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U.C.C. Article 4A - Wire or Wire Not? Consequential Damages Under Article 4A and a Critical Analysis of Evra v. Swiss Bank, 11 Computer L.J. 341 (1991)

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U.C.C. ARTICLE 4A — WIRE OR WIRE NOT? CONSEQUENTIAL DAMAGES UNDER ARTICLE 4A AND A CRITICAL ANALYSIS OF *EVRA V. SWISS BANK*

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I. INTRODUCTION AND OVERVIEW

Nearly ten years ago, the members of the banking world were sent scrambling to their wire transfer operations to check for reliability problems when the district court decision in *Evra Corp. v. Swiss Bank Corp.*[1] was announced.[2] The district court found the Swiss Bank liable for consequential damages in the amount of $2.1 million for delaying a $27,000 wire transfer. Even though the district court decision was later overturned, it is little wonder, in light of the influence of the banking lobby, that Article 4A of the Uniform Commercial Code ("Article 4A"), proposed by the National Conference of Commissioners on Uniform State Laws, disallows consequential damages for wire transfer failure except where provided in an express written agreement.[3] Ironically, this approach may actually increase the bank's risk exposure.

Contract damage provisions offer a wonderfully flexible method for allocating risks and liabilities between the contracting parties. However, this process can only be effective if the contracting parties both possess the knowledge and relative strength to bargain vigorously.

Article 4A undercuts this process when it causes the default risk of consequential damages arising from a system failure to fall on the party with the least ability to assess problems in the system and with the least incentive to bargain aggressively: the bank's customer. Inevitably, the bargaining process will fail to properly allocate this risk.

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

2. An interview with an officer in a large Los Angeles bank revealed that they still have one of their night watchmen checking the paper rolls on the Telex machines. This is interesting because *Evra* has been reversed and the reversed decision has been followed in other jurisdictions. Liability got the bank's attention but it is not their only reason for the extra care. *See generally* Budnitz, *The Finicky Computer, the Paperless Telex and the Fallible Swiss: Bank Technology and the Law*, 25 B.C. L. REV. 259 (1984).

The interview information came from an afternoon spent in the wire transfer department of a large nationwide bank. Because of the competitive nature of the wire transfer business and the possible sensitive nature of some of the information, the name of the bank involved has been omitted. However, I would like to acknowledge the cooperation extended by the banking industry and thank them for it.

3. U.C.C. §§ 4A-305, 4A-306 (1989). At various points, this note cites to two previous drafts of Article 4A: the February 1989 draft, which has comments, and the July 1987 draft, which also has a prefatory comment. The final version, which is presently being edited for style, changed the damage provision from section 4A-306 to section 4A-305 and in its present form has no comments.

As a result, contract law will fail in its goal of increasing economic efficiency. Moreover, the bank customer's lawyer will logically turn to tort law in search of a remedy. As discussed in this Note, this will result in a more unpredictable liability allocation and, therefore, greater risk exposure for the banks.

A. THE WIRE TRANSFER SYSTEM

In order to comprehend the importance and possible implications of Article 4A, it is important to understand the wire transfer system and appreciate its size and complexity. Reliable wire transfers are made possible by the rapid technological advances in computers and communication gear.[4] A bank can send an order to credit a bank account almost any place in the world in a very short time and at a very low cost.[5] The transfers are generally dependable; the chances of a mistake are generally negligible.[6] However, because of the size of the transactions,

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4. *See* Kutler, *Rockwell International Money Transfer System Integrates All Wire Network Links*, AM. BANKER, Jan. 31, 1979, at 32; Feldman, *International Funds Transfer Gains Sophistication*, AM. BANKER, Dec. 14, 1979, at 22.

Article 4A was designed to be flexible in the face of advancing technology. The regulations are not tied to a particular mechanical device. The term "funds transfer" is used rather than "wire transfer." U.C.C. § 4A-104 (1989). A "payment order" can be transmitted orally, in writing or electronically. *Id.* § 4A-103(1) (1989).

At present, the normal wire transfer is initiated by a phone call to the originating bank. (These phone calls are often recorded by the bank in order to have a record in case there is a later discrepancy in the instructions that go with the wire.) The originating bank's wire transfer department then looks for a path, using, if possible, a chain of corresponding banks that will get the funds to the beneficiary's bank. (Corresponding banks maintain mutual accounts and lines of credit so that funds can transferred without movement of currency or use of the Federal Reserve's settling mechanism. The banks only need to use other sources of credit if the mutual accounts get too far out of balance or if they cannot find a route through mutual correspondents.) The wire transfer department uses computer equipment to track the various accounts to optimize the use of its accounts and to keep them in balance. Once a chain of correspondents is found, the bank sends a telex to the first bank. A telex is simply an electronic message which, in this case, contains instructions that tell the receiving bank what to do from that point on. Usually a transfer can be accomplished by a chain of one or two telexes domestically and with one or two additional telexes if the beneficiary is overseas.

Eventually, the technology will be commonly available to allow customers direct computer access to the wire transfer departments. Also, it may be feasible to have direct computer links between corresponding banks which could eliminate much of the need for the telex. These advances, which are already in use in the consumer electronic fund transfer system, could greatly increase the speed and efficiency of the process. However, they could also make the system much more vulnerable to some types of error (software or hardware error) and some forms of electronic fraud. This possibility makes it all the more important that Article 4A establish the correct rules for liability for wire transfer error.

5. U.C.C. art. 4A prefatory note, at iii (draft July 1987).

6. *See infra* note 51.

an error can be very costly in both direct damages and consequential damages.

Wire transfer is by far the most common method of transferring capital in the banking world.[7] Compared to other possible means it accounts for the greatest dollar amount:

> The dollar volume of payments made by wire transfer far exceeds . . . payments made by other means. The volume of payments by wire transfer over the two principal wire payment systems — the Federal Reserve wire transfer network (Fedwire) and the New York Clearing House Interbank Payments System (CHIPS) — approaches $1 trillion per day.[8]

Federal Reserve figures (for Fedwire alone) indicate that for 1987 84,022,023 transfers were processed for a total of $224,480,835,000,000.[9]

Wire transfers offer speed, reliability, and low cost, which accounts for their widespread use. These economic considerations make a strong public policy argument for protecting the viability of this process. Hence, both courts and legislatures have been cautious in their application of laws which would discourage use of wire transfers.[10]

B. THE LIABILITY QUESTION

Under current contract law, liability for damages from wire transfers is uncertain. Rapid advances in technology create questions regarding the proper standard to which banks should be held. Should they be held to the latest technological standards, the most common standards, their own standards, or some kind of "reasonable" standard?[11]

Beyond this is the question of how these standards may differ between tort and contract theories.[12] Article 4A is an attempt to define these standards and provide a statutory framework to clear up the confusion in the law of wire transfers.[13]

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7. U.C.C. art. 4A prefatory comment (Draft July 1987).

8. *Id.*

9. Federal Reserve Bank, DETAILED REPORT, FEDERAL RESERVE BANK EXPENSES BY ACTIVITY 228 (1987).

10. The cases and other materials almost universally discuss the importance of wire transfers and the need for caution. Legislation tends to be written and interpreted narrowly. However, what some courts have considered treading lightly has caused much concern in the banking industry. *See* Bradford Trust Co. v. Texas Am. Bank, 790 F.2d 407 (5th Cir. 1986); Walker v. Texas Com. Bank, 635 F. Supp. 678 (S.D. Tex. 1986); Securities Fund Servs. v. American Nat'l Bank & Trust Co. of Chicago, 542 F. Supp. 323 (N.D. Ill. 1982). *See also* Alces, *Toward a Jurisprudence of Bank-Customer Relations*, 32 WAYNE L. REV. 1279 (1986).

11. U.C.C. §§ 4A-202, 4A-205 (1989); *see also* Alces, *supra* note 10.

12. *See infra* text accompanying notes 38-75.

