Some Legal Implications of the Use of Computers in the Banking Business*

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The introduction of computers into the banking business has a wide variety of legal implications that merit careful attention at this very early stage. The industry is highly regulated by government and, hence, is subject to many statutes and regulations. It also is affected by important common law rules established by courts. The legal ramifications involve not only the mechanization itself, but also the very significant, economically attractive phenomenon of off premises processing. It is essential to identify and provide for many legal aspects right now, before systems and practices crystallize, in order to avoid the later impact of unanticipated physical complications and expense.

The legal aspects of computerization in the banking business are especially diverse. In some states, there might be the basic question whether banks are authorized by law to invest in the new facilities, either directly or through cooperatives. More challenging are questions relating to off-premises processors, particularly with respect to the obligation not to disclose information concerning a bank's customers, the adequacy of fidelity bond coverage, the extent of liability for improper refusal to pay a check, and susceptibility to regulation by government agencies. Also pertinent is the propriety of data processing by banks for nonbank entities and particularly of the rendering of that service without charge for bank depositors.

How much may a bank spend to buy computers outright? May a bank use an outside computer processor? How much in money damages might an outside computer processor have to pay a depositor if it caused his bank to refuse improperly to honor his check? May a bank do data processing for customers that are not banks? More generally, how are the traditional legal liabilities and obligations of banks affected by their use of outside data processors? And are the liabilities of outside data processors any greater than those of the banks for whom they work? These are just a few of the many important legal questions that arise when banks turn to computers. The answers to applicable questions like these disclose factors for which provision should be made in cost estimates, contracts, fidelity bonds, systems designs, and other activities relating to computer use in banking. Those factors are of direct concern not only to banks and outside data processors, but also to customers of banks, bonding companies and governmental regulatory authorities.

Consideration of legal topics like those mentioned is essential because the adoption of the new technology in banking is making major changes in many critical operations in that business and is introducing new entities whose rights and duties are just being defined. This is an ideal time to make this study, before many policies have been formulated and legal rules adopted. Conclusions reached can help greatly in achieving controlling policies and laws that reflect the peculiar needs of the new technology and of persons affected by its use in banking.

This article undertakes to provide a broad review of the many legal implications that might flow from the introduction of computers into the banking business [1]. Although oriented primarily for the layman who is involved in either banking or data processing, the discussion also should provide much assistance to lawyers unversed in the new electronic information processing technology. The primary purpose of this presentation is to help laymen concerned with the use of the machines in the banking business identify factual aspects of potential legal significance for further study by legal specialists. It is essential that those laymen be able to serve as problem finders and perform that function at the earliest possible stage in the adoption of computers in specific applications, while solutions are the easiest and least expensive to accomplish and while contracts are being negotiated.

However, this article is not intended to make lawyers out of bankers and computer specialists or even to give definitive answers to many of the possible legal problems identified. As usual, legal generalities can provide only clues. Meaningful answers to problems must be formulated with respect to specific fact situations and in terms of applicable laws. Laws frequently vary among states, for example, and the proper ones must be applied in each instance. To give the general treatment greatest value, however, as many factual examples as possible will be used.

To provide laymen with a feeling for legal problems lurking in the mechanization of banking, the subject will be approached here from a number of different points of view, some legal, some factual. Essentially, considerations underlying and characterizing the pertinent legal rules and requirements will be identified. Knowing them, it should be possible to spot many legal problems not previously recognized and not covered here. At the outset, successively, the sources of legal rules and requirements will be pointed out, the nature of legal implications that should be anticipated will be indicated, the types of interests in the banking area that legal rules exist to protect will be explained, and activities that appear to require particular attention will be suggested. Thereafter, a series of examples of legal questions will be presented, drawn from the activities in mechanized banking considered to warrant special study. Finally, recommendations will be offered of programs for avoiding or at least minimizing legal problems in the banking business.

Sources of Legal Rights and Obligations

Legal rights and obligations pertinent to the mechanization of the banking business, like such rights and obligations generally, have a variety of different sources. However, none is of greater significance than the others. Each must be considered and re-

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spected with equal care. All have to be examined in searching out potential legal considerations in banking mechanization.

Statutes. Statutes enacted by Congress and state legislatures probably are the first source of legal rules normally thought of. The banking business is highly regulated because of its importance to society and the grave dangers inherent in the possible abuses that might be practiced. Hence, statutory enactments pertinent to banking are extensive and cover a wide range of its aspects, and many of them are relevant in this discussion. For example, Congress forbids member banks of the Federal Reserve System to pay interest on demand deposits, directly or indirectly [2]. Similarly, many States limit the portions of the capital of banks that may be invested in data processing facilities [3].

