APPEAL NO. 13-1879
CROSS APEAL NO. 13-1931

In the
UNITED STATES COURT OF APPEALS
for the
EIGHTH CIRCUIT

Choice Escrow and Land Title, LLC,
Plaintiff – Appellant/Cross-Appellee,

v.

BancorpSouth Bank,
Defendant – Appellee/Cross-Appellant.

On Appeal from the United States District Court for the Western District of Missouri,
Case No. 6:10-CV-03531-JTM,
The Honorable John T. Maughmer, Magistrate Judge.

APPELLANT'S PETITION FOR REHEARING EN BANC

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REASONS FOR REHEARING EN BANC

1. Awarding Banks Contractual Attorney Fees Will Have A Chilling Effect On Customer Rights Under UCC §4A-202.

This case involves a question of first impression of exceptional importance regarding whether the Panel's Opinion, granting contractual attorney fees to a bank in a Uniform Commercial Code §4A-202 case, effectively abrogates the statute and renders it meaningless for bank customers. The effect of the Opinion will be that banks can indirectly preclude customer's right to file Article 4A lawsuits through indemnity provisions. The Court En Banc should grant rehearing to determine whether such a result is unduly harsh and in conflict with the statute.

2. §4A-202(c) Instructs The Bank To Implement Security Procedures That Review The Size, Type And Frequency Of Customer Wire Transfers.

The panel decision conflicts with Patco Const. Co. v. People's United Bank, 684 F.3d 197 (1st Cir. 2012). The split between the two Circuits regards whether §4A-202(c) instructs the bank to use security procedures that consider the "size, type and frequency" of wire transfer payment orders. The 1st Circuit held that banks are mandated, directed and instructed to have security procedures that consider the size, type and frequency of its customer's payment orders. Patco, at 212. On the other hand, the Opinion here holds that banks' security procedures need not

consider the size, type and frequency of payment orders. Consideration by the full Court is therefore necessary to resolve this conflict and secure and maintain uniformity of the Court's decisions.

Article 4A Background

This case regards a bank's acceptance of a $440,000 fraudulent foreign wire transfer out of a customer's trust account by a cyber-criminal, and whether the bank or the customer should bear the loss. The controlling law is §4A-202 of the UCC.

Article 4A was drafted because principles of common law and equity did not adequately address the issues associated with wire transfers. *§4A-102, Comment.* Article 4A is the exclusive means of determining the rights, duties and liabilities of customers and banks, and resort to principles of law or equity outside of Article 4A is not appropriate to create rights, duties and liabilities inconsistent with those stated in Article 4A. *Id.* A "payment order" is the customer's instruction to the bank to perform a wire transfer. *§4A-103(a)(1).* To approve payment orders, the parties use a "security procedure", which verifies that a payment order is that of the customer or detects errors in a payment order. *§4A-201.*

Section 4A-202 controls "unauthorized" (fraudulent) wire transfers through a "risk-shifting" analysis that is utilized to determine whether the

stolen funds from an unauthorized wire transfer should be borne by the bank or the customer. Patco Const. Co. v. People's United Bank, 684 F.3d 197, 208 (1st Cir. 2012). Under the statute, the bank initially bears the loss unless it can prove, inter alia, that its security procedure was "commercially reasonable". *Id.* Commercial reasonableness is a question of law for the court, determined by using the four factors stated in §4A-202(c). Id. at 209. If the bank fails to satisfy all requirements of §4A-202, it bears the loss of the unauthorized wire transfer. Id. at 208. [1]

1st Reason for Rehearing: Attorney Fees' Chilling Effect is of Exceptional Importance

While the award of attorney fees through an indemnity provision is devastating to Choice and its continued viability, the effect of the Panel's Opinion will be felt well-beyond this case, in that it will have a profound and pervasive chilling effect on customer's §4A-202 rights. [2]

Under §4A-202, if a customer prevails, it is only reimbursed the amount stolen from its account, making the customer's net gain/loss $0. The customer is awarded no compensatory damages, but rather is only refunded the amount debited from its account by the bank. Therefore,

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[1] A more detailed discussion of Article 4A can be found in Patco, at 207-213.

[2] Note: BancorpSouth only sought attorney fees. However, in future cases, the Opinion would be precedent to allow indemnity of all litigation fees, expenses and costs incurred by a bank if a customer files a §4A-202 lawsuit.

under the Opinion, no matter how much is stolen and then refunded, the customer will **always** lose a significant amount of money.

