ALLOCATION OF CHECK KITING LOSSES UNDER THE UCC, REGULATION CC, AND THE BANKRUPTCY CODE: RECONCILING THE STANDARDS

*A. Brooke Overby**

Depositary institutions have significant exposure to losses due to check kiting by their depositors. This Article examines in detail the allocation of kiting losses under the UCC, under Regulation CC of the Board of Governors of the Federal Reserve System, and under section 547 of the Bankruptcy Code. The Article identifies the potential conflicts among the three liability schemes as currently interpreted by the courts. The Article concludes by advocating for a reexamination of Regulation CC due to the Regulation's operation in kiting cases and also argues that a limited number of payments made in the course of a kite are properly the subject of preference attack under section 547 by a kiting debtor's trustee in bankruptcy.

INTRODUCTION

The practice of check kiting exposes financial institutions to significant financial risks. In a check kite, a bank's customer uses uncollected funds balances in its checking account to secure, in effect, an unauthorized loan from the financial institution.[1] When kites collapse and are extremely large, the potential losses to financial institutions can reach well into the millions of dollars.[2]

The question of which solvent party or parties will ultimately bear those losses can be decided through the application of a number of statutes. Because a kite involves the use of checks that are deposited at financial institutions, Articles 3 and 4 of the Uniform Commercial Code ("UCC") apply to allocate the liabilities among the

---

* Judge René H. Himel Professor of Law, Tulane University Law School. I would like to thank Jim Brook, Lawrence Ponoroff, Mark Wessman, and Tim Zinnecker for their comments on earlier drafts of this Article, and Brandon Thibodeaux (Tulane 2009) for his research assistance.

1. *See infra* text accompanying notes 16–22.

2. *E.g.*, *In re* Spring Grove Livestock Exch., Inc., 205 B.R. 149, 153 (Bankr. D. Minn. 1997) (involving banks that reversed provisional settlements of over $70 million and transferred over $90 million in collected funds into those accounts to cover possible overdrafts); *see also infra* notes 30–31 and accompanying text (discussing frequency of check kiting and losses incurred through the practice).

parties after a check kite collapses.[3] However, the loss-allocation system now no longer rests solely with the application of the state law UCC. Parties increasingly are invoking Regulation CC of the Board of Governors Federal Reserve System (Regulation CC),[4] promulgated under the authority granted by Congress under the federal Expedited Funds Availability Act ("EFAA"),[5] to shift liability between parties involved in the check kite. Finally, because kiting often involves an insolvent customer of the financial institutions caught up in the kite, and because a filing in bankruptcy can often follow in the immediate wake of a kite, the Bankruptcy Code[6] potentially may provide a vehicle for allocating the losses.[7]

In light of the number of available theories, the allocation of losses after a check kite collapses cannot simply be resolved through a straightforward application of the appropriate rules of the UCC, the principal statute that regulates checks and bank collections. As this Article discusses, the three regulatory schemes often result in the application of markedly different loss-allocation principles in the case of kiting. The UCC establishes a regime that, for the most part, leaves the losses where they fell immediately after the kite collapsed.[8] Because Regulation CC and the Bankruptcy Code contain standards that can alter that result, Regulation CC and the Bankruptcy Code are in tension with the UCC's scheme.

Yet, the federal regimes are themselves at odds. Because the federal EFAA establishes a strong federal policy in favor of allowing customers access to uncollected funds,[9] a key condition for the creation of check kites in the first instance, the attempts of bankruptcy trustees to impose liability on financial institutions for kiting losses because the institutions allowed such access in the first instance arguably places the federal EFAA and the Bankruptcy Code in opposition to each other. For this reason, bankruptcy courts have taken a variety of positions on whether the Bankruptcy Code may be successfully employed by trustees to reallocate the losses left after a check kite collapses, typically using a preference theory and

---

3. *See infra* text accompanying notes 38–86. Article 3 of the UCC covers "negotiable instruments," *see* U.C.C. § 3-102(a) (2002), and a check is a common form of negotiable instrument, *see* § 3-104(a) (definition of "negotiable instrument"), § 3-104(f) (definition of "check"). Article 4 of the UCC regulates Bank Deposits and Collections. U.C.C. § 4-101 (2002); *see* § 4-101 cmt. 3 ("Article 4 defines rights between parties with respect to bank deposits and collections."). In cases of conflicts between Articles 3 and 4, Article 4 governs over Article 3. U.C.C. §§ 3-102(b), 4-102(a).

4. 12 C.F.R. § 229 (2008); *see infra* text accompanying notes 104–10.

5. 12 U.S.C. §§ 4001–4010 (2006).

6. 11 U.S.C. §§ 101–1532 (2006).

7. *See infra* text accompanying notes 111–206.

8. *See infra* text accompanying notes 60–66.

9. *See* 12 C.F.R. § 229.12, .16 (establishing availability schedule for deposited funds and disclosure rules for institutions' availability policies); *see also* 12 U.S.C. §§ 4002–4004 (statutory rules to the same effect).

section 547 of the Bankruptcy Code to recover payments made to a bank involved in a kite. Some courts defer to the policies expressed by the UCC and the EFAA and reject a significant role for bankruptcy law in arriving at a final loss allocation among banks and other creditors of the kiting debtor.[10] However, because preference law seeks to ensure equal distribution of a bankrupt debtor's assets among all of a debtor's creditors and to minimize strategic behavior by creditors in the face of an imminent bankruptcy filing,[11] other courts permit the recovery of some payments made to the banks in check kites as preferences, in effect allowing the Bankruptcy Code's policies to trump the positions possibly taken by the EFAA or the UCC.[12]

In sum, the question of whether a kiting case is seen as a UCC case, an EFAA/Regulation CC case, or as a bankruptcy case can significantly affect the allocation of the losses incurred in a kite. This Article evaluates these three overlapping, and potentially contradictory, regulatory schemes. Part I of the Article provides a brief overview of the practice and mechanics of check kiting.[13] Part II discusses in detail the UCC, the EFAA/Regulation CC, and the Bankruptcy Code theories employed by courts to resolve the question of which parties bear the loss after a kite collapses.[14] The Article advances in Part III an approach to allocate the losses in a manner that, it will be argued, effectively balances the roles that each of these legislative schemes play in regulating bank collections.[15]

10. *See, e.g.*, *In re* Cannon, 237 F.3d 716, 717 (6th Cir. 2001) (noting in a kiting case in which the trustee was asserting a preference theory to avoid payments made to a depositor's account, that "we are faced with a collision between Article 4 of the UCC (and federal banking regulations) and the Bankruptcy Code"); Laws v. United Mo. Bank of Kan. City, N.A., 98 F.3d 1047, 1051 (8th Cir. 1996) (adopting a rule that advances made in routine circumstances by a bank to its customer do not create antecedent "debts" under the Bankruptcy Code because "[a] contrary rule would pin banks between a strong federal policy in favor of expedited funds availability and [the] Bankruptcy Code"); Pereira v. Summit Bank, 44 U.C.C. Rep. Serv. 2d 806, 818–19 (S.D.N.Y. 2001) (following *Laws* view on the importance of respecting funds availability).

11. *See* Lawrence Ponoroff, *Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time*, 1993 WIS. L. REV. 1439, 1445–50 (discussing policy underlying preference law); *see also* Charles J. Tabb, *The Brave New World of Bankruptcy Preferences*, 13 AM. BANKR. INST. L. REV. 425, 433 (2005) (discussing the same policy). For a discussion of the history of, and academic views on, preference law, see Ponoroff, *supra*, at 1447 nn.18 & 19, 1448 n.21.

12. *See infra* text accompanying notes 144–54.

13. *See infra* text accompanying notes 16–36.

14. *See infra* text accompanying notes 37–206.

15. *See infra* text accompanying notes 207–35.

I. THE MECHANICS OF KITING

The term "check kiting" can mean different things to different courts.[16] The best description of a simple, but classic, kite was described by the United States Supreme Court as follows:

> The check kiter opens an account at Bank A with a nominal deposit. He then writes a check on that account for a large sum, such as $50,000. The check kiter then opens an account at Bank B and deposits the $50,000 check from Bank A in that account. At the time of deposit, the check is not supported by sufficient funds in the account at Bank A. However, Bank B, unaware of this fact, gives the check kiter immediate credit on his account at Bank B. During the several-day period that the check on Bank A is being processed for collection from that bank, the check kiter writes a $50,000 check on his account at Bank B and deposits it into his account at Bank A. At the time of the deposit of that check, Bank A gives the check kiter immediate credit on his account there, and on the basis of that credit pays the original $50,000 check when it is presented for collection.
>
> By repeating this scheme, or some variation of it, the check kiter can use the $50,000 credit originally given by Bank B as an interest-free loan for an extended period of time. In effect, the check kiter can take advantage of the several-day period required for the transmittal, processing, and payment of checks from accounts in different banks . . . .[17]

---

16. *In re* Consol. Pioneer Mortgage Entities, 211 B.R. 704, 716 (Bankr. S.D. Ca. 1997) ("The court recognizes that different experts might use the term 'check kiting' in different contexts to mean different things.") *aff'd in part, rev'd in part*, 166 F.3d 342 (9th Cir. 1999). In *Pioneer Mortgage*, part of the kite was located only at one bank, with the debtors kiting checks between accounts at the same bank. *Id.*

17. Williams v. United States, 458 U.S. 279, 281 n.1 (1982) (quoting Brief for the United States at 12–13), *superseded by statute*, Comprehensive Crime Control Act of 1984, Pub. L. No. 98-473, § 1108(a), 98 Stat. 1976, 2147 (codified as amended at 18 U.S.C. § 1344 (2006)). In *Williams*, the Supreme Court held that the perpetrator of a check kite did not violate 18 U.S.C. § 1014, which criminalizes "false statement[s] or report[s]" for the purpose of influencing "in any way the action of" federally insured financial institutions. 18 U.S.C. § 1014 (2006); *see* 458 U.S. at 288–90. This was because, in the view of the majority of the *Williams* Court, a check is not a "statement" that can be described in terms of truth or falsity. 458 U.S. at 284–86. The holding in *Williams* was counteracted by Congress through the addition of 18 U.S.C. § 1344 (2006), the federal bank fraud statute, which more precisely applies to prosecutions for kiting. *E.g.*, United States v. Kucik, 844 F.2d 493, 498–500 (7th Cir. 1988); United States v. Best, 731 F. Supp. 833, 834 (M.D. Tenn. 1990). Section 1344 criminalizes the knowing execution of a "scheme or artifice— (1) to defraud a financial institution." 18 U.S.C. § 1344 (2006).

Because check kiting constitutes bank fraud, claims under the Racketeer Influenced and Corrupt Organizations Act (RICO) are possible once a

As this excerpt shows, the simplest form of kiting involves two accounts that are maintained by the same depositor at two separate banks, with the worthless checks being transferred between the two institutions to create the impression of a positive balance. As the depositor uses more and more of the funds in the balance, the size of the kite, and the banks' potential risk due to an uncollectible overdraft should the kite collapse, necessarily grows. In practice, kites can attain enormous complexity. Often they expand to involve multiple parties,[18] multiple banks,[19] or multiple accounts,[20] and a variety of combinations thereof.[21] As kites progress, they can reshape and reform by moving across a number of banks, with some banks withdrawing after they discover a possible kite and with new, unsuspecting banks being brought in by the customer to continue the kite.[22]

If depositary banks[23] only allowed their customers[24] to have access to or use of the funds from deposited checks after the bank had received a final payment or settlement for the checks, it would

kite has been unraveled. Although a RICO claim is an unlikely vehicle to recoup kiting losses from the (most likely insolvent) check kiter, parties have raised RICO claims against the banks involved in the kite, even though establishing the requisite fraud may prove to be a difficult obstacle to recovery under a RICO theory. *E.g.*, First Chicago Int'l v. United Exch. Co., 836 F.2d 1375, 1376–77 (D.C. Cir. 1988) (dismissing an inter-bank RICO claim due to lack of jurisdiction); Firstar Bank of Sioux City, N.A. v. Beemer Enters., Inc., 976 F. Supp. 1233, 1240–42 (N.D. Iowa 1997) (denying summary judgment on RICO claim against a bank involved in a kite); Bank of Vt. v. Lyndonville Svgs. Bank & Trust Co., 906 F. Supp. 221, 227–28 (D. Vt. 1995) (dismissing interbank RICO complaint for failure to plead with particularity the fraud involved).

18. *E.g.*, Fed. Deposit Ins. Corp. v. Flagship Auto Ctr., Inc., No. 3:04CV7233, 2006 WL 2711788, at *1–2 (N.D. Ohio Sept. 21, 2006) (involving the principals of two car dealerships engaged in phony "dealer trades" to cover up a kiting scheme that used two banks).

19. *E.g.*, *In re* Cannon, 237 F.3d 716, 717–18 (6th Cir. 2001) (involving three banks in a check kite); Nat'l City Bank v. Citizens Nat'l Bank of Sw. Ohio, No. 20323, 2004 WL 2588182, at *1 (Ohio App. Nov. 12, 2004) (involving four banks in a kite).

20. *E.g.*, *In re* Summit Fin. Servs., Inc., 240 B.R. 105, 109 & n.5 (Bankr. N.D. Ga. 1999) (involving six accounts at one bank in a kiting scheme); *In re* Spring Grove Livestock Exch., Inc., 205 B.R. 149, 152–53 (Bankr. D. Minn. 1997) (involving corporate and personal debtors maintaining multiple accounts at two banks).

21. *E.g.*, *In re Pioneer Mortgage*, 211 B.R. at 707–08 (involving debtor entities kiting checks between a number of banks, and between accounts at one bank).

22. *E.g.*, *In re* Montgomery, 983 F.2d 1389 (6th Cir. 1993).

23. A "depositary bank" is "the first bank to take an item." U.C.C. § 4-105(2) (2002). Banks in kites usually act in dual capacities as both depositary banks and as payor banks. *See infra* note 27.

24. "Customer," under Article 4, is defined as "a person having an account with a bank or for whom a bank has agreed to collect items, including a bank that maintains an account at another bank." U.C.C. § 4-104(a)(5) (2002).

be impossible for kiting to occur.[25] A kite only becomes possible when a bank permits its customer to have access to uncollected funds that are nonetheless provisionally credited to the customer's account at the initiation of the collection process. After a bank's customer deposits a check at a depositary bank, the bank usually makes a provisional settlement[26] for the amount of the deposit. The check is then sent through the collection system to the payor bank, also known as the drawee,[27] for payment. The collection process may take a period of time, depending on the check, the locations of the depositary and payor banks, and the method used for collection. If the banks in a kite did not allow a customer access to any funds represented by the deposit until they were assured that the drawee of a check deposited there had finally paid the check, it would be impossible for a kite to start. In such a case, withdrawals or debits against a deposited check could only occur after the depositary bank was itself entitled to the amount from the payor. As a matter of long-standing banking practice, banks nonetheless routinely have granted their business customers access to the funds provisionally credited even before there is final payment of the check, and such access is now ensured under federal law through the EFAA, as will be discussed later in this Article.[28] However, subject to these federal requirements, a depositary bank does have a right under the UCC to refuse withdrawals against uncollected funds, and it is only the depositary bank's failure to do so that facilitates the practice of

25. *E.g.*, First Nat'l Bank in Harvey v. Colonial Bank, 898 F. Supp. 1220, 1222–23 (N.D. Ill. 1995) (observing that check kiting only occurs due to the UCC's policy favoring withdrawals against uncollected funds and to the UCC's final payment rule). The increasing use of electronic check collection, facilitated through the federal Check 21 Act, 12 U.S.C. §§ 5001–5018 (2006), promises to reduce the incidence of check kiting for the simple reason that electronic presentment will reduce the period of "float" that is a necessary precondition for check kiting.

26. A bank "settles" for an item such as check if it "pay[s] in cash, by clearing-house settlement, in a charge or credit or by remittance, or otherwise as agreed." U.C.C. § 4-104(a)(11) (2002). Settlements can be either provisional or final. *Id.* When provisional, a depositary bank may revoke that settlement if it does not itself receive a final settlement for the item and revokes in a timely manner. U.C.C. § 4-214(a) (2002) ("If a collecting bank has made provisional settlement with its customer for an item and fails by reason of dishonor . . . to receive settlement for the item which is or otherwise becomes final, the bank may revoke the settlement given by it . . . .").