Common-law rules. Exercising their inherent powers under our Anglo-American system of law, courts formulate legal rules in areas not covered by statutes, as they decide specific cases. These cases generally involve suits relating to contracts or suits for damages because of harmful conduct, the latter commonly known as tort suits. A substantial body of legal rules has been built up in this fashion. Like statutes, they cover a very wide range of subjects and situations. Although, in the main, common law rules apply generally and are, in that respect, relevant to banking operations, some few have peculiar application to situations in that business [4]. For example, in this fashion, it has been established that a bank that discloses information about a customer, without legal privilege, is liable to him for damages suffered and also that a bank that refuses improperly to honor a business depositor's check must pay substantial damages to him for slander of credit. As will be explained later, the rigors of the latter rule have been mitigated substantially for banks by statute.

Requirements of administrative agencies. Requirements established by government regulatory agencies with jurisdiction over banks constitute a very important source of rules with the force of law. Those requirements might be formalized as published regulations. They might, however, also stem from less formally determined ways of performing administrative functions, like bank examinations or audits. Normally, administrative agencies are given merely general responsibilities by the legislative bodies that set them up and are expected, by means of their rules and regulations, to furnish the details that give meaning to the underlying policies and to apply them to specific fact situations. A unique characteristic of administrative agencies is their power to decide specific cases involving the application of their regulations, as well as to promulgate those regulations in the first instance. Hence, agency decisions and rulings relating to particular fact situations also disclose important legal rules. As stated, the banking business is highly regulated. This is indicated at least superficially, by the number of agencies involved in the process, all of whose regulations are pertinent. They include, for example, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the various state departments of banking, and the Federal Internal Revenue Service. The regulations of those agencies most pertinent to this discussion probably are those relating to examinations and audits of banks.

Private contracts. The specific agreements and understandings that banks enter into with their customers or with outside data processors also reflect legal considerations highly pertinent in connection with bank mechanization. Although such contracts usually are in writing, and always should be, they might be oral. And written contracts might consist of an exchange of correspondence as well as a single formal document executed by both parties. Those contracts constitute, for the parties to each transaction separately, a body of special and frequently very important rules of law. They might, for example, define the extent to which each of the parties will suffer any losses, either by paying out damages or by foregoing the receipt of damages as compensation, where economic harm flows from improper acts in the course of the relationship. It should be borne in mind that contracts normally cannot limit liability that exists to other persons. In a few types of situations, parties may not alter their liabilities by contract. For example, under Pennsylvania's version of the Uniform Commercial Code, a bank may not escape liability, in connection with its handling of bank deposits and collections, for its own lack of good faith or failure to exercise ordinary care, or limit the amount of damages it must pay for harm resulting from such conduct [5].

Nature of Legal Implications Possible

The kinds of different legal implications that might flow from banking mechanization are as varied as the sources of legal rules out of which they might arise. Circumstances are considered to constitute legal implications because, as indicated in the examples detailed below, by virtue of the authority or coercive power of a government body, a person enjoys a benefit or suffers a burden. The natures of the possible burdens differ widely. Some probably are not usually identified as legal penalties. Their practical effects, however, are similar, and all warrant careful consideration to their avoidance wherever possible.

Lawsuits for damages. The type of legal entanglements most commonly thought of is a civil suit in the courts for damages. These suits can seek to enforce rights created by contracts or to secure money damages for harm resulting from an act made improper by statute or by the common law rulings of judges. Enforcement of these rights is left entirely to the private person who suffers injury. Suit is brought at his discretion and at his expense. No civil penalty is suffered for a transgression unless injury is suffered and a claim is pressed. Reference already has been made to the obligations of banks to pay damages to customers harmed by the improper disclosure of information about them or by the wrongful dishonor of their checks. Such damages would be sought by a civil suit.

Criminal prosecutions. Many legal rules make particular conduct improper and impose criminal penalties for indulging in it. Although criminal prosecutions in the banking business are not common, the possibility always is present and cannot be ignored. Criminal penalties particularly pertinent to the introduction of computers into banking are found in laws relating to the preservation of records [6] and to the falsification of records [7]. Many of these criminal penalties for acts of the banks themselves, like the failure to preserve records, are applicable to their officers personally.

Remedial action to comply with rules. Frequently, a person found to be in violation of a legal requirement will have to take steps to remedy the deficiency. For example, a bank might fail to provide, in a computer system, for records deemed necessary by its state banking department for the conduct of examinations. The need to suffer expense in order to achieve compliance, although not ordinarily thought of as a penalty, can be a legal implication as significant as, if not even more burdensome than, a judgment for damages.

Drafting contracts. Transactions between banks and their customers or their outside data processors involving data processing, in and of themselves, have impportant legal imlications. For

example, the allocation between the parties of the losses resulting from improper conduct, like carelessness or intentional acts, should be decided upon in advance and stated in a contract. The parties have many opportunities, in this manner, to establish special, but very important, legal rules applicable only to their own dealings [8]. Full use should be made of these opportunities to adopt provisions that will help resolve conflicts, which inevitably arise. Of a similar nature, are arrangements between banks or data processors and their bonding companies, by which the burdens of legal liability are spread through insurance.

