PART 2

A Historical Perspective on Money[26]

A review of the history of money in the United States reveals several points that are relevant to the work of the Task Force.[27] First, private "money," i.e., money issued by a private entity rather than a governmental organization, has been a part of U.S. monetary history since the founding of the republic. Second, the electronic transfer of bank credit did not begin in the computer age, as many believe, but has been a part of U.S. monetary history since the telegraph. Third, the issuers of private "money" have contributed to several economic crises throughout our history, particularly when those issuers either abused or exploited their privilege as issuers.

In the seventy years following the American Revolution, the federal government had only a limited role in the issuance of paper currency.[28] Instead, notes issued by banks chartered under the laws of the states served as a form of private "money" or currency. These notes represented promises to pay, or monetary obligations, of the banks that issued them. Ordinarily, state bank notes were not payable at par and the discount rate for such notes usually varied with their perceived creditworthiness.

Because information during this period was communicated inefficiently and imperfectly, a person deciding whether to take a state bank note might find himself in a difficult position. To assist with the decision-making, this person might consult one of the "bank note reporters" that circulated and contained valuation amounts for the notes of various issuers. There also existed an active brokerage market, with brokers buying notes at a steep discount and then attempting to sell them at a more modest rate. Even in this early period of our national history, arbitrage was alive and well.

During this period, bank failures were common. When a bank failed that had issued circulating notes, the holders of such notes often sustained considerable losses. Counterfeit notes were also a problem, which was exacerbated by the inefficient means of communicating financial information during the period, malefactors were able to cheat people with counterfeits because the victims would be duped into taking the bad paper without having a means to communicate with the purported issuer to determine whether it was authentic. The absence of uniformity in state bank

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[26] The discussion of the history of money in the United States is based in large part on FEDERAL RESERVE BANK OF N.Y., FROM ROCKS TO RICHES AN ILLUSTRATED HISTORY OF COINS AND CURRENCY (1992)

[27] For a discussion of the genesis of money in England prior to the America Revolution, see BENJAMIN GRYA, THE LAW OF ELECTRONIC FUNDS TRANSFER § 102 (1998)

[28] The federal government's indirect role was greater, for example, the banks of the United States, although private issuers, were governmental instrumentalities. Various governmental policies, such as the Specie Circular of 1836, affected the acceptability of state bank notes but the federal government's direct role was insubstantial.

The term "federal government," as used herein, refers to the constitutional government of the United States. The Continental Congress did have a role in the issuance of currency. In the face of huge expenses with inadequate taxing authority the Congress met the financial needs by issuing notes, which came to be called "continentals." FEDERAL RESERVE BANK OF N.Y., supra note 26 at 14

notes also added to the problem, the more different bank notes crossed an individual's hand, the less likely that individual would know that a particular bank note conformed to type.

One serious attempt to respond to these problems was the so-called "free banking movement." Supporters of this movement demanded that free banks support their note issuances with state of federal securities. A well-run issuer whose notes were backed by collateral might find that its notes traded at or near par with gold. On the other hand, if a bank were poorly run, or if word leaked out that its notes were not sufficiently supported by collateral, this could lead to a run on the bank and a reluctance on the part of commercial counterparties to take the paper of an impugned issuer. By many accounts, the free banking movement was a successful attempt at stabilizing the value of bank notes.

The federal government did not become involved in money matters until 1861. In an effort to finance the Civil War, the federal government began to issue its own currency. These federal notes were called "greenbacks" because of their distinctive color. The greenbacks were issued in denominations of $5, $10, and $20, and were redeemable by the government in coin on demand at designated subtreasuries.

In 1862, the greenbacks took a new form, a currency that was "legal tender" for all debts, with the notable exception of import duties and interest on public debt. These notes were the first federal experience with legal tender currency. Initially, $150 million of these notes were issued.

The greenbacks did not displace privately issued notes in the nation's money supply. Instead, the government paper and private paper coexisted from the time of the Civil War to 1913, when the Federal Reserve Act (FRA)[29] was enacted. It took approximately twenty more years before national bank notes were no longer in circulation.