The following example demonstrates how the award of attorney fees, affects a customer's right to a §4A-202 lawsuit. A cyber-criminal completes a $100,000 unauthorized wire transfer out of a customer's account. The customer prevails in a §4A-202 suit and the bank must refund the customer the $100,000. However, under this Opinion, the bank is awarded its attorney fees of $250,000. The result is that although the customer prevailed and was "made whole" with regard to the stolen funds, it suffered a net loss of $250,000 (not including its own attorney fees and litigation expenses). This example holds true even if the amount of the attorney fees are less than the amount stolen and recovered.

The conflict between the Opinion's reasoning and the Statute and the drafters' Comments is self-evident. While the Opinion is correct that the award of attorney fees did not change §4A-202's risk-shifting analysis, the customer in the above example is worse off than before filing suit. Thus, customers will forego filing suit, not because of the "balanced" risks and liabilities the drafters established in the statute, but rather because of the heavy financial burden the Opinion places on them by awarding the bank its attorney fees. Only the wealthiest customers can afford to seek such a

moral victory in order to prove the bank was wrong, but lose substantial amounts of money doing so.

Can this be the intent of the drafters of the UCC and the legislatures that adopted it? We urge that it is not. This issue is of exceptional import since the Opinion will effectively abrogate §4A-202, severely affecting all banking customers in the 8th Circuit. Choice requests rehearing En Banc.

1.1 Background: Article 4A and the Comments

The drafters made it clear that Article 4A represents a "careful and delicate balancing" of the competing interests of banks and customers, which were "thoroughly considered", and shall be the **exclusive** means of determining the rights, duties and liabilities of the parties. *§4A-102, Comment*. The drafters deliberately wrote "with a clean slate", creating unique, precise and detailed rules to assign responsibility, allocate risks and establish limits on liability. *Id*. "Resort to principles of law or equity outside of Article 4A is not appropriate to create rights, duties and liabilities inconsistent with those stated in this Article." *Id*.

Therefore, Article 4A displaces common law claims in two specific areas, (1) where the common law claims would create rights, duties or liability inconsistent with Article 4A; and (2) where the circumstances giving rise to the common law claims are specifically covered by Article 4A.

Zengen, Inc. v. Comerica Bank, 158 P.3d 800, 808 (Cal. 2007). Specific to unauthorized wire transfers under §4A-202, the statute expressly states that "… rights and obligations arising under this section **may not be varied by agreement**." *§4A-202(f) (emphasis added).*

1.2 The Opinion Conflicts with Article 4A

After citing similar Article 4A and Comment language, as well as Zengen, the Opinion states that awarding bank attorney fees is "extrinsic to Article 4A's attempts to balance the risk of loss due to a fraudulent payment order" and that the indemnification provision "is not inconsistent with Article 4A". *Opinion*, p. 24-25. Choice contends this conclusion lacks merit, since it violates §4A-202(f), the drafters' Comments and Zengen.

First, although the bank is presumed to initially bear the loss (Patco, at 208), this presumption only applies after the customer files suit, since prior to suit, the customer's account will have been debited the stolen funds. Therefore, in order to determine if the bank or customer should bear the loss, the drafters conferred the customer a right to file suit under §4A-202. See *§4A-202(c)(*"Commercial reasonableness is a question of law…"; and *§4A-202, Comment 4 (*"A security procedure is not commercially unreasonable simply because another procedure might have been better or because the judge deciding the question would have opted for a more

stringent procedure". Absent a customer's lawsuit, the customer always bears the loss, since there is no "question of law" or "judge decision".

Second, the question becomes: what is the effect of the award of indemnification on future customers' rights to a §4A-202 lawsuit? Answer: customers' rights under §4A-202 are chilled, in that the Opinion undercuts the "careful and delicate balancing" of rights and liabilities established by the drafters of Article 4A. Indemnification creates a new right for the bank and a new liability for the customer, which the statute does not provide. The drafters' "delicate balancing" of rights and liabilities is upset by this new and heavy weight of attorney and litigation expenses favoring only banks and not customers. Therefore, contractual attorney fees violate §4A-202(f) and are displaced under both prongs of the statute, as provided in Zengen. [3]

Section 4A-202(f) provides that rights arising under §4A-202 may not be varied by agreement. Nearly universally, the bank will draft the agreements. Thus, §4A-202(f) was a part of the drafters' "careful and delicate balancing" of the parties' rights by prohibiting banks from contractually placing more burden on its customers than the statute

[3] Choice sets forth the analysis of §4A-202(f), but the same analysis demonstrates that awarding a bank indemnification for its litigation costs is displaced by both prongs of Article 4A, as set forth by Zengen.

provides. Since a customer has a right to a §4A-202 lawsuit, it is clear that pursuant §4A-202(f), a bank agreement is prohibited from containing the following provision which **directly** varies the rights and liabilities of the parties: "Customer shall not file suit under §4A-202."