Interests Legal Rules Exist to Protect

Obviously, legal rules do not exist for their own sake, however unreasonable or unnecessary, on a rare occasion, they might appear to laymen to be. They always are adopted to protect or foster very specific interests in society. With a knowledge of the reasons why legal rules were adopted, of the interests they aim to protect, it might be possible to anticipate how existing rules will be applied to new types of situations and what new rules might be expected for novel circumstances. Various interests intended to benefit from laws applicable to banking are treated below.

Right of bank customers to recover damages. Customers of banks have the right not to be subjected to economic loss because of the careless or intentional improper acts of employees of banks. Legal rules provide that they are entitled to receive damages for any injury they suffer in that way. The right of a customer to sue for damages resulting from the improper disclosure of information about him or from the unwarranted refusal to pay his check are examples of legal protections of this type.

Supervision of bank operations. To protect depositors from losses due to improper bank management, governmental supervisory agencies reserve extensive examination privileges. To make certain that banks are economically stable, examiners regularly check on the sufficiency of assets on hand and on the existence of adequate protections, like fidelity bonds and insurance, to cover losses that might result from thefts, damage suits by customers, and similar misfortunes.

Restriction of banks to banking functions. Generally, statutes and supervisory authorities will not permit banks to engage in nonbanking activities and businesses, in order to protect depositors from the resulting risks of loss. The economic hazards inherent in banking are known and can be provided for to a reasonable extent. Foreign risks are variable and frequently are of unknown magnitudes and, hence, cannot safely be taken. In this respect, is it economically safe for a bank to engage in the data processing business?

Activities in Bank Computerization Requiring Attention

The last way to approach the legal implications of the use of computers in the banking business is to examine the particular activities or operations that seem to have such implications. Not all aspects of banking have special legal considerations because of automation. The few that do should be scrutinized closely to determine the facts involved. Since most readers will be operation-oriented, this approach will be developed in greater depth than the previous three, and its various facets will be illustrated with numerous examples. This topic will be broken down into the following four categories: the use of computers to conduct banking operations, the acquisition of computers by banks, resort to off-premises processing, and performance by a bank of data processing for its customers.

It should be recognized that the discussion and illustrations below are not exhaustive. As stated at the outset, they are furnished to provide an overview or perspective on the subject, from which other legal implications can be identified by persons intimately acquainted with the operations involved.

To a certain extent, however, because numerous examples will be provided, this segment of the discussion actually will serve as a check list of many legal implications of computerized banking that are recognized readily and should be considered by banks, data processors, supervisory agencies, bonding companies, and customers of banks. To achieve the completeness appropriate to a check list, necessarily many of the examples referred to previously will be repeated, but generally with elaboration.

The following review of legal considerations will provide the basis for the recommendations that conclude this article.

Use of Computers in Banking

There are a number of very different legal considerations that flow directly from the phenomenon of using computers in the banking business. As might be expected, they concern banks primarily, rather than the other persons involved. However, the others, especially users of bank services, are affected in some instances and should find the discussion pertinent to themselves.

Use of computer systems by banks. Ordinarily, it would be unusual to question whether a bank may use computers in its own operations. That would seem to be the prerogative of any business. However, the extremely highly regulated nature of the banking business gives that inquiry substance. Conceivably, the supervising agencies that maintain close watch over bank operations might object, in a mood of extreme conservatism, to the radical change in records and operations that sophisticated computer systems have in store, if not to less substantial alterations already being experienced. Those agencies probably have considerable power to dictate operating methods of banks, if they choose to exercise it.

Of course, viewed rationally, there should be no question about the privilege of banks to adopt the new technology. In doing so, they should be able to satisfy conveniently all reasonable documentation requirements of their supervising agencies. In fact, in many situations, banks probably have an obligation to computerize. Only in that way, for example, will commercial banks be able to cope with the tremendous volume of check transactions. Manual operations prove quite inadequate for the task. Furthermore, the new machines are making it possible to achieve significant economies and to reduce bank service charges, reversing the upward trend of many years.

If any direct legal authority is needed for the use of computers by banks, it can be found in the many state statutes that permit banks to invest in the devices [9], and the Federal law covering bank service corporations [10]. Such authorization is implicit in those statutes.

Distribution of losses from encoding errors. Considerable attention has been given to the way to allocate among banks possible losses resulting from errors in inscribing in MICR the dollar amounts of checks on their lower margins so that they can be processed by computers. This is a highly technical subject of the law of negotiable instruments, covered by the Negotiable Instruments Law and the newer Uniform Commercial Code. For present purposes, and to avoid duplication, it should suffice to refer

readers to well considered articles appearing elsewhere [11]. If laymen have any question concerning this aspect, they should recognize, as undoubtedly they expect, that every effort will be made to impose liability on the bank whose employee made the mistake.

