governs clearing times and bank responsibilities attaching to the process. The operating circulars issued under those regulations may differ among the various Federal Reserve Districts, which tends to keep the system flexible and dynamic. The system recognizes a need for uniformity while responding to local needs. This approach might well serve as a model for the European Community if bank collection rules are ever truly harmonized in that region.

BK: Is it your opinion that the midnight deadline rule applies to collection items as well as cash items?

AL: The answer is necessarily equivocal because the courts have not yet spoken with one voice on this point. A collection item contains a special instruction, or "flag," which requires that the processing bank, to which it is directed, follow certain instructions. These instructions may, for example, require the bank to notify its customer before taking it for collection. Because of the special handling required, it is virtually impossible for a bank dealing in volume to turn this type of item around within the midnight deadline.

Unfortunately, the law is not clear regarding the bank's liability in this situation. Again, U.C.C. § 4-103(2) may provide a provisional solution, pending more precise legislation, where a clearing house rule or similar fiat has been handed down by local regulators. In New York this has been done through an opinion given by the Superintendent of Banking,[7] although I do not know of any situations where that opinion has actually been invoked.

BK: Could you comment on *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.*[8] which highlights the difficulties with *Price v. Neal*,[9] a classic Mansfield decision which held the drawee bank liable for the drawer's forgery. Where a repeated forgery could have been discovered by the drawer and the drawee can prove his diligence in accordance with industry standards, are you in favor of qualifying the scope of *Price v. Neal*?

AL: No. I believe that the final payment rule of *Price v. Neal*, which is incorporated in U.C.C. § 3-418, is a good rule which usually works an equitable result. In *Putnam*, the court was faced with a potentially inequi-

7. Opinion Letter, State of New York Banking Department to the Council on International Banking, Inc., October 20, 1987.

8. 74 N.Y.2d 340, 546 N.E.2d 904, 547 N.Y.S.2d 611 (1989).

9. 3 Burr. 1354, 97 Eng. Rep. 871 (K.B. 1762).

table result flowing from the facts of the case. To deal with its problem, the court chose to frame the issue in terms of evidentiary burden shifting. One can only wonder what the result might have been if the defendant had submitted proof of general banking usage. The court rejected the bank's reading of U.C.C. § 4-103(3), the so-called "safe harbor" provision,[10] which had been used in earlier cases.[11] The court found that it was the bank, and not the customer, which has the burden of proving compliance with banking usage. The customer was not obliged to disprove the defendant's compliance with general banking usage in a field which is somewhat of a mystery to the layman. *Putnam* is an interesting case, but I don't think it derogates from the rule of *Price v. Neal.*

BK: In your opinion, is there a reluctance to have the courts establish the rule in this area by having testimony, banking testimony, on what the custom should be?

AL: It is extremely difficult to prove banking usage. What is reasonable for Bank A, may not be reasonable for Bank B, because of a difference in processing volume or a difference in the capacity of check processing equipment within a banking community. There are any number of variables that have to be taken into consideration. The problem lies in the extreme difficulty Bank A will have getting a witness to come forward from Bank B, who will say that Bank A's practice is reflective of banking usage. Bank B does not want to be tainted by endorsing a policy which is different from its own. Clearly, there is a bank custom and there is a standard of reasonableness, but it eludes description. To paraphrase a Supreme Court Justice when asked to define pornography, "I can't define it, but I know it when I see it!" This is something many banks are looking at in light of *Putnam.*[12]

BK: Can you comment on the effect of Regulation CC[13] on the banker's handling of check kiting operations?

AL: Regulation CC is probably the most extreme example of modification of the midnight deadline. It is the creature of the Expedited Funds Availability Act[14] and effectively negates the "float factor" in the clearance of checks. Yet there has not been a significant increase in large-scale check kiting. The adoption of the federal legislation and the implementing regulations have sensitized bankers to the dangers of check kiting and banks have taken steps to protect themselves against these illicit operations.

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10. *See supra* note 4 and accompanying text.

11. *See e.g.*, Five Towns College v. Citibank, N.A., 108 A.D.2d 420, 489 N.Y.S.2d 338 (1985).

12. The New York Court of Appeal's view in *Putnam* is far from universal. *See e.g.*, Wilder Binding Co. v. Oak Park Trust and Savings Bank, 1990 Ill. Lexis 18 (Sup. Ct., Ill.). Decision filed February 16, 1990 pending rehearing.

13. Federal Reserve Bank Regulation CC, 12 C.F.R. § 229 (1989).

14. 12 U.S.C. 4001.

BK: Will the reduction in float time reduce the instances of check kiting?