27. A "payor bank" is an Article 4 term for the drawee of a draft. U.C.C. § 4-105(3) (2002). The "drawee" of a draft, an Article 3 term, "means a person ordered in a draft to make payment." U.C.C. § 3-103(a)(4) (2002). In a two bank, one customer kite, for example, there would be two payor banks, and each would receive for deposit checks drawn by the customer on the other. Thus, for each check a bank would serve dual roles as a depositary bank (for checks drawn on the other bank), and as a payor bank (for checks deposited at the other bank).

28. *See infra* text accompanying notes 89–96.

kiting.[29]

If allowed to flourish, kites can pose significant risks for the institutions involved. Although check kiting constitutes a small source of the check fraud-related cases at depositary institutions,[30] the losses per case can be substantial when compared to other types of fraud.[31] Kites bear identifying characteristics,[32] and in many cases a bank, be it acting as a payor bank or depositary bank, can uncover the existence of a kite if it carefully monitors and reviews the activity in its depositor accounts. Thus, banks do have the ability to act upon suspicious activity, although detecting a kite can sometimes be difficult or perhaps impossible, depending upon the lengths to which a customer goes to hide the practice.[33] Even if a

29. *In re* Consol. Pioneer Mortgage Entities, 211 B.R. 704, 708 n.1 (Bankr. S.D. Cal. 1997).

30. ABA DEPOSIT ACCOUNT FRAUD SURVEY REPORT Ex. 4, at 20 (2007) (based on number of cases, kiting constitutes 0.8% of community banks' check fraud-related cases, 1.8% of mid-sized banks', 1.5% of regional banks', and 0.6% of superregional/money center banks').

31. *See id.* at 26 fig.15.

32. The Office of the Comptroller of the Currency lists the following factors or events that are "suspicious circumstances which may indicate a check-kiting scheme:"

- Several accounts with similar names, owned or controlled by the same individuals.
- Regular or excessive drawing against uncollected funds.
- Frequent daily negative ending balances or overdrafts that eventually clear or are covered in a short time frame.
- Identifiable patterns of transactions such as deposits, transfers between accounts, withdrawals, and wire transfers, often with similar or increasing amounts.
- Deposits of large checks drawn on out-of-area banks or foreign banks.
- Frequent requests by the customer for account balances, collected items, or cleared items.
- Frequent, large deposits drawn on the same institution.
- Large debits and credits of even dollar amounts.
- Frequent check withdrawals to the same institution, with the maker listed as payee.
- A low average daily balance in relation to deposit activity.
- A low collected fund balance in relation to the book balance.
- A volume of activity or large debits and credits inappropriate in relation to the nature of the business of the account holder involved.

Office of the Comptroller of the Currency, *OCC Advisory Letter AL 96-6* (Aug. 6, 1996), at 2–3, *available at* http://www.occ.treas.gov/advislst.htm. For a discussion of the warning signs of a check kite, see Thomas E. McCurnin & Peter A. Frandsen, *Grounding Check Kiting With Check 21: The Civil and Criminal Ramifications of Check Kiting in the 21st Century*, 125 BANKING L.J. 295, 301–02 (2008).

33. Firstar Bank Sioux City, N.A. v. Beemer Enters., Inc., 976 F. Supp. 1233, 1241 (N.D. Iowa 1997) ("The court also recognizes that check-kiting is notoriously difficult to detect, particularly when the kite is between accounts at different banks."); *see also* First Nat'l Bank in Harvey v. Colonial Bank, 898 F.

bank suspects a kite, it may be reluctant to act upon that decision due to concerns about protecting its relationship with its customer or over the possible liability to its customer should it turn out that the bank misjudged the situation.[34]

When a bank knows or suspects that a kite is occurring, it is required to file a Suspicious Activity Report ("SAR") with its regulator.[35] In any event, at some point the kite will collapse, either in the rare case when the customer deposits "good funds" to cover the overdraft(s) created by the kite and begins to write checks only on collected funds or, more likely, when one payor bank withdraws from the kite by dishonoring checks presented to it for payment. The dishonored checks are then returned to the depositary bank. That dishonor often is sufficient to put that depositary bank on notice of the kite, the whole scheme collapses, and the banks are left calculating their potential loss exposure due to the kite. These losses ordinarily are not covered by insurance.[36]

Supp. 1220, 1222–23 (N.D. Ill. 1995) (summarizing views on the difficulties in discovering a kite).

34. *First Nat'l Bank in Harvey*, 898 F. Supp. at 1223. If the bank is wrong in its assessment and dishonored checks on the mistaken belief that there were not sufficient funds in the account, it may be liable for wrongful dishonor, *see* U.C.C. § 4-402 (2002), or defamation, or simply may face the displeasure of an important business customer. 898 F. Supp. at 1223.

35. Each regulatory body for financial institutions has substantially identical regulations that implement the SAR requirement. For example, the Federal Reserve's requirements are found at 12 C.F.R. § 208.62 (2008), which generally provides that a member bank shall file a SAR, among other instances, "when it detects a known or suspected violation of Federal law." *Id.* § 208.62(a). As mentioned earlier, check kiting falls within the federal bank fraud statute. *See supra* note 17. Known or suspected federal criminal law violations which aggregate $5000 or more must be reported "where the bank believes that it was either an actual or potential victim of a criminal violation . . . and the bank has a substantial basis for identifying a possible suspect." 12 C.F.R. § 208.62(c)(2) (2008).

36. Riders to a bank's fidelity bond are available for kiting losses. Comptroller of the Currency, *Risk Management and Insurance*, COMPTROLLER'S HANDBOOK 6 (1990), *available at* http://www.occ.treas.gov/handbook/insurance1.pdf. A standard financial institution fidelity bond now contains an exclusion intended to prohibit recovery for check-kiting losses. That exclusion excludes from coverage:

> [L]oss resulting directly or indirectly from payments made or withdrawals from a depositor's account involving items of deposit which are not finally paid for any reason, including but not limited to Forgery or any other fraud, except when covered under Insuring Agreement (A) . . . .

U.S. Fid. & Guar. Co. v. Planters Bank & Trust Co., 77 F.3d 863, 867–68 (5th Cir. 1996) (interpreting the exclusion as covering kiting losses). Even when a bank secures insurance specifically for kiting losses, its actions may prevent it from recovery under the policy. *See also* Exch. State Bank v. Kan. Bankers Sur. Co., 177 P.3d 1284, 1288–90 (Kan. Ct. App. 2008) (explaining that bank's conscious decision to advance credit against kite overdrafts was a "willful extension of credit" falling within exclusion contained in a check kiting fraud

II. THE LIABILITY FRAMEWORK

Once a kite has collapsed, in the usual case one or more of the banks involved are left with customer accounts that contain substantial negative balances. Because the depositary bank receives payments into the accounts, either from payor banks involved in the kite or from good deposits unrelated to the kite, a depositary bank's final overdraft exposure[37] will depend on whether the depositary bank is entitled to retain those payments, and therefore reduce or extinguish its losses. By contrast, if the parties making payments to the depositary bank account can reverse or otherwise retain those payments, the depositary bank's overdraft exposure will be increased, but the retaining parties' liability will be decreased. In its most simple conceptualization, the loss-allocation question becomes one of who gets to retain the payments made into the kiter's account(s), and the victor on that question will have its losses reduced or even eradicated. Depending on the facts of a particular kiting case, the UCC, Regulation CC, and the Bankruptcy Code each are possible vehicles for allocating the losses after a kite collapses. This Section discusses each theory in turn.

A. The Uniform Commercial Code

The UCC's system for allocating kiting losses among the parties in the check collection system is, in the words of one court, "carefully circumscribed, determinate, and reticulated."[38] The initial liability of the banks involved is governed by the UCC's standard for final payment.[39] In short, if a payor bank is determined to have made "final payment" on a check presented to it, it will be liable in nearly every case to the parties in the collection chain for the amount of that check, including the depositary bank. The payor bank's only recourse will be against either any collected funds in the account of its kiting customer or, if such funds are absent, the customer itself. On the other hand, if final payment has not occurred, the payor bank validly may dishonor the check and reverse any settlements previously given. It is then the depositary bank that must seek recovery from the kiting customer. "Final payment" by the payor bank thus acts as a point which demarcates the liability between the

loss policy).

37. To simplify matters, the discussion in this Section analyzes the question of liability as one between a single depositary bank and a single, different, payor bank. In practice an institution will act as a depositary bank for some checks (those drawn on other banks in the kite) and as a payor bank for other checks (those drawn on it and deposited at other banks). The ultimate losses will be derived by evaluating each party's liability based on its respective capacity for each check.

38. Chi. Title Ins. Co. v. Cal. Canadian Bank, 2 Cal. Rptr. 2d 422, 429 (Ct. App. 1991).

39. S*ee* U.C.C. § 4-101 cmt. 3 (2002) ("Article 4 defines rights between parties with respect to bank deposits and collections.").

payor bank and the depositary bank on each check deposited in a kite.

Final payment can occur in a number of ways,[40] but usually occurs when a payor bank makes a provisional settlement and fails to return the check within the time established by the UCC.[41] The default time is the bank's "midnight deadline" because a payor bank is accountable for the amount of a check if it retains the check beyond that deadline.[42] The midnight deadline is midnight of the

40. Checks are finally paid by a payor bank in three circumstances. Under U.C.C. § 4-215(a) (2002), a payor bank finally pays an item when it has done any of the following:

> (1) paid the item in cash;
> (2) settled for the item without having a right to revoke the settlement under statute, clearinghouse rule, or agreement; or
> (3) made a provisional settlement for the item and failed to revoke the settlement in the time and manner permitted by statute, clearing-house rule, or agreement.

Id.

41. *See id.* § 4-215(a)(3), quoted *supra* note 40 (providing that an item is finally paid by a payor bank when the bank has "made a provisional settlement for the item and failed to revoke the settlement in the time and manner permitted by statute, clearing-house rule, or agreement"). Section 4-301 of the UCC gives the payor the right to revoke the provisional settlement that is referred to in § 4-215(a)(3). *See* § 4-215 cmt. 4 (stating that an "example of a statutory right on the part of the payor bank to revoke a settlement is the right to revoke conferred by section 4-301").

"Return" of a check is defined by UCC section 4-301(d), which provides that a check is returned

> (1) as to an item presented through a clearing house, when it is delivered to the presenting or last collecting bank or to the clearing house or is sent or delivered in accordance with clearing-house rules; or
> (2) in all other cases, when it is sent or delivered to the bank's customer or transferor or pursuant to instructions.

U.C.C. § 4-301(d) (2002). An improper return under Regulation CC, discussed *infra* text accompanying notes 87–110, can still be a timely return for UCC purposes. *See* NBT Bank v. First Nat'l Cmty. Bank, 287 F. Supp. 2d 564, 571–72 (M.D. Pa. 2003) (finding that an otherwise timely return under the UCC was not altered by the fact that a breach of Regulation CC duties could also be established).

42. U.C.C. §§ 4-301, 4-302 (2002). Section 4-302(a) provides with respect to checks as follows:

> (a) If an item is presented to and received by a payor bank, the bank is accountable for the amount of:
> (1) a demand item, other than a documentary draft, whether properly payable or not, if the bank, in any case in which it is not also the depositary bank, retains the item beyond midnight of the banking day of receipt without settling for it or, whether or not it is also the depositary bank, does not pay or return the item or send notice of dishonor until after its midnight deadline . . . .

Id. § 4-302(a)(1). The term "accountable" in this section is construed as imposing strict liability on the payor bank in the amount of the check due to its failure to adhere to its deadline. *E.g.*, First Nat'l Bank in Harvey v. Colonial Bank, 898 F. Supp. 1220, 1226–28 (N.D. Ill. 1995) (discussing other decisions);

banking day after the banking day it received the check.[43] Thus, if a check is presented for payment on a Monday morning (that is a banking day) the payor bank must revoke its initial settlement by midnight of the next banking day—Tuesday night in the usual case—or be found accountable for the full amount of the item.

The impact of final payment and of the payor bank's accountability for the amount of the item is to limit significantly the payor bank's ability to recover the amount of the check from anyone other than its customer. Upon final payment by the payor bank, all provisional settlements made in the collection process also become final.[44] After its settlement becomes final, the payor bank, in essence, must pay the amount of the check to the banks that sent the item along for collection, and is left to seek recovery for the amount of the check from its customer.[45] In the case of a kite, where

---

Chi. Title Ins. Co. v. Cal. Can. Bank, 2 Cal. Rptr. 2d 422, 426–28 (Ct. App. 1992) (discussing case law and rejecting argument that estoppel, waiver, or unclean hands defenses might be employed to countermand a payor bank's strict liability for amount of item after final payment). Unlike the liability of collecting banks, which is reduced by the amount that could not have been recovered had ordinary care been exercised, *see* U.C.C. § 4-103(e), a payor bank's liability for final payment is the amount of the check, irrespective of the care taken in returning the item. SOS Oil Corp. v. Norstar Bank of Long Island, 563 N.E.2d 258, 261 (N.Y. 1990). As stated in *SOS Oil*, the "heavy burden" imposed by § 4-302

> serves important commercial purposes: it expedites the collection process by motivating banks to process instruments quickly, and it firms up the provisional credits received by each bank in the collection chain, thereby supplying a key element of certainty in commercial paper transactions. By requiring that deficiencies in the drawer's account be determined swiftly, the midnight deadline rule is a vital part of the payor bank's role in assuring the integrity of commercial paper.

SOS Oil Corp*,* 563 N.E.2d at 261 (citation omitted). Although the midnight deadline is the default standard for the time to return items, shorter periods may apply by agreement. *See* U.C.C. § 4-215(a)(3) (2002) (referencing agreements); *see also* Lockhart Svgs. & Loan Ass'n v. Republicbank Austin, 720 S.W.2d 193, 196 (Tex. App. 1986) (enforcing a shorter clearinghouse rule for timely return of items).

Under U.C.C. § 4-302(a), the bank must make a provisional settlement by midnight of the day of receipt (midnight of the first banking day) in order to retain the ability to revoke that settlement by the midnight deadline (midnight of the next banking day). The failure to make such a settlement will result in accountability for the item even of the checks are subsequently returned the next banking day in a timely manner. *See* Hanna v. First Nat'l Bank of Rochester, 661 N.E.2d 683, 688 (N.Y. 1995) (explaining that failure to make settlement by midnight of the day of receipt results in accountability even where dishonor was timely under midnight deadline rule).

43. U.C.C. § 4-104(a)(10) (2002) (defining midnight deadline).

44. *Id.* § 4-214.

45. *Id.* § 4-401 ("A bank may charge against the account of a customer an item that is properly payable from the account even though the charge creates an overdraft."). The customer will not be liable if it neither signed the item nor benefited from the proceeds of the item. *Id.* § 4-401(b).

usually there are scant collected funds in the customer's account and there is a customer teetering toward insolvency, that route is unlikely to be a profitable one for payor banks left with a loss due to final payment. At the same time, the depositary bank in the kite receives its final settlement, which can be used to offset any liabilities the customer may owe for checks drawn on that bank. The ultimate effect of final payment is to place any losses due to overdrafts in the kite on the payor bank.

Although a depositary bank and collecting banks can assert final payment as a reason for the payor bank's accountability to them for the amount of the item, the kiter may not employ the same argument. In 1990, revisions to UCC Articles 3 and 4 clarified that, in instances of check kiting, the defrauding party ought not to be able to rely upon a payor bank's final payment as a justification for payor-bank liability.[46] Article 4 now provides that a payor bank's liability due to retaining a check beyond the midnight deadline is subject to the bank's defense of "proof that the person seeking enforcement of the liability presented or transferred the item for the purpose of defrauding the payor bank."[47] This new section sides with the payor bank by taking the position that "[a] payor bank that makes a late return of an item should not be liable to a defrauder operating a check kiting scheme."[48] This clarification of prior law may assist banks vis-à-vis the check kiter (and, importantly, other persons or entities, such as a trustee in bankruptcy, that stand in the shoes of the kiter),[49] but it does not act to reallocate losses among banks, absent proof that another bank had a "purpose of defrauding the payor bank."[50] For an example of the application of

46. Prior to 1990, the issue of whether the kiter could assert final payment by the payor bank was addressed only through case law rather than directly by the UCC. U.C.C. § 4-302 cmt. 3 (2002) (citing Bank of Leumi Trust Co. v. Bally's Park Place Inc., 528 F. Supp. 349 (S.D.N.Y. 1981) and Am. Nat'l Bank v. Foodbasket, 497 P.2d 546 (Wyo. 1972)); *see also In re* Spring Grove Livestock Exch., Inc., 205 B.R. 149, 159–61 (Bankr. D. Minn. 1997) (discussing and applying pre-1990 UCC case law, while taking into consideration the subsequently-enacted revised § 4-302(b)).