Misuse of checks with MICR account numbers. The inscription on checks of bank and customer account numbers in MICR probably will alter practices, and eventually legal rules, respecting the proper care and safeguarding of check blanks. Where old style checks are used and the myth of careful bank examination of all signatures, to detect forgeries, is prevalent, depositors have no obligation to safeguard their blank checks. Apart from any names imprinted with regular ink, all checks of a bank are the same and, presumably, are equally useless to unauthorized persons.

The situation respecting blank checks is very different where MICR inscribing is present and computers are used to sort and process checks [12]. Signature checking and filing of checks by customers are the only manual operations that remain. When machine filing is achieved, every effort will be made to eliminate signature checking overtly. Under those circumstances, the check inscribed with an account number in MICR becomes, for all practical purposes, the equivalent of a check signed in blank today or a credit card. Looking forward to that development, one very reasonable to expect, it probably is safe to forecast that customers will be required increasingly, from now on, to safeguard their own inscribed checks and to notify their banks in the event of loss. In addition, it probably also will become necessary to enact laws making it a crime to use a check bearing another's account number in MICR with intent to defraud, to forge an account number in MICR, and to engage in similar practices.

Anachronism of check certification. In automated systems, processing certified checks becomes an unnecessarily expensive procedure, for which cashier's checks seem to provide an entirely satisfactory substitute. Certified checks are demanded because they signify that funds are on hand at the bank. To accomplish this, when a check is certified, the bank earmarks funds in the depositor's account to cover it. If certified checks were processed by machine systems in the normal manner, when they were presented for payment, they would make deductions from the depositor's accounts without being associated with the earmarkings. This would be tantamount to a second deduction for the same check. To avoid this, certified checks must be handled manually, as exceptions to the machine system. To accomplish this treatment, many banks multilate the customer's MICR number when making the certification. As indicated, cashier's checks, in sharp contrast, flow smoothly and normally through the new systems.

As desirable as it might be to eliminate check certification, that step is not yet possible. Many statutes and official regulations provide for the acceptance of such checks but not cashier's checks [13]. Efforts probably should be initiated to secure official acceptance of cashiers' checks routinely and to discourage the use of certified checks.

Availability of substitute equipment. Undoubtedly, banks using computers, either on or off premises, will have to satisfy their supervisory agencies that substitute equipment is available if the primary machines are knocked out by power failure, breakdown or other catastrophe. Where accounting, check processing and other functions are done manually by a large staff, a complete cessation is extremely rare. Reliance upon a machine alters the situation completely. Operations are entirely dependent upon its sustained functioning. Governmental authorities will not brook such vulnerability, even if a bank might be cavalier about it. Contractual arrangements will have to be made for standby equipment conveniently available.

Protection secured by fidelity bond. Although a fidelity bond does not cover the expense to compute the amount of the loss involved, it will provide reimbursement for the cost of repairing the harm done to an accounting system by a disloyal employee. This cost can be required to untangle an accounting system that has been snarled in the course of a scheme to defalcate. Where computer systems are used for bank accounting, it is entirely possible that greater expense will be required to straighten out the records than in the case of a manual system.

Review of system documentation. There may be legal situations in which it is essential to determine whether a bank used reasonable care in taking action. If such action is carried out by a machine system, all the ingredients making up reasonable care are reflected in the system documentation. This includes, particularly, precautions to avoid error. It should be recalled that, in litigation, legal adversaries frequently can secure evidence from the files of the other side. Hence, system documentation would be readily accessible, in that manner, for examination and use in evidence. Under the circumstances, computer users—and banks are no exception—should be careful that their system documentation does not contain incriminating or harmful information. Since notions of the propriety and sufficiency of precautions frequently change, such documentation should be reviewed periodically.

Acquisition of Computers by Banks

Because banks are so highly regulated, the extent to which they may invest in computers and in the capital stock of companies providing data processing service is provided for by law. Statutes specify the percentages of their capital that banks may devote to those purposes. In Pennsylvania, for example, they may not invest more than 25 per cent of their capital and surplus in real estate and data processing facilities combined [14]. Similarly, no bank may invest more than 10 per cent of its capital and surplus in a bank service corporation authorized by Federal law [15].

Closely allied to the acquisition of computers by banks is their ownership of stock in outside processors. Many states and the Federal government have enacted laws to authorize this step [16].

Off-Premises Processing

The legal implications of off-premises processing probably are the most interesting of all those resulting from the introduction of computers into the banking business. The phenomenon of off-premises processing is entirely unique. It represents the first time that traditional bank operations have been entrusted to outsiders. The practice was entirely unanticipated when existing legal rules applicable to banks were established by legislatures and courts.