AL: Quite the contrary. The potential for kiting is increased, because the actual collection time now lags well behind the availability time. However, the federal ban fraud statute[15] should provide a real deterrent to the "major" kiting artist. One object lesson is the E.F. Hutton prosecution of several years ago, where corporate cash managers were accused of crossing the line from legitimate cash flow techniques into a massive kiting operation.[16]

BK: Can you comment on the ongoing efforts to revise U.C.C. Article 5,[17] your goals and views on this revision?

AL: Yes. Bankers and letter of credit practitioners have struggled with the evolution of the letter of credit device under a body of custom and statutes which do not address many of the problems created by technology and the advent of non-bank issuers. Originally, I was inclined to agree with Henry Harfield that "If it ain't broke, don't fix it," but after spending many Saturday afternoons in a stuffy New York conference room with my Task Force colleagues, I have come to believe that at least a good fine tuning is in order. The basic framework is there, but it is time to take account of technological change, and some aberrations (such as nondocumentary conditions and silent confirmations) which have erupted since Article 5 was drafted. A revised U.C.C. will probably have international implications and form the nucleus of a harmonized worldwide trade law somewhere down the road. I feel honored to think that the Task Force Report[18] will be its cornerstone.

BK: Can you comment on the composition of the Task Force?

AL: The Task Force was carved out of the Letter of Credit Subcommittee of the ABA's Uniform Commercial Code Committee. It worked for over two years in formulating and evaluating ideas for revising U.C.C. Article 5. The unusual characteristic of the group is that it was not limited to practicing lawyers and academics. It benefited from the participation of several working bankers, who were probably more comfortable with the Uniform Customs and Practice than the Uniform Commercial Code, but who brought to the table a tremendous amount of expertise and enabled the group to focus on the issues most likely to vex bankers and other letter of credit users.

BK: Will developments in automation affect letter of credit law?

AL: The Task Force looked at this aspect of letter of credit law and recognized that we needed to respond to it. I have real problems with some of the approaches that have been taken in the automated letter of credit field. The idea of a cut-and-paste letter of credit, and the ability of the account party to dictate the terms of a credit from a remote terminal can create problems

15. 18 U.S.C. 1344.

16. United States v. E.F. Hutton & Co., Criminal Information No. 85-0083 (D.C.M.D., Pa. 1985).

17. U.C.C. Article 5, Letters of Credit.

18. An Examination of U.C.C. Article 5 (Letters of Credit): A Report of the Task Force on the Study of U.C.C. Article 5, 1989.

which might be avoided if the drafting is left to technical specialists. I believe the issuer should control the destiny of the transaction.

BK: Could you comment on the standard of care required from the banker in ascertaining strict compliance with letter of credit terms and conditions?

AL: The standard adopted by the Task Force is that of strict compliance. In a non-conforming presentation, however, there will always be a degree of subjectivity. So, the standard must be one of reasonableness. This will obviously create problems of interpretation.

BK: Is the system of basic banking regulation that governs lending limits a sound one? Do you believe that scheme works despite the very stark picture of bank failures and instability? How do you implement this system from day to day? Could you illustrate how it works from your position at Citibank?

AL: I have to respond to this question in a very limited fashion. As I explained at the outset of this interview, I deal with the transactional and operational aspects of banking and have little to do with credit-related issues. However, in my work I have to be conscious of the overriding regulatory framework. If we look at the deterioration of some segments of the financial service industry, such as the savings and loan failures of recent years, it is reasonable to conclude that stronger controls were needed. We could certainly have done worse than the risk based capital framework now in place.[19] Certain types of lending could have been prohibited or deposit insurance premiums might have been increased drastically. To the extent that the present guidelines require a careful evaluation of risk, they should prove beneficial to the system.

BK: Could you comment on the current problem of money laundering, and whether and how banks could be more involved in detecting it?

AL: Most major banks are already actively involved in controlling the problem of money laundering and have devoted substantial resources to the activity. Current federal regulations require us to detect and report currency transactions over $10,000 and report the transportation of currency over $10,000. Legislation has been proposed which would lower the threshold and expand the requirement for electronic fund transfers, but there has been such a response on the part of banks that the regulators are deluged with reports. So, I do not think that there is need for more involvement. Although the problem is very frustrating for law enforcement authorities, I believe that most prosecutors would probably agree that the major banks are doing their part. In fact, a good deal of time and effort is spent by bankers in detecting so-called structured transactions, which are often difficult to spot in a multi-branch bank.

19. Federal Reserve Bank Risk-Based Capital Guidelines, 12 C.F.R. 208 (state member banks); Federal Reserve Bank Risk-Based Capital Guidelines, 12 C.F.R. 225 (national banks).

But reporting is only one side of the picture. International banks are also subjected to an increasing number of subpoenas and restraining orders arising from money laundering prosecutions initiated in the United States. There has been an evolution of case law since the late 1950's which gives extraterritorial effect to grand jury subpoenas, even though the disclosure of the requested information may subject the subpoenaed bank to civil or criminal penalties in the jurisdiction where the subject account is located.