The Opinion avoids this by allowing the rights and liabilities of the parties to be **indirectly** varied, even though the end result is the same (i.e. customers are discouraged from filing §4A-202 suits). Now all bank agreements will contain an indemnification provision that places such a heavy financial burden on the customer that it becomes economically impracticable to file suit under §4A-202, even though it does not directly affect the suit or the §4A-202 analysis. The Opinion calls this consideration "extrinsic". Choice asserts that this is a distinction without a difference, since the effect of both contract provisions is the same. Both "direct" and "indirect" provisions effectively end the customer's right to suit, which violates §4A-202(f).

Further, as the Opinion states (p. 24), §4A-202 contains no provision expressly addressing attorney fees. Excluding attorney fees is part of the drafters' delicate balancing of rights. Thus, permitting bank indemnification creates a new "liability" for the customer. This is highlighted by the fact that the drafters knew how to provide for attorney

fees, as they did in Section 305 of Article 4A. *See §4A-305 and §4A-305, Comment 4.* Therefore, the principle Inclusio Unius Est Exclusio Alterius ("*The inclusion of one is the exclusion of another*") applies. Watt v. GMAC Mortg. Corp., 457 F.3d 781, 783 (8th Cir. 2006).

1.4 Chilling Effect on Customers' Filing of Suits

The logical result of the foregoing is that the Opinion will have a chilling effect on customer's decision to seek determination of their §4A-202 rights.[4] Although under the Opinion a customer will experience the above-established net loss regardless of the amount of the bank's attorney fees, the loss is exacerbated by the likely fact that the amount of the bank's litigation costs will exceed the amount of funds stolen that the customer could recover under §4A-202.

In this case, the cyber-criminal stole $440,000 from Choice. On July 24, 2012 (BancorpSouth's last provided discovery response on litigation expenses incurred), BancorpSouth was claiming over $127,000 in attorney and expert fees. [Joint Appendix 178-179.] This amount from nearly two year ago does not include a majority of the costs BancorpSouth has now incurred in this lawsuit, including depositions, summary judgment motions and appeal. Thus, Choice anticipates BancorpSouth's attorney fees in this

[4] Solely to demonstrate that this is not a newfound argument, Choice points out this chilling effect argument was made to the trial court and the Panel. Joint Appendix 175.

case to approach $500,000. Had Choice known that it would lose over $500,000 even if the Court awarded refund of the §440,000, it (and any prudent businessperson) would clearly not have filed suit.

The immediate reactions of the legal and banking communities to the Opinion recognize this inherent chilling effect. Charisse Castagnoli, an adjunct professor of law at the John Marshall Law School, stated: "This is the first time a court has ruled on fee shifting, and that will certainly have a chilling effect on litigation." See Brian Krebs, http://krebsonsecurity.com/2014/06/ruling-raises-stakes-for-cyberheist-victims/. Barkley Clark, a partner at Stinson Leonard Street LLP specializing in banking institutions and financial payment systems, wrote: "It seems likely that the attorney's fees were substantial. The upshot is that plaintiffs facing an indemnity provision may be chilled from bringing suit against the bank, except where the losses are very high." See Barkley Clark, Eight Circuit: Bank Customer Who Rejects "Dual Control" Over Outgoing Wires Assumes Risk of Corporate Account Takeover.

1.5 Conclusion

Choice requests Rehearing En Banc since the issue of allowing indemnity of bank attorney fees in §4A-202 actions is of exceptional importance, in that it will chill bank customers' decisions to file suit,

thereby effectively varying the rights and obligations customers outside of the delicate balancing established by the drafters in Article 4A.

2nd Reason for Rehearing: Split in the Circuits Regarding "size, type and frequency"

As mentioned above, the Court determines whether the bank bears the loss from an unauthorized wire transfer based, in part, on whether the bank has provided a "commercially reasonable" security procedure. This determination must be made by using the four factors stated in §4A-202(c). Only one factor ("the circumstances of the customer") is at issue here:

> "Commercial reasonableness of a security procedure is a question of law to be determined by considering… the circumstances of the customer known to the bank, including the size, type and frequency of payment orders normally issued by the customer to the bank…". *§4A-202(c)*.

Regarding this section of the statute, there is an noticeable conflict and split between the 1st Circuit and the Panel's Opinion. In Patco, the 1st Circuit held that banks must have security procedures that consider the size, type and frequency of its customer's payment orders. Patco, at 212. In this case, the Panel held that banks do not have to use security procedures that consider the size, type and frequency of payment orders.