Before considering the possible legal considerations of off-premises processing, it is important to recognize the role of the practice in the banking business. Like in other areas of the economy, it is an important practical means for providing banks with data processing services at lower costs or with greater efficiencies made possible by specialization and a high volume of business. In many situations, lower processing costs are achieved by that

practice because, apart from any minimum charge, payment is made only for actual services utilized and varies directly with need and use. Consequently, there are sound economic reasons for achieving solutions to legal questions involving off-premises processing favorable to the practice.

Examination of outside processor. It must be recognized that an outside processor will be subject to the same examination by supervisory agencies as is the bank for which it does work [17]. Banks could not possibly minimize examination of their activities by farming out their clerical and accounting operations, and none expects that. Methods for providing for examination of outside processors are being formulated now. Under the Bank Service Corporation Law, banks subject to examination by a Federal supervisory agency must make arrangements with their outside processors for examination and must submit written assurances to that effect [18]. All state banking departments undoubtedly will have similar requirements.

Many, if not all, banks must pay a fee to the supervisory agencies to cover examination costs [19]. Consideration should be given to how the portion of the expense covering the outside processor will be handled. This probably is merely a matter of mechanics since the bank will pay it in the end, one way or another, or at least an amount that is reasonable for such an operation. Banks have had long experience with examinations, but outside processors will find it a new experience. Undoubtedly, they will be expected to facilitate the periodic step in order to keep the costs for it to a minimum.

Where the outside processor is located in a State different from that of the bank, it is important to make certain that the bank's examiners will cross state lines to visit the data processor. It is most likely that the state authorities will cooperate in that respect. Informal inquiry corroborates this expectation. However, this important point should not be assumed.

Outside processor's liability to depositor for wrongful dishonor of check. It already has been pointed out that the courts feel that the improper refusal to pay a businessman's check constitutes slander of credit and entitles the customer to substantial damages as a matter of course, without proof of specific harm suffered or negligence on the part of the bank. If the customer has enough money on deposit, the bank simply must pay his checks. This is the common-law rule. In considering the scope of this rule, it should be recognized that the important factor behind it probably is the harm suffered by the customer and not the causation of that harm by a bank.

In recent years, banks have persuaded state legislatures to mitigate the penalty for wrongful dishonor, and now damages generally can be collected for that act only to the extent that they can be proved specifically. For obvious reasons, in light of the enactment of those laws in the pre-computer era, the protection appears to be accorded only to banks, at least the statutes so state if they are to be taken literally [20]. How do outside processors fit into the picture?

Although, in most situations, it is unlikely that an outside processor would perform an operation that would be the cause of an improper dishonor of a check, conceivably it could. If so, especially if it is considered to be a matter of tort law rather than contract law, the outside processor might, under the common law rule, be held liable to a business depositor for damages. There probably would be adequate legal basis for imposing that liability on the processor even though it was doing work for a bank and had no overt relationship with the customer affected. But most significantly, it could be argued that the processor does not enjoy the special protection provided by statutes to banks. In this respect, there is a legal principle that statutes enacted in derogation of the common law are construed strictly. Applied here, the word "bank" would mean bank and not also data processing company.

Of course, persuasive contrary arguments can be made. For example, the data processor is not an entirely separate and distinct entity, but, for practical purposes, occupies the position of a bank in the new scheme of things. Similarly, it might be insisted that if the legislature were to enact the law now, it undoubtedly would include the data processor within it scope. Hence, it should not be deprived of the bank's protections arbitrarily and without good reason. Approached differently, it might be contended that the common-law rule arises solely from an implied contractual obligation of the bank to its customers and that there is no equivalent contract tie between the data processor and the bank's depositors.

If the data processor is susceptible to greater liability than its bank, depositors suffering wrongful dishonor because of its acts undoubtedly will try to sue it rather than the bank. When two distinct entities have different degrees of legal liability for the same harm, the one from whom the greater amount can be collected generally is sued. In the case of industrial accidents, for example, an injured employee usually tries to recover from the machinery manufacturer for negligence, where verdicts are not limited, rather than from his employer under the much less munificent fixed schedules of workmen's compensation laws.

Where statutes limiting liability of banks already are on the books, their amendment to cover data processors as well should be considered in states in which data processors might have common law liability. There probably is no sound reason for distinguishing between the two. Similarly, when such statutes are henceforth enacted, such as by the adoption of the Uniform Commercial Code, inclusion of data processors should be provided where appropriate. Unless this latter action is taken, it can be argued persuasively that the adoption of such a law after the problem has been recognized shows that the legislature intended to give the protection only to banks.

Liability for disclosure of information about a bank's customer. Courts also hold, under the common law, that the disclosure by a bank, without legal privilege, of information about a customer makes it liable for damages for any harm caused. The classic case on this point is *Tournier v. National Provincial and Union Bank of England,* [1924] 1 K.B. 461, decided in England in 1923. It held that the nondisclosure obligation was implied in the contract between the customer and the bank. This rule raises at least three interesting questions. Does it apply to the tactic of using an outside data processor? Does it apply to the outside processor as well as to the bank? What steps should a bank take to protect itself, under the rule, when it uses an outside processor? These questions are considered in the succeeding paragraphs.

