St. Mary's Law Journal

Volume 8 | Number 3 Article 10

9-1-1976

Crediting Accounts for Deposited Drafts before Their Final Payment Constitutes Loan.

John David Bell

BANKS AND BANKING—Banker's Blanket Bond—Crediting Accounts for Deposited Drafts Before Their Final Payment Constitutes Loan

Calcasieu-Marine National Bank v. American Employers' Insurance Co., 533 F.2d 290 (5th Cir. 1976).

The Lake Rice Mill and the Rex Rice Co. sold rice and prepared sight drafts on their purchasers to cover the shipments. They deposited the drafts in their respective bank accounts, and the banks forwarded them for collection. Both banks credited the accounts for the drafts and allowed the customers to draw against that credit before the drafts were honored. In each case the draft was dishonored. The rice companies, which had already depleted the funds anticipated by the drafts, became insolvent. The banks claimed recovery under their banker's blanket bonds, but their insurance companies refused to pay, citing an exclusion for unpaid loans. The district court found that the loss incurred by the dishonored draft was a theft and covered by the bond.[1] The insurance companies appealed to the Court of Appeals for the Fifth Circuit. Held—*Reversed.* When a bank credits a customer's account for the amount of a deposited draft before its final payment, the transaction constitutes a loan.[2]

The term "loan" has been interpreted many times;[3] however, a generally accepted definition is that it is a contract under which one delivers a sum of money to another and the latter agrees to return, at a future time, an equivalent amount plus any interest which may be charged for its use.[4] In determining whether a transaction constitutes a loan, the intent of the parties controls over the form.[5] A transaction may be regarded as a loan whether it provides for interest or not,[6] and the substance or nature of the agreement is more persuasive than the particular terms it contains.[7]

---

1. Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 388 F. Supp. 465, 469-70 (W.D. La. 1974), *rev'd*, 533 F.2d 290 (5th Cir. 1976).

2. Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 533 F.2d 290, 292 (5th Cir. 1976).

3. *E.g., In re* Grand Union Co., 219 F. 353, 356 (2d Cir. 1914), *appeal dismissed sub nom.* Hamilton Inv. Co. v. Ernst, 238 U.S. 647 (1915); Hudson v. Repton State Bank, 75 So. 695, 696 (Ala. Ct. App. 1917); Zurich Gen. Accident & Liab. Ins. Co., Ltd. v. Safe-T-Kros Drug Co., 170 N.E. 351, 352 (Ind. App. 1930) (en banc); *In re* Nellis' Will, 214 N.Y.S. 378, 379 (Sur. Ct. 1926).

4. *In re* Grand Union Co., 219 F. 353, 356 (2d Cir. 1914), *appeal dismissed sub nom.* Hamilton Inv. Co. v. Ernst, 238 U.S. 647 (1915).

5. *Id.* at 356; *see* Merchants' Nat'l Bank v. First Nat'l Bank, 238 F. 502, 507 (8th Cir. 1916). *See generally* 9 C.J.S. *Banks and Banking* § 383 (1938).

6. *See* Burgess v. Williamson, 506 F.2d 870, 875-76 (5th Cir. 1975); Brownell v. City of St. Petersburg, 128 F.2d 721, 724 (5th Cir. 1942); *In re* Nellis' Will, 214 N.Y.S. 378, 379 (Sur. Ct. 1926).

7. United States v. Neifert-White Co., 247 F. Supp. 878, 881 (D. Mont. 1965),

The banker's blanket bond is the product of a joint effort of the American Banker's Association and the American Surety Association.[8] It provides, in part, insurance against any loss of property through robbery, burglary, theft, false pretense, or a good faith purchase of forged instruments.[9] The bond does not, however, provide insurance for unpaid or defaulted loans.[10]

In the normal course of the banking business, depositary banks frequently allow their regular customers to withdraw funds prior to the collection of a deposited item.[11] The credit, however, is provisional and subject to revocation in the event the item cannot be collected.[12] When the bank has allowed the depositor to draw against the provisional credit, it may, at its option, charge back the depositor's account by entering a debit or, if qualified, pursue payment on the instrument as a holder in due course.[13]