13. Article 4A may also be intended to preempt tort law. *See infra* text accompanying notes 114-21.

C. Scope of Article 4A

Article 4A has a narrow scope. It is intended to cover large commercial transfers of funds, such as payments for large contracts or internal money transfers between a corporation and its subsidiaries.[14] These usually involve large dollar amounts transferred between sophisticated parties with bargaining power on both sides.[15] Article 4A excludes: internal bank to branch and bank to bank transfers for their own accounts, most Federal Reserve Bank transfers, most consumer transfers, and most Western Union type telegraph transfers.[16]

However, substantial numbers of wire transfers have a consumer at least at one end.[17] The implications of consumer use are beyond the scope of this paper.[18] This Note assumes that the parties to the wire transfer agreements have at least some sophistication and bargaining power.

The purpose of Article 4A is to establish clear and definite liability standards for wire transfers.[19] However, there has been a significant amount of dissent, especially from the large users of wire transfers.[20] In any event, even if the Code is fair on the larger issues, a cog is missing in the works that could disrupt the whole mechanism. Consequential damages is this missing cog.

D. Consequential Damages in Wire Transfers

Consequential damages can arise in a number of different ways as a result of a wire transfer error. Modern money management calls for maximum use of capital,[21] and wire transfers fill this need. The sender has the money in his account until it is due. The payee receives his money exactly when due and gets instant credit for it in his account.

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14. U.C.C. art. 4A prefatory comment (draft July 1987).

15. There is, however, a caveat. In my conversations with various bank officials, they stated that a significant portion of their wire transfer business had a consumer at one end. These transactions involved things like home loan principal transfers and stock purchases. Thus, it may not be as easy to separate the commercial business from the consumer business as Article 4A implies.

It is important to note that many of the assumptions in Article 4A may be based on being able to easily distinguish between consumer use and business use. To the extent this distinction is not clear, there could be vast implications for Article 4A. The policies that apply in a business context may have a different application in the consumer context. *See Regulation J*, Daily Rep. for Exec., Oct. 9, 1987 at 10; Wallace, *Q & A*, Boston Globe, Sept. 22, 1988, at B1.

16. U.C.C. § 4A-101 (draft July 1987); *id.* § 4A-108 (draft Feb. 1989).

17. *See supra* note 15.

18. *Id.*

19. U.C.C. art. 4A prefatory comment (draft July 1987).

20. *See infra* pp. 372-74 and accompanying notes.

21. R. Brealey & S. Meyers, Principals of Corporate Finance 725-88 (1981).

However, sometimes things go wrong and the payments do not arrive on time. This can cause a contract to be breached[22] or cause the sender to miss a profitable, time-critical opportunity.[23] These consequential damages, arising out of the breach of a separate contract, are the focus of this Note, the question being: How can Article 4A best handle these situations?

E. STATUTORY ANALYSIS OF U.C.C. § 4A-305

In order to understand how consequential damages are addressed under Article 4A it is necessary to analyze the language of the Code itself. Section 305 of Article 4A covers damages for late execution, improper execution, or failure to execute a wire transfer order.[24]

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22. A short and sad hypothetical story: O.R. Hero, a young MBA trained entrepreneur had landed a big contract. He had the exclusive rights to an exercise device that has the potential of being the next craze. Because of the high risks, the manufacturer made significant concessions in the contract, making it potentially very profitable. The manufacturer was located in another country and the contract required large payments due at intervals throughout the term of the contract.

Thoroughly trained in optimal money management, Hero approached his bank with his situation. The bank, eager for his business, pushed its modern wire transfer department. The bank's presentation emphasized reliability, speed, and low cost. Hero started using wire transfers to make the payments.

Hero invested heavily in advertising the new device and it started to pay off. His business skyrocketed. His supplier started to regret the contract and was looking for a way out.

When the next payment came due, something went wrong. Due to bank error, the payment did not arrive until it was one week late. By then the manufacturer had repudiated the contract and arranged to distribute the product themselves. Hero's business collapsed, he was out $10,000,000 in lost profits and $2,000,000 in advertising.

Hero lost before the arbitration board that the equipment contract called for. Hero had borrowed the $200,000 payment from the bank so damages under present 4A rules are going to be negligible. His only recourse is tort. *See* Compania Anoima Venezolana De Navegacion v. American Express Int'l Banking Corp., No. 84 Civ. 2047 (PKL) (S.D.N.Y. 1985).

23. O.R. Hero had the one time opportunity to buy a commodity at fire sale prices. However, the payment had to be there on time or the opportunity was lost. A bank employee diverted the funds to the wrong account and the account holder absconded. Lost profits were $2,000,000. Present Article 4A damages are replacement of the $100,000 payment with interest for the week it was missing.

24. U.C.C. § 4A-305 (1990). The text: LIABILITY FOR LATE OR IMPROPER EXECUTION OR FAILURE TO EXECUTE PAYMENT ORDER.

> (a) If a funds transfer is completed but execution of a payment order by the receiving bank in breach of section 4A-302 results in delay in payment to the beneficiary, the bank is obliged to pay interest to either the originator or the beneficiary of the funds transfer for the period of delay caused by the improper execution. Except as provided in subsection (c), additional damages are *not* recoverable.
>
> (b) If execution of payment order by a receiving bank in breach of section 4A-302 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 or-

Interestingly, the wording in the Code does not explicitly say, "no consequential damages." Sub-sections (1) and (2) list the available damages. These include interest on delayed funds and expenses, interest, and incidental costs for misdirected funds.[25] This is notable because interest could arguably be a consequential damage.[26] Sub-sections (a) and (d) allow parties to contract for the provision of other damages including consequential damages, by express written agreement. The only direct reference to consequential damages is in comment 2, which specifically states that consequential damages are *not* allowed unless written in the contract.[27]

The consequential damages provision of Article 4A is based on *Evra v. Swiss Bank*. Comment 2 specifically mentions *Evra* and uses the same language and rationale as the court decision. For example, the drafters indicated that the originators of the transfer are in the best position to evaluate the risks of the transfer and take precautions.[28] The fallacies in this argument are discussed later in this Note.

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der that does not comply with the terms of the payment order of the originator, the bank is liable to the originator for its expenses in the funds transfer and for incidental expenses and interest losses, to the extent not covered by subsection (a), resulting from the improper execution. Except as provided in subsection (c), additional damages are *not* recoverable.

(c) In addition to the amounts payable under subsections (a) and (b), damages, including consequential damages, are recoverable to the extent provided in an *express* written agreement of the receiving bank.

(d) If a receiving bank fails to execute a payment order it was obligated by express agreement to execute, the receiving bank is liable to the sender for its expenses in the transaction and for incidental expenses and interest losses resulting from the failure to execute. Additional damages, including consequential damages, are recoverable to the extent provided in an *express* written agreement of the receiving bank, but are *not* otherwise recoverable.

(5) Reasonable attorney's fees are recoverable if demand for compensation under subsection (1) or (2) is made and refused before an action is brought on the claim. If a claim is made for breach of the agreement under subsection (4) and the agreement does not provide for damages, reasonable attorney's fees are recoverable if demand for compensation under subsection (4) is made and refused before an action is brought on the claim.

(6) Except as stated in this section, the liability of a receiving bank under subsection (1) and (2) may not be varied by agreement.

(emphasis added).

25. *Id.* § 4A-305(a), (b).

26. Interest could be said to arise under a separate contract and therefore be consequential damages. So there may really be some foreseeability rationale going on here: the banks can easily foresee the loss of interest, which is after all, their business. However, it is also arguable that they can foresee other lost profits. Why does Article 4A draw the line here?

In contrast, money loans are one of the exceptions to consequential damages. Historically, consequential damages were not available for breach of a loan contract. However, it is doubtful that this is the rational behind section 4A-305; wire transfers are not loans.

27. U.C.C. § 4A-306 comment 2 (1990).

28. *Id.*

However, the drafters were quick to separate themselves from *Evra* on the issue of "notice of special circumstances." The drafters noted that one interpretation of *Evra* is that consequential damages can be imposed if the culpable bank had notice of special circumstances. The drafters disapproved of such an interpretation, stating that it is not a practical solution to the problem. The drafters expressed concerns regarding proof problems in litigation and the rising cost of wire transfers because of the uncertainty resulting from such a rule.[29] The major theme of this note is that this small gain in certainty may risk a large amount of uncertainty in the future.