Undoubtedly, the rule against unprivileged disclosure of information about a customer will not, in itself, prevent resort to outside processors [21]. In the first place, generally, the rule penalizes a bank only where harm is suffered by a customer. Where that approach prevails, mere disclosure, without accompanying injury, does not expose the bank to any penalty. Since the outside processor normally will observe strict secrecy, no injury will be suffered by the bank's customers. In this regard, however, it has been held that a depositor can secure an injunction to prevent his bank from disclosing information about him to out-

siders, specifically a district attorney [22]. That ruling tends to undermine the rationale suggested, but probably will not invalidate the practice under consideration. Secondly, resort by banks to outside processing is a legally sanctioned step and might be regarded as a privileged act. As pointed out, a Federal law and many state statutes authorize banks to use the services of data processing cooperatives and so-called bank service corporations, although they do not cover ordinary data processors. While it might be argued that those special entities are bank-dominated and, hence, most likely will observe all of the cautions of a bank, a genuinely valid distinction between them and data processing companies not owned by banks might be hard to demonstrate. Finally, and probably most conclusively, the bank utilizing an outside data processor undoubtedly remains liable to its customers for harm suffered from improper disclosure by the processor. Hence, if it is willing to risk the penalties, it is free to take the step. Utilizing an outside processor cannot give a bank immunity under the rule. Customers generally are unaware of the use of outside facilities when they deal with a bank. But, in any event, they have every reason and right to expect that the bank will do nothing to disclose information about them to others or to make that disclosure possible. Of course, a bank might try to eliminate its liability by using elaborate precautions in selecting and dealing with its outside processor. Certainly, no bank should go outside, in any case, without taking such measures. However, they probably will not insulate the bank.

The common-law rule on improper disclosure probably will be applied to outside data processors for banks. Data processors would be foolhardy to assume that it will not. Bank customers should not be deprived of their legal right to the preservation of the privacy of their affairs by the fiat of the bank in going outside for data processing. They probably will have the choice of suing the bank or the outside processor. If a bank is forced to pay damages for the improper disclosure of its outside processor, it should have no difficulty in securing at least reimbursement if not additional damages for any provable tarnished reputation. In any event, data processors would be hardput to deny liability for improper disclosure. Every one assures its customers of the secret treatment of information entrusted to it.

What protective measures must a bank take when using an outside processor to satisfy its obligation under the rule? Actually, there are none, because its legal duty is an absolute one under contract law and does not arise from its failure to take reasonable care. As indicated, a bank probably cannot shield itself from liability by using an outside processor and will remain liable to an injured customer, possibly along with the guilty processor. Nevertheless, the bank should take some precautions designed to prevent improper disclosures by the outside processor, at least to minimize its exposure to suit. Along these lines, it probably would be unreasonable to ask the outside processor to warrant that no improper disclosure will occur. After all, no liability attaches until injury measurable in money damages is proven by the customer. However, it would seem to be reasonable to insist that the outside processor's personnel be reminded, on a continuing basis, of the secrecy obligation.

The bank's main legitimate personal concern is to secure indemnification from a guilty outside processor for damages that have to be paid to an injured customer. Although a right to this indemnification very likely exists under the common law, preferably it should be provided for specifically in the contract between the bank and its processor. But the bank wants and needs more than a mere promise of reimbursement. It wants to be certain of actual payment. Probably, the best assurance of the financial responsibility of the outside processor in the event of the bank's liability for its acts is a fidelity bond covering the processor's employees. If such a bond covers losses suffered by the processor as a result of the wrongful or dishonest acts of its personnel, it should encompass legal obligations stemming from improper disclosures, in the normal situation.

Fidelity bond considerations. Banks themselves must carry fidelity bonds to provide financial protection in the event of losses resulting from the dishonesty of their own employees and to maintain their stability. As indicated, the outside processor should carry similar coverage not only for its own protection but also for the banks it serves. In relying on the fidelity bond of an outside processor, however, the bank should recognize the precariousness of that protection. Coverage of a specific employee generally is lost if he is retained with knowledge of his commission of an act to which the bond applies, without notifying the bonding company. As unlikely as such a situation might seem, the numerous cases involving just that indicate that the risk should not be overlooked. Hence, a bank could lose an important economic bulwark through no fault of its own and without even knowing about it. As time goes on, *some* protective measures probably will be worked out. Possibly, banks will be able to secure bonding coverage directly on persons who are not their employees but whose acts can subject them to loss.

Even where a bank secures full protection for itself through bonds, the outside processor also must carry its own bonds as well. A bonding company that paid a loss to a bank because of an improper act of a processor's employee would be subrogated to the bank's claim against the processor and probably would press it. Its own bond would cushion the processor against such a loss.

