Legal Aspects of Unauthorized Bank Payments

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Abstract

One of the complex matters in banking law is the problems and mistakes which occur in the process of bank payments. Mistake of banker or error in processing of information in bank networks may result in payment delay or paying money to the account of a person other than who was really intended. This article is about rules for allocation of losses between account holders implicated and the intermediary bank-based payments.

The paper discusses common mistakes and usual forms of unauthorized payments with intermediation of one or more banks. The main idea of this paper is that the bank may be responsible for some errors and mistakes; even if there is no agreement about or against this liability.

Keywords: unauthorized payment, liability of bank, payment by mistake, misuses notice, customer’s obligation.

JEL Classification: K20, K22, K35

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Introduction

The contract between the customer and the bank is classified as a debtor-creditor relationship in all types of bank accounts. This contract requires the bank to honor all valid and proper orders of the customer to pay amounts from his account with the bank, as long as funds remain available in the customer's account.

In a bank payment, one or more than one bank is involved as agent of their customers. It is not likely that particular payment be contrary to the mandate of payer or made according to an unauthorized forged signature or in spite of customer's order (notice) to the bank to stop payment or to block his account or refrain from payment of particular instrument or to paying to certain person. As another problem, which may arise in the relation of a bank and its customers, the instruction of payment may be issued by dishonest or unauthorized person. It is not impossible that a given payment be erroneously effected twice or the payer becomes insolvent before receiving payment.

Generally, restitution of money paid by mistake or law, needs to be claimed in a competent court. However it is possible that the bank conclude contract or insert a term in contract of deposit to reimburse the money paid by mistake from the account of the customer who was unjustly enriched from such payment. Anyway, the burden of proof and expense of mistake or unauthorized payment is imposed to a person who is wrong at the time of payment. That person could be the payer or payee's bank.

This paper is divided into two parts as follows: Rules governing unauthorized bank payments (part I), and classification of unauthorized bank payments (part II).

Part One: Rules Governing Unauthorized Bank Payments

Reliability of legal relations as a principle requires accepting some measures including legitimacy of holder's possession as a proof for his ownership. As another rule, the customer has both legal and contractual duty to inform bank about any problem such as crimes against his bank account or negotiable instrument or even missing of his payment bills or orders. These matters will be discussed as follows:
I. Protection of Legitimate Holder

Section 3-302 of United States Uniform Commercial Code (UCC) provides a measure for recognition of true holder. It states that the holder of a negotiable instrument who (1) gave value (2) in a good faith and (3) without notice of a claim or defense to the instrument or notice that the instrument is overdue, is a holder in due course. Section 3-305 of UCC then provides that a holder in due course cuts off all claims of third parties to the instrument and all defenses (except particularly serious defenses which are listed in section 3-305 (2) and are known as real defenses).1

Therefore, as a rule, a holder in due course of a cheque will normally have an undisputed claim to payment by the bank. This protection should be given to persons who are not holders in due course, but who have in good faith changed their position in reliance on their ownership of an instrument or it proceeds in disputed.2

The above rule seems to be applicable, but partly, in Iranian law, due to the fact that the structure of appropriation doctrine (ghashb) is applicable as a general rule in all parts of property law including negotiable instruments. As an acceptable rule in commercial law, holders who have good faith should be protected against malicious endorsers or fraudulent issuers of bills of exchange or cheque. Article 325 of Iran civil code provides a full protection umbrella in favor of holder of others' property in good faith not against the true owner or beneficiary but against a transferor (e.g. seller) who has knowingly and so deliberately sold property which belonged to another.

About bank cheques, holders of those cheques enjoy two advantages not given to ordinary cheques. The first one is that they are assured of solvent obligor because the bank is certifying that received the fund from applicant of this cheque and then issued it. The second one is that the holder of a bank cheque is generally assured that payment cannot be stopped without reason and thereby, collection of this cheque is made more convenient.

2. Ibid, 142.
Consequently, a claim that the payment has been unauthorized is conflicting with the accepted rules of private and banking law and should be proved by claimant. Until providing such proof, the ultimate payee of fund is recognized as holder in due course of instrument at the time before its collection and then he is also regarded as legitimate payee (lawful receiver of money) after its payment.

II. The Customer’s Duty to Inform Bank about any Problem

As a rule of banking law, any customer owe a duty to inform his bank about any crime, missing, mistake or error in any kind of payment order as soon as he becomes aware of it. This is regarded as a duty of customer to inform his bank and thus by accepting this duty deliberate silence may become significant and amount to a representation.\footnote{Lord Tomlin at Greenwood v. Martins Bank Ltd (1933) AC 51.} For establishing this duty it is immaterial that who acquired the payment order and whether the bank is able to know the problem and declined from payment or not.

The measure of duty to inform is the act of reasonable person. Therefore, if a customer fails to report a crime on payment order to the bank, before its payment, he is not liable for losses of bank. In Common Law such circumstances do not raise an estoppel against customer.