47. U.C.C. § 4-302(b) (2002).

48. *Id.* § 4-302 cmt. 3.

49. *In re Spring Grove Livestock Exch.*, 205 B.R. at 158–59 (finding that a trustee in bankruptcy was not able to raise final-payment argument because the trustee stands in the shoes of the kiting, insolvent customer, and that therefore the fraud exception to section 4-302 applies); *see also* Lawyers Title Ins. Corp. v. United Am. Bank of Memphis, 21 F. Supp. 2d 785, 807–10 (W.D. Tenn. 1998) (denying insurance company standing to bring action based on section 4-302 due to status as subrogee of defrauding customer).

50. For example, in *Chicago Title Insurance Co. v. California Canadian Bank*, 2 Cal. Rptr. 2d 422, 428 (Ct. App. 1992), a bank that had missed its midnight deadline—and therefore was accountable for the amount of the

the exception, in *Bank of America v. Hubert*, a dishonest employee began kiting checks from her employer's account.[51] The depositary bank, Bank of America, attempted to reverse the provisional settlement for the checks. The employer was able to show that the payor bank had not returned the check by its midnight deadline, which ordinarily would preclude any reversal of the settlement made in the employer's account.[52] However, because the employer, acting through its authorized employee, had behaved fraudulently, the exception to final payment applied, and there was no final settlement.[53] The settlement was still provisional and, therefore, the depositary bank could charge back the credit given to the employer.[54]

As stated earlier, final payment ordinarily results in all

checks—attempted to argue revised U.C.C. § 4-302(b) as a reason why the plaintiff, Chicago Title, could not assert the bank's accountability under Article 4. The court rejected this argument because, among other things, of the lack of evidence that Chicago Title had engaged in any fraudulent conduct that would bring the exception into play. *Id.* ("[T]he Bank conceded at argument that nothing the Company did caused the Bank to miss its midnight deadline, by retarding or sabotaging the Bank's internal check-return procedures or otherwise.").

51. Bank of Am. v. Hubert, 101 P.3d 409, 411 (Wash. 2004).

52. *Id.* at 413–16; *see also supra* note 42 and accompanying text. In *Hubert*, the checking account had been sold by Key Bank to Sterling Bank, but Key Bank still appeared as the drawee on the check. *Hubert*, 101 P.3d at 411. Processing occurred through Sterling Bank's processing agent, who returned the checks in question in a timely manner. *Id.* at 411–12. The court found that Key Bank, the original drawee bank, was the "payor bank." *Id.* at 415. Because Key Bank did not return the checks by its deadline, it ordinarily would be accountable for the amount of the checks, and the collecting bank would be liable to its customer. *Id.* at 416. Given the key role that final payment plays in allocating the losses in a kite, and given that final payment is an event that can only occur at a "payor bank" as defined by the UCC, *see supra* note 27 and accompanying text, a bank left with potential liability for checks drawn in a kite has a strong incentive to argue, as was argued in *Hubert*, that it is not a "payor bank" and thus is not liable for the amount of a check. *See, e.g.*, *Chi. Title*, 2 Cal. Rptr. 2d at 424–26 (involving a bank attempting to circumvent midnight deadline rule by arguing that an admittedly timely return to its own check processing center was a timely return under the UCC and clearinghouse rules); Wells Fargo Bank, N.A. v. Citizens Bank of Tex., N.A., 181 S.W.3d 790, 797–800 (Tex. App. 2005) (rejecting defrauded depositary bank's attempt to argue that correspondent collecting bank was in fact a payor bank and thus had a duty to reverse settlement by its midnight deadline).

53. In the underlying bank/depositor agreement the employer agreed that it would be liable for all actions of its authorized representatives, enhancing the bank's argument that the employer was liable for the acts of its employee. *Hubert*, 101 P.3d at 418.

54. *Id.*

settlements made in the collection chain becoming final. Thus, any reversal of the settlement given to "upstream" parties is impossible.[55] After final payment, a payor bank does have a few possible routes for recovery of the amounts paid. Recovery for breach of warranty is theoretically possible after final payment,[56] but is highly unlikely to be successful in a check-kiting situation.[57] Another theory is recovery for payment by mistake or based on restitution: the 1990 revisions to the UCC resolved a conflict in the courts over the availability of a mistake theory for payor banks after final payment[58] and established that a mistake theory is in fact available, in the abstract, after final payment.[59]

Although now clearly available as a general legal matter under the text of the UCC, a mistake theory is, in many if not most cases of check kiting, quite unlikely to be a successful route for recovery by the payor bank. The UCC only allows a mistake action in circumstances such as check kiting when the local law of mistake and restitution allows such an action.[60] Thus, a payor bank that

55. U.C.C. §§ 4-215(d) (2002) (describing the effect of final payment on settlements), 4-214(a) (allowing for collecting banks' right of charge-back only in the case of dishonor and other circumstances).

56. *Id.* § 4-302(b) ("The liability of a payor bank to pay an item pursuant to subsection (a) is subject to defenses based on breach of a presentment warranty."). Prior transferors in the check-collection process make a set of presentment warranties to the payor bank. *Id.* § 4-208(a). In the ordinary check collection process, these warranties cover forged or unauthorized signatures and alterations. *Id.* § 4-208(a)(1)–(3).

57. Because there are usually no forged or unauthorized signatures on, or alterations of, a kited check, proving a breach of the presentment warranties is likely to be an impossible task for the payor bank in the aftermath of a kite.

58. *Compare* Nat'l Svgs. & Trust Co. v. Park Corp. 722 F.2d 1303, 1305–06 (6th Cir. 1983), *and* Farmers & Merch. State Bank v. W. Bank, 841 F.2d 1433, 1437–38 (9th Cir. 1987) (holding that final payment does not cut off the right of banks to recover mistaken payments), *with* Town & Country State Bank of Newport v. First State Bank of St. Paul, 358 N.W.2d 387, 395 (Minn. 1984) (holding that final payment cuts off ability to raise an action based on mistake or restitution). For discussion of whether a payor bank has a right to raise a restitution action after final payment, see JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 616–21 (5th ed. 2000); Anita F. Hill, *A Drawee's Right to Restitution of Mistaken Payments Under Articles 3 and 4 of the U.C.C.: A Plea for Clarification*, 7 J.L. & COM. 293 (1987).

59. U.C.C. § 3-418 cmt. 4 (2002) ("The right of the drawee to recover a payment or to revoke an acceptance under Section 3-418 is not affected by the rules under Article 4 that determine when an item is paid. Even though a payor bank may have paid an item under Section 4-215, it may have a right to recover the payment under Section 3-418."). In other words, the revised UCC adopts the approach of the *Park Corp.* case cited *supra* note 58.

60. Article 3 establishes two general categories for which a mistake action is available. First, an action for payment by mistake is available (irrespective of whether it would be available under the local law of mistake and restitution) when a payor pays an item on the mistaken belief that (1) payment of the check

seeks to utilize a restitution theory to recover check-kiting losses from other parties in the check collection process, such as the depositary bank, must initially establish that the applicable local law supports the action given the facts of the case.[61] Moreover, even when local law allows the action, a mistake or restitution action can never be asserted "against a person who took the instrument in good faith and for value or who in good faith changed position in reliance on the payment."[62] The depositary bank and other collecting banks often will satisfy this test and, therefore, will be insulated from any possible mistake action. Although technically available as a mechanism for shifting the losses in a check kite after final payment, a mistake or restitution action is, in the usual case,

had not been stopped or (2) the signature of the drawer was authorized. U.C.C. § 3-418(a) (2002). This section does not apply to kiting cases, which do not involve stop-payment orders or unauthorized drawer's signatures. A mistake action in the aftermath of a check kite rather is established through section 3-418(b), which provides:

> (b) Except as provided in subsection (c), if an instrument has been paid . . . by mistake and the case is not covered by subsection (a), the person paying . . . may, to the extent permitted by the law governing mistake and restitution, (i) recover the payment from the person to whom or for whose benefit payment was made . . . .

Id. § 3-418(b). Thus, mistake is only a viable theory in kiting cases when supported by the local law of mistake and restitution.

61. Comment Three to UCC § 3-418 discusses the circumstances in which subsection (b) might establish a mistake action, but indicates that, in the case of check kiting, it is unclear whether local law should support an action for mistake:

> In some cases, however, it may not be clear whether a drawee bank should have a right of restitution. For example, a check-kiting scheme may involve a large number of checks drawn on a number of banks in which the drawer's credit balances are based on uncollected funds represented by fraudulently drawn checks. No attempt is made in Section 3-418 to state the rules for determining the conflicting claims of the various banks that may be victimized by such a scheme. Rather, such cases are better resolved on the basis of general principles of law and the particular facts presented in the litigation.

U.C.C.§ 3-418 cmt. 3.

62. U.C.C. § 3-418(c) (2002). Because the kiter can never be considered to have been acting in good faith, the kiter cannot successfully use section 3-418(c). Beyond that, where a party acted self-consciously to shift the losses to another bank, that party's good faith perhaps may come into question. *See* Farmers & Merchs. State Bank v. W. Bank, 841 F.2d 1433, 1443–49 (9th Cir. 1987). In *Farmers & Merchants*, a bank officer of F&M secured a cashier's check from Western Bank, another bank involved in the kite. F&M had discovered the kite and had dishonored the checks which had been presented for payment by Western Bank, a dishonor that was unknown to Western at the time it issued the cashier's check. *Id.* at 1435–36. In addition, F&M had ample evidence that a kite existed but ignored those facts for a substantial period of time. *Id.* at 1447. The court found that these actions were sufficient to call into question the bank's good faith and, therefore, the bank was not immune from a mistake or restitution action under the predecessor to revised section 3-418. *Id.* at 1451.

unlikely to be a realistic theory for recovery for payor banks.

Perhaps because of these quite limited avenues for recovery, banks left with a large negative balance after the collapse of a kite have attempted to raise general good-faith-and-fair-dealing claims, claims based upon nondisclosure or other common-law theories against the bank that extricated itself from a kite earlier by dishonoring checks drawn on it. The UCC contains a general duty of good faith,[63] and the standard for good faith under Articles 3 and 4 is the broad subjective and objective standard of "honesty in fact and the observance of reasonable commercial standards of fair dealing."[64] In order to succeed on a tort or other common-law claim, that cause of action first must not be displaced by the Code.[65] Even assuming that the action is permitted, proving the claim is another hurdle, because courts have demonstrated a notable reluctance to impose duties on banks toward others who are involved in the collection process or who otherwise are impacted by the kite beyond those duties expressly stated in the UCC. Although these theories are frequently argued, they are usually resoundingly rejected by the courts.[66]

63. U.C.C. § 1-304 (2002) ("Every contract or duty within [the Uniform Commercial Code] imposes an obligation of good faith in its performance and enforcement."). *But see* Ennis State Bank v. Heritage State Bank, 53 U.C.C. Rep. Serv. 2d 441 (Tex. App. 2004) (rejecting the argument that UCC supports an independent action for breach of good faith absent breach of some other contract or duty).

64. U.C.C. § 3-103(a)(6) (2002). Prior to the 1990 revisions to Articles 3 and 4, the good faith standard was one of subjective honesty in fact alone. It was therefore harder to show that the standard of good faith had been contravened in a check kiting situation since proof of subjective dishonesty on the part of any party was harder to come by than proof that reasonable commercial standards of fair dealing had not been observed. As stated by one court, the subjective standard seemed "to protect the objectively stupid so long as he is subjectively pure of heart." Seinfeld v. Commercial Bank & Trust Co., 405 So. 2d 1039, 1042 (Fla. Dist. Ct. App. 1981). Thus, at least arguably, the broadening of the standard of good faith in 1990 to admit objective criteria of reasonable commercial standards of fair dealing opened the way for more expansive use of good faith by defrauded banks to reallocate losses after a kite. Courts, however, have been resisting the invitation. *See infra* note 66. The actual standard for good faith in a jurisdiction will depend on whether that jurisdiction has enacted the standard advanced in the revisions.

65. U.C.C. § 1-103 (2002) (providing that other principles of law and equity shall supplement the Code unless "displaced by the particular provisions of this Act"); *see also* FDIC v. Flagship Auto Ctr., Inc., No. 3:04CV7233, 2006 WL 2711788, at *5 (N.D. Ohio Sept. 21, 2006) (finding that section 1-103 supplants the common law in most instances).

66. Estate of E. Beim v. Hirsch, 121 F. App'x. 950, 954 (3d Cir. 2005) (holding that bank is not liable under respondeat superior for employee's involvement in kite); Frost Nat'l Bank v. Midwest Autohaus, Inc., 241 F.3d 862, 871–74 (7th Cir. 2001) (collecting cases on whether there is a duty to disclose and finding that there is no duty to disclose or refrain from attempting to shift kite losses); Alta Vista State Bank v. Kobliska, 897 F.2d 930, 932–34 (8th Cir. 1990) (holding that banks in collection process have no special relationship that

In sum, the general judicial preference for interpreting and applying the UCC after a kite collapses is one that tends heavily toward having the losses remain where they lay immediately after the kite collapsed. Rigorous application of the UCC's rules regarding final payment essentially freezes the situation as it existed at the midnight deadline for the last checks and places the losses on payor banks left holding checks after that deadline. The limited ability of payor banks to employ alternative theories such as mistake, restitution, good faith, or common-law approaches to reallocate the losses otherwise placed on it through application of

---

would support a duty to disclose suspicions of a kite); Mid-Cal Nat'l Bank v. Fed. Reserve Bank of S.F., 590 F.2d 761, 763–64 (9th Cir. 1979) (holding that absent special relationship, there is no duty to discover a kite); Ohio Cas. Ins. Co. v. Bank One, No. 95-C-6613, 1997 WL 428515, at *5–6 (N.D. Ill. July 23, 1997) (rejecting claim that bank's duty of good faith requires it to notify payor bank or corporate customer to disclose a suspected kite, but finding that bank's actual knowledge of a kite could create a duty to disclose); First Nat'l Bank in Harvey v. Colonial Bank, 898 F. Supp. 1220, 1232 (N.D. Ill. 1995) (holding that self-conscious taking advantage of laws and regulations to shift loss on another party does not constitute bad faith); Cumis Ins. Soc'y, Inc. v. Windsor Bank & Trust Co., 736 F. Supp. 1226, 1231–36 (D. Conn. 1990) (finding that banks involved in kite have no duty to disclose the existence of a kite to the others, and rejecting good faith, aiding and abetting, and tort claims); Kesselman v. Nat'l Bank of Ariz., 937 P.2d 341, 346 (Ariz. Ct. App. 1996) (finding no duty of bank toward beneficiaries of fiduciary accounts); Commerce Funding Corp. v. Cal. Factors & Fin., Inc., No. B145765, 2002 WL 475400, at *8–12 (Cal. Ct. App. Mar. 29, 2002) (collecting case law on banks' duties to others in check kiting); Bank One, Springfield v. Roscetti, 723 N.E.2d 755, 767 (Ill. App. Ct. 1999) (holding that bank has no good faith duty to inform guarantor of principal's check-kiting scheme); Schwegmann Bank & Trust Co. v. Bank of La., 595 So. 2d 1185, 1188–89 (La. Ct. App. 1992) (holding that failure to disclose is not bad faith); Cmty. Bank v. U.S. Nat'l Bank of Or., 555 P.2d 435, 440 (Or. 1976) (holding that bank's failure to report suspicions about a kite to another bank does not constitute bad faith); Commerce Bank of Pa. v. First Union Nat'l Bank, 911 A.2d 133, 138–44 (Pa. Super. Ct. 2006) (rejecting negligence, unjust enrichment, and constructive trust claims by defrauded bank); Wells Fargo Bank v. Citizens Bank of Tex., 181 S.W.3d 790, 800–02 (Tex. App. 2005) (holding that correspondent bank had no special or fiduciary duty that would require it to send checks to payor bank in more expeditious manner); Ennis State Bank v. Heritage Bank, 53 U.C.C. Rep. Serv. 2d 441 (Tex. App. 2004) (holding that bank involved in a kite has no duty to discover the kite or to warn of the kite, absent proof of some special relationship).