Effect of outside processing on obligations of prior parties to checks. A question has been raised whether use of an outside processor, with delivery of checks directly to it rather than to the bank itself, affects, in any way, the obligations of prior parties to the check in the event of its dishonor. This question also involves interpretations of the Negotiable Instruments Law and the Uniform Commercial Code. It has been the subject of a number of articles and it will not be treated here [23].

Restriction on branch banking. In some states that forbid banks to have branch offices, the question has arisen whether resort to outside processing breaches that restriction. That probably is a concern born of excessive conservatism. When subjected to close study in a number of instances, the possible handicap was felt not to be real.

Performance by Bank of Data Processing for Its Customers

Many banks are offering to perform data processing service for their customers. This novel step raises a number of legal questions, some of which are considered at this point. The factual variations pertinent to those questions are numerous. Some of these banks have computers on their own premises; others rely upon outside processors entirely. Some of the customers are other banks; others are engaged in various other businesses. Some of the work is identical to that done by the bank for itself; other work runs the entire gamut of data processing, business, industrial, statistical and scientific.

Performance of data processing for customers that are not banks. It is not entirely clear that banks may render data processing service for their customers that are not other banks. Such serv-

ices might involve, for example, payroll processing, inventory control, sales forecasting, or engineering calculations. As already stated, banks are restricted to performing banking functions. They may not engage in other businesses whose risks are variable and unknown and hence might jeopardize the assets of their depositors. Is rendering data processing service generally such a proscribed business?

For some time, banks have been providing services that a layman would not readily identify with banking. For example, many serve as travel agents, an activity that originated as an adjunct of their foreign operations. Undoubtedly, this involves a nominal investment and entails minimal risks. Similarly, banks perform investigatory services of various sorts, usually on an informal, irregular and uncompensated basis, largely as an accommodation to good customers. Again, such services probably are not extensive enough to be significant. Do such services provide an adequate precedent for full blown commercial data processing operations by banks?

A consideration that might be pertinent in determining the propriety of banks engaging in the data processing business appeared in the recent curbstone opinion of a state banking department official. He felt that that activity might be proper if a bank had genuine open machine time on computers suited and acquired primarily for its own needs but not if it secured computers specifically for that purpose or greatly in excess of its own reasonable requirements. This presents an extremely difficult yardstick, if it were to be adopted officially. The very fact that it was mentioned, however, seems to indicate the persistence of the restriction of banks to the performance of banking functions.

It is argued that banks should be permitted to sell data processing service as a means of securing customers for traditional banking services. Presumably, that ancillary benefit gives commercial data processing an aura of a banking function. This argument probably is most persuasive when payroll processing is involved, although largely on an emotional rather than a rational basis. It seems to be extremely tenuous when engineering calculations are to be made.

As the situation is developing, it seems likely that data processing service will become a normal banking function by default. Regulatory agencies do not appear to be facing the problem directly and ruling on the propriety of the activity. If that is so and if they procrastinate much longer, the amazing rapidity of current technological change will produce a longstanding customary practice to validate the activity. Even customs are easier to create with computers.

Credit to data processing customers for demand deposits maintained. Some banks are reported to be granting reductions in the charges for data processing service to the extent that the customer maintains demand deposits with them. That practice on the part of banks that are members of the Federal Reserve System appears to violate the law against paying interest on demand deposits, directly or indirectly, by any device whatsoever [24].

Of course, commercial banks generally allow checking account depositors credit, against service charges, for the amount of money kept on deposit. Although the customer never can get a net payment in this way, he can reduce the cost of his checking account. However, this reduction seems to bear a direct relationship to the charge against which it applies since it is measured by the benefit to the bank from the bank account it handles. This probably is the basis on which the practice escapes collision with the law.

The practice of allowing credit to data processing customers for demand deposits maintained apparently is proving to be less desirable to the banks offering it than was anticipated. If that is the case, the problem will solve itself. However, if the practice becomes prevalent, Federal regulatory agencies will be forced to rule on its legality under the statute cited.

Power of bank service corporations to do data processing for customers of banks they serve. Bank service corporations covered by the Federal statute might be authorized to do data processing for nonbank customers of banks they serve, if they so desire, although this is not positive. That desire is not remote, because banks well might sell data processing to be performed by outside processors, which could include such corporations. Under the law, bank service corporations may not do such work directly for customers that are not banks. They may perform only "bank services" for banks. However, the definition of "bank services" might be construed to authorize them to do general data processing indirectly through the banks they serve. Permissible services are defined there to mean not only a series of specified activities ordinarily associated primarily with banking, like check and deposit sorting and posting, but also "any other clerical, bookkeeping, accounting, statistical, or similar functions performed for a bank." In accordance with the earlier discussion, if general data processing is considered to be a banking function when sold by a bank, then bank service corporations might be authorized on that basis to do the work when so sold.