Many forms of bank transactions have been examined by the courts to determine whether they constituted loans. Among these are overdrafts,[14] check-kiting schemes,[15] and credit granted under fraud or misrepresenta-

---

aff'd, 372 F.2d 372 (9th Cir. 1967), *rev'd on other grounds*, 390 U.S. 228 (1968); Woodbury v. United States, 192 F. Supp. 924, 936 (D. Ore. 1961), *aff'd*, 313 F.2d 291 (9th Cir. 1963); Hudson v. Repton State Bank, 75 So. 695, 696 (Ala. Ct. App. 1917); Zurich Gen. Accident & Liab. Ins. Co., Ltd. v. Safe-T-Kros Drug Co., 170 N.E. 351, 352 (Ind. App. 1930) (en banc).

8. *See generally* Dingus & Haley, *The Doctrine of Contra Proferentem in Fidelity Coverage Cases*, 10 FORUM 75 (1974).

9. National Bank v. Fidelity & Cas. Co., 131 F. Supp. 121, 123 (S.D. Ohio 1954); Fields, *Bankers Blanket Bonds: What They Cover and What They Do Not*, 27 INS. COUNSEL J. 318 (1960).

10. Fields, *Bankers Blanket Bonds: What They Cover and What They Do Not*, 27 INS. COUNSEL J. 318, 322 (1960); *see* 13 G. COUCH, CYCLOPEDIA OF INSURANCE LAW § 48:167, at 155 (Supp. 1975).

11. Hawkland, *Depositary Banks as Holders in Due Course*, 76 COM. L.J. 124, 128 (1971). *See generally* Annot., 18 A.L.R.3d 1376 (1968).

12. Collins, *Bank-Customer Relations Under the Uniform Commercial Code*, 64 W. VA. L. REV. 657, 675 (1962); Sneed & Morrison, *Bank Collections—A Comparative Study*, 29 TEXAS L. REV. 713, 719-20 (1951).

13. TEX. BUS. & COMM. CODE ANN. § 4.212(a) (Tex. UCC 1968). The bank takes a negotiable instrument for value when it allows the depositor to draw against the provisional credit. Farmers & Merchants Nat'l Bank v. Boardwalk Nat'l Bank, 245 A.2d 35, 38 (N.J. Super. Ct. App. Div. 1968); United States Cold Storage Corp. v. First Nat'l Bank, 350 S.W.2d 856, 858 (Tex. Civ. App.—Fort Worth 1961, writ ref'd n.r.e.); City State Bank v. Lummus, 277 S.W.2d 262, 266 (Tex. Civ. App.—Amarillo 1954, writ ref'd n.r.e.). Several other requirements must be met for a bank to obtain a refund as a holder in due course. *See* TEX. BUS. & COMM. CODE ANN. §§ 3.302-.303, 4.208(a) (Tex. UCC 1968). *See generally* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE §§ 13-14 (1972); Bell, *The Depositary Bank As a Holder in Due Course: A Case Study*, 8 IDAHO L. REV. 1 (1971).

14. Prowinsky v. Second Nat'l Bank, 265 F. 1003, 1004 (D.C. Cir. 1920); Schramm v. Bank of Cal., 20 P.2d 1093, 1096 (Ore. 1933).

15. First Nat'l Bank v. Insurance Co. of N. Am., 424 F.2d 312, 315-16 (7th Cir.), *cert. denied*, 398 U.S. 939 (1970); Fidelity & Cas. Co. v. Bank of Altenburg, 216 F.2d 294, 304 (8th Cir. 1954), *cert. denied*, 348 U.S. 952 (1955); Liberty Nat'l Bank & Trust Co. v. Travelers Indem. Co., 295 N.Y.S.2d 983, 985-86 (Sup. Ct. 1968). "A check-kiting scheme . . . is a process whereby a person with a checking account in

tion.[16] The decisions have generally held that an overdraft constitutes a loan.[17] This construction is based upon an implied promise of the drawer of the check to reimburse the bank for any advances necessitated by the honoring of that check.[18] In contrast, when confronted with check-kiting schemes, the courts have refused to consider the extension of credit to be a loan.[19] Other activities involving fraud, however, may constitute loans.[20] Courts have found transactions to be loans where credit was extended on bogus warehouse receipts[21] and on duplicate automobile certificates of title.[22] Even if the credit was procured by trick, fraud, or false pretenses, it may still be a loan and, therefore, within the banker's blanket bond exclusion;[23] but a transaction is not necessarily a loan simply because a