The FRA was, in part, a response to the Panic of 1907. Immediately after that financial crises but before enactment of the FRA, the Aldrich-Vreeland Act[30] came into force. This legislation permitted associations of national banks to issue a temporary currency (Aldrich-Vreeland notes) that would expand the money supply during financial crises, with the approval of the Treasury Department. Notes of this kind, however, did not constitute legal tender. When the FRA displaced the Aldrich-Vreeland Act, its supporters considered the FRA to be a "currency bill."[31] The federal reserve note occupied a central part of the statutory scheme, revealing the importance of the currency issue at this time.[32]

The new federal reserve currency caught on quickly and, by 1920, comprised about half of the currency in circulation.[33] Like the Aldrich-Vreeland note, it was an elastic asset-backed currency, not legal tender. Unlike the Aldrich-Vreeland note, the federal reserve note was a direct obligation of the U.S. government as well as an obligation of the issuing federal reserve bank. In 1933, the federal reserve note was made legal tender. Today, the federal reserve note remains the

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[29] Ch 6, 38 Stat 251 (1913) (codified as amended at 12 USC §§ 221-552 (1994)

[30] Ch 229, 35 Stat 546 (1904)(repealed as amended in scattered sections of 12 USC)

[31] un readable

[32] The federal reserve note is authorized in § 16 of the FRA, 12 USC § 411 (1994)

[33] MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES 1867-1960, at 190, 210,217 (1963)

only circulating form of legal tender. It is regarded both in the United States and worldwide as the money of the United States.

Bank credit measured in the form of bank balances started to be used as a form of currency as early as 1782. Initially, the medium of transfer was paper. With the advent of modern telecommunications, however, came the birth of the so-called "cable transfer," which still remains a part of our federal statutory law.[34] A cable transfer refers to a bank balance that is transferred pursuant to a payment order issued by telegraph. When the first transatlantic cable was completed in 1866, commercial parties started to make cable transfers to hedge the greenback's fluctuation against the price of gold.[35]

The cable transfer is a significant artifact from the nation's monetary history because it reveals that commercial parties were using telecommunication technologies to effect payments at a much earlier stage in history than many believe. When the PRA was enacted in 1913, the cable transfer received a tremendous boost, which probably was not intended or anticipated by the framers of the FRA. The twelve federal reserve banks created by the FRA all maintained accounts with each other and banks that were members of the Federal Reserve System all had accounts with the federal reserve bank serving the geographical area where the banks were located. The result was an interlocked network of bank accounts spanning the entire United States.

> Since the earliest days, the Federal reserve banks were linked to one another by telegraph or telephone, and balances were transmitted from one member hank to another by instructions communicated by cable. These cable transmissions came to be known over time as "FedWire' and transfers affected in this manner came to be called "wire transfers." Since World War I, the wire transfer has occupied a critical place in the wholesale payments system, and its basic character has not changed in eighty-three years. Today, as it was in 1913, a wire transfer is simply a descriptive term used to characterize the transfer of bank credit pursuant to an electronic instruction.
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> Of course, computer technology gave FedWire a significant boost because it automated the accounting that needed to be done (debiting the originator of the wire transfer and crediting the beneficiary). Before the computer, the accounting was performed by clerical personnel; postings were made by hand to account ledgers which represented the bank's assets and liabilities.
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> In many ways, the history of FedWire reveals how we arrived at where we are today and is instructive because it suggests where we may be going with retail electronic payments. The telegraph was the midwife at the birth of FedWire and the system reached maturity when it was wed to the computer -- another technological marvel. Both technologies were extremely important in the development of the current highly successful wholesale payments products, which effect the transfer of credit, not money.
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> There is a perception that stored-value cards and electronic "money" products are revolutionary and unprecedented. Our monetary history should firmly debunk that myth.

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[34] See FRA § 14, 12 USC 353 (1994)

[35] Friedman & Schwartz, *supra* note 33, at 26 & n 13

PART 3

Payment Is a Legal Concept

The evolution of money in the United States is illustrative of what may be the future of stored-value products. For a significant period of time, bank credit was our only currency and produced some problems, as previously summarized.[36] These problems, and the need to finance the Civil War, led to the development of paper currency and to the creation of the Federal Reserve System. With the enactment of the National Banking Act of 1933,[37] federal deposit insurance was introduced for certain types of bank obligations. Thus development is significant because, in essence, the government stepped in to directly guarantee the bank credit which was being used as money — namely bank deposits.[38]