In spite of the overwhelming and consistent rejection of good faith or common-law theories of recovery, there is some limited support to the argument that when a bank deliberately seeks to manipulate the rules of the UCC to obtain a better position in a kite, liability should rest with that bank. *See supra* note 62; *see also* NationsBank of Md. v. Harris Bank Glencoe-Northbrook N.A., No. 93 C 615, 1993 WL 179522, at *5 (N.D. Ill. May 25, 1993) (refusing to dismiss on the pleadings a claim regarding whether a "deliberate attempt to shift the risk of loss stemming from a check kiting scheme" contravened obligations established by the UCC); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. First Nat'l Bank of Little Rock, 774 F.2d 909, 914–15 (8th Cir. 1985) (finding that bank committed fraud when it purposefully delayed the return of items presented to it while expeditiously collecting items deposited with it).

the final payment standard means that, for the most part, final payment ultimately will dictate the liability of banks after the kite collapses. Conversely, where the payor bank has returned checks prior to the expiration of the midnight deadline, the UCC allows payors to avoid liability. This shifts the loss back to the depositary bank and, if that bank allowed its customer to withdraw the funds represented by the check, it is left with a negative account balance.

The case of *First National Bank in Harvey v. Colonial Bank*[67] illustrates the application of these intricate UCC provisions. First National and Colonial were two of three banks involved in a kite operated by two related companies, Shelly Internal Marketing and World Commodities.[68] Immediately prior to the collapse of the kite, First National had presented for payment over $1.5 million in checks deposited by Shelly at First National and drawn on Colonial, and Colonial had presented for payment $1.5 million in checks drawn on First National and deposited by Shelly at Colonial.[69] First National had begun to suspect a kite and dishonored, by its midnight deadline, the $1.5 million in checks that had been presented by Colonial, thus avoiding liability on those items.[70] First National sent direct notice of its nonpayment[71] to Colonial, but indicated that the reason for the return was a generic "return to maker" rather than specifically referring to a kite.[72] Colonial received this notice on Wednesday afternoon.[73]

The checks presented for payment to Colonial by First National were also presented on Tuesday of the week at issue.[74] After contacting the customer and being assured that the checks just

67. 898 F. Supp. 1220 (N.D. Ill. 1995).

68. *Id.* at 1223.

69. *Id.*

70. *Id.* at 1223–24. The checks were presented to First National on Tuesday, February eleventh, and on Wednesday the twelfth First National returned the checks. *Id.*

71. This is required under federal law for checks in amounts at or over $2500. *See infra* note 100 and accompanying text.

72. *First Nat'l*, 898 F. Supp. at 1224. Although the court found that First National had no duty to disclose the existence of, or suspicions about, a kite, another court has found that a misstated reason for return might create a triable issue of fact. *Id.* at 1229–33. In *Keybank National Association v. International Finance Bank,* 874 So. 2d 664 (Fla. Dist. Ct. App. 2004), a payor bank involved in a kite returned unpaid checks stamped "uncollected funds" rather than "insufficient funds." *Id.* at 665. The depositary bank argued that had the returned checks been stamped with the latter reason, it "would have been alerted to the true situation surrounding [the depositor's] banking activity." *Id.* at 665–66. The court found that a triable issue of existed for the depositary bank's claims against the payor bank for misrepresentation or gross negligence. *Id.* at 666.

73. *First Nat'l*, 898 F. Supp. at 1224.

74. *Id.* at 1223.

dishonored by First National were good and should be resent for collection, Colonial Bank officers decided not to return its checks on Wednesday.[75] However, Colonial then met with its customer on Thursday of that week, the morning after the midnight deadline had passed, and decided to return the checks presented by First National—past its deadline under the UCC.[76] Because Colonial had retained the checks past its midnight deadline, the court found that Colonial Bank, as payor bank, was accountable to First National for the amount of the checks.[77] Moreover, in light of First National's timely return of the checks on which First National had been payor, Colonial would also absorb the loss for those checks.[78]

After the application of these rules for final payment, Colonial was bearing quite significant losses. Colonial, therefore, argued that First National acted in bad faith because it failed to disclose the existence of the kite, a duty based on the fact that First National had suspected the kite prior to its own, timely dishonoring of the checks presented to it.[79] That bad faith, Colonial argued, counteracted any claim made by First National that Colonial was accountable for the checks it held past the midnight deadline.[80] However, consistent with the vast majority of courts that have addressed the matter,[81] the court found that the duty of good faith did not require a bank to disclose the existence of, or even suspicions about, a kite.[82]

Finally, Colonial attempted to argue that it should be able to recover the $1.5 million considered finally paid by it under the provisions of the UCC that permit recovery for mistake or restitution.[83] The court rejected this argument on the grounds that a bank that has made "a conscious extension of unsecured credit to its customer . . . has not made a 'mistaken payment,'" and thus that the UCC did not support an action for mistake.[84] The court also

75. *Id.* at 1224.

76. *Id.*

77. *Id.* at 1226–28. The court discussed in detail the case law that overwhelmingly supports the conclusion that the term "accountable" under section 4-302 means strict liability for the face amount of the check. *Id.*; *see also supra* note 42.

78. *First Nat'l*, 898 F. Supp. at 1228.

79. *Id.* at 1229.

80. *Id.*

81. *See supra* note 66.

82. *First Nat'l*, 898 F. Supp. at 1229–33.

83. *Id.* at 1233–35; *see also supra* text accompanying notes 60–62 (discussing UCC position on actions for mistake and restitution after final payment).

84. *First Nat'l*, 898 F. Supp. at 1234; *see also* WHITE & SUMMERS, *supra* note 58, at 613–16 (raising the same argument). The court applied section 3-418(b),

rejected Colonial's claim that allowing First National to retain the amounts paid by Colonial would somehow result in unjust enrichment of First National.[85] In sum, the court strictly applied the final payment standards of the UCC to allow the losses to remain as they were immediately following the end of the kite, and rejected any significant role for the common law in reallocating those losses.

Colonial Bank makes evident the very limited and uncertain routes for recovery after the mechanical rules for final payment have been applied to determine the liability of the parties in the bank collection process. The UCC's reliance upon the bright-line rule of final payment makes the scheme analogous to the children's game of "hot potato," with the object passed being the check: If a payor bank gets rid of the check in time, it escapes liability entirely. On the other hand, if it retains the item past its midnight deadline, it bears full liability. Additional theories based on mistake, good faith, or a duty to disclose a kite are unlikely, under the UCC and under current case law, to provide viable means for banks to shift the losses to other parties. For most commentators, the UCC's approach to the matter that allows the losses to lie where they initially fell is a sound position, albeit an admittedly ruthless one for the payor banks left holding the checks after the kite has collapsed and the midnight deadline has passed.[86]

B. Regulation CC

The UCC originally was the principal mechanism for the allocation of losses after a kite collapsed. However, Congress's enactment in 1987 of the Expedited Funds Availability Act[87]

discussed *supra* note 60 and accompanying text, as the basis for a possible UCC mistake action in the case of kiting. Because no action for mistake was supported by the circumstances, the court did not need to address the issue of whether First National qualified for the defense established by UCC section 3-418(c), discussed *supra* text accompanying note 62. *First Nat'l*, 898 F. Supp. at 1233–35.

85. *First Nat'l*, 898 F. Supp. at 1235.

86. *See, e.g.*, 1 BARKLEY CLARK & BARBARA CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS ¶ 9.04, at 9–15 (2008) (advocating that losses in a kite should be left where they lie immediately after collapse); WHITE & SUMMERS, *supra* note 58, at 523 ("[W]e hope that few people are successful in asserting restitution causes of action after kites, but we anticipate that those arguments will be made."); *id.* at 524 (observing that "in kites the usual rule is to take yours and may the devil take the hindmost"); *id.* at 619–20 (arguing against expansive use of restitutionary theories to allow recovery after a kite). *But see* Stephanie A. Lucie, Note, *Check Kiting: The Inadequacy of the Uniform Commercial Code*, 1986 DUKE L.J. 728, 740 (arguing in favor of a loss allocation scheme for check kiting based upon proportional fault of the parties involved).

87. Pub. L. No. 100-86, 101 Stat. 552 (codified at 12 U.S.C. §§ 4001–4010 (2004)).

("EFAA") has created potential federal law bases for recovery after check kites. The EFAA has been implemented by the Board of Governors of the Federal Reserve System (the Federal Reserve or FRB) through its Regulation CC.[88]

Congress enacted the EFAA to ensure that banks' customers received access to the funds represented by deposited checks earlier than otherwise was afforded under the state law UCC.[89] The EFAA, in principle, can be seen as vaguely tolerant of kiting through its facilitation of enhanced availability to bank depositors of uncollected funds because a necessary condition to the occurrence of kiting is the customer's access to uncollected funds. Subpart B of Regulation CC is comprised of a detailed schedule that delineates the time periods within which funds deposited into an "account"[90] must be made available for withdrawal, the exceptions thereto, and the requirements for disclosing to bank customers the availability policy.[91] As a general matter, banks are required to make funds available to the depositor[92] within two business days in the case of

88. 12 C.F.R. § 229 (2008).

89. *See generally Expedited Funds Availability Act: Hearing on H.R. 28 Before the H. Comm. on Banking, Finance and Urban Affairs*, 100th Cong. 1 (1987). Prior to the enactment of the EFAA, the question of the depositary bank's right to place a hold on settlements for deposited checks was addressed by the UCC or, in some states, by separate state statutes that regulated the process. *See* 1 CLARK & CLARK, *supra* note 86, at ¶ 7.04. The UCC now expressly defers to federal law. *See* U.C.C. §§ 4-103(b), 4-102 cmt. 1.

90. Under Regulation CC, an account generally includes all "transaction accounts" as defined by the FDIC. 12 C.F.R. § 229.2(a)(1) (referring to 12 C.F.R. § 204.2(e) for the definition of "transaction account'). *See* 12 C.F.R. § 204.2(e) (defining "transaction account" as "a deposit or account from which the depositor or account holder is permitted to make transfers or withdrawals by negotiable or transferable instrument, payment order of withdrawal, telephone transfer, or other similar device for the purpose of making payments or transfers to third persons or others or from which the depositor may make third party payments at an automated teller machine (ATM) or a remote service unit, or other electronic device, including by debit card, but the term does not include savings deposits or accounts described in [§ 204.2(d)(2)] . . . even though such accounts permit third party transfers"). Thus, virtually all standard checking accounts, consumer and business, are covered under the Regulation CC definition and are subject to its rules.

91. 12 C.F.R. §§ 229.10–.21.

92. The EFAA and Regulation CC only prescribe the time periods within which a bank must make the funds from a deposit available to the depositor. They do not impact a bank's rights to revoke a settlement given after a check is dishonored. 12 U.S.C. § 4006(c)(2) (2006) (the EFAA does not affect depositary institution's right to revoke or charge back settlements). Rather, they merely require deposited funds to be made available to the depositor, on the grounds that most checks are in fact honored and that allowing a customer access to the funds therefore raises little risk to depositary banks. The policy of availability does not create, in other words, an absolute right of the customer to the funds. *See* Essex Constr. Corp. v. Indus. Bank of Wash., Inc., 913 F. Supp. 416, 417–18 (D. Md. 1995) (finding that "the EFAA place[s] no limit on [a depositary bank's] right under state law to revoke the provisional credit"). A bank's liability for

local checks[93] and five business days in the case of non-local checks.[94] However, where a depositary bank has "reasonable cause to believe that the check is uncollectible from the paying bank,"[95] it may invoke an exception from these requirements, and it need not follow the established availability schedule.[96]

In kiting, the problem does not arise from a bank *failing* to provide its depositors access to their deposited but uncollected funds, but rather from a bank *allowing* its customer such access far too liberally. In order to facilitate quicker return of dishonored checks than otherwise might occur under the UCC,[97] Subpart C of

failure to comply with the availability schedule is governed rather by 12 C.F.R. § 229.21.

93. 12 C.F.R. § 229.12(b) (2008). In some cases where a deposit represents little risk to the depositary bank, such as Treasury checks and the like, the customer is given next-day availability of the deposit. *Id.* § 229.10.

94. *Id.* § 229.12(c).

95. *Id.* § 229.13(e). Regulators have suggested that a belief that a customer might be kiting checks will support the bank invoking this exception. *See* Office of the Comptroller of the Currency, Depository Service, COMPTROLLER'S HANDBOOK at 58 (Sept. 2006) (reasonable cause exception may be invoked where the depositary bank believes a kite may exist).

96. 12 C.F.R. § 229.13(e) (2008). The exceptions are delineated in 12 C.F.R. § 229.13. Exceptions are allowed, generally, for (1) new accounts, § 229.13(a)(1); (2) large deposits, § 229.13(b); (3) redeposited checks, § 229.13(c); (4) accounts that have been repeatedly overdrawn, § 229.13(d); (5) deposited checks when there is "reasonable cause to doubt collectability," § 229.13(e); and (6) emergency conditions, § 229.13(f). In order to invoke an exception the depositary bank must give notice to its customer, in most cases apart from new accounts, under the rigorous notice procedures established under § 229.13(g).

97. The UCC's legal regime affecting banks' duties on presentment and dishonor of checks could not exist comfortably with the EFAA and Regulation CC's policy that mandated early availability of funds deposited with the depositary bank. *See* 1 CLARK & CLARK, *supra* note 86, ¶ 7.04, at 7–8 (noting concern that banks might be required to release funds, "but there was no vehicle [under state law] by which they could receive earlier word of nonpayment by the drawee bank"). Under the UCC, a payor bank must only return the item by its midnight deadline. The UCC does not prescribe a detailed *manner* of a return. All collecting banks are under a general duty of ordinary care in sending notice of dishonor and in returning items, *see* § 4-202(a)(2) (2005), but taking action by the bank's midnight deadline establishes the exercise of ordinary care. *See* § 4-402(b) ("A collecting bank exercises ordinary care under subsection (a) by taking proper action before its midnight deadline following receipt of an item . . . . Taking proper action within a reasonably longer time may constitute the exercise of ordinary care, but the bank has the burden of establishing timeliness."). Thus, in a collection process that involved a number of banks, many days or weeks could pass prior to the depositary bank's receipt of notice that a check had been dishonored by the payor bank, even when all banks had comported with their duty of ordinary care under the UCC. Because the EFAA and Regulation CC mandated that the funds deposited with the depositary bank be made available to the depositor within a prescribed period, additional return responsibilities were critical to ensure that the availability rules established under the EFAA could function effectively without undue risk to financial institutions. *See* Statement by Wayne A. Angell, Board of Governors of the Fed. Reserve Sys. Before the

Regulation CC establishes federal duties regarding return of dishonored checks, and violation of these duties can be important in the kiting context. For all checks, paying banks[98] now are required to return a dishonored check in an "expeditious manner."[99] Moreover, for dishonored checks in amounts of $2500 or more, the paying bank has a duty to give direct notice of nonpayment to the depositary bank by 4:00 p.m. of the second business day following the banking day of presentment.[100] In cases in which a bank fails to exercise ordinary care in complying with the requirements of

Comm. on Banking, Finance and Urban Affairs, in House Hearings, *supra* note 89 at 149, 151–52 (indicating the Federal Reserve's intention to improve the return process after Congress enacted the EFAA).

Because of the limited duties of intermediary banks (that is, collecting banks other than the depositary bank, *see* U.C.C. § 4-105(4) (2005)) under the UCC, in the usual case they are insulated from possible UCC liability as long as they act in a timely manner. In the rare case where the midnight deadlines are not met, an intermediary bank may be exposed to some liability in a kiting case. *See, e.g.*, Nat'l State Bank v. Fed. Reserve Bank of N.Y., 979 F.2d 1579, 1580–81 (3d Cir. 1992) (describing how the Federal Reserve, as collecting bank, allegedly delayed months in returning dishonored checks in a kite). However, proving the delay and proving the loss caused thereby can be significant hurdles even in these cases. *See id.* at 1582–83 (noting lack of evidence as to where checks were lost); U.C.C. § 4-103(e) (2005) (damages for failure to exercise ordinary care "is the amount of the item reduced by an amount that could not have been realized by the exercise of ordinary care").