II. THE COMMON LAW CASES: *EVRA V. SWISS BANK* ANALYZED

Because of the relative reliability of the wire transfer system, the issue of consequential damages has only rarely come before the courts. The results have been a mosaic of mixed law. The courts have used U.C.C. Articles 3 and 4 analogies, common law analogies, and mixed tort and contact theories almost randomly.[30] The consensus is that, at present, the U.C.C. doesn't directly apply.[31]

The following is a discussion of the *Evra* decision. It follows the *Evra* court's reasoning step by step and attempts to identify where the court's opinion may be deficient. For example, the *Evra* court failed to clearly discuss the separation between contract and tort law and used non-standard applications of the rule in *Hadley v. Baxendale* and the Illinois consequential damage law. For contrast, other court decisions are used to show alternative rules that could arguably apply to wire transfers. The point in contention is that *Evra*, as it stands, is not a sufficient discussion of contract consequential damage claims as applied to wire transfers.

Evra v. Swiss Bank[32] was decided in the seventh circuit, and the opinion was written by Judge Posner.[33] The case involved a ship char-

29. *Id.*

30. Bradford Trust Co. v. Texas Am. Bank, 790 F.2d 407, 409 (5th Cir. 1986); Evra v. Swiss Bank, 673 F.2d 951 (7th Cir. 1982), *cert. denied*, 459 U.S. 1017 (1982); Walker v. Texas Com. Bank, 635 F. Supp. 678, 681 (S.D. Tex. 1986); Miller, *Report on the New Payments Code*, 41 BUS. LAW. 1007 (1985-86).

31. Miller, *supra* note 30, at 1010.

32. 673 F.2d 951 (7th Cir. 1982), *cert. denied*, 459 U.S. 1017 (1982).

33. With apologies to the distinguished judge. He almost certainly did not have in mind the far reaching effects Article 4A's use would give it. This is perhaps another example of the maxim of great (hard or interesting) cases making bad law, especially appropriate in this situation because (as will be later discussed) much of Article 4A's consequential damages clause is based on this case. If Article 4A is adopted in its present form, the influence of this case will be raised exponentially. *See* U.C.C. § 4A-306 (1989 draft). As noted, *supra*, the comments mention *Evra* specifically and cite to many of that

ter between an Illinois based scrap metal company (Hyman-Michaels) and the owners of a ship called the *Pandora*. The charter was for one year with an option to extend for a second year. The contract price was to be paid in advance and the ship owners were allowed to cancel if the payment was late. Payment was to be made in Geneva, Switzerland. The usual method of payment was by wire transfer.[34]

Within six months, charter rates skyrocketed, making the charter very advantageous. Understandably, the ship owners wanted to get out of their charter agreement. They almost succeeded when Hyman-Michaels tried to pay by check through the mail. The check could not have arrived on time. In the resulting dispute, the contract called for arbitration. The board decided that the delay was excusable, but stipulated that all the rest of the payments must be on time.[35]

Several payments later, the day before a payment was due, Hyman-Michaels telephoned its bank, requesting that $27,000 (the amount due on the contract) be wired to Geneva. That bank's London office attempted to send a telex to a corresponding bank in Switzerland. After several attempts, they succeeded in contacting a backup telex machine. However, the transfer was never completed. After several days of trying to find the missing telex, another was sent, but by then it was too late. The arbitration board allowed the contract to expire for breach of payment. It was never determined what went wrong, but it could have been as simple as the telex machine running out of paper. Damages for the lost profits under the shipping contract were $2.1 million.[36]

The district court found the Swiss bank liable under a negligence theory and awarded the full damages. On appeal, the Seventh Circuit Court of Appeals reversed the decision and found that, as a matter of law, the Swiss bank was not liable.[37]

A. CONTRACT VERSUS TORT IN GENERAL

The outcome of the *Evra* case was determined largely by the court's decision to use contract law as the basis for its ruling rather than tort law. One authority has noted that contract duties arise by agreement, while tort duties arise from public policy: "Tort-contract interplay occurs throughout the common law. Most often, . . . the two perspectives conflict, and courts must decide whether a collective allocation of loss

decision's rationales. However, the inappropriateness of such rationales is addressed *infra*.

34. 673 F.2d at 952.

35. *Id.* at 953.

36. *Id.*

37. *Id.* at 951.

(tort) should supersede a private allocation (contract)."[38]

Whether a court chooses to apply the legal principles of contract or tort to a given case can have vast implications.[39] Statutes of limitations are often different.[40] Damages and the extent of liability are different.[41] Public policy considerations are different.[42] Foreseeability and proximate cause determinations all affect the outcome (both perform similar functions in tort and contract but have different meanings and effects). Often the whole case will rest on these distinctions.[43]

1. Evra — *Contract versus Tort*

Arguably, the most noticeable problem with the *Evra* case is the failure of the appeals court to separate contract theories from tort theories. Although the district court based its award on a negligence tort,[44] nevertheless on appeal, the discussion centered on contract cases.[45] It is difficult to justify basing a case on contract theories in the absence of any contract between the two parties.[46] Admittedly, consequential damages is one of the areas where contract law blends into tort law, but this decision only further confuses the two concepts rather than explaining how the distinction was made.

At any rate, the *Evra* court started its discussion with a contract case, *Siegel v. Western Union Telegraph Co.*[47] *Siegel* involved the misdirection of a money order that was meant to be used in placing what would have been a winning bet. The court refused to award damages based on a contract claim stating that the damages were not foreseeable.[48]

a. The Utility Argument

By using *Siegel*, the *Evra* court may be suggesting that wire transfers should be treated like a regulated utility. The *Siegel* court's decision was greatly influenced by the fact that telegraph rates are

38. Perlman, *Interference with Contract and Other Economic Expectancies: A Clash of Tort and Contract Doctrine*, 49 U. CHI. L. REV. 61, 62 (1982).

39. *See* Wade, *Is Section 402A of the Second Restatement of Torts Preempted by the U.C.C. and Therefore Unconstitutional?*, 42 TENN. L. REV. 123 (1974).

40. East River S.S. Corp. v. TransAmerica Dalaval Inc., 476 U.S. 858 (1986).

41. *See, e.g.* Evra v. Swiss Bank, 673 F.2d 951, *cert denied*, 459 U.S. 1017 (1982).

42. Note, *infra* note 75; Wade, *supra* note 39.

43. *East River*, 476 U.S. at 860.

44. It must be noted that the district court did discuss *Hadley v. Baxendale* even though it based its decision on a negligence tort.

45. *Evra*, 673 F.2d at 676.

46. There was no contract between Swiss Bank and Hyman-Michaels. *Id.* at 958.

47. 312 Ill. App. 86, 37 N.E.2d 868 (1945).

48. *Id.* at 96.

regulated and not subject to case by case bargaining.[49] Therefore, Western Union could not adjust for special circumstances in a given message. This rationale has been used to justify court decisions and statutes limiting contract damage claims against regulated utilities. In addition, this gives strong public policy reasons for not allowing open-ended tort damages. However, *Evra* is distinguishable on all of these points.

On the surface, wire transfer appears similar to a utility case. The rates are low, but this is due to competition, not regulation. While banks are highly regulated on other matters, the part of their operation involving wire transfers is not regulated as to fees charged. If costs went up or liability was imposed, the banks could (and presumably would) raise rates.[50]

There may be some fear that the rates would have to go too high and would come to interfere with efficient capital movement. However,

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49. *See* Meyers, *Liability Limitations in International Data Traffic: The Consequences of Deregulations* 16 CASE W. RES. J. INT'L. L. 203 (1984). The issue here is considerably more complex than this. The courts have made a distinction between "conduit and content." Telegraph carriers have been held to a higher standard than telephone companies because senders depend on the telegraphic operators for sending the correct content rather than just as a conduit for the message. It is probable that banks would be held to this same standard or even a higher standard. The banks have total control of the message and the medium and the sender is almost completely dependent on the bank. Thus, even if there was utility like protection, it would be at the lowest level.

Further, it is questionable how these exceptions will survive the increasingly deregulated atmosphere of our federal government. "The consequences of deregulation on liability limitations for both domestic and international [data] traffic have yet to be fully appreciated. United States-based services which were previously regulated will be governed instead by the common law doctrines of contract and tort liability applicable to like services provided under private contract." *Id.* at 219.