What, then, is a bank deposit? From a legal point of view, it is a liability owed by a bank to its customer represented by a credit entry in a liability account on the bank's books (and a corresponding credit entry in an *asset* account on the books of the customer which represents a chose in action or a claim against the bank).[39] Thus, if a bank customer were to take $100 in federal reserve notes (i.e. money) and deposit them, the customer would exchange a $100 claim against the sovereign for a $100 claim against his bank. Before the Great Depression, this distinction between a claim on a bank and a claim on the sovereign had commercial significance. The introduction of federal deposit insurance, however, has mitigated the degree to which there is a substantive difference, at least for depositors with balances at or below the current measurable limit of $100,000.

In the commercial world, large transactors consider bank credit to be the functional equivalent of money.[40] In fact, bank credit may be even better than money when one considers the feasibility of closing a $200 million acquisition with federal reserve notes. Perhaps that is one reason why people (other than academics and lawyers writing reports like this one) do not pay any attention to the legal difference between bank credit and money. From a practical perspective, it is irrelevant. There remains, however, an important *legal* difference between federal reserve notes and an insured deposit. Federal reserve notes represent "legal tender,"

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[36] *See supra* text accompanying notes 28-29

[37] Ch 89, 48 Stat 162 (1933) (codified as amended at 12 USC §§ 78-227 (1994)

[38] In the past, the government guarantee was merely the guarantee implicit in the government bond-backed currency of the free-banking system.

[39] Smith v Ajax Pipe Line Co, 87 F2d 567, 569 (8th Cir 1937), Fulton County v Wright, 91 SE 487,489 (Ga 1917), Universal Adjustment Corp v Midland Bank, Ltd, 184 NE 152,157 (Mass 1933), First Nat'l Bank v Clark, 32 NE 38, 39 (NY 1892), Richardson v Passumpsic Sav Bank, 13 A 2d 184, 186 (Vt 1940)

The Federal Deposit Insurance Act defines "deposit" for assessment and insurance purposes as obligations of the institution to give credit to a consumer's account, monies held for a special purpose, or claims against the bank under written instruments such as cashier's checks. 12 USC 1813(1) (1994)

[40] The Federal Open Market Committee, for example, considers the transaction account to be a part of M1, one of the monetary aggregates considered in fashioning monetary policy. See Federal Reserve Bull, March 1982, at 176 ("The 1980 redefinition of the monetary aggregate was designed to bring all transaction accounts into M1")

while insured bank credit does not.

Legal Tender

"Legal tender" is a concept, not a thing. When legislation of a sovereign government provides that only certain types of paper or objects, if tendered to an obligor, will discharge indebtedness, that concept is known as legal tender. The weakest form of legal tender laws merely oblige the government to accept a particular media of exchange in satisfaction of taxes. Such laws enhance the acceptability of the paper, commonly known as money, because almost all persons will eventually be indebted to the tax collector and will, therefore, need money to discharge such indebtedness. Stronger forms of legal tender laws provide that certain media of exchange, if presented to a private party, will be deemed to satisfy debts denominated in such currency. These laws may apply unless the party specifically objects or even if the party objects. The strongest legal tender laws contain criminal sanctions against a transactor who refuses to accept the tender.

Congress first authorized notes issued by the United States as legal tender for the payment of all debts, both private and public, as an emergency measure to raise funds during the Civil War (Legal Tender Act).[41] In 1869, the U S Supreme Court determined that the Legal Tender Act could not be applied retroactively to contracts executed before its enactment but left undecided whether the statute was constitutional if applied prospectively.[42] In a series of later federal court cases based upon the Legal Tender Act (Legal Tender Cases), decided between 1870 and 1884, the U S Supreme Court held that Congress had the power, under the necessary and proper clause of the Constitution,[43] to establish as legal tender a medium other than gold or silver coin. The Court stated that legal tender could be used to satisfy both public and private debts and to discharge a contract by tendering whatever constitutes legal tender at *the* time of *payment.*[44] Although the Legal Tender Cases focused ostensibly on whether Congress had the authority to establish paper as a national currency and to make that currency lawful *for* all purposes, the collective opinions can be interpreted more broadly. One can read these cases as authorizing Congress to designate *any* money as legal tender which directly or indirectly enables Congress to exercise its express power to borrow on the credit of the United States and to coin money and regulate the value thereof.[45]