98. Regulation CC uses the term "paying bank," defined at 12 C.F.R. § 229.2(z), whereas the UCC uses the term "payor bank." *See* U.C.C. § 4-105(3) (2005) (UCC definition of "payor bank"). Regulation CC "paying banks" include traditional UCC "payor banks," but the federal definition is broader than the state definition and therefore places federal return responsibilities on a broader number of institutions. For example, under Regulation CC, when a check states that it is "payable through" a stated institution, that institution is considered a "paying bank." 12 C.F.R. § 229.2(z) (2008). By contrast, under the UCC use of such terminology merely designates a collecting bank. U.C.C. § 4-106(a) (2005). Thus, the time periods established by Regulation CC for return apply to "payable through" banks as well as to traditional UCC "payor banks." *See, e.g.*, Farm Credit Servs. of Am. v. Am. State Bank, 339 F.3d 764, 768–70 (8th Cir. 2003) (finding that a payable through bank was subject to payor bank's expedited return and notice requirements under Regulation CC).

99. 12 C.F.R. § 229.30 (2008). This duty can be satisfied by meeting one of two tests: (1) the two-day/four-day test or (2) the forward collection test. *Id.* Under the first test (two day/four day), a paying bank must return a check in a manner that normally would result in receipt by the depositary bank by four p.m. (local time) of the second business day in the case of local checks or the fourth business day in the case of non-local checks. *Id.* § 229.30(a)(1). Under the latter test (forward collection), the duty of expeditious return is met if the paying bank sends the check in a manner that it would if it were the depositary bank of a similar check, sending it for forward collection. *Id.* § 229.30(a)(2). Banks other than the paying bank involved in the Regulation CC return process are subject to the same tests. *Id.* § 229.31(a) (describing duties of returning banks).

100. *Id.* § 229.33. Notice can be by "any reasonable means, including the returned check, a writing (including a copy of the check), telephone, Fedwire, telex, or other form of telegraph." *Id.*

Subpart C, a payor bank may be liable, but only to the extent the payor bank's failure caused a loss to the injured party.[101] Thus, establishing a breach of a duty under Regulation CC alone is insufficient to recover the full amount of the check. Rather, the injured party must demonstrate that the failure to return the check in a timely manner caused a loss.[102] This is a critical distinction between Regulation CC and the UCC's standard of liability for final payment, where a payor bank that delays its return beyond the applicable deadline is strictly and absolutely accountable for the amount of the check, regardless of whether the delay actually harmed the depositary bank.[103] Although a possible breach of a bank's Regulation CC return duties can offer a viable theory for possible recovery by depositary banks left with losses after the collapse of a kite, the difficulty in proving damages may be a significant hurdle. In the usual kiting case, the depositary bank's losses are not due to any delay in return by paying and returning banks, but rather are due to the depositary bank's own decision to allow its customer very early access to uncollected funds.

Another part of Regulation CC, however, can be an important mechanism for payor banks left holding checks after the UCC midnight deadline to shift kiting losses back to the depositary bank. Regulation CC contains a *federal* extension of the *state* law midnight

101. The liability section for Regulation CC's subpart C provides in pertinent part as follows:

> (a) . . . A bank that fails to exercise ordinary care or act in good faith under this subpart may be liable to the depositary bank, the depositary bank's customer, the owner of a check, or another party to the check. The measure of damages for failure to exercise ordinary care is the amount of the loss incurred, up to the amount of the check, reduced by the amount of the loss that party would have incurred even if the bank had exercised ordinary care.

Id. § 229.38(a). The limited liability of the bank failing to abide by its federal return responsibilities can be reduced further if the other party also failed to exercise ordinary care. *See also id.* § 229.38(c) (establishing comparative negligence standard). In *Bank One Chicago, N.A. v. Midwest Bank & Trust Co.* the United States Supreme Court held that there was federal court subject-matter jurisdiction for suits brought by one bank against other institutions for a violation of their Regulation CC duties. 516 U.S. 264, 272 (1996). Thus, a bank's alleged violation can be enforced through a private right of action.

102. Such proof can be difficult to establish. *See* NBT Bank v. First Nat'l Cmty. Bank, 287 F. Supp. 2d 564, 572–73 (M.D. Pa. 2003) (liability for an alleged encoding error under Regulation CC was limited to actual harm caused by the error); First Nat'l Bank in Harvey v. Colonial Bank, 898 F. Supp. 1220, 1236 (N.D. Ill. 1995) (rejecting claim based on breach of Regulation CC's return duties due to failure of the claimant to establish a causal relationship between any delay and the loss).

103. *See supra* text accompanying notes 40–45; *see also* Farmers Deposit Bank v. Bank One, No. Civ.A. 3:04-43-JMH, 2005 WL 3455979, at *3, *9 (E.D. Ky. Dec. 16, 2005) (UCC liability after final payment is not contingent on lack of ordinary care, although Regulation CC liability is so contingent).

deadline for return of items under the UCC.[104] The UCC time for final payment, under state law the midnight deadline, is extended by Regulation CC to the time of dispatch of a returned item when

> A paying bank uses a means of delivery that would ordinarily result in receipt by the bank to which it is sent—
>
> (1) On or before the receiving bank's next banking day following the otherwise applicable deadline by the earlier of the close of that banking day or a cut-off hour of 2 p.m. or later set by the receiving bank under U.C.C. 4-108 . . .; this deadline is extended even further if a paying bank uses a highly expeditious means of transportation, even if this means of transportation would ordinarily result in delivery after the receiving bank's next cut-off hour or banking day referred to above.[105]

A paying bank's motivation for returning the check late, such as a deliberate intention to avoid kiting losses otherwise imposed on it by the UCC, is irrelevant for determining whether the extension applies; the focus of the extension is on the speed of the chosen method of return rather than on the reason for the delay.[106]

In light of the UCC's use of the strict-timing standard of the midnight deadline to demarcate the payor bank's liability (or lack of it) on a check, the possibility of a federal-law argument to extend that deadline "even further" in cases where a "'highly expeditious' means of transportation"[107] is used to return the check is extraordinarily valuable for payor banks left with kited checks after their return deadline has passed. If the UCC midnight deadline is extended under Regulation CC, the payor bank avoids final payment of, and accountability on, the check, and the losses in the amount of the check are in effect shifted back to the depositary bank. Such arguments are succeeding in the courts: the second clause of the extension has been successfully used in check kiting cases to extend the midnight deadline beyond that otherwise established under the UCC.[108] For example, in one case a payor bank delayed one day in

104. 12 C.F.R. § 229.30(c). The EFAA expressly preempts the UCC when the latter is inconsistent with federal law, *see* 12 U.S.C. § 4007(b) (2004), but Regulation CC retains the midnight deadline rule of the UCC as a general matter. *See* 12 C.F.R. Pt. 229 app. E, § XVI(A)(9)(a) (2008) (noting that banks are still required to make timely return under the UCC even in light of Regulation CC); *see also* Huntington Nat'l Bank v. JP Morgan Chase Bank, No. 2:07-cv-378, 2007 WL 2123763, at *4 (S.D. Ohio July 20, 2007) (collecting case law in area). Thus, the state law regime, generally, governs the required time of return (subject to the extension discussed above), while the federal regime governs the manner of return.

105. 12 C.F.R. § 229.30(c)(1).

106. *See* First Nat'l Bank of Chi. v. Standard Bank & Trust, 172 F.3d 472, 478–80 (7th Cir. 1999).

107. *Id*. at 476–77.

108. Oak Brook Bank v. N. Trust Co., 256 F.3d 638 (7th Cir. 2001) (applying

returning $3.7 million in kited checks,[109] an event which, under the UCC, would result in the bank being accountable for the full amounts of the checks. However, because the payor bank rushed the dishonored checks back to the depositary bank by cab, the court found that the Regulation CC extension of the UCC deadline applied, and thus that the return was timely.[110] The extension effectively shifted the loss back on the depositary bank, a result not contemplated by the UCC.

The federal (EFAA/Regulation CC) and state (UCC) law regimes therefore establish potentially conflicting standards when those standards are applied to check kiting. State law, on the one hand, gives priority to a payor bank that complies with the inflexible midnight deadline, and denies that bank priority when it fails to comply. Federal law, on the other hand, allows banks alternative theories to employ in the case of kiting, based on a bank's alleged failure to return checks in a proper and timely manner and on a possible extension of the state law deadline. Success using these federal theories can result in a reallocation of losses in a manner not contemplated by the strict timing standards of the UCC. The EFAA is not the sole source of potential conflict between state and federal law. The federal Bankruptcy Code provides an additional layer of federal law theories for use in kiting cases that deviate from the loss allocation structure of the UCC, as the next Section discusses.

C. *The Bankruptcy Code*

The banks' customer in the case of kiting is often insolvent, or nearing insolvency, and a filing of a bankruptcy petition is imminent.[111] Although a number of theories might be raised by a

extension); *First Nat'l Bank*, 172 F.3d at 475; (using section 229.30(c) to extend payor bank's midnight deadline); Wells Fargo Bank v. Citizens Bank of Tex., 181 S.W.3d 790, 804 (Tex. App. 2005) (discussing the use of section 229.30(c) by collecting bank that delayed in return of checks).

109. *First Nat'l Bank*, 172 F.3d at 474. The checks were presented for payment to the payor bank on a Friday. The other bank involved in the kite made a timely dishonor of checks drawn on it on Monday. The payor bank, upon receiving the notification that those checks had been dishonored, then dishonored on Tuesday the checks presented to it. *Id*.

110. *Id*. at 476–77.

111. Indeed, the impending insolvency of the customer might be a powerful motivating cause of the kite, and when a kite of immense dimensions collapses, the ensuing bankruptcy litigation may involve a complex web of relationships that need to be unraveled, as this court addressing the bankruptcy issues in a kite that involved upwards of $91 million in kited checks suggests:

> This is Act IV in a drama of indeterminate length. The parties suggest a theatrical assemblage: On one side are the trustees who seek to recover millions of dollars for their insolvent estates. On the other side are the defendants [the banks] who, having already been duped out of twenty-one million dollars, seek to prevent further losses. Off-stage are the debtors, two of whom, in the midst of this drama, perpetrated a check kiting scheme of epic proportions.

bankruptcy trustee in kiting cases,[112] preference theory predominates as the primary mechanism by which a trustee might attack payments in a kite. The policy behind preference law is distinct from the policies underlying the UCC and the EFAA. While the latter two regulations seek to control the check collection and return processes, preference law addresses the relationship among a debtor's creditors and the preservation of a debtor's assets for those creditors.[113]

Under section 547 of the Bankruptcy Code, the trustee:

> [m]ay avoid any transfer of an interest of the debtor in property –
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such a transfer was made;

In re Spring Grove Livestock Exch., Inc., 205 B.R. 149, 152 (Bankr. D. Minn. 1997).

112. For example, a bank's right of setoff against its customer's account pursuant to Bankruptcy Code section 553 frequently is raised in kiting litigation in the bankruptcy context. *E.g.*, *In re* Vendsouth, Inc., No. 00-10112C-7G, ADV. 01-2016, 2003 WL 22399581, at *12 (Bankr. M.D.N.C. Oct. 12, 2003) (finding that bank's setoff rights only apply where deposits are made in good faith and in the due course of business, and where the kiting involves loan fraud); Pereira v. Summit Bank, 44 U.C.C. Rep. Serv. 2d 806, 821 (S.D.N.Y. 2001) (finding that section 553(a)(3) precludes setoff where bank had placed withdrawal restrictions on the account, and where bank had full knowledge of the kite); *In re* Summit Fin. Serv.'s, Inc., 240 B.R. 105, 120–21 (Bankr. N.D. Ga. 1999) (finding setoff permissible under section 553(a)(3) where bank received deposits prior to becoming aware of the fact there was a kite); *In re* Frigitemp Corp., 34 B.R. 1000, 1017–23 (S.D.N.Y. 1983) (protecting bank's setoff rights against overdrafts and immunizing most setoffs from possible preference attack). Other kiting arguments include subordination of one bank over another, s*ee In re Summit*, 240 B.R. at 122–23 (rejecting trustee's argument that court should use its equitable powers to shift losses to the bank that successfully managed to extricate itself from a kite, using section 105 of the Bankruptcy Code); *In re Spring Grove Livestock Exch*., 205 B.R. at 161–63 (rejecting trustee's equitable subordination argument under Bankruptcy Code section 510 due to the lack of evidence that banks engaged in inequitable conduct sufficient to support a claim of equitable subordination), fraudulent transfers, *see In re* Consol. Pioneer Mortgage Entities, 211 Bankr. Rep. 704, 714–18 (S.D. Ca. 1997) (rejecting argument that the U.C.C. § 4-210 security interest is a fraudulent transfer under section 548 of the Bankruptcy Code), and the earmarking doctrine, *see In re* Brown, 209 B.R. 874, 879–81 (Bankr. W.D. Tenn. 1997) (finding that, where depositor covered final overdraft with a loan from a friend, made for the specific purpose of paying overdrafts, earmarking doctrine applied and preference could not be established); Laws v. United Mo. Bank of Kan. City, 188 B.R. 263, 266–67 (W.D. Mo. 1995), (rejecting the application of the earmarking doctrine where customer borrowed four million dollars to pay off negative balance after a kite, because there was no evidence that the disclosed purpose of the loan was to pay off the overdraft).

113. *See* Ponoroff, *supra* note 11, at 1452.

(3) made while a debtor was insolvent;

(4) made –

(A) on or within 90 days before the date of the filing of the petition; . . . .

(5) that enables such creditor to receive more than such creditor would receive if –

. . .

(B) the transfer had not been made; . . .[114]

Assuming that the transfer of an interest of the debtor in property occurred within the prescribed ninety-day period,[115] a number of types of transfers that occur in the check collection process might arguably be considered preferences under this section. Trustees mainly employ preference law in kite situations in two ways: first, to argue that the settlements made among banks during the kite (and during the preference period) are preferences,[116] and second, to argue that payments made to a bank involved in a kite from an outside source to reduce a bank's overdraft exposure are preferences.[117] The following examples demonstrate these two types

114. 11 U.S.C. § 547(b) (2005).

115. For determining when a transfer of the debtor's property occurs through the payment of a check drawn by the debtor, the operative time is when the check is honored by the payor bank. Barnhill v. Johnson, 503 U.S. 393, 399 (1992). In *Barnhill*, the debtor wrote a check in payment of a debt to the petitioner Barnhill. *Id.* at 395. The check was delivered to Barnhill more than ninety days prior to the debtor's bankruptcy filing, but paid by the payor bank within the ninety day preference period. *Id.* The United States Supreme Court resolved a split in the Court of Appeals by finding that the date of honor, rather than the date of delivery, should govern actions under section 547(b). *Id*. at 396–99. Thus, checks honored within the ninety days prior to the filing are potentially subject to attack under a preference theory.

116. *See, e.g.*, *In re Consol. Pioneer Mortgage*, 211 B.R. at 710 (discussing how final settlements that covered withdrawals against provisional settlements were alleged to be preferences because the withdrawal created a debt and final settlement satisfied that debt); *In re Brown*, 209 B.R. at 878 (discussing the same issue).