There are also international implications of these rules. Not all nations recognize the utility exception. At any rate, it is difficult to justify using a utility based exception to a service that has never been closely regulated when services that have had the exemption may be losing it because of deregulation.

50. At present, the bank at which I conducted my interview is charging a flat rate for a wire transfer regardless of the amount. This would probably change under an expanded liability option. However, since direct damages are presumably proportional to size of transfer, the flat rate system would not correctly allocate costs under present Article 4A rules.

Wire transfers could arguably be considered services rather than profit centers. However, this is a shallow analysis. If, in order to get business, the bank has to take a loss leader, the costs must be spread over the total business. Presumably all banks are in the same position on this point and therefore competing on level ground. They are not doing it as a favor; it is simply part of the cost of business. At any rate, the bank officer interviewed saw the wire office as a profit center returning approximately 20% on the bank's investment. *See* Steinberg, *Banks' Fate May Hinge Upon Ability to Provide EFT Links*, PC WEEK, Oct. 13, 1987, at C1; Kantrow, *Funds Net Basks in Citicorp Spotlight; Money Transfer Vendor Bank Competes Against Western Union*, AM. BANKER, Sept. 2, 1987, at 6; Arahood & Friedman, *Internal Funds Transfer Pricing: A Multiple Pool Methodology*, BANK ADMIN., Mar. 1983, at 62.

the wires are quite reliable and are advertised by the banks as such.[51] It seems hypocritical that banks advertise the system as being so reliable while at the same time are so concerned about the unreliability in the system. This whole discussion fits better into a cost spreading-argument or an argument for insurance, under which analysis the bank would probably be the better cost-spreader.[52]

b. Contract versus Tort-Foreseeability

The *Evra* court made the extraordinary statement that *Siegel* held that foreseeability was the same under both contract and tort theory. The *Evra* court stated: "[t]he district judge found that Swiss Bank had been negligent . . . and . . . that Swiss Bank should therefore be liable for a broader set of consequences than if it had only broken a contract. But *Siegel* implicitly rejects this distinction."[53]

It is probable that Judge Posner really meant that the choice of contract or tort shouldn't matter in a case such as *Evra*. Commercial cases should award the same damages under either theory. This idea may have some merit, but *Siegel* does not directly support it.[54] The conventional wisdom is that because contract liability is strict, foreseeability of damages should also be more strict.[55] Therefore, the lower court's decision to use a negligence tort theory should have been a major issue on appeal.

It is clear that the *Evra* court failed to properly address the significance of the contract versus tort issue. This makes it difficult for a court following the decision to discuss intelligently the choice between contract and tort in similar cases. Without guidelines, the issue be-

51. *Id.* In fact, this is one of the big selling points for the banks. They advertise wire transfers as being reliable, and compete with other banks on that basis. (This information is derived from an interview with a bank wire transfer official who claimed his system was 99% or more reliable and indicated that the competition made similar claims. It must be noted that these figures may be distorted by the fact that the 99% figures are per transaction and each transfer would have several transactions before completed. Also, these figures may not include all types of problems such as intentional employee fraud, which is often not revealed publicly.) *See also infra* text accompanying note 127.

52. *See infra* text accompanying notes 125-37.

53. Evra v. Swiss Bank, 673 F.2d 951, 956, *cert. denied*, 459 U.S. 1017 (1982). *Siegel* only discussed contract law; the court never addresses the issue of contract-tort separation. It did discuss negligence, but in the context of breach of contract duties, not tort duties.

54. Most authority rejects this idea. *See* Wade, *supra* note 39, at 126-29; Note, *infra* note 75.

55. Hadley v. Baxendale, 156 Eng. Rep. 145 (1854). The rules as to what constitutes foreseeability have changed over time. The original rule was replaced by an even more stringent "tacit agreement" in some jurisdictions. However, the more modern rules are more like foreseeability than actual notice.

comes much more unpredictable. For a more thorough discussion of the issue, one must look to a different source.

2. *Justice Blackmun — Contract versus Tort*

The United States Supreme Court explored the differences between tort and contract theories in *East River Steamship v. Transamerica Delaval, Inc.*[56] *East River* was the case of first impression for contract-tort choice of law in admiralty and concerned a warranty/products liability claim.[57] Justice Blackmun proceeded step-by-step through the relevant rules in various jurisdictions. This is the type of analysis that is missing in *Evra*.

East River involved a contract to build several steamships. The turbines on two of the ships were defective, resulting in damage to the turbines and loss of profit while the ship was being repaired. The statute of limitations had already run on the contract warranty claim, so the case turned on the issue of choice of law.[58]

Justice Blackmun based the major part of his analysis on two cases lying at the opposite ends of the spectrum: *Seely v. White Motor Co.*[59] and *Santor v. A and M Karagheusian, Inc.* [60] *Santor* was a New Jersey case involving defective carpet. The court found the manufacturer had a duty to produce nondefective products where the defect had an unreasonable risk of causing harm, even if the only harm was to the product itself. The court stated:

> [W]e perceive no sound reason why the implication of reasonable fitness should be attached to the transaction and be actionable against the manufacturer where the defectively-made product has caused personal injury, and not actionable when inadequate manufacture has put a worthless article in the hands of an innocent purchaser who has paid the required price for it. In such situations considerations of justice require a court to interest itself in originating causes and to apply the principle of implied warranty on that basis, rather than to test its application by whether personal injury or simply loss of bargain resulted from the breach of the warranty. True, the *rule of implied warranty had its gestative stirrings because of the greater appeal of the personal injury claim. But, once in existence, the field of operation of the remedy should not be fenced in by such a factor.*[61]

The *Santor* court traced the origins of strict liability in tort to per-

56. 476 U.S. 858 (1986).

57. *Id.* at 859.

58. *Id.*

59. 63 Cal. 2d 9, 403 P.2d 145, 45 Cal. Rptr. 17 (1965).

60. 44 N.J. 52, 207 A.2d 305 (1965).

61. *Id.* at 55, 207 A.2d at 309 (emphasis added).

sonal injury cases but saw no reason to limit it there.[62] The test articulated by the *Santor* court was "[i]f the article is defective, i.e., not reasonably fit for the ordinary purposes for which such articles are sold and used, and the defect arose out of the design or manufacture or while the article was in the control of the manufactures . . . [then] liability exists."[63]

The *Santor* rule can be applied to Article 4A. Banks are in the business of supplying and transferring funds: these are their products. Wire transfers that are not delivered as expected could be construed as defective products. It follows that a court applying the *Santor* test could allow actions in both negligence and strict liability in tort.

Justice Blackmun next discussed the intermediate cases. The courts in those cases distinguished "disappointed users" from "endangered ones." Tort liability depends upon the type of risk, the nature of the defect, and the manner in which the injury arose.[64] Because it is unlikely that a wire transfer mistake will physically endanger anyone, these minority jurisdictions are the least likely to apply tort law.

Justice Blackmun then turned to a discussion of other cases that distinguished between gradual deterioration and calamitous, accident-like damage.[65] The loss of a wire transfer could fit under the accident-like description, arguably supporting a product liability tort in jurisdictions following this rule.

All of the preceding cases discussed by Justice Blackmun are minority decisions. However, they represent a significant minority of the states.[66] In such jurisdictions, a tort claim could be construed out of an *Evra*-like case. In *East River*, Justice Blackmun rejected these rules but there is no reason to believe that they will not be followed in the future.[67]

Finally, Justice Blackmun turned to the majority case: *Seely v. White Motor Co.*[68] *Seely* was a California Supreme Court case involving a heavy-duty truck which developed defective brakes. The defect caused the truck to overturn causing damage to the truck but no injury

62. *Id.* Historically, the expansion of tort law begins with a limited concept which over time is expanded to a greater or lesser degree, depending on the jurisdiction, politics and economics of the time.

This case approaches free choice between tort and contract—the ultimate liberal position—and is at present definitely the minority position. Since *Santor* was decided, New Jersey courts have not followed it to such a liberal extent.