Part Two: Classification of Unauthorized Bank Payments

As a first matter, a bank payment may be requested or completed under a crime. So it needs to stop this type of payment or recognize the right of reclamation for true owner of money misappropriated. Second problem is that sometimes the payment of bank is contrary to the mandate of the customer (payer) and this may oblige the bank to recover the payer. Thirdly, a bank payment may be made by mistake of cashier or error of banking networks and finally payment may be done after misuse notice of payer or true owner to the bank. In this part we will discuss these 4 subjects respectively.

I. Payment under a Crime

Where an instrument obtained by a crime such as theft or fraud or a signature on a bill is forged or placed thereon without authority of the person whose
signature purports to such instrument is wholly invalid and no right to holder for retaining the instrument or using it to discharge his obligations or enforce payment against issuer.

According to Article 14 of Iranian Cheque Issuance Act, the issuer of a cheque or any beneficiary or legal representative can give to the bank a written declaration that the cheque has been acquired by finding it or theft or forgery or other crimes like as fraud or disloyalty. In these circumstances the bank should stop payment after revealing the identity of holder. For preserving rights of holder, the bank will issue a certification of non-payment indicating the cause of it. The holder can sue against the applicant of stop order and it could be a crime against the issuer of cheque if it is proved that his application of stop order was wrong.

If the paying bank disregards that declaration to stop order and collect the cheque, it will be responsible on behalf of the true owner of that cheque or his legal representative.

In relation to the money paid by such instrument, the legal rules of unjust enrichment will apply. So the true owner of the cheque can sue against the bank which was in fault and the unduly recipient of fund by showing himself as rightful owner.

II. Payment Contrary to the Mandate

Generally in current and other forms of account, there is an agreement between bank and the owner of account which authorize the bank to pay an instrument according to an order if given instructions are in accordance with the terms of that agreement. For example, if in the agreement it was required that the order should be signed by A and B, the signature of one of them could not be sufficient. Thus, if the bank honors a cheque bearing a sole signature it has breached the mandate and could be responsible in behalf of the customer (account owner) or true owner of that cheque.

According to the yardstick of Article 3 of Iran Cheque Issuance Act, if the face of cheque wholly or partly be contrary to the pre-mandate of cheque

issuer (depositor) to the payer bank, the latter should stop the payment. For preserving the rights of holder, Article 4 of that Act states that the bank must issue non-payment declaration (certification), by determining the cause or causes of it, and give it to the holder of the cheque. The holder could use it as evidence against the issuer of the cheque, if he proves that the stop order has been unduly wanted.

An important question is about discharge of obligation of payer by an unauthorized payment. Does a bank that has been paid a legitimate debt of its customer, but contrary to his mandate affirmed in their agreement, can recover the paid money from that customer? Positive answer to this question seems to be reliable. In Common Law according to equitable approaches to some cases, a person who has been paid the debt of another one without authority is allowed taking advantage of his payment. So if the final result of unauthorized payment is discharge of obligation of payer the banker will be entitled to the benefit of that payment, provided the bank can prove that such payment went to discharge a legal liability of the customer. In this case in fact there is no loss to customer because the legal obligation which has to be discharged is discharged.

In Iran law, it seems that the above approach is acceptable. According to Article 267 of Iran Civil Code, anyone can pay the debt of any debtor, with or without his permission. The only effect of permission is that it provides the right to demand the payment obligation for payer. As a rule in Islamic law, without prior permission to pay, there is no right to demand. This rule could be problematic for banks when they are paying debts of their customers but with some incompatibilities in the formalities of payment instruments. For resolving the problem, a bank can provide a term for acquiring customers pre-consent for such payments in its deposit contract. Of course if there was no debt, the payment which has been done by bank is based on incomplete or faulty instrument and thus incur all of losses of fund to the bank itself and the bank has no right for debiting account of the customer. In this case, the result

1. A L Underwood Ltd v Bank of Liverpool & Martins [1924] 1 KB 775 244; Liggett (Liverpool) Ltd v Barclays Bank Ltd [1928].
2. Wright J at A L Underwood Ltd v Bank of Liverpool & Martins [1924].
of unjust enrichment is conceivable only between the bank and payee and the customer of the payer bank has not any obligation or duty in this relation.

III. Payment by Mistake or Error

Sometimes unauthorized payment is driven from banker’s mistake of fact or law or from any type of error in computers or network of bank. So, there are typical differences between the processes of occurrence of mistake in comparison with error. However, in general, the consequences of both of them are the same for payer, his bank and payee and his bank. If payment has been made because of an error, recovery may be claimed either from the ultimate payee or from his bank. In many cases the two may be sued jointly.¹

Legal effects of mistake is imposed on the bank as organization when its officer or network did a mistake or error. This is because the contract on which the payment is based e.g. deposit or current account contract, has been concluded between bank and its customer. Therefore, the customer has a contractual right to demand money paid mistakenly or by error from his account. Of course his bank right to sue against mistaken officer or deceive party (ultimate payee) may be protectable by criminal law or tort.