Regarding creating splits among the circuits, this Court held, "Although we are not bound by another circuit's decision, we adhere to the policy that a sister court's reasoned decision deserves great weight and precedential value. As an appellate court, we strive to maintain uniformity in the law among the circuits, wherever reasoned analysis will allow, thus avoiding unnecessary burdens on the Supreme Court's docket. Unless our 11 courts of appeals are thus willing to promote a cohesive network of national law, needless division and confusion will encourage further splintering and the formation of otherwise unnecessary additional tiers in the framework of our nation court system." Aldens v. Miller, 610 F.2d 538, 541 (8th Cir. 1979). Below Choice demonstrates that the 1st Circuit has the better-reasoned approach, which, pursuant to Aldens, should be followed.

First, Choice must clear up a misunderstanding highlighted by the Opinion. The phrase "transactional analysis" is merely a short-hand term for §4A-202(c)'s requirement that the security procedure must consider the "size, type and frequency" of customer payment orders. Choice never argued that transactional analysis must occur exclusively via manual review by a human being, as the Opinion asserts. *Opinion, p. 12*. Review of the "size, type and frequency" of a customer's past payment orders (i.e. transactional analysis) **may** be performed by a human. This is established

in Patco and the drafters' Comments. Patco, at 213 (*observing some New England banks commonly used manual review to authenticate suspicious transactions*); and §4A-202, Comment 3 (*stating that employees of the bank can be trained to test the payment order*). Nonetheless, in all likelihood, the payment order review will be performed electronically by computer software (as observed in Patco, 202). Choice argued that "no BancorpSouth person **or computer program**" was reviewing the size, type or frequency of Choice's payment orders. See Appellant's Reply Brief, pp. 49-50. This fact was admitted by BancorpSouth. [Joint Appendix 501, 1031, 1091.]

The 1st Circuit's Opinion in Patco

The 1st Circuit implicitly and unequivocally held that the audience that must adhere to and follow §4A-202(c) is banks. It held that the bank in that case "ignored Article 4A's **mandate that security procedures** take into account 'the circumstances of the customer' known to the bank. "Article 4A **directs banks** to consider such circumstances as 'the size, type and frequency of payment orders normally issued to the bank'." "The bank's generic 'one-size-fits-all' approach to customers violates Article 4A's **instruction** to take the customer's circumstances into account." Patco, at 212 (emphasis added). As opposed to the Panel Opinion (p. 12), the 1st

Circuit did not hold that the intended "audience" of §4A-202(c) is the Court.

The bank in Patco argued that it did comply with the mandate, direction and instruction of §4A-202 because it's computer program created a risk-profile based on its customer's e-banking habits such that the security system could compare the characteristics of each transaction against those in its customer's profile. Id. at 212. In fact, the bank did have such a program. Id. at 202. However, the Court held that the bank's electronic security system triggered no authentication requirements and the bank did nothing with the information generated by comparing the fraudulent transactions against its customer's profile. Id. at 212. The Court stated that the bank did not manually review any of the transactions to determine their legitimacy or notify its customer. Id. at 205.

The Panel Opinion Conflicts with the 1st Circuit

In contrast, the Opinion here held that the intended "audience" of §4A-202(c) is the Court, and that "Article 4A does not instruct the bank to consider the 'size, type and frequency' of each payment order". *Opinion*, at 12. It determined that "BancorpSouth was not required to perform transactional analysis". *Opinion*, at 13. This is fundamentally at odds with the 1st Circuit's above holding.

While the bank's system in Patco was ultimately ineffective at considering the size, type and frequency of its customer's payment orders, at least that bank tried to satisfy the mandate, direction and instruction of §4A-202 to consider "size, type and frequency". BancorpSouth made no such effort, and thus, violated §4A-202(c), prohibiting BancorpSouth from prevailing in this case. Had this case been in the 1st Circuit, Choice would have prevailed. Due to the inherent split in the Circuits, Choice requests this Petition for Rehearing En Banc be granted in order to secure and maintain uniformity of the Court's decisions.

Conclusion

Rehearing En Banc is proper for a number of reasons of exceptional importance: it is a case of first impression in an emerging area of the law; the Court can follow its policy of avoiding a split in the circuits; the chilling effect of granting attorney fees to the bank which are not provided in the carefully balanced UCC statute, effectively abrogating customers' rights under statute, can be avoided; and this will likely be the last chance to do so, since 8th Circuit bank customers will not file §4A-202 suits.

Respectfully submitted,

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CERTIFICATES OF COMPLIANCE & SERVICE

The undersigned counsel for Appellant certifies that this Petition for Rehearing En Banc has been scanned for viruses and is virus-free, and that:

(a) On June 25, 2014, the foregoing was electronically filed with the Clerk of the Court for the United States Court of Appeals for the Eighth Circuit by using the CM/ECF system; and

(b) All participants in the case are registered CM/ECF users and service will be accomplished by the CM/ECF system.

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