63. *Id.* at 66-67, 207 A.2d at 313.

64. East River S.S. Corp. v. TransAmerica Dalaval Inc., 476 U.S. 858, 862 (1986).

65. *Id.*

66. *Id.*

67. *Id.* Generally, the Supreme Court's decisions are not controlling on state tort law.

68. 63 Cal. 2d 9, 403 P.2d 145, 45 Cal. Rptr. 17 (1965).

to the driver or anyone else.[69]

The *Seely* court ruled that damages for breach of warranty was the appropriate remedy for commercial transactions of this type.[70] Following this rationale, Justice Blackmun found that this was the correct rule for admiralty as well and applied it in *East River*.[71]

At first this appears to be friendly to the *Evra* decision and Article 4A. However, a closer examination of *Seely* reveals that the decision allowed recovery of consequential damages for lost profits under a warranty claim. Part of the rationale underlying *Seely* was that contract warranty damages adequately compensated the plaintiff for the commercial losses suffered.[72] Thus the court apparently saw no need to use tort law, with its more open damage structure, when contract damages were adequate. Contract damages are usually more limited and predictable, and are therefore more suited to a commercial business setting.

Article 4A, in effect, takes away the possibility of consequential damages under a contract claim.[73] Using the *Seely* rationale, it is conceivable that a court could allow a tort claim in the case of consequential damages where the default contract law doesn't allow for them. By failing to allow consequential damages under contract theories, Article 4A may be an open invitation to the courts to shift the action to tort.[74] By failing to provide a clear, usable standard, the *Evra* decision may simply encourage such a shift.[75]

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69. *Id.* at 12, 403 P.2d at 147, 45 Cal. Rptr. at 19.

70. *Id.* at 14, 403 P.2d at 148, 45 Cal. Rptr. at 20.

71. 476 U.S. at 863.

72. 63 Cal. 2d at 16-18, 403 P.2d at 150-51, 45 Cal. Rptr. at 22-23.

73. U.C.C. § 4A-305 (1989). In effect, because it seems extremely unlikely that any bank will voluntarily write a contract allowing such damages.

74. *See infra* text and accompanying notes 117-21.

75. By unnecessarily crippling contract law, the emphasis shifts to a form of action that could redress the injury (tort law). When faced by such a rule, a competent lawyer would not waste time arguing contract, but instead would argue that his case is really a tort. *See* Note, *Lender Liability the Shift From Contract to Tort Doctrine Deters Banks From Enforcing Unjust and Detrimental Contract Provisions*, 21 J. MARSHAL L. REV. 369 (1988).

It is important to note that recent courts have been less friendly to the expansion of tort law. However, there is no reason to believe that this trend will continue forever in all jurisdictions.

One recent California Supreme Court case that has drawn considerable attention is *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988). In *Foley*, an employee was seeking a wrongful discharge claim under contract law and asking for punitive tort damages. Despite what could be described as a friendly fact situation, the California Supreme court refused to allow tort damages.

However, *Foley* was a wrongful discharge suit. The plaintiff had claimed a "special relationship" existed which the defendant had breached. The court went to great pains to explain why it was reluctant to interfere with the management decisions of the employer.

B. Consequential Damages in General

Once the *Evra* court decided to use contract law, it next addressed the issue of whether contract law would allow recovery of consequential damages. The concept of consequential damages is very difficult to understand without looking at it in an historic context. The first instinct is to think of consequential damages as something extra, something beyond normal contract damages. However, they are really a limit on damages: the contract equivalent of proximate cause in torts.[76]

Originally, damages were awarded solely at the discretion of the jury. Consequential damages were the result of a judge-made rule of law to limit damage awards made by juries. In the nineteenth century, industry was new and the expanding economy required special protection.[77] In post-industrial America, these rules have taken a different form. When looked at in this modern context, it becomes important to note the public policy reasons behind the various rules and limits that have arisen over the years. The policy that is most important to Article 4A should point to the correct rule to follow.

1. Evra *and* Hadley v. Baxendale

The *Evra* court went from its evaluation of *Siegel* to a discussion of *Hadley v. Baxendale*. In order to get consequential damages under *Hadley v. Baxendale*, the contracting party must have given "notice" of the possibility of damages ("notice" is the term employed by Judge Posner).[78] The nature and extent of this notice has varied over the years, but in general something much less than actual notice is the rule in

This has become an area of special sensitivity because of the proliferation of wrongful discharge suits. *Id.* at 670, 765 P.2d at 385, 254 Cal. Rptr. at 222.

The economic policy arguments are much more balanced in the wire transfer cases. Wire transfer cases involve consequential damages for economic injury, not punitive damages under a "special relationship."

76. J. Calamari & J. Perrillo, Contracts § 14-5 (3d ed. 1987).

77. It must be noted that *Hadley v. Baxendale* may have been a political battle for protection between two interests: the rural mill owners and the London transport company. *See infra* notes 95-104 and accompanying text.

78. Hadley v. Baxendale, 156 Eng. Rep. 145 (1854). It is important to note the *Hadley v. Baxendale* rule *never* directly required "notice." The rule discussed damages naturally arising or in the contemplation of the parties at the time of contract. Later some courts narrowed this further to "tacit agreement"; meaning that the parties could have been considered to agree to assume the risk (this minority approach is generally considered obsolete). Judge Posner's discussion seems to follow these courts. However, Illinois does not follow this rule, using instead a foreseeability test. *See also* Freuhaf Trailer Co. v. Lyndel, 52 Ill. 486 (1945). Somehow the court changed the rules in both *Hadley v. Baxendale* and Illinois without any real support in the caselaw.

Article 4A separates itself from the *Evra* decision on this point by disallowing the idea of "notice" altogether. Consequential damages are only available by "actual agreement." *See* U.C.C. § 4A-305 (1989).

most jurisdictions. However, the *Evra* court failed to discuss which rule should apply and what degree of foreseeability (notice) would have been enough to justify consequential damages under these conditions.

a. Special Knowledge and "Notice"

One of the factors a court can use in determining whether the consequential damages are foreseeable, is the relative sophistication of the defendant and any special knowledge that he or she has about the plaintiff's business. For example, in *Siegel* Western Union had no special knowledge about betting.[79] Therefore, foreseeability of the damages was difficult to establish under the rule of *Hadley v. Baxendale.*

However, *Evra* is arguably closer to another English case: *Victoria Laundry v. Newman Indus. Ltd.*[80] The court in *Victoria Laundry* allowed consequential damages (although somewhat limited) without notice because of the defendant's special knowledge about the plaintiff's business.[81] This line of reasoning continued in the case *Koufos v. Czarnikow Ltd. (The Heron II).*[82] There the court went further, and said that the extent of the defendant's knowledge regarding market fluxations did not matter. All that mattered was that the shipowner had some knowledge that prices could go down and they did.[83]

The *Evra* court appears to acknowledge this idea when it states, "electronic funds transfers are not so unusual as to automatically place a bank on notice of extraordinary consequences."[84] This, however, is *not* the *Victoria* test. Instead, if a transaction is usual, and therefore within the bank's knowledge and expertise, then *less* notice, or possibly *no* notice at all, is sufficient.[85]

In the *Evra* case, the bank knew the wire was for a contract and should have known the contract could be lost if payment was not made.

79. Siegel v. Western Union Tel. Co., 312 Ill. App. 86, 37 N.E.2d 868-71 (1945).

80. 2 K.B. 528 (1929). Another English case, *Victoria Laundry* involved the installation of laundry equipment by an engineering firm. The expert knowledge of the engineers about the plaintiff's business was held to be enough to put them on notice as to the possibility of consequential damages from lost contracts when the installation was delayed. Interestingly, the court limited the damages to the most certain (perhaps using a more strict rule of damage certainty than normal). *See also* RESTATEMENT (SECOND) OF CONTRACTS § 351(3).

81. *See infra* text accompanying notes 132-36.

82. A.C. 350 (1969). *The Heron II* involved a charter ship that was delayed while transporting sugar. The sugar market dropped and the shipper sued for the market change. The court awarded damages, reasoning that even though the shipowners did not know the details of the sugar market and they had not been informed that the sugar was for sale, the situation should have been obvious to the shipowners.