117. *See, e.g.*, *In re* Vendsouth, Inc., No. 00-10112C-7G, ADV. 01-2016, 2003 WL 22399581, at *3 (Bankr. M.D.N.C. 2003) (observing that money from a line of credit under which the customer was an obligor was used to fund a controlled disbursement account where the kiting occurred, and creditor advanced $1.9 million based on phony kite balance); Pereira v. Summit Bank, 44 U.C.C. Rep. Serv. 2d 806, 811–17 (S.D.N.Y. 2001) (involving approximately seventeen million in third party checks and wires that were transferred into the account with the kited bank, an account which bank had shut down to avoid further transfers out); *In re* Summit Fin. Serv.'s, Inc., 240 B.R. 105, 110 (Bankr. N.D. Ga. 1999) (observing that bank received wire transfers, certified check, and $1500 check and set off these funds against a negative balance in another account, eliminating its losses due to a kite); *Laws*, 98 F.3d at 1048 (involving bank that received a four million wire transfer to cover negative collected-funds

of situations:

> *Example 1: Customer is kiting checks between Bank A and Bank B during the preference period. Bank A makes provisional settlements for checks drawn on Bank B and deposited in Bank A. Bank B makes final settlement of those checks under the UCC. Customer has withdrawn all funds from Bank A. Trustee seeks to recover the settlements by Bank B to Bank A through final payment as preferences.*

> *Example 2: Customer is kiting checks between Bank A and Bank B during the preference period. Bank B discovers the kite and returns to Bank A $1 million in checks properly before its midnight deadline, thus avoiding liability under the UCC. Customer has withdrawn the full $1,000,000 in provisional funds given by Bank A when Customer deposited the checks and thus has a $1 million overdraft. Bank A demands that Customer cover the overdraft. Customer wires $1 million in non-kite funds to Bank A to cover the overdraft. (Or, in other cases, Bank A moves $1 million from a blocked account to satisfy the overdraft, or uses other similar deposits of good funds from a non-kite source to offset the overdraft). Customer then files for bankruptcy protection, and Trustee seeks to recover the $1 million wire transfer (or other deposits) as a preference.*

A substantial amount of divergent case law has emerged addressing the trustee's ability to recover from a bank in the kite using a preference theory in either of the examples above.[118] There are two points of focus: first, whether a settlement made for a kited check constitutes a "transfer of an interest of the debtor . . . for or on account of an antecedent debt"[119] and, second, even if such a transfer has taken place, whether that transfer enabled the creditor bank to receive more than it would have received had the transfer not been made.[120] Even assuming that the settlements given in the collection process do create a debt relationship, the second preference issue evaluates the banks' status as secured parties in kited checks.[121] If banks are considered secured parties, a payment in satisfaction of the secured debt would not, in many kiting cases, enable it to receive more than it otherwise would have received, and thus the payment cannot be attacked successfully as a preference under the Bankruptcy Code. Each issue will be addressed in turn.

---

balance left after a kite).

118. *See, e.g.*, *In re Vendsouth, Inc.*, 2003 WL 22399581 at *12 (finding genuine issue of material fact on preference claim); *Pereira*, 44 U.C.C. Rep. Serv. 2d 806 (S.D.N.Y. 2001); *In re Summit Fin. Serv.'s*, 240 B.R. 105.

119. 11 U.S.C. § 547(b)(2) (2006).

120. *Id.* § 547(b)(5)(B).

121. *See infra* text accompanying notes 133–43.

1. *Provisional Settlements and "Antecedent Debts"*

The first issue addresses whether the provisional settlement given by banks in the check collection process can be characterized as creating an "antecedent debt."[122] If the settlement does not create a debt, then further payments that satisfy that debt simply cannot be considered preferences.[123] Nearly all bankruptcy courts[124] agree that a bank's provisional settlement given to its customer will, at some point in the check collection process, create an antecedent debt, but courts differ as to the time at which the settlement transforms itself into an antecedent debt.

There are three possible times that this could occur. The first event in the bank collection process that arguably could lead to the creation of a debt in favor of the depositary bank is when the bank gives its customer a provisional settlement for the check. Because a debt would be created at the time a provisional settlement is made, it could be seen as a possible preferential transfer even for a bank to reverse a provisional settlement given where the bank did not receive final settlement. For example, in the case of *In re Spring Grove Livestock Exchange*,[125] a bank reversed $91 million in provisional settlements posted to the customer's account after a kite collapsed.[126] The Trustee claimed that this reversal was a preferential transfer.[127] However, the court found that mere routine

122. *See infra* text accompanying notes 124–32.

123. *See supra* text accompanying note 114. This is because if there is no "antecedent debt" for an account of which the transfer was made, there is no section 547(b) argument that the transfer was a preference.

124. *But see In re* Consol. Pioneer Mortgage Entities, 211 B.R. 704, 712–13 (Bankr. S.D. Cal. 1997) (suggesting that advances under a provisional settlement are "more like a transfer of ownership in the deposited checks and less like a loan"); *In re* Brown, 209 B.R. 874, 883 (Bankr. W.D. Tenn. 1997) ("The court is not persuaded that the proof before it establishes that debt was created upon the use of provisional credit in this case."); *In re* Frigitemp Corp., 34 B.R. 1000, 1015–16 (Bankr. S.D.N.Y. 1983) (suggesting that a provisional credit, even where applied to an existing overdraft, was simply too "provisional" to create a debt for bankruptcy purposes). If the advances do not qualify as antecedent debts, payments in satisfaction of those advances are not subject to a preference attack by the Trustee. The *Pioneer Mortgage* Court based its argument on the fact that when a check is deposited, the depositor is the owner of the check and the depositary bank is its agent. 211 B.R. at 711; *quoting* U.C.C. § 4-201 (2002) ("[T]he [collecting] bank, with respect to the item, is an agent or subagent of the owner of the item . . . even though credit given for the item is subject to immediate withdrawal as of right or is in fact withdrawn."). When a depositor makes withdrawals against a provisional settlement, the depositary bank acquires a security interest to the extent of the withdrawal under section 4-210. 211 B.R. at 711; *see also infra* text accompanying notes 135–37 (discussing UCC security interest). The transfer of a security interest could be viewed as a transfer of equitable ownership in the proceeds of the check, 211 B.R. at 713, rather than as collateral for a loan, *id.* at 712.

125. 205 B.R. 149 (Bankr. D. Minn. 1997).

126. *Id.* at 153.

127. *Id.* at 154.

advances against uncollected funds did not constitute antecedent debts for purposes of the Bankruptcy Code and, therefore, the reversal of those credits was not subject to avoidance by the Trustee.[128]

Although courts view the giving of the provisional credit alone to be insufficient to create a debt for purposes of preference law, the preponderance of courts find that such a debt is created when the settlement is given *and* the funds are withdrawn.[129] Courts adopting this view find that something that at least approximates a debtor-creditor relationship is established between the bank and its depositor at the time when the funds are withdrawn by the depositor. This is because, in the words of one court, "[w]hen a customer draws on a provisional credit, the customer becomes obligated to the bank to pay the amount advanced by the bank as a result of the use of the provisional credit."[130] Thus, under this approach, a debt is created and a possible preferential transfer conceivably could occur when the customer withdraws against a provisional settlement given for a check that remains still uncollected.

Courts are not unanimous, however, in finding that a debt relationship exists between the depositary bank and its depositor at the time of withdrawal. A depositary bank's actual right to charge back a settlement given at the time of deposit does not arise until a deposited check is returned unpaid by the payor bank.[131] Until a check is dishonored, therefore, no true debt in fact can exist because, unlike a normal creditor, the bank does not have the immediate right to collect the amount of the settlement from the customer prior to dishonor. For this reason, other courts find that an antecedent debt does not arise until the time a check is dishonored.[132]

In many respects, the debate in the courts over whether and when an "antecedent debt" for bankruptcy preference purposes exists can be inconsequential. This is because even if a debt exists, a depositary bank's status as a secured party may undermine a trustee's preference argument, as the next section discusses.

128. *Id.* at 155.

129. *In re* Vendsouth, Inc., No. 00-10112C-7G, 2003 WL 22399581, at *7 (Bankr. M.D.N.C. Oct. 10, 2003); *In re* Summit Fin. Servs., Inc., 240 B.R. 105, 114–15 (Bankr. N.D. Ga. 1999); *In re* Consol. Pioneer Mortgage Entities, 211 B.R. at 710; *In re* Spring Grove Livestock Exch., Inc., 205 B.R. 149, 155 (Bankr. D. Minn. 1997) (no debt exists until depositor withdraws against provisional settlement).

130. *In re* Vendsouth, Inc., 2003 WL 22399581, at *7.

131. *See* U.C.C. § 4-214(a) (2002) (a right of charge-back exists in cases of dishonor or where collecting bank "otherwise [fails] to receive settlement for the item which is or becomes final.").

132. *See, e.g.*, Laws v. United Mo. Bank of Kan. City, 98 F.3d 1047, 1051 (8th Cir. 1996) (explaining routine advances do not create debt until deposited check is dishonored); Pereira v. Summit Bank, 44 U.C.C. Rep. Serv. 2d 806, 824 (S.D.N.Y. 2001).

2. Banks' Statuses as Secured Parties

Even if an antecedent debt is found in a particular kiting case, many bankruptcy courts hold that the depositary bank's status as a secured party is sufficient to insulate the bank from possible preference liability for transfers received on account of that debt.[133] Under the Bankruptcy Code, in order to qualify as a preference, the transfer must "[enable a] creditor to receive more than such creditor would receive if . . . the transfer had not been made."[134] If the bank involved was in fact a secured creditor, the satisfaction of that secured debt in the usual case would not benefit the creditor because the creditor was entitled in the first instance to the property received. Thus, no preferential transfer can occur.

Article 4 of the UCC establishes a collecting bank's security interest, and thus its secured party position:

> (a) A collecting bank has a security interest in an item and any accompanying documents or the proceeds of either:
>
> (1) in case of an item deposited in an account, to the extent to which credit given for the item has been withdrawn or applied;
>
> (2) in case of an item for which it has given credit available for withdrawal as of right, to the extent of the credit given, whether or not the credit is drawn upon or there is a right of charge-back; or
>
> (3) if it makes an advance on or against the item.[135]

The policy behind the Article 4 security interest is to facilitate the granting of provisional settlements by providing banks some assurance that they will be in a preferred position during the course of collection.[136] The UCC security interest is self-perfecting; in other

133. *See, e.g.*, *Pereira*, 44 U.C.C. Rep. Serv. 2d at 825 (explaining that the bank was fully secured for uncollected provisional exposure under Article 4); *In re Consol. Pioneer*, 211 B.R. 704, 714 (holding the bank's UCC security interest precluded use of preference or fraudulent conveyance theory to avoid payments in a check kite); *In re Summit Fin.*, 240 B.R. 105, 122; *In re* Brown, 209 B.R. 874, 885–87 (Bankr. W.D. Tenn. 1997) (holding bank's secured party status eliminated possible preference argument by trustee).

134. 11 U.S.C. § 547(b)(5)(B) (2006); *see supra* text accompanying note 114.

135. U.C.C. § 4-210(a) (2002).

136. "If a collecting bank has made an advance on an item which is still outstanding, its right to obtain reimbursement for this advance should be superior to the rights of the owner to the proceeds or to the rights of a creditor of the owner." *Id.* § 4-201 cmt. 5; *see also In re Consol. Pioneer*, 211 B.R. at 715 n.13 ("The purpose of the security interest is to grant some limited protection to the bank when the bank provides a service to its customer that it is not required to provide."). Trustees' arguments that a kited check is a worthless check, and thus that the bank's security interest is of no value have been rejected. *In re Summit Fin.*, 240 B.R. at 116. The security interest constitutes

words, a bank needs to do nothing additional in order to establish or perfect its rights.[137]

Two points with respect to the UCC security interest illuminate its limitations when evaluating whether a transfer constitutes a preference under Bankruptcy Code section 547(b). First, the security interest extends to, but only to, the "item and any accompanying documents or the proceeds of either."[138] Although the bank is a secured party, the bank's security interest under Article 4 is not a far-ranging or blanket security interest in all of the debtor's assets and property, but rather one in the check and its proceeds only. Second, the security interest does not arise when a credit is entered, but rather when a credit is entered by the depositary bank in its depositor's account *and* that credit is withdrawn or applied, is available as of right,[139] or when the bank makes advances against the deposited check.[140] In the usual check collection case, receipt by the bank of final settlement is a realization on the security interest, and if final settlement is not received, the security interest continues to the extent it was initially granted.[141]

The extent of the term "proceeds" covered by the UCC security interest therefore is of great importance in determining whether a preference exists. On the one hand, the term conceivably could be

giving "value" for the purpose of establishing a holder's holder in due course status. *See* U.C.C. §§ 4-211, 3-303(a)(2); *see also id.* § 3-302(a) (requirements for establishing holder-in-due-course status). In the case of enforcing dishonored instruments, holders in due course are not subject to a wide array of defenses to payment. *Id.* § 3-305(b) (rights of a holder in due course). However, that is not of paramount importance in the check-kiting area—the writer of the check most likely has no assets to pay, irrespective of any defenses.

137. U.C.C. § 4-210(c); *see also In re Brown*, 209 B.R. at 887 (rejecting a trustee's argument that banks' U.C.C. § 4-210 security interest was unperfected due to lack of filing). Subsection (c) of UCC § 4-210 provides that, with respect to the security interest established under the section:

> (1) no security agreement is necessary to make the security interest enforceable (section 9-203(1)(a));
>
> (2) no filing is required to perfect the security interest; and
>
> (3) the security interest has priority over conflicting perfected security interests in the item, accompanying documents, or proceeds.

U.C.C. § 4-210(c)(1)–(3).

138. U.C.C. § 4-210(a); *see supra* text accompanying note 135.

139. A credit given by a depositary bank becomes "available as of right" in the usual case when final settlement has occurred and when the bank has had a reasonable time to receive return of the check and the check has not been received. U.C.C. § 4-215(e)(1). This is subject to funds-availability rules under the EFAA and Regulation CC, discussed *supra* notes 89–96 and accompanying text. *See also* § 4-215(e)(i). The EFAA funds availability schedule therefore often will dictate "availability as of right" under the UCC, and the bank's security interest will arise at that time. *See id.* cmt. 11 ("With respect to checks Regulation CC Sections 229.10–229.13 or similar applicable state law Ssection 229.20) control.").

140. *Id.* § 4-210(a)(1)–(3).

141. *Id.* § 4-210(c).

read broadly to include any funds transferred into the account.[142] On the other, the term could be seen as a much more narrow term, referring only to the funds or other property directly collected or exchanged for the deposited check.[143] If the term is read in its former, broader sense, nearly all deposits into a kiting customer's account would constitute proceeds and therefore would be subject to the bank's security interest. If "proceeds" is read in the latter, narrower sense, a more limited number of types of payments received by a depositary bank could be considered proceeds of the deposited and dishonored check.

3. Applying Preference Theory in Kiting Cases

The Sixth Circuit's decision in *In re Montgomery*[144] is a prominent one in which the court found that transfers to a bank in a check kite constituted voidable preferences. In *Montgomery*, the bank's customer was involved in kiting checks in accounts at Third National Bank in Nashville, Tennessee, and in other checking accounts at other banks.[145] Although Third National suspected that its customer was kiting checks in November 1987, it was not until April of 1988 that Third National decided to terminate the cash management arrangement.[146] At that point, there was a substantial

142. *See In re* Cannon, 237 F.3d 716, 720–21 (6th Cir. 2001); *In re* Sophisticated Commc'ns, Inc., 369 B.R. 689, 697–98 (Bankr. S.D. Fla. 2007).

143. Gen. Motors Acceptance Corp. v. Union Bank & Trust Co., 329 F.3d 594, 599 (8th Cir. 2003); *In re* Stiennon, 73 B.R. 905, 908 (Bankr. W.D. Wis. 1987); *see also* Schwab v. Walden Savs. Bank, 441 N.Y.S.2d 195, 197 (Sup. Ct. 1981) (explaining that funds from provisional settlement given for a dishonored check which was paid to a third party were "proceeds" of the deposited and dishonored check).

144. 983 F.2d 1389, 1392 (6th Cir. 1993).

145. *Id.* at 1390–91. The bankrupt debtor maintained two accounts at Third National: a "Main Funding Account" and a "Zero Balance Account." *Id* at 1390. The Funding Account received all of the debtor's receipts and deposits, while the Zero Balance Account was the customer's checking account, funded daily by the Main Funding Account to cover checks paid by the bank the day before. *Id.* Each account had a persistent negative collected funds balance over the course of the kite, and the debtor had immediate access through his computer to his balance at any time, thus allowing the customer to monitor the kite's progress. *Id.* A $500,000 line of credit backed the overdraft liability in the Main Funding Account, but this line was nearly immediately exhausted to pay overdrafts after the system was implemented. *Id.* Such cash management arrangements are common services provided to accommodate businesses' payments and cash flow needs. However, by providing a precise figure on the customer's overdraft liability at any particular point, the customer was able to precisely ascertain "how much and where to fuel the kite to keep it floating." *Id.* at 1391 (quoting *In re* Montgomery, 123 B.R. 801, 806 (Bankr. M.D. Tenn. 1991)).