Recommendations

At the outset, it was stated that study of the legal implications of the use of computers in the banking business is timely because, with the adoption of the new technology, unique but important fact situations are coming into existence, for which applicable legal principles have not been formulated yet. The number of legal questions left unanswered in the preceding discussion indicates how very much legal work along these lines lies ahead. Furthermore, additional legal implications can be expected to arise as substantially more sophisticated use is made of computers in banking. This general situation presents a challenge and an opportunity to computer users to participate in the development of the legal rules they will have to live with.

The paucity of laws pertaining specifically to computer use in banking is understandable. The technology itself is so very new. In addition, the process of law-making also contributes to the dearth of specifically designed rules.

Thus far, legislatures have failed to act in many areas because persons concerned with deficiencies in the law have failed to press for legislation. In highly specialized areas, like banking, suggestions for legislation normally come from the persons involved. Usually, legislators do not act spontaneously. Supervisory agencies still are becoming acquainted with the technology. They probably have not yet commenced to study the many legal questions in earnest. Their regulations lie ahead. Similarly, courts have not started to mold the common law on the subject because specific cases involving the technology have not been brought before them.

Computer users can and should participate in all aspects of the law-making process described. Since law is a means for minimizing severe frictions in society and grows out of the environment in which it operates, its content frequently can be influenced substantially by the persons affected by it. The present situation is no exception. There are a number of practical

steps persons concerned with the use of computers in banking can take now to mold the legal rules applicable to that phenomenon. Those steps fall into two general categories. One is the formulation and presentation of specific recommendations for legislation and administrative regulations. The other is the creation among makers of law, who include legislators, regulatory agency personnel, judges, and potential jurors, of an understanding of the nature of computer technology used in banking and its role in that business.

In undertaking to formulate recommendations for legislatures and supervising agencies, careful study should be made of present and potential unnecessary frictions and impediments to the use of the new technology that exist in current rules of law. Already, we have some good examples. These include the frequent legal requirement that certified checks be used and the possibility that outside data processors might be subject to greater liability than banks if they cause the improper dishonor of a business customer's check. The recommendations should include both changes in existing laws and entirely new legal rules, if any appear to be necessary.

Anticipating legal requirements is a very constructive approach. It is an exercise in preventive law. It is far superior to permitting legal problems to be solved by means of rules designed for entirely different situations. It spares the courts and supervisory agencies the need to stretch and contort legal rules designed for other purposes.

The suggested program to win friends for computers is less tangible than making concrete recommendations of legal rules, but is no less important. Legal rules applicable to the use of computers in banking inevitably will be made by legislators, banking departments, judges and jurors. The attitudes with which they approach that task will determine, in large measure, the bias their legal products will reflect. If they feel that the new technology represents a substantial bonanza to its users, especially one whose benefits are not shared with customers by means of reduced charges, they will tend to resolve doubts against users and shift legal burdens to them. They will suspect that the banks' customers are being subjected to new, unnecessary risks of economic loss in the rush to automate [25]. However, if the law makers see the new technology as a necessity to carry on activities important to society, like the use of commercial checks, for example, and as a benefit enjoyed not only by users but by their customers as well, they will be more temperate in allocating legal burdens among the various types of persons involved. Then, all will be expected to share the risks as it seems appropriate. By means of the suggested educational program, law makers should be informed, through all media and on all occasions possible, of the accuracy levels achieved in computer systems, economies in prospect through their use, and the essentiality of using them to maintain, if not even improve, important banking services. Speeches, articles, demonstrations and similar devices can make an important contribution in this respect.

These recommendations are offered in the belief that they contribute to the widest use of computer technology in the banking business with an absolute minimum of legal friction. Lawyers stand ready to aid in this program to the extent that they are called upon by persons concerned with the operational aspects. Guided by the review of the types of legal implications flowing from the introduction of the new machines in the banking business, technically oriented personnel should be better equipped to identify situations that might benefit from the attention of legal specialists. A constructive and important task confronts bankers and computer specialists working with them. It is hoped that they will acquit their responsibilities promptly and with vigor.

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3. Title 7 Purdon's Penna. Stats. §819—1012.
4. For probably the first reported litigation, however imaginary, arising from the use of computers in banking, see Haddock v. The Generous Bank Ltd., Computer 1578/32/W1, The Magical Electronic Contrivances Ltd., and the Central Electricity Board, reported in HERBERT, A. P. The computer in court. *Punch* (Feb. 13, 1963), 239–41.
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17. For a valuable discussion of the scope of examinations, see Examination of Automation of National Banks. Office of the Comptroller of the Currency, 1962.
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19. See, for example, Title 7 Purdon's Penna. Stats. §754.
20. Title 12A Purdon's Penna. Stats. §4—402, which is Pennsylvania's version of the Uniform Commercial Code that probably will be adopted in many States. The prior law, Title 7 Purdon's Penna. Stats. §211, applied only to a "bank, trust company, or banker."
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