83. *Id.*

84. 673 F.2d at 957.

85. *Victoria Laundry*, 2 K.B. 528 (1929).

The court stated that the bank did not know when the payment was due,[86] but the fact that the payment was by the fastest method available should have forced an assumption that the payment was due immediately. The only information that the bank did not have was the exact extent of damages. However, it surely knew that at least some consequential damages were possible. The rules in *Victoria Laundry* and *Koufos* could have allowed consequential damages. The *Evra* court failed to discuss these cases and instead concentrated on *Hadley v. Baxendale*.[87]

b. The Economic Basis

The *Evra* Court attempted to modernize *Hadley v. Baxendale* by injecting a quasi-Hand "least cost avoider" theory.[88] There may well have been economic reasons for *Hadley v. Baxendale*, but the analysis is much more complicated.

The *Evra* court stated that the result in *Hadley v. Baxendale* was justified because the mill should have had a spare shaft on hand rather than depending on the transportation system.[89] This almost certainly was not really the reasoning behind *Hadley v. Baxendale*.[90] The transportation system at that time surely was sufficiently reliable to justify sending away for a part rather than maintaining the kind of redundancy that the *Evra* court discussed.

In the modern era, a prudent manager would most likely carry the absolute minimum inventory and depend on a reliable transport system to keep it in operation. This is a great part of the so called "Japanese secret." Japanese factories operate on a hand-to-mouth system.[91] Indeed, market efficiency and public policy might well argue for a different result in *Hadley v. Baxendale* today.

Even if we accept this sort of economic justification, there are big problems with *Evra*'s application. The court somehow inferred bad faith in Hyman-Michaels' payment scheme.[92] Modern fiscal management is based on very tight payment schedules. Part of the attraction of wire payment is the ability to pay at the last moment. This minimizes float time and maximizes the use of capital. Capital spends as little

86. 673 F.2d at 957.

87. *Id.* at 956.

88. *Id.* For an alternative economic analysis, see *infra* text accompanying notes 94-104.

89. 673 F.2d at 957.

90. 156 Eng. Rep. 145 (1854). The court did discuss the spare shaft. However, it is doubtful that this was convincing. It would make little sense to require a manufacturer to maintain another complete mill in order to be considered economically prudent.

91. Burck, *Will Success Spoil General Motors?*, FORTUNE, Aug. 22, 1983, at 94, 95.

92. 673 F.2d at 954.

time as possible in non-productive limbo as it is being sent from party to party. Arguably, by paying at the last minute and by using the most efficient method of payment, Hyman-Michaels was simply exercising prudent money management.[93] Part of contract law public policy is promotion of efficient business transactions.

2. Hadley v. Baxendale — *According to Danzig*

For a clearer understanding of *Hadley v. Baxendale*, one must look to another source: Richard Danzig.[94] By the mid-nineteenth century, England had already become an industrial society. This brought to a head the conflict between the old rules of law and rapidly expanding businesses. Complex contractual relationships exposed these businesses to ever widening risks.[95] The traditional damage rule left the extent of damages to the jury. The general understanding of the rule was that damages would be awarded only for the "natural consequences" of the breach.[96]

Because the new industries were operating in a high risk atmosphere, they required investment and certainty. The old contract damages rule left too much discretion to the jury. It was necessary for the judge to become involved in order to make damage awards more predictable.[97]

Over time the industrial factions gained power in the courts and finally, in 1854, *Hadley v. Baxendale* came up.[98] By then, some of the lawyers who made their living defending the industrial interests had found their way to the Exchequer Court.[99] This, combined with the increasing power of the judges, at the expense of the jury, made the time right for change.

It should be noted that the facts in the case were not particularly friendly to this decision. It is possible that the mill's clerk may have informed the transportation company of the importance of the mill

93. *See* Webeman, *Cash Like a Flash*, FORBES, Apr. 1977, at 42; Sullivan, *EFT Concentration: Is It Right For Your Firm?*, CASHFLOW MAG., Mar. 1984, at 33.

94. Danzig, *Hadley v. Baxendale: A Study in the Industrialization of the Law*, 4 J. LEG. STUD. 249 (1975).

95. *Id.* at 263. "This was a time, moreover, when commercial interactions involved increasing agglomerations of capital and a pyramiding and interlocking of transactions, so that any error might lead to damages that could significantly diminish annual profits or even destroy the personal fortunes of those sharing in thinly financed ventures." *Id.*

96. *Id.* at 253.

97. *Id.* at 271. It should be noted that the uncertainty discussed in the article was both the uncertainty of the damages involved for the party being sued and the uncertainty that the damages would cover the cost of litigation for the party seeking damages.

98. At least two cases in the previous ten years involving some of the same litigants had come out the other way—upholding the old damages rule. *Id.* at 256.

99. *Id.* at 257.

shaft.[100] The court ignored this evidence, instead concentrating on arguments about keeping spare shafts on hand.[101] This action by the court suggests that this was a rule waiting for a case, rather than anything special about the facts of *Hadley v. Baxendale*. The economic and historic forces had gathered, and this case merely got in the way.

In post-industrial America, these forces have long since come and gone. We no longer see the need to give special protection to businesses. In fact, modern products liability theory puts significant extra burdens on vendors.[102]

It seems likely that if *Hadley v. Baxendale* were tried today in an American court, it would have come out the other way. The clerk's discussion could almost certainly have satisfied any foreseeability requirement. Economic policy would be on the side of the mill owner, who showed sensible inventory management.[103]

III. THE REAL WORLD OF *EVRA V. SWISS BANK*

A. WHAT WENT WRONG IN *EVRA?*

The real world question is: What, if anything, went wrong in *Evra* (i.e., Why did the court decide the way it did)? The first, and most obvious, conclusion is that the *Pandora*'s owners made a bad bargain. However, on closer examination, there is no evidence of bad faith on Hyman-Michaels' part that would justify even the most liberal of realist courts to abrogate the contract. The contract probably correctly reflected the market of the time. In fact, the court stated that market conditions changed after the time of contract and prices rose dramatically.

The ship owners showed more bad faith in their eagerness to use

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100. *Id.* at 254. However, there is some disagreement about this conversation regarding whether it happened and what was said.

101. *Id.* Again, this argument is spurious because, when carried to its ultimate extreme (there is no evidence of any sophisticated cost-benefit analysis so who would know when to quit), it would mean having to maintain a whole spare mill. As previously noted, it seems likely that it was economically sensible, even at this time, to depend on the transportation system (primitive as it was) rather than keeping a spare shaft. It is probable that such shaft breakage was a rare occurrence.

102. *Id.* at 277-84. The Danzig article goes on to discuss various efficient breach ideas that have no direct bearing here. It is doubtful that a bank would purposely decide to breach by not sending a wire. However, there is a different kind of breach involving what level of precaution the bank would take in order to avoid breach. If consequential damages do not come into the picture a bank may *not* spend up to its most efficient level to avoid breach.

However, there are arguably other forces that should limit this possibility. The banks have independent competitive reasons for maintaining the most reliable wire transfer mechanisms. *See supra* note 51.

103. Danzig, *supra* note 94, at 250.

any justifiable excuse to get out of the contract.[104] Hyman-Michaels' slow payments could be adequately explained as being simply prudent money management.

B. Windfall or Unearned Profit?

A court could be tempted not to reimburse an unearned profit if doing so would damage the other party. This would appear to make good sense from a policy standpoint because the economic theories behind contract law would not be disturbed if the profit was truly unearned. The problem is defining "unearned."

The micro economics show a vast disadvantage for the ship owners if the contract were enforced. Conversely, Hyman-Michaels was arguably damaged less by the cancellation. Because the underlying contract to sell scrap had been cancelled, the rising charter rates became simply a windfall.[105] However, this windfall was presumably the result of fair bargaining and therefore *was earned*.[106]

It is beyond the scope of this Note to determine who, if anyone, got a windfall. If the price rise was due to increased demand and the original contract had been at a profit, then arguably the ship owners received a "windfall" when they were allowed out of the contract. If the original contract had been disadvantageous and the rising prices merely reflected rising costs, then there probably was no windfall, but rather only that profit which Hyman-Michaels fairly bargained for. Most economists would look at this transaction as the normal give and take of the market and would be hard put to justify the results on a reliance argument.