BK: But when faced with a potential economic penalty are they able to resist through legal means?

AL: Banks have always had to balance the duty of confidentiality owed to the customer with the requirement to comply with a valid subpoena or court order. Over the years the major United States banks with offices overseas were forced to test the validity of such orders and subpoenas in the courts. The reaction of the United States courts, prompted by the growing concealment of drug money, was to increase the pressure on suspected money launderers by putting extreme pressure on their banks. In the later cases involving extraterritorial effect, some courts found that a bank's efforts to obtain a court order blocking U.S. efforts to obtain account information abroad amounted to "bad faith."[20] With the advent of the Money Laundering Control Act of 1986,[21] the powers of the federal government to combat money laundering are extremely broad, even to the point of being able to compel a witness before a grand jury to authorize access to his accounts. So, there are a whole variety of tools open to the prosecutor today. Banks recognize this policy as a risk of doing business.

BK: What happens in practice when you suspect a money laundering transaction?

AL: In our organization, the legal affairs office has a unit which deals with these specific problems as they arise. If I encounter a money laundering problem in the course of my work, I refer the matter to one of our in-house experts.

BK: What effect will changes in Western Europe in 1992 have on banking?

AL: I think they will have a tremendous effect. By way of example, there is going to be a new network of regulations covering insider trading. The restrictions on insider trading have already proliferated within the common market. Spain and France have broad rules which are still in the developmental stage. Although the Europeans are years behind our system, they are catching up fast. In my particular field, we are likely to see some changes in the law governing checks, collections and fund transfers, but these are likely to be slow in coming, since there is no external impetus driving such revisions as there are in the areas of insider trading and money laundering.

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20. United States v. Bank of Nova Scotia, 740 F.2d 817 (11th Cir. 1984), cert. denied, 469 U.S. 1106 (1985).

21. 18 U.S.C. §§ 1956, 1957.

BK: How can United States banks position themselves to compete in post 1992 Europe? Will banks rush to incorporate in Europe?

AL: Most of the positioning is already underway. A few years ago, many banks were closing offices in Europe for economic reasons, but many non-European banks which had a presence there stayed on and will continue to be involved in the development of the region.

BK: Do you anticipate problems as a result of technological developments, and if so, what factors are important?

AL: The speed of the transaction is particularly important. To give you one example which occurred about a year and a half ago, a midwestern bank nearly suffered a loss of $70,000,000 on a fraudulent wire transfer, in which the test-word procedures at that bank were compromised by a dishonest employee. The attempted fraud occurred during a transitional period when the bank was automating its operation and some basic controls were not in place. The fraud was not sophisticated, but the means of delivery ensured an instantaneous transfer to a numbered account in a secrecy jurisdiction other than Switzerland. Practically every financial institution has seen a simple forgery or simple fraudulent deception translated into an instantaneous loss by virtue of the speed of transmission. Fortunately, the bank in this case was able to recover the funds from the receiving banks before they could be drawn down.

The facsimile machine has also become a tool for fraud, but practical and legal measures can be taken to protect an institution against fraudulent fax instructions. One practical control is to restrict physical access to a machine or use a confidential access code. An indemnity agreement should also be included in the basic account agreement with the customer.

BK: Clearly, the use of computers and the corresponding speed of the transaction has forced an enormous degree of uniformity in the terminology of commercial law. It stands to reason that the law underlying these transactions has to be uniform, or at least not conflictive, to allow computer programs to communicate with each other. In the context of uniformity, how do you see the relationship between U.C.C. Articles 3 and 4 and the Geneva Convention, which is the law so many civil countries in the world have adopted when it comes to negotiable instruments. Do you see any areas where harmonization is necessary?

AL: I do see some need for harmonization. I would say to a large extent, having recently dealt with the Negotiable Instrument Regulations of Saudi Arabia, which are based on the Geneva Convention, that there is a remarkable similarity to the common law in result, if not in modality. In Saudi Arabia, where the commercial life has developed more recently than in Europe, there has been a willingness to be flexible in interpretation. Where you have entrenched interpretations of the law, however, there is less flexibility. For example, concepts of recourse and risk of loss differ between the common

law and civil law systems and there are even some key distinctions between English and American negotiable instrument laws. For example, the Bills of Exchange Act does not contain any provision analogous to the statement of account rule found in U.C.C. § 4-406.

Because of the entrenched positions and the different legal underpinnings of the various legal systems it will be difficult to achieve complete congruency, but there certainly is room for harmonization. At the moment these commercial concerns hold a low priority on the European Community's legislative agenda. Until harmonization is achieved we will have to be satisfied with a patchwork effect, and perhaps a greater movement toward understanding comparative law principles. Bankers and lawyers in the United States could benefit from a better understanding of comparative legal systems. I do not think you can say one system is necessarily better than another; rather, there is room for improvement in both systems.