146. *Id.* at 1390–91. Prior to shutting down the accounts, Third National met several times with the debtor in the interim to attempt to have the debtor reduce his negative balances in the Third National accounts. *Id.* at 1391.

overdraft of around two million dollars.[147] The debtor ceased moving money out of the accounts at that point, but deposits continued to flow *into* the accounts.[148] These deposits were used to offset the debtor's overdraft liability to Third National. Some of these deposits represented legitimate business receipts, while other deposits were kited checks drawn on other banks.[149] In other words, after Third National withdrew from the kite, its customer simply moved the kite over to other banks, and payments from those checks were used to offset the customer's overdraft liability to Third National. By the time involuntary petitions in bankruptcy were filed against the debtor on June 3, 1988, Third National had completely erased the debtor's overdraft liability with the infusion of these funds.[150]

The Trustee sought to recover, as preferential transfers, the nearly two million dollars in deposits that were used to offset Third National's overdraft exposure after it withdrew from the kite.[151] The Bankruptcy Court agreed with the Trustee, holding that the overdraft due to check kiting constituted an "antecedent debt" for preference purposes.[152] Without addressing the question of the bank's status as a secured party, the Bankruptcy Court found that the transfers therefore constituted preferences,[153] and the Sixth Circuit ultimately affirmed the Bankruptcy Court's determination on the issue of First Tennessee's preference liability.[154]

Montgomery provides, at least superficially, strong support for the position that transfers to a bank to cover the overdraft liability remaining in the aftermath of the collapse of the kite can be voided as preferential transfers. The *Montgomery* approach, however, has not been well-received universally. Some courts have attempted to distinguish *Montgomery* because the bank in *Montgomery* had

147. *Id.* at 1391. In March 1988, the debtor had a total overdraft of $1,971,978.75, combined from all accounts at Third National. *Id.* at 1391–92.

148. *Id* at 1391.

149. *Id.* at 1389–90.

150. *Id.* at 1391 ("Deposits continued to be made in the Main Funding Account until May 3, 1988; it appears that funds commingled in that account were used to clear up the arrearages in all of the Third National accounts.").

151. *Id.*

152. *In re* Montgomery, 123 B.R. at 807–11. Although the court's discussion is somewhat unclear, it appears to have found that a debt was created at the time the kiting depositor used a provisional settlement made in its account. *Id.* at 811.

153. *Id.* at 816–17. The court determined that First Tennessee improved its position to the amount of $2,012,418 in cash infusions to cover the overdraft in the preference period. *Id.* at 817. The Bankruptcy Court also rejected First Tennessee's claim that the transfers to reduce the overdraft were in the ordinary course of business and thus excluded from a possible preference attack. *Id.* at 813–17; *see* 11 U.S.C. § 547(c)(2) (2006) (ordinary course of business defense to preference claim).

154. *In re Montgomery*, 983 F.2d at 1392.

knowledge of the kiting scheme,[155] while other courts simply take positions directly contrary to that expressed in *Montgomery*. The Eighth Circuit's opinion in *Laws v. United Missouri Bank of Kansas City* represents an opposing position on the matter from that expressed in *Montgomery.*[156] In *Laws*, a customer of United Missouri Bank ("UMB") was kiting checks among several banks. Late in the kite, as the customer neared insolvency, UMB decided not to allow advances from uncollected deposits.[157] The customer wired four million dollars—partial proceeds of a loan from another bank—to its account to eliminate the uncollected funds balance at UMB.[158] Such an action is similar to that taken by the customer in *Montgomery*, where the bank withdrew from the kite and used subsequent deposits to satisfy the customer's overdraft liability.[159] After the customer filed for bankruptcy protection, as in *Montgomery*, the Trustee sought to avoid this transfer as a preference.[160]

The Eighth Circuit affirmed the trial court's decision in favor of UMB and against the Trustee.[161] The court ruled that "routine advances" against provisional settlements do not create an antecedent debt for purposes of the Bankruptcy Code, adopting, in effect, the "time of dishonor rule" for the creation of a debtor-creditor relationship between bank and customer.[162] First, the court observed that, until dishonor, it was an open question as to whether

155. *E.g.*, *In re* Cannon, 237 F.3d 716, 720 (6th Cir. 2001) ("Thus, while *Montgomery* provides guidance for situations where the depository or collecting bank acts with knowledge of the kiting scheme, it does not control situations such as the case at bar where the bank acts in the ordinary course of business, without knowledge of questionable banking practices by its account holder."); *In re* Brown, 209 B.R. 874, 884–85 (Bankr. W.D. Tenn. 1997) (noting that, unlike *Montgomery*, "[t]he two banks were not participants in any shifting of the kiting from them to another bank" and suggesting that *Montgomery* should be authority where a bank "knowingly benefits from a kiting scheme").

156. Laws v. Mo. Bank of Kan. City, 98 F.3d 1047, 1051 n.4 (8th Cir. 1996). The court in *Laws* noted that, while it disagreed with the broad language in the *Montgomery* opinions, it agreed that the transfers in that case were to satisfy antecedent debts for preference purposes because the line of credit in *Montgomery* was sufficient to establish a debtor-creditor relationship between the depositor and the bank. *Id.*

157. *Id.* at 1049.

158. *Id.* The Trustee argued unsuccessfully at the trial court level that the earmarking doctrine precluded any possible preference argument regarding the four-million-dollar transfer. Laws v. United Mo. Bank of Kan. City, 188 B.R. 263, 267 (W.D. Mo. 1995). The trial court rejected this argument because UMB did not allege that the disclosed purpose of the loan was to pay off the debt to UMB, a requirement of the earmarking doctrine. *Id.*

159. *See supra* notes 148–50 and accompanying text.

160. *Laws*, 98 F.3d at 1048.

161. *Id.* at 1052.

162. *Id.* at 1051.

a bank had the right to recover uncollected deposits, and therefore the existence of a true "debt relationship" was open to question.[163] The court also observed that banks usually do not consider these advances as loans.[164] Finally, the court was concerned whether a contrary ruling would place the Bankruptcy Code at odds with the EFAA and the UCC, and those regulations' policies that encourage quick funds availability.[165]

Although the *Laws* court rejected the notion that a debt relationship existed in the usual case of advances against provisional settlements, the court did suggest that *non-routine* advances might be sufficient to create a debt.[166] UMB's increasing concern over the negative balances in the customer's account, and evidence that the Bank at some stage of the kite realized that it was in effect making a loan to its customer,[167] might have been sufficient to establish an implied loan agreement.[168] Regardless, however, the court found that UMB had a security interest in the kited checks and their proceeds under the UCC,[169] and that the four-million-dollar transfer did not improve UMB's position.[170] The court thus ruled against the Trustee.[171]

The case of *In re Summit Financial Services, Inc.*[172] attempts to resolve the seeming conflict, identified in *Laws*, between the policy of quick availability of deposited funds and the Bankruptcy Code. In *Summit*, the debtors were customers of the Bank of Newnan and First Citizens Bank and were kiting checks between the banks through a number of accounts.[173] On April 4, 1997, First Citizens discovered the kite and notified Newnan of that fact.[174] The kite immediately collapsed, and First Citizens dishonored checks drawn on it that had been deposited at Newnan and then presented for

163. *Id.* ("[T]here are no prior cases determining whether a bank has a legal right to recover advances on uncollected deposits *before those deposits are dishonored*.").

164. *Id.*

165. *Id.* Given the court's later determination that advances that did constitute debts would not be preferences because of the bank's UCC security interest, *see infra* notes 169–70 and accompanying text, the court's concern over hindering easy availability of funds is perhaps overstated.

166. *Laws*, 98 F.3d at 1051–52.

167. UMB's own documents described the negative balance in the customer's account as an "interest free loan" and there was testimony from a UMB officer that the bank had, in effect, made an unauthorized loan to its customers by permitting negative collective funds balances. *Id.* at 1051.

168. *Id.* at 1052.

169. The UCC security interest is discussed s*upra* notes 135–41 and accompanying text.

170. *Laws*, 98 F.3d at 1052.

171. *Id.*

172. 240 B.R. 105 (Bankr. N.D. Ga. 1999).

173. *Id.* at 108–09.

174. *Id.* at 110.

payment to First Citizens.[175] The debtors' accounts at First Citizens had a negative collected funds balance of over one million dollars.[176] Newnan Bank, on the other hand, honored all checks presented for payment prior to its discovery of the kite.[177] Three legitimate[178] deposits were made into the Newnan Bank accounts in the period right before the kite collapsed: a $90,963.69 wire transfer, a $99,000 certified check, and a $1500 check.[179] After it discovered the kite, Newnan set off the amounts reflected by these deposits against its negative balance related to the kite of $71,440.15.[180] Having made itself whole, Newnan then transferred the remainder of the collected funds to First Citizens.[181] First Citizens, holding a significant overdraft, filed involuntary Chapter 7 bankruptcy petitions against the debtors on June 4, 2007.[182] The Chapter 7 Trustee sought to recover "at least $847,665" in preferential transfers received by Newnan Bank prior to the discovery and collapse of the kite and another $611,356 received by Newnan after the kite collapsed.[183] Although the case is unclear on the matter, it appears that these transfers included the final settlements received by Newnan prior to the discovery of the kite[184] and the wire transfer, cashier's check, and third-party check deposits made at Newnan Bank.[185]

The *Summit* court first found that, when Newnan Bank made

175. *Id.*

176. *Id.*

177. *Id.*

178. That is, deposits which were unrelated to the kite and which represented "good funds."

179. *Id.* at 110. The funds reflected in the wire transfer were immediately available by right, because, upon acceptance of a payment order by a beneficiary bank, the bank has the right to receive payment of that order, and is obliged to pay the beneficiary. *See* U.C.C. § 4A-402(b) ("With respect to a payment order issued to the beneficiary's bank, acceptance of the order by the bank obliges the sender to pay the bank the amount of the order."); § 4A-404(a) ("[I]f a beneficiary's bank accepts a payment order, the bank is obliged to pay the amount of the order to the beneficiary of the order."). The issuer of a cashier's check is contractually obligated to pay the amount of the instrument. *Id.* § 3-412. Thus the funds deposited by cashier's check were backed by the contractual liability of the bank that issued the check. The third-party check deposit did not appear to be involved in the kite, *see In re Summit Fin.,* 240 B.R. at 110, and thus likely would be honored by the payor bank.

180. *In re Summit*, 240 B.R. at 110. The deposits were made in one account, but used to zero out, through setoff, the negative balance in another account maintained by the debtors at Newnan Bank. *Id.*

181. *Id.*

182. *Id.* at 108.

183. *Id.* at 111, 120.

184. *Id.* at 111. In other words, checks paid by First Citizens which had been deposited at Newnan Bank.

185. *Id.* at 120. The court observed that it was unclear how the Trustee arrived at the $611,356 figure. *Id.* At the minimum, however, the figure appeared to include the funds deposited in the accounts at Newnan, which were used to offset the negative balance after the kite collapsed. *Id.*

provisional settlements for deposited checks, an antecedent debt for preference purposes was created at the point the debtors withdrew funds provisionally credited.[186] However, the court found that the payments made by First Citizens were not preferences because Newnan Bank, the beneficiary of the payments, was a secured party under Article 4, and thus the payments were not subject to preference attack "because there was no depletion of estate assets."[187] The court made no decision as to the status of the funds deposited and set off by Newnan as preferences.[188] Thus, consistent

186. *In re Summit*, 240 B.R. at 114–15. The court's line of reasoning was roughly as follows: A "debt" is defined under the Bankruptcy Code as "liability on a claim." *Id.* at 114; 11 U.S.C. § 101(12) (2006). A claim is defined as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(5)(A). Under Articles 3 and 4 of the UCC, the normal agent-principal relationship between depositary bank and depositor is transformed into a debtor-creditor relationship when the depositor withdraws against a provisional credit given for a deposited item. *In re Summit,* 240 B.R. at 114. And, under the UCC, the withdrawal gave the Bank the right to enforce the instrument for that amount should the deposited check be dishonored. *Id.* at 114–15. The depository bank therefore had a "claim" against the depositor, and the withdrawn provisional settlement was a "debt" for purposes of the Bankruptcy Code. *Id.* at 115.

187. *Id.* at 115–19.

188. *Id.* at 120. A host of other claims by the Trustee followed the preference argument. The Trustee argued that Newnan's setoff to reduce the debtors' negative bank balance was recoverable under section 553(b) of the Bankruptcy Code, *see id.* at 121–22, which provides as follows:

> (1) Except with respect to a setoff of a kind described in section 362(b)(6), 362(b)(7), 362(b)(14), 365(h), or 365(i)(2) of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of—
>
> (A) 90 days before the date of the filing of the petition; and
>
> (B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.

11 U.S.C. § 553(b) (1996). The court rejected this argument given that Newnan was a secured creditor during the kite due to its Article 4 security interest. 240 B.R. at 121. As a secured creditor, there was no "insufficiency" necessary for section 553(b) to apply. *Id.* "Insufficiency" for purposes of section 553(b) is defined as the "amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim." 11 U.S.C. § 553(b)(2). Finally, the court rejected the Trustee's argument that the Bankruptcy Court should use its equitable powers under the Bankruptcy Code to reallocate the losses between First Citizens and Newnan. 240 B.R. at 122–23. In the court's view, such a use of the court's equity powers would contradict its earlier decision that the payments to Newnan were not preferences. *Id.* at 123 ("It would be an abuse of discretion to use section 105 as a substantive recovery device when recovery has been denied under other provisions of the Bankruptcy Code."). Nor was there any evidence that Newnan Bank acted in bad faith or otherwise engaged in misconduct that might support use of the court's equitable powers. *Id.*

with the UCC approach, the Bankruptcy Court let the losses lie where they were when the kite collapsed.

When, as in *Summit*, the depositary bank receives deposits from a non-kite source to cover overdraft liability in a kite, it is not entirely clear that the bank's UCC security interest in the kited checks deposited earlier should be a sufficient basis to avoid preference liability.[189] Yet, this was also the result in the Sixth Circuit's decision in *In re Cannon.*[190] In *Cannon*, the depositor, William Cannon, was kiting checks among three different banks: First Tennessee Bank, United American Bank, and Hibernia Bank.[191] The month or so before the kite collapsed, Cannon deposited $163,350 in checks drawn on Hibernia Bank at First Tennessee. Hibernia returned the checks for insufficient funds, and after First Tennessee represented the checks,[192] Hibernia dishonored the checks again.[193] Although First Tennessee exercised its UCC charge-back rights upon dishonor by Hibernia, Cannon's account had insufficient funds because Cannon had withdrawn funds against the provisional settlements for the deposited checks.[194] Cannon deposited two third-party checks in a total amount of $163,350 to cover the negative balance.[195] The kite collapsed several weeks later, Cannon was forced into bankruptcy, and the Trustee sought to avoid the $163,350 in transfers by Cannon as preferential transfers.[196]

The Bankruptcy Court sided with the Trustee, finding that the provisional credit extended by First Tennessee to Cannon created an antecedent debt for purposes of the preference provision, and that because the provisional credit was unsecured, the transfers were avoidable by the Trustee as preferences.[197] The Sixth Circuit reversed, finding that Article 4 of the UCC gave First Tennessee a valid security interest in the kited checks, which "arose by operation of law, and remained in effect until it was satisfied by Cannon's deposit."[198] The Trustee argued that, since the deposits were money from sources apart from the kite, First Tennessee's security interest

189. *See infra* text accompanying notes 224–27.
190. 237 F.3d 716 (6th Cir. 2001).
191. *Id.* at 717.
192. As a matter of banking practice, checks often are represented for payment after the first dishonor, since the vast majority of returned checks are paid on the second presentment. *See id.* (noting that ninety percent of checks clear on the second attempt at presentment).
193. *Id.*
194. *Id.* at 717–18.
195. *Id.* at 718 & n.3.
196. *Id.* at 718. The transfers occurred within ninety days prior to the filing of the bankruptcy petition, thus making them subject to a possible preference attack. *See supra* text accompanying notes 114–15.
197. *In re Cannon*, 237 F.3d at 718.
198. *Id.* at 720. The "deposit" was the $163,350 in third-party checks that the Trustee sought to avoid on a preference theory.

in the dishonored deposited checks did not extend "to reach the funds which originated elsewhere."[199] The court rejected this argument—the focus was on whether First Tennessee was a secured creditor and not on the source of the funds that made First Tennessee whole.[200]

Logic and policy propelled the *Cannon* court to focus on First Tennessee's status as a secured creditor generally, rather than as a secured creditor in kited checks and their proceeds. First, the Trustee acknowledged that had Cannon deposited the checks into his account at Hibernia, First Tennessee would have a right to the funds represented by the deposited checks.[201] Basing the occurrence of a preference simply upon which bank the funds were deposited with was, to the court, counterintuitive.[202] Moreover, the court suggested that a contrary conclusion supporting the Trustee's preference theory could "wreck Article 4's system of conditional credits."[203] By creating a rule that hinged preference liability on the source of the funds, conditional credits would be unsecured and effectively circumvent the UCC and Regulation CC system that operate under the assumption that these credits are routinely granted.