---

two banks can create an illusion of money in his accounts. A check drawn on the first bank is deposited with the second bank. Before the check reaches the first bank for payment, a check drawn on the second bank is deposited in the first bank." Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 533 F.2d 290, 294 n.3 (5th Cir. 1976).

16. United Pac. Ins. Co. v. Idaho First Nat'l Bank, 378 F.2d 62, 66 (9th Cir. 1967); First Nat'l Bank v. Aetna Cas. & Sur. Co., 309 F.2d 702, 705 (6th Cir. 1962), *cert. denied*, 372 U.S. 953 (1963); Hartford Accident & Indem. Co. v. FDIC, 204 F.2d 933, 936 (8th Cir. 1953).

17. Prowinsky v. Second Nat'l Bank, 265 F. 1003, 1004 (D.C. Cir. 1920); Schramm v. Bank of Cal., 20 P.2d 1093, 1096 (Ore. 1933); Sagerton Hardware & Furniture Co. v. Gamer Co., 166 S.W. 428, 432 (Tex. Civ. App.—Fort Worth 1914), *rev'd on other grounds*, 213 S.W. 927 (Tex. 1919).

18. Bromberg v. Bank of America Nat'l Trust & Sav. Ass'n, 135 P.2d 689, 692 (Cal. Dist. Ct. App. 1943).

19. National Bank of Commerce v. Fidelity & Cas. Co., 312 F. Supp. 71, 75 (E.D. La. 1970), *aff'd per curiam*, 437 F.2d 96 (5th Cir.), *cert. denied*, 403 U.S. 906 (1971); Liberty Nat'l Bank & Trust Co. v. Travelers Indem. Co., 295 N.Y.S.2d 983, 985-86 (Sup. Ct. 1968). *Contra*, Citizens Nat'l Bank v. Travelers Indem. Co., 296 F. Supp. 300, 301 (M.D. Fla. 1967) (money obtained through a check-kiting scheme was a loan). When a bank required a customer to sign promissory notes to cover checking transactions after being alerted to a possible check-kiting operation, one court held the subsequent loss to be due to the nonpayment of a loan. First Nat'l Bank & Trust Co. v. Continental Ins. Co., 510 F.2d 7, 13 (10th Cir. 1975), *cert. denied*, 421 U.S. 949 (1976); *see* First Nat'l Bank v. Insurance Co. of N. Am., 424 F.2d 312, 316 (7th Cir.), *cert. denied*, 398 U.S. 939 (1970) (reasonable commercial practice for a bank to honor drafts against the uncollected deposits of unsuspicious customers).

20. Community Fed. Sav. & Loan Ass'n v. General Cas. Co. of Am., 274 F.2d 620, 625 (8th Cir. 1960) (loan); Community Nat'l Bank v. St. Paul Fire & Marine Ins. Co., 399 F. Supp. 873, 879 (S.D. Ill. 1975) (loan exclusion applied). *But see* First Continental Nat'l Bank & Trust Co. v. Western Contracting Corp., 341 F.2d 383, 390 (8th Cir. 1965) (loan exclusion not applicable); Johnstown Bank v. American Sur. Co., 174 N.Y.S.2d 385, 387 (Sup. Ct. 1958) (transaction not a loan).