C. Then Why?

The legal and economic arguments examined above have not adequately explained the decision. The peculiar fact situation of this case seems far more important than anything special about banking law or wire transfers.[107]

104. 673 F.2d at 955.

105. *Id.* Courts generally find it more important to protect reliance than expectancy. There was no strong evidence of reliance on Hyman-Michaels' part. The price in the scrap contract no longer depended on the charter rate. Hyman-Michaels was simply profiting on the sub-charter.

106. *Id.* Charter rates could have gone down. If that happened, Hyman-Michaels could have paid a penalty on the sub-charter.

107. Some observers have noted that arbitration boards often follow the letter of the law too closely. Contracts contain arbitration clauses in order to reflect real world business situations but these often backfire, and turn out less flexible. They often tend to merely reflexively enforce the often arbitrary rules of law. In *Evra*, the board had already cancelled the contract, and the ship owners (and the real profit) were no longer in

Perhaps the *Evra* court was merely constructing the contract that it thought the parties would have agreed to anyway. However, while the bank had no notice of the underlying contract and possible damages, it is likely that Hyman-Michaels similarly lacked knowledge of the reliability of wire transfers.

Thus, Judge Posner's decision appears to have been uncharacteristically realist. It is very difficult to justify holding a party (the bank), whose total revenue, much less profit from a transaction, is only a few dollars, liable for millions in damages.[108] The real profit-taker (the ship owner) was out of the picture and, to the casual observer, Hyman-Michaels was merely denied a windfall profit[109] that it arguably did not deserve.

The problem is that Judge Posner did not acknowledge the situation. He went through a convoluted and confusing economic argument to justify a decision that appears to be based only on some kind of visceral concept of justice. The economic arguments in this case come out even at best.[110]

IV. ARTICLE 4A AS A WHOLE

When any segment of the economy is regulated, the most "interested" parties will inevitably have the most say. Often these most "interested" parties are also those who are the most powerful and organized. Other "interested" parties may also have a large stake in the proceedings but, because of poor organization and other pressing interests, may lose out to the more organized groups. In banking regulation, the banks and bank lawyers are by far the most powerful interests.

This whole process is part of the perennial problem of regulation: the regulators are generally the regulated. Understandably, they make the regulations according to what they perceive to be their own best interest. Often they slant the rules too much in their favor. This can hurt business and cause the courts to change the rules or use other methods (such as tort recovery) to redress meritorious grievances. The result is damaging not only to the regulated business but also to the

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the picture. The arbitration board in this case seemed to exercise restraint. It may well have been easier to decide the case if the board had not canceled the contract, but its actions were within the realm of reason. Gordon, *Critical Legal Studies Symposium: Critical Legal Histories*, 36 STAN. L. REV. 57, 65 (1977).

108. Even though the profit on this transaction is negligible, the entire system is profitable. Under a cost-spreading analysis, the cost of these losses should be spread over the entire system. Under such an analysis, the banks probably would be the best cost spreaders.

109. I call it "windfall," not because it really is, but because that is the way it might appear to the casual observer.

110. *See supra* text accompanying notes 105-08.

economy as a whole. Nevertheless, as presently formulated, proposed Article 4A appears to be taking a similar approach to consequential damages.

A. The Standards

Article 4A appears to put strong requirements on the banking industry. Section 4A-202 holds receivers of wire transfers to a "commercially reasonable" standard of providing security. Determining commercial reasonableness is a matter of law, taking into account such factors as the receiver's knowledge of the sender's normal use and practices and the general security used in the trade.[111] Incidently, this information is the same type of information courts have regarded as significant when determining consequential damages in other cases.[112]

The Article sets notice standards and has other information-forcing provisions.[113] At some point in this process, it seems reasonable that enough information would be available to allow consequential damages.

B. Does Article 4A Preempt Tort Law?

Is Article 4A designed to sweep the field and establish liability rules for wire transfers by preempting common-law tort rules? If so, the most direct danger to the banking industry —the growth of tort law—would be gone.

History says no.[114] U.C.C Articles 3 and 4 have been interpreted by the courts as allowing tort claims in addition or as an alternative to the contract claims.[115] There is sound reasoning for this. As previously discussed, tort duties arise directly from public policy. Contract claims arise from private agreement. It is not contradictory that, in a given situation, both duties may be breached. The problem then becomes which standard will govern.[116]

Legislatures have limited liability in certain instances. This is the result of a balancing by the legislatures of various public policy considerations. For example, regulated public utilities enjoy some liability protection.[117]

However, in the case of wire transfers, there is no special reason to

111. U.C.C. § 4A-202(3) (draft Feb. 1989).

112. Koufos v Czarinkow Ltd. (The Huron II), A.C. 350 (1969); Victoria Laundry v. Newman Indus. Ltd., 2 K.B. 528 (1929).

113. U.C.C. art. 4A (1989).

114. *See* Wade, *supra* note 39; Note, *supra* note 75.

115. *Id.*

116. Wade, *supra* note 39, at 126-29; Note, *supra* note 75.

117. Meyers, *supra* note 49.

preempt tort law.[118] As previously noted, this part of bank operations is not highly regulated, and the lack of consequential damages could harm the bank's customers by undercompensating their losses.

C. THE CONSEQUENCES

There may be a real danger here for the banking industry. Sooner or later, a case with facts begging to be redressed will come along, and the court will use the only tool available: tort law. Once the precedent is set, it may be difficult to keep it from expanding.[119]

The banking industry may be indulging in "overkill." By the industry's own estimation, the wire transfer process is very reliable.[120] The damages from any source ought to be negligible compared to the total volume of the system. Direct damages are almost certainly more likely than consequential damages, and in the normal case (misdirected funds), likely to be larger.[121] By attempting to avoid the least likely type of damage claim, the banking industry is risking the possibility that the damage provisions of Article 4A will be superseded by tort law.

V. HOW CAN ARTICLE 4A BE IMPROVED?

Wire transfers are an important part of the banking industry. Banks advertise and compete on the basis of both their reliability as a whole and the reliability of their individual wire transfer departments. Banks regularly absorb the losses that do occur to avoid negative publicity, especially in the case of fraud.[122] Banks are very image conscious, and very concerned that they appear to be reliable. For this reason, it is important to the banks that they are not seen to cause losses to their customers.

There may be an argument that Article 4A, as it is presently drafted, merely reflects the type of contract that would be written any-

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118. *Id.*

119. Wade, *supra* note 39 at 124-26.

120. Caveat: the banking industry is not always completely candid on this subject. Much fraud goes unreported. How this might effect the reliability figures is uncertain.

121. *ATM Fraud Costs Banks up to $100 Million in 1983, DOJ Says*, [Jan.-Jun.] Wash. Fin. Rep. (BNA) vol. 44, No. 11 at 465 (Mar. 18, 1985). A Department of Justice study revealed that twelve of sixteen banks interviewed (75%) reported wire transfer problems. These problems totaled 139 transactions with an average risk exposure of $900,000 and the largest over $37 million. Unintentional errors far exceeded intentional fraud: 94% unintentional compared to 6% fraud. However, all errors have fraud potential: Money routed to wrong account and holders "spend money in ignorance." *Id.* The usual loss tended to be comparatively small, averaging $18,861.

The study notes that the figures may not be accurate. Banks often distort these figures because of adverse publicity.

122. *Id.*

way, and therefore is efficient. It would save transaction costs and make bargaining easier. However, even if all contracts written under any version of Article 4A would disclaim consequential damages if possible, it is doubtful that Article 4A will increase efficiency by making that the default situation in the law. The probable reason that contracts would have such clauses is that the banks have greater knowledge and bargaining power. While banks know of the risks, failure is rare enough that customers could be unaware of the problem. Also, it follows that the banks are the only party exposed to enough risk to bargain aggressively.[123]

The forces behind the universality of clauses disallowing consequential damages would have more to do with information availability and bargaining power than economic efficiency. Whatever little gain there is in transaction costs could easily be outweighed by shifting the risk to the less efficient cost avoider. Almost certainly the bank has the relevant knowledge and bargaining power to be the best cost avoider.