Montgomery, *Laws*, *Summit*, and *Cannon* demonstrate the significantly different perspectives in the courts on whether payments in the check-collection process should be viewed as preferences. *Montgomery* is one of a scant few cases that reaches the point of invalidating payments as preferences,[204] and yet the remaining cases use different, and sometimes conflicting, routes to arrive at the point of rejecting trustees' preference arguments. As just discussed with regard to *Cannon,* some of these cases base their decision to reject the preference argument, in part, on a desire to avoid a perceived conflict between the UCC, the EFAA, and the

199. *Id.* at 721.

200. *Id.* The court's rationale in full was as follows:

> Whether or not the Debtor satisfied the security interest by depositing the funds directly into his First Tennessee accounts, or indirectly by depositing the funds into the Hibernia account, either transaction serves to "satisfy" First Tennessee's security interest. Once Cannon entered bankruptcy, First Tennessee would be entitled to obtain the funds as a secured creditor, regardless of their location, up to the value of the checks. The focus is on whether or not First Tennessee would be a secured creditor in bankruptcy; under Article 4, it obviously would.

Id.

201. *Id.* The Trustee apparently conceded this point at argument. Presumably the Trustee meant to refer to a situation where the dishonored checks were hypothetically honored due to the deposits. If the checks had been dishonored and the money was deposited after that fact, it is hard to see how those deposits are "proceeds" of the checks.

202. *Id*.

203. *Id.*

204. *See supra* text accompanying notes 144–55.

Bankruptcy Code.[205] Yet, these courts fail to explain exactly what the conflict between the statutes in fact is and why the conflict might merit rejecting preference arguments entirely in the case of check kiting.

In sum, the three liability regimes for allocating losses after check kiting that have been discussed in this Part potentially conflict with each other, and significant disagreement exists among bankruptcy courts as to the role that preference theory should play in kites. The next Part of the Article advances an approach to voiding payments in check kiting as preferences that balances the UCC and EFAA concerns with bankruptcy policy. As will be argued, preference theory can—and should—play a small role in voiding certain types of payments made to banks in the course of a kite, consistent with the underlying policies of all three statutes.

III. HARMONIZING THE APPROACHES

As discussed in Part II, courts can apply different legal regimes to allocate the losses after a kite. Under the UCC, the approach allows the losses to stand where they were at the point at which the kite ended, after application of the UCC's final payment standards.[206] At a basic level, the UCC ruthlessly rewards the bank that manages to extricate itself from a kite first and, moreover, is neutral on the practice of kiting through its refusal to reallocate the losses in most cases after final payment.[207] By contrast, the EFAA arguably can be read as facilitating kiting by requiring that customers have access to their funds prior to final payment of the check, a necessary condition for kiting to occur.[208] Regulation CC also adds additional theories of liability that may be employed to reallocate kiting losses in a manner not contemplated by the UCC.[209] Finally, the Bankruptcy Code provides yet another loss allocation vehicle through preference law.[210] The three legislative schemes, as interpreted by the courts, advance different—and sometimes potentially conflicting—theories and standards for allocating losses after a kite.

A useful starting point for resolving these disparate standards is the UCC, which is the primary source of regulation for the check collection process. The UCC's approach, which simply allows the losses to stand after rigid application of the midnight deadline rule, provides a relatively bright-line standard, one that has much to commend for itself: such a standard reduces litigation and, arguably, provides banks powerful incentives to adopt procedures

205. *See* cases cited *supra* note 10.
206. *See supra* text accompanying notes 38–86.
207. *See supra* text accompanying note 86.
208. *See supra* text accompanying notes 87–96.
209. *See supra* text accompanying notes 97–110.
210. *See supra* text accompanying notes 111–204.

that prevent and detect kiting operations. The lack of a UCC remedy in the aftermath of a kite, in other words, encourages financial institutions to reduce their possible exposure to kiting losses to the greatest extent possible. This is because such losses could likely be borne by that institution, and the losses will be unable to be shifted onto other parties after the kite collapses. Although the UCC has been criticized for failing to provide a comprehensive remedial scheme for check kiting that would expand available remedies to apportion losses on a pro-rata basis,[211] the current approach is a sound one. Even if proportional loss sharing might arguably provide greater incentives to discover and report kites,[212] the added costs of implementing such a scheme through legislation and the cumbersome process of judicial decision-making undermine any utilities that might be obtained by expanding the available UCC remedies. For example, a vague standard of a "duty to report a kite" is highly uncertain in application, and most likely would generate inconsistent results in the courts. A similar attempt in the UCC to implement proportional loss sharing in the area of check forgery has proven to be highly ineffective in the courts.[213] It is unlikely that such a scheme could be any more effective if adapted to the practice of kiting. For these reasons, the UCC's approach to kiting as currently conservatively interpreted by the courts, one that lets the losses simply stand where they were at the collapse of the kite after the application of the midnight deadline rule, is an effective method to minimize additional costs and protracted litigation in the aftermath of a kite.

Simply by adding alternative theories to reallocate the losses from the result otherwise obtained under the UCC, the EFAA and the Bankruptcy Code reduce the efficiencies obtained under the state-law regime. These added costs are difficult to justify unless they are outweighed by other benefits or are necessary to advance other, non-UCC goals. Consider first the FRB's extension of the midnight deadline in kiting cases,[214] which has increased the theories available in litigation surrounding kites. The extension of the midnight deadline has been stated to be based on a desire to emphasize the time of receipt of a dishonored check by the depositary bank—the focus of Regulation CC funds availability policies—rather than the time a payor bank sends the dishonored check.[215] It is questionable, though, whether the expense generated by the strategic use of the federal extension of the deadline in kiting

211. Lucie, *supra* note 86, at 729 (claiming that inconsistencies in judicial approaches toward kiting under the pre-revision UCC occurred "because the UCC does not provide remedies for check kiting activities").

212. *Id.* at 740–46.

213. *See generally* A. Brooke Overby, *Check Fraud in the Courts After the Revisions to U.C.C. Articles 3 and 4*, 57 ALA. L. REV. 351 (2005).

214. *See supra* text accompanying notes 104–10.

215. 1 CLARK & CLARK, *supra* note 86, at ¶ 8.01, at 8–6.

cases is justified by any intangible incentives the extension gives for institutions to expeditiously return items.

Nor does the extension, when applied to kiting, significantly advance the underlying goals of the federal policy ensuring timely availability of funds. In the usual case, the banks involved in a kite have been allowing their customers nearly immediate access to uncollected funds, far earlier than otherwise required under federal law. The situation in kiting is not one of allowing too stringent access to funds, but rather far too liberal access. Allowing one bank the ability to shift kiting losses onto another by claiming an extension of the midnight deadline because the returned check was received by the depositary bank somewhat earlier than perhaps could have been expected simply overlooks the fact that kiting involves banks that choose not to protect themselves from the practice by limiting access to funds. Privileging one bank simply because it used a highly expeditious means of transportation for return does not, in most kiting cases, merit the added litigation increasingly occurring under the federal midnight deadline extension in those cases.

Because Regulation CC, including the midnight deadline extension, supersedes any inconsistent provisions of the UCC,[216] any reexamination of the extension will have to come after an evaluation by the Federal Reserve,[217] rather than through judicial or state legislative processes. Several options are available to limit the application of the extension in kiting cases. For example, the FRB could begin to emphasize that a bank's motive in returning an item late is relevant in determining when the extension applies. Alternatively, a causal standard for damages when a highly expeditious means of transportation is used for return could be established, similar to the general standard for damages due to a breach of Regulation CC.[218] Such a causal standard for liability would substitute for the strict liability standard that is functionally the result of the current blanket extension of the midnight deadline.

The conflict between the UCC and the preference section of the Bankruptcy Code also has generated expensive litigation leading to inconsistent results. In these types of cases, the UCC's efficient and litigation-reducing liability regime must be balanced with the Bankruptcy Code and preference law's principle of equal treatment of all creditors of the debtor and the desire to minimize strategic maneuvering by a creditor immediately prior to a bankruptcy filing.[219] Viewed through this lens, section 547 of the Bankruptcy

216. 12 C.F.R. § 229.41 (2006).

217. Insufficient information exists on the use of the extension in non-kiting cases, where the extension conceivably could have benefits that outweigh the costs of the extension's strategic manipulation in kiting cases.

218. 12 C.F.R. § 229.38; *see supra* note 101 and accompanying text.

219. *See supra* text accompanying note 11.

Code should be interpreted narrowly to allow possible recovery of payments to a bank caught up in a kite in a very limited number of cases.

First, consistent with the majority of courts that have addressed the matter,[220] a debt is created in the bank-depositor relationship after a deposit is made, a provisional credit has been made, and that credit has been withdrawn or applied in some manner. As some courts have noted, when these events occur the relationship between bank and depositor bears many of the attributes of that between creditor and debtor.[221] In addition, after giving the provisional settlement, a depositary bank has the right under the UCC to charge back the settlement given in the event of dishonor.[222] Until withdrawal by the customer, such a charge-back results in only the reversal of a bookkeeping entry. However, upon withdrawal of the credit prior to final settlement, a bank's charging back of a settlement results in the bank's being able to recover the funds withdrawn by the depositor, similar to the rights of a creditor in a traditional debtor-creditor relationship. The fact that the UCC gives the bank a security interest upon withdrawal or application of a settlement[223] is another indication that a debtor-creditor relation is assumed at the time of withdrawal, because creditors uniquely stand as possible holders of security interests in the debtor's property. Thus, an antecedent debt is created at the time a bank's kiting customer withdraws against a settlement of uncollected funds.

Whether—and when—a "debt" exists for preference purposes is far less important than resolving whether funds received through final payment of a deposited check, or through additional deposits used to satisfy a depositor's overdraft liability, should be subject to a possible preference attack. The two situations, in effect Examples 1 and 2 from the discussion earlier in this Article,[224] merit different treatment under the Bankruptcy Code. If final payment has occurred, the depositary bank should be viewed as entitled to the funds finally paid, irrespective of any preference claim by the debtor/customer's trustee. This result is mandated by a proper interpretation of the section of the UCC that gives a depositary bank a security interest in the check.[225] The funds rightly due to the depositary bank under the UCC after final payment are clearly "proceeds" of the deposited check[226] and are subject to the depositary

220. *See supra* text accompanying notes 129–30.
221. *See supra* text accompanying note 130.
222. U.C.C. § 4-214 (2002).
223. *See supra* text accompanying notes 135–37.
224. *See supra* text accompanying note 118.
225. *See supra* text accompanying note 135.
226. For a discussion of the term "proceeds" see *supra* text accompanying notes 142–143. "Proceeds" is defined under U.C.C. § 9-102(a)(64) (2002) and includes:

bank's security interest under the UCC. Indeed, the bank's security interest is satisfied through receipt of the final settlement under the terms of the UCC.[227]

Section 547 of the Bankruptcy Code therefore should not be interpreted as allowing recovery from a depositary bank of any funds received through final settlement from a payor bank. Although a "debt" exists (due to the funds withdrawn by the customer), the bank's security interest in the check and "any of the proceeds thereof"[228] rebuts the argument that a preferential transfer has occurred when interbank settlements are made in the check collection process. Through its express grant of a security interest in the check and its proceeds, the UCC clearly intends to subordinate the bankruptcy policy of equal treatment of all creditors to the need for a quick, secure, and efficient check collection process.

Funds from an outside, non-kite source that are deposited with the depositary bank to cover overdrafts stand on a different footing from settlements made among the banks involved in the collection process. Such funds, in the usual case, are not "proceeds" of the deposited check.[229] They are, rather, simply debtor assets being deployed by the debtor toward paying off an existing debt of the customer—a classic preference situation in which the assets of the bankrupt estate are depleted for the benefit of one creditor. Because non-kite funds ought not to be construed as being proceeds of the deposited check, such funds are not covered by the depositary bank's security interest under Article 4 of the UCC. Subject to other bankruptcy arguments that might justify a bank in having priority to such non-kite funds,[230] and subject to the bank's security interest, if any, in any new deposited items,[231] deposits of non-kite assets by the debtor to reduce a debtor's overdraft liability to its bank in the aftermath of a kite therefore should be subject to possible avoidance

> (A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;
> (B) whatever is collected on, or distributed on account of, collateral;
> ....

U.C.C. § 9-102(a)(64) (2002).

227. U.C.C. § 4-210(c) (2002) ("Receipt by a collecting bank of a final settlement for an item is a realization on its security interest in the item, accompanying documents, and proceeds.").

228. *See id.* § 4-210(a), quoted *supra* text accompanying note 135.

229. *See supra* note 226.

230. *See supra* note 112.

231. If, for example, a kiter deposits a check for $100,000 to satisfy an overdraft at Depositary Bank of the same amount, Depositary Bank will have a security interest in that new, deposited check, when it applies it against the overdraft. *See* U.C.C. § 4-210(a), quoted *supra* text accompanying note 135 (stating that bank has a security interest when provisional settlement is "applied"). If that check finally is paid, Depositary Bank should be entitled to the funds represented by the check, free from any claim of preference.

as a preference.

Contrary to the opinion of some courts,[232] allowing a narrow right of trustees to avoid some payments made by the debtor to a bank after a kite unravels does not run perilously at odds with the UCC or the EFAA, or any policies promoted by the two statutes. Although both of these regulations admittedly encourage banks to allow customers access to uncollected funds, neither advances a policy of allowing customers to implement kites by having unfettered access to such funds. The UCC, for example, adopts a tough stance on banks caught up in a kite that denies banks broad remedies against the other banks involved, thus discouraging them from granting liberal access to uncollected funds.[233] The EFAA, too, cannot be viewed as a mandate for allowing easy access to uncollected funds in cases of suspected kiting, most principally because the EFAA and Regulation CC give banks an exception from the availability schedule in such circumstances.[234] Allowing recovery of deposits of non-kite funds used to satisfy kiting overdrafts therefore does not place the Bankruptcy Code or preference law in conflict with the UCC and the EFAA. Rather, such a position harmoniously balances the policies of the three liability schemes. The other creditors of the kiting debtor are assured fair and equitable treatment through such an interpretation of the Bankruptcy Code without undermining the policies of the UCC and the EFAA that seek to establish and maintain a secure and efficient check collection system. Indeed, utilizing preference law to "undo" some types of transfers that might compensate banks for kiting losses can be viewed as advancing the UCC's tough and inflexible standards that, in effect, place the losses on the bank whose practices allowed the kite to bloom in the first instance.

CONCLUSION

Losses due to check kiting are a major risk to depositary institutions. As this Article has discussed, three liability schemes have emerged to address loss allocation after a kite has collapsed, each of which is based upon different principles and advances different policies. The UCC's mechanical and rigid standard of final payment provides the initial starting point for loss allocation and, it has been argued, is an effective and litigation-reducing mechanism for allocating the losses after kites. However, two federal schemes, the EFAA and the Bankruptcy Code, have been applied in manners that conflict with the UCC's general stance that allows kiting losses to stand as they were when the kite collapsed. The EFAA's extension of the UCC midnight deadline threatens to embroil banks

232. *See supra* note 10.
233. *See supra* note 86 and accompanying text.
234. *See supra* note 95 and accompanying text.

in costly and protracted litigation to reallocate the losses after the rules of the UCC have been applied. Given the limited purposes served by applying the extension in kiting situations, the Federal Reserve should reconsider its modification of state law through the extension in cases where the extension applies to check kiting.

The Bankruptcy Code also has been interpreted in a manner that potentially can undermine the efficiencies of the UCC. Although settlements made between banks for kited, deposited checks should be immune from preference attack, due to a bank's security interest granted under Article 4 of the UCC, there is a small role for preference law to play in the allocation of losses after a kite has collapsed. As discussed in the previous Part, some deposits of non-kite funds that are not subject to a depositary bank's security interest should be seen as potentially recoverable as preferences. Such deposits are classic preferences that seek to advantage a bank left with an overdraft over the other creditors of the debtor and, subject to other arguments that might support a bank in retaining such payments,[235] they should be subject to avoidance by the debtor's trustee in bankruptcy.

235. *See supra* note 112.