It is important to be noted that criminal sanction for unintentional or erroneous conduct is rarely available. Because there are no mens rea (mental element of a crime), as one of essential elements of criminal conduct, exist in wrongful or erroneous act. Especially recognizing criminal liability for payee (ultimate receiver of paid money) is not possible in Iran criminal law even if he has been removed those funds from his account knowing that those monies are not belonging to him. This act could not be regarded as theft because it has not had one of the essential elements of theft i.e. obbing. Banker’s mistake or bank’s network error is not crime of breach of confidence; due to the fact that it has not the element of intentionally deposit to the receiver of money. Therefore, there is an apparent gap in Iran criminal law about withdrawal of unjust money which credited without

causation to the account of one person because the title of no crime is fitting to this conduct.

In tort, the act of the receiver of unjust money is totally coinciding with the concept of unjust enrichment. As a rule in all of civilized systems of law, the law bounds to provide remedies to prevent a person from retaining the money or some benefit derived from another which is against conscience that he should keep. Such remedies fall within a category of quasi contract or restitution. Payment under mistake of fact is only one head of this category of the law. The gist of the action is a debt or obligation implied or more accurately imposed by law.¹

For proving unjust enrichment the plaintiff (payer or his bank) must claim for restitution. For a restitutionary claim to lay payer or his bank must show that: (i) the defendant (payee) has been enriched at the claimant expense and (ii) the circumstances are such that the enrichment must be given up to claimant. In other words, the enrichment was unjust.²

Finally, it should be noted that the effects of customer’s personal mistake or misunderstanding is imposed to himself only, not to his bank. This is because payment by bank is based on a contract between bank and customer and the bank only is agent of him. The general rule in contract is that a contracting party is not relieved from his obligations merely because he misunderstood the effect on the agreement of miss-assessed extrinsic factors.³

IV. Payment after Misuse Notice

In some situations the bank is receiving a notice that an agent acting on behalf of a customer is misusing his authority in order to misappropriate his principal money. In such cases two duties of a bank are conflicting each other. From one hand, the bank has duty of care about deposits and funds of its customers and in the other hand, it has duty to honor payment instructions given in accordance with customer’s mandate.⁴

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For resolving this conflict looking deeply to the concept and extent of both duties of bank (care and honor) are necessary. About the duty of care, as Steyn J. stated in the absence of telling indications to the contrary, a banker will usually approach a suggestion that a director of a corporate customer is trying to defraud the company with an initial reaction of instinctive disbelief. Therefore, trust is the basis of a bank's dealings with its customers.

Concerning the bank duty to honor payment instructions, it is important to note that the banker should rely only on apparent factors in a payment order or instrument such as the standing of the corporate customer, the bank's knowledge of the signatory, the amount involved the need for a prompt transfer and the presence of unusual features. The scope and means of making reasonable inquiries may be relevant and could be observable. Thus, the banker has not any duty to inquire for example about the facts of relation between a company and its chairman and managers. What is important to the bank is passing banking formalities by payment order. So, if in the network system of bank, there has been only one signature of chairman of a company declaring as essential and it was consistent with by-law of that company, the bank has no duty to investigate for example about decision of shareholders on need to the signature of auditor of that company.

Accordingly, as May LJ stated about cheques, it is considered as reasonable duty to bankers to pay his customer's cheques in accordance with his mandate. So, there are very rare situations in which cheques should not be paid immediately upon presentation and need reasonable enquiry. Those circumstances are so that any reasonable cashier would hesitate to pay a cheque at once and refer it to his or her superior.

In these cases, when a reasonable superior waver to authorize payment of such cheques it could be said that they are not payable and the bank should prefer the duty of care to the duty of honor payment instructions apparently given in accordance with the customer's mandate only in such circumstances as a narrow exception to the latter duty. That is because the banker's duty of honor is derived directly from his contractual obligation mentioned in current

or other types of bank accounts. Thus the order of the same customer for stop payment should not be admissible for bank unless it is accompanied with evidences or proofs indicating its reasonability and acceptability according to the law. The structure and mode of statement of Article 14 of Iran Cheque Issuance Act is confirming this argument, too.

Conclusion

As a rule in banking law, if a bank pays a cheque after a timely stop payment order by the depositor (issuer of the cheque), the bank is usually liable to the depositor for the amount paid. This rule applies in other types of payment orders. As another rule, if the payment order or instrument has been already paid, cleared or certified by bank, thus the depositor or claimant of its ownership cannot place a stop payment on an instrument like this. However his claim of unjust enrichment is actionable in competent court provided to all its conditions and limit.

Finally, the cash is a single way to discharge obligations. Therefore, negotiable instruments and all other payment orders are conditional payment orders. Thus, as a general rule, unless otherwise instructed, a bank, as an agent for collection of obligation in behalf of its customer, has no authority to receive in payment anything but cash, and when the bank does accept anything other than cash in payment it will be liable to his principal for any loss the latter may suffer. Therefore the liability and burden of proof of discharge is not on obligator (payer) but on bank or payee. If there was any problem in collection of a payment instrument, between the bank and payee, whenever one of two innocent persons must suffer by the acts of a third, he who has enabled such third person to occasion the loss must sustain it ¹.

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References