21. First Nat'l Bank v. Aetna Cas. & Sur. Co., 309 F.2d 702, 705 (6th Cir. 1962), *cert. denied*, 372 U.S. 953 (1963).

22. Union Banking Co. v. United States Fidelity & Guar. Co., 213 N.E.2d 191, 198 (Ohio Ct. App. 1965).

23. Bank of the Southwest v. National Sur. Co., 477 F.2d 73, 77 (5th Cir. 1973). *But see* American Nat'l Bank & Trust Co. v. Fidelity & Cas. Co., 431 F.2d 920, 923 (5th Cir. 1970) (loss on counterfeit stock certificates recoverable).

bank's money was wrongfully obtained or converted and the wrongdoer must repay it.[24]

In *Calcasieu-Marine National Bank v. American Employers' Insurance Co.*[25] the Fifth Circuit looked to the reasonableness of expectation of payment in deciding that the transactions constituted loans.[26] The court decided that when a bank credits an account with the amount of a deposited check, its expectation that the check will be paid in the normal course of business is reasonable since checks are regularly honored. Deposited drafts, however, can afford no reasonable expectation of payment since they have, by their very nature, a greater tendency to be dishonored.[27] If a bank credits an account with the amount of a check when it is deposited and allows immediate withdrawal, the transaction is not considered a loan because of the reasonable expectation that the check will be paid, despite the fact the check may be returned for insufficient funds or is part of a check-kiting scheme. Conversely, when credit is given for a deposited draft or a bank honors a check creating an overdraft in an account, no reasonable expectation of payment can be said to exist even though the advance has been recovered on numerous prior occasions.[28]

The court distinguished the facts in the *Calcasieu* case from an earlier case, *National Bank v. Fidelity & Casualty Co.*[29] That decision, which formed the basis of the district court's opinion in *Calcasieu*, held that similar losses were not loans.[30] A customer deposited sight drafts based upon fictitious deliveries, and a credit was immediately entered for his account. Even though interest was charged in the transaction, the court found that, due to the false pretenses involved, there was no meeting of the minds to support a loan agreement.[31] The existence of false pretenses weighed heavily in the district court's decision in the *Calcasieu* case.[32] In reversing that holding, the Fifth Circuit cited *Maryland Casualty Co. v. State Bank & Trust Co.*,[33] which held that even though false pretenses are implicit in a transaction it can still be

24. Shoals Nat'l Bank v. Home Indem. Co., 384 F. Supp. 49, 54 (N.D. Ala. 1974), *aff'd mem.*, 515 F.2d 1182 (5th Cir. 1975); *see* First Nat'l Bank v. Insurance Co. of N. Am., 424 F.2d 312 (7th Cir.), *cert. denied*, 398 U.S. 939 (1970).

25. 533 F.2d 290 (5th Cir. 1976).

26. *Id.* at 300. The banker's blanket bond excludes "any loss the result of the complete or partial nonpayment of or default upon any loan made by or obtained from the Insured, whether procured in good faith or through trick, artifice, fraud or false pretenses . . . ." *Id.* at 293.

27. *Id.* at 300.

28. *Id.* at 300.

29. 131 F. Supp. 121 (S.D. Ohio 1954).

30. *Id.* at 124; Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 388 F. Supp. 465, 468 (W.D. La. 1974), *rev'd*, 533 F.2d 290 (5th Cir. 1976).

31. National Bank v. Fidelity & Cas. Co., 131 F. Supp. 121, 124 (S.D. Ohio 1954).

32. Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 388 F. Supp. 465, 468 (W.D. La. 1974), *rev'd*, 533 F.2d 290 (5th Cir. 1976).

33. 425 F.2d 979 (5th Cir.), *cert. denied*, 400 U.S. 828 (1970).

a loan.[34] As a result, the Fifth Circuit found that the fact credit was obtained through false pretenses does not determine whether the loan exclusion applies.[35] Even though fraud may occur, the immediate cause of the loss may still be the loan.[36]

In this manner, the court in *Calcasieu* rejected the argument that the existence of fraud determines the nature of the transaction.[37] The court also refused to hold in favor of the insured on the basis that the term "loan" is ambiguous;[38] instead, it considered the reasonableness of expectation of payment to be paramount.[39]

Although in a check transaction the bank may be justified in relying upon the integrity of the endorser, in a loan transaction security as well as interest is normally required.[40] Both transactions involve the extension of credit, but the court in *Calcasieu* was particularly impressed by the routine manner in which checks are handled by banks.[41] Checks are dealt with in bulk as "cash" items on the assumption that they will usually be honored.[42] When a bank provides credit to a customer after he has deposited a check endorsed without a disclaimer of liability, both parties presume that the bank will recover the amount without incident.[43] The bank's expectation of payment of checks is clearly reasonable, whereas the payment of a loan is not so readily assumed.[44]

In *Calcasieu* the court found the collection of drafts to be more similar

34. *Id.* at 982; Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 533 F.2d 290, 294 (5th Cir. 1976).

35. Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 533 F.2d 290, 294 (5th Cir. 1976).

36. *Id.* at 294; Bank of the Southwest v. National Sur. Co., 477 F.2d 73, 75 (5th Cir. 1973); Community Fed. Sav. & Loan Ass'n v. General Cas. Co. of Am., 274 F.2d 620, 625 (8th Cir. 1960).

37. Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 533 F.2d 290, 294 (5th Cir. 1976).

38. *Id.* at 296. *Contra*, First Nat'l Bank v. Insurance Co. of N. Am., 495 F.2d 519, 522 (5th Cir. 1974) (the word "loan" in exclusion clause is ambiguous and must be interpreted in favor of the insured).

39. Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 533 F.2d 290, 300 (5th Cir. 1976).

40. Pioneer Valley Sav. Bank v. Indemnity Ins. Co. of N. Am., 225 F. Supp. 404, 411 (N.D. Iowa 1964), *aff'd*, 343 F.2d 634 (8th Cir. 1965).

41. Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 533 F.2d 290, 300 (5th Cir. 1976).

42. Farnsworth, *Documentary Drafts Under the Uniform Commercial Code*, 22 BUS. LAW. 479, 482 (1967).

43. Universal C.I.T. Credit Corp. v. Guaranty Bank & Trust Co., 161 F. Supp. 790, 793 (D. Mass. 1958).

44. *Compare* Pioneer Valley Sav. Bank v. Indemnity Ins. Co. of N. Am., 225 F. Supp. 404, 411-12 (N.D. Iowa 1964), *aff'd*, 343 F.2d 634 (8th Cir. 1965), *with* Farnsworth, *Documentary Drafts Under the Uniform Commercial Code*, 22 BUS. LAW. 479, 482 (1967).

to loan transactions than to checking transactions.[45] Even though previous drafts may have been paid in the normal course of business, it is always incumbent upon the drawee to inform the bank whether to honor them.[46] The bank's expectation of payment, then, cannot be as strong or as reasonable for drafts as it is for checks because of the differences in their nature and frequency of being honored.[47] A Ninth Circuit case involving drafts in circumstances different from those in *Calcasieu*, however, held that a reasonable expectation of payment existed when the normal course of business in the community was to give immediate credit for drafts on a particular company's bank account because they were always honored.[48] Consequently, the bank's loss caused by the fraudulent dishonor of several drafts was covered by the blanket bond.[49] Although that case can be distinguished from *Calcasieu* by the special circumstances present in that community, it illustrates that a reasonable expectation of payment can exist for drafts under appropriate conditions.

While the *Calcasieu* decision applies the reasonable expectation of payment test and finds the draft transaction to be a loan, it also clearly states that the presence or absence of fraud does not influence the application of the loan exclusion clause of the blanket bond.[50] Although the difficulty in ascertaining the existence of fraud in banking transactions varies in the different types of transactions,[51] the immediate cause of the loss determines whether recovery should be allowed.[52] A loan may be procured by fraud and remain within the bond's exclusion provision, while other losses due to fraud will be covered.[53] That a bank's money is wrongfully converted and the wrongdoer is required to restore it does not mean that the wrongdoer has succeeded in getting a loan from the victim bank.[54]

---

45. Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 533 F.2d 290, 299-300 (5th Cir. 1976).

46. *Id.* at 300.

47. Farnsworth, *Documentary Drafts Under the Uniform Commercial Code*, 22 BUS. LAW. 479, 482 (1967).

48. United Pac. Ins. Co. v. Idaho First Nat'l Bank, 378 F.2d 62, 66-67 (9th Cir. 1967).

49. *Id.* at 66.

50. Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 533 F.2d 290, 294 (5th Cir. 1976).

51. Capital Bank v. Fidelity & Cas. Co., 414 F.2d 986, 989 (7th Cir. 1969) (credit for assignment of worthless accounts receivable); Exchange Nat'l Bank v. Insurance Co. of N. Am., 341 F.2d 673, 676 (2d Cir.), *cert. denied*, 382 U.S. 816 (1965) (money advanced on shipments not completed); State Bank v. Hanover Ins. Co., 267 N.Y.S.2d 672, 675 (Sup. Ct. 1965) (credit extended on forged accounts).

52. Community Fed. Sav. & Loan Ass'n v. General Cas. Co. of Am., 274 F.2d 620, 625 (8th Cir. 1960).

53. Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 533 F.2d 290, 294 (5th Cir. 1976).

54. First Nat'l Bank v. Insurance Co. of N. Am., 424 F.2d 312, 316 (7th Cir.), *cert. denied*, 398 U.S. 939 (1970); Hartford Accident & Indem. Co. v. FDIC, 204 F.2d

The term "any loan" found within the bond exclusion forbids the distinction of one type of loan from another,[55] but it is inadequate to transform a check transaction or a loss caused by fraud into a loan. The general definition of a loan involves an obligation to repay a sum borrowed with or without interest.[56] Money paid under fraud or in a check-kiting scheme cannot justifiably fit this category, but bank transactions involving deposited drafts, in which an expectation of payment is not reasonably certain, provide better grounds for holding that a loan resulted. Although no security is taken, the bank relies upon the implied obligation of the customer, similar to the one found in the case of overdrafts, to reimburse the bank for honoring checks drawn against the uncollected deposits.[57]

The court in *Calcasieu* denied recovery under the blanket bond by holding that crediting accounts for deposited drafts before their final payment constituted a loan.[58] The banker's blanket bond does not provide credit insurance.[59] Although banks may extend credit based upon uncollected deposits —a practice which is not unreasonable in the case of preferred or established customers[60]—the Calcasieu-Marine National Bank nurtured the business of one customer "too long and too hard."[61] Absent prevailing circumstances to the contrary, an extension of credit based upon deposited drafts will be considered by the courts to be a loan, and any resulting losses will not be insured. Banks which continue this policy must do so at their own risk.

John David Bell

933, 937 (8th Cir. 1953); Shoals Nat'l Bank v. Home Indem. Co., 384 F. Supp. 49, 54 (N.D. Ala. 1974), *aff'd mem.*, 515 F.2d 1182 (5th Cir. 1975).

55. Indemnity Ins. Co. of N. Am. v. Pioneer Valley Sav. Bank, 343 F.2d 634, 652 (8th Cir. 1965).

56. Burgess v. Williamson, 506 F.2d 870, 875-76 (5th Cir. 1975); *In re* Grand Union Co., 219 F. 353, 356 (2d Cir. 1914), *appeal dismissed sub nom.* Hamilton Inv. Co. v. Ernst, 238 U.S. 647 (1915).

57. *Compare* Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 533 F.2d 290, 300 (5th Cir. 1976), *with* Bromberg v. Bank of America Nat'l Trust & Sav. Ass'n, 135 P.2d 689, 692 (Cal. Dist. Ct. App. 1943).

58. Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 533 F.2d 290, 301 (5th cir. 1976).

59. Allen State Bank v. Traveler's Indem. Co., 270 So. 2d 270, 273 (La. Ct. App. 1972); *see* First Nat'l Bank v. Aetna Cas. & Sur. Co., 309 F.2d 702, 705 (6th Cir. 1962), *cert. denied*, 372 U.S. 953 (1963).

60. First Nat'l Bank v. Insurance Co. of N. Am., 424 F.2d 312, 316 (7th Cir.), *cert. denied*, 398 U.S. 939 (1970).

61. Calcasieu-Marine Nat'l Bank v. American Employers' Ins. Co., 533 F.2d 290, 298 (5th Cir. 1976).