The real problem with consequential damages is their unpredictability. Banks are understandably nervous about being held liable for these open-ended, unpredictable damages.[124] At some point, the question must be: What can be done to improve Article 4A? How can it allow consequential damages and still keep enough predictability in the system to keep it operating? The following ideas do not exhaust the possibilities but are useful suggestions.

A. BARGAINING AND INSURANCE?

A combination of bargaining and insurance is probably the most likely solution. The default liability would fall on the bank. They could presumably contract out of the liability and/or provide insurance to their customers. There should be a disclosure provision to insure that the contract provision was bargained for. This is probably the most flexible alternative. A customer that did not need time-critical money transfers could opt out of the insurance and save money. A great percentage of wire transfers have little consequential damage exposure.[125] Moreover, the combination of bargaining and insurance has the bonus of serving a cost spreading function.[126] The banks probably can best

123. This is really the strongest argument for strict liability for the banks.

124. U.C.C. § 4A-306 comment 2 (Draft Feb. 1989).

125. *See supra* notes 22, 23, 121.

126. Cost spreading is a more modern public policy that has replaced business protection in post-industrial America. For a critique of the limitations of cost spreading, see Comment, *Contract Damages and Cross-Subsidization*, 61 S. CAL. L. REV. 1125 (1988).

For a discussion of bank insurance, see E. Armstrong, *Which One of the EFT Insurance Policies Suits Your Bank?*, ABA BANKING J., Feb. 1983, at 107; Hyde, *Light At the End of The Tunnel*, U.S. BANKER, June 1986, at 17.

perform cost spreading either through the purchase of insurance or self-insurance with an accompanying increase in rates to cover the losses.

B. A Modest Proposal—Predictable Consequential Damages

Contract damages are often under-compensatory.[127] This has encouraged many lawyers to turn to tort damages. Perhaps it is time to take advantage of the marvelous flexibility of contract damage theory to handle these complex problems. Some courts have shown imaginative use of damage theories that could have some use here.

As previously discussed,[128] the court in *Victoria Laundry* used an expanded notion of notice to award consequential damages. However, the court used the uncertainty of some of the consequential damages to limit the amount awarded.[129]

It flies in the face of the logic behind the idea of notice or foreseeability that giving notice of any amount of damages (even a minute amount) will make all damages actually suffered foreseeable. If a contracting party is given notice of $1 of possible damages, it is logical that he or she will take $1 worth of precaution.[130] When the damages turn out to be $1 million it is too late to take the $1 million of precaution he logically would have taken. By the insurance or cost avoidance rationale, it seems logical to hold the party liable only for the damages about which he or she knew or should have known and for which he or she could have prepared.[131]

If the court had followed this rule in the *Evra* case, it could easily have awarded damages equal to the amount of the wire transfer. This amount was foreseeably at risk, either from direct damages or consequential damages.[132]

If the difference between direct damages and consequential damages is too great, the consequential loss could be limited. The application of this principal could be difficult,[133] but usually in these cases the largest possible direct damages can be calculated (loss of the principle and some interim interest). This amount or some multiple of this amount, could be used as a limit on the consequential damages.

127. Comment, *Sailing the Uncharted Seas of Bad Faith: Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*, 69 MINN. L. REV. 1161, 1186 (1985).

128. *See supra* note 81 and accompanying text.

129. 2 K.B. 528 (1929).

130. *See generally* Kniffin, *A Newly Identified Contract Unconscionability: Unconscionability of Remedy*, 63 NOTRE DAME L. REV. 247 (1988).

131. *Id.*

132. *Evra*, 673 F.2d 951.

133. It could be difficult to determine where to draw the limits. *See* RESTATEMENT (SECOND) OF CONTRACTS, § 351(3) (1981); Kniffen, *supra* note 130.

C. Strict Liability

The imposition of strict liability is the simplest of the solutions, and probably the most difficult for the banks to swallow. Nevertheless, it also makes the most economic sense. Because the wire transfer system is so reliable, and the banks are not only the only ones with real knowledge regarding the degree of reliability, but are also in control of that reliability, the banks should have total responsibility for any problems. By artificially insulating the banks from the true costs of a system failure, Article 4A could encourage the banks to spend less than the optimal amount on system reliability.[134]

Because of the near 100% reliability, the banks almost certainly are the only parties with enough risk exposure to have any incentive to bargain aggressively for their version of the consequential damages clause. In short, allowing bargaining would be the same as eliminating consequential damages; all contracts would come out that way. Thus, it appears that the only real solution is to hold the banks strictly liable for all "foreseeable" consequential damages.

Under this scenario, the banks are the only true cost spreaders and cost avoiders. The economically optimal contract would put the risk on the banks and, therefore the default risk bearer under Article 4A should be the banks. The banks are the only ones with the necessary knowledge and resources to spread the risk. Presumably they would increase the rates to cover the costs.[135]

There is one major problem with strict liability. Not all wire transfers are "time critical"[136] and those which are not would have little risk exposure for consequential damages. However, strict liability would force users without such time requirements to pay for the consequential damages arising from the "time critical" users. If this cost became substantial, it could limit system use.[137]

VI. CONCLUSION

Wire transfers have become too important to be allowed to languish in legal limbo without clear rules governing liability. Certainty should be an important goal of any regulation of the banking industry. The irony is that, in its efforts to achieve certainty, the drafting committee

134. *See supra* text accompanying note 120-21. *But see* note 103.

135. To a certain extent, this is what is happening now. In order to avoid adverse publicity, the banks are absorbing the losses due to internal fraud, rather than trying to collect or prosecute. *See supra* note 121.

136. "Time critical" is important because consequential damages arise mainly because funds did not arrive "on time." To many users, a delay of a day or even a week would cause little damage beyond inconvenience. Article 4A allows damages for lost interest.

137. *See supra* notes 22, 23, 121.

may well have aggravated the problem by disallowing consequential damages.

Economic efficiency is enhanced when contracting parties are allowed to allocate risks and write their own rules through fair bargaining. Traditional theory left strictly economic matters in contract law. Theories like efficient breach looked at least cost, rather than fault, in determining who paid damages and in what amount. However, over the past few decades tort law has taken over much of what was traditionally contract law.

There are many reasons for this trend, but at least one important argument is the tendency for contract law to undercompensate for damages. Under contract damage law, it is generally true that a party is rarely made as well off as if the bargain had been completed.[138] The availability of consequential damages weakens this argument by allowing the injured party to prove a wider range of damages.

Article 4A ignores strong arguments that would make the default risk of consequential damages fall on the banks. The banks know how reliable the system is, and in fact advertise the system as being highly reliable (possibly even distorting the reliability by not admitting problems publicly). The banks thus have superior knowledge of all of the relevant facts, except the amount of possible consequential damages.

When the banks claim such great reliability, they make the possibility of damages look unimportant and, therefore, they decrease the likelihood that damages will be the subjects of hard bargaining. Such a bargaining process may lead to a breakdown of the contract loss allocation process. Under such conditions, a court might find the application of tort law appropriate.

Even though consequential damage amounts are unpredictable, it is likely that they would aggregate to a smaller amount than direct damages (which are mainly the bank's responsibility under Article 4A).[139] Thus the banks may be risking a predictable system to eliminate the least likely problem. Moreover, if too many customers experience significant losses, it could damage the reputations of the banks. At present, the banks are voluntarily absorbing most losses for this reason.[140]

This Note discusses several possible ways to limit consequential damages, or at least make them more predictable. It may be too much to ask for the economically sensible solution: strict liability on the banks. However, some kind of increased liability, combined with disclosure provisions, could function just as well by encouraging the parties to

138. *See* Gordon, *supra* note 107. *But see* Comment, *supra* note 127.

139. *See supra* note 121.

140. *Id.*

bargain for the economically optimal risk allocation. This would have the added advantage of correctly allocating costs between "time critical" users and ordinary users. Each could purchase the degree or risk protection necessary.[141]

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141. This business looks like a natural for the insurance industry. The actuarial tables should be easy to generate (the banks keep records) and the risk exposure should be quite predictable.

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