Currently, for dollar-denominated indebtedness governed by U S law, "United States coins and currency (including federal reserve notes and circulating notes of federal reserve banks and national banks) are legal tender for all debts, public charges, taxes and dues. Foreign gold or silver coins are not legal tender for debts."[46] Tender of U.S. coin or currency in an amount

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[41] Ch 33, 12 Stat 345 (1862)

[42] Hepburn v Griswold, 75 US (8 Wall) 603 (1869)

[43] US CONST art I, § 8, cl 18

[44] See Juillard v Greenman, 110 US 421, 448 (1864), Legal Tender Cases, 79 US (11 Wall) 457 (1870). These cases establish the power of Congress to determine the *form* of legal tender. Other cases dealing with the Gold Reserve Act of 1934 determined the power of Congress to regulate the *value* (for convertability) of legal tender. See Perry v United States, 294 US 330 (1935), Nortz v United States, 294 US 317 (1935), Norman v Baltimore & Ohio RR, 294 US 240 (1935)

[45] See US CONST art I, § 8, cl 2

[46] 31 USC 5103 (1994), see 31 CFR 100.2 (1995) (governing the exchange of coin and paper currency of the United States including national bank notes)

equivalent to the dollar-denominated indebtedness will, therefore, work a discharge.[47]

The new payment products described in Part 1 of this Report are not legal tender, no more so than checks or wire transfers. Our unqualified legal opinion is that they represent choses in action or claims.[48] Our opinion is based on the intended use and design of these products namely, a promise by the issuer to pay the claims represented by the "value" subject to any terms and conditions on that promise. Similarly, under the UCC, these products are not money because they do not represent "a medium of exchange authorized or adopted by a domestic or foreign government."[49] To the extent that people mean "legal tender" when they say "money" the new payment products are not money. A person is not, therefore, required to accept any of the new payment products in satisfaction of a monetary obligation. More- over, tender of the new payment product does not, as a matter of law, discharge the underlying debt obligation. Consequently, there is a legal distinction between "electronic money" and legal tender.

Having stated our legal opinion, we also do not want it to be misinterpreted. It is one thing to say that stored value is not money, but it may well function almost exactly like money. The term "money" is often used colloquially to mean any thing that is widely accepted as payment by market participants in exchange for goods or services or to extinguish debts. If market participants are willing to accept stored value as if it were money, then using terminology like "electronic money" may be appropriate. For purposes of performing a comprehensive legal analysis of stored-value products, however, it is crucial that the stored value be understood to represent evidence of a claim and not to constitute either money or legal tender.

Transfer of Bank Credit

Earlier, we observed that large transactors have come to prefer bank credit as the medium of exchange.[50] Under the commercial law, the transfer of bank credit is the preferred method in discharge large debts. In part, this is because the transfer of bank credit can effectively discharge obligations to the same extent as if money had been tendered. It is also sustained from the fact that banks are closely supervised and highly regulated, coupled with the fact that bank credit *is* often guaranteed by federal insurance.[51] As a result, payments systems that transfer bank credit between parties have the public's confidence and are widely used.

But bank credit is less dominant m the retail payments system. For example, in the United States, traveler's checks, an extremely popular retail payment product, are issued almost

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[47] A person can limit the times when, and location where, legal tender may be made. See Nemser v NYC Transit Auth, 530 NYS 2d 493 (NY Sup Ct 1988). In the same vein, a person may be liable for a *prima facie* tort if a demand for payment in cash is made in a manner that causes an irreparable harm to the person making the payment. See American Bank & Trust Co. v Federal Reserve Bank, 256 US 350 (1921)

[48] Some products may be designed such that the initial purchaser of the "value" cannot go back to the issuer and redeem the "value" for the equivalent amount of money. For these products, the claim arguably does not arise until the "value" on the card or other storage device is transferred to a third party.

[49] U C C 1-201(24) (1995) The Board of Governors of the Federal Reserve System (Board of Governors) has, however, indicated that "electronic money" will be included in the monetary aggregates. Thus, there is at least one context in which "electronic money" is viewed as "money." Edward W Kelley Jr., Member Board of Governors of the Federal Reserve System. Remarks at the CyberPayments '96 Conference (June 18,1996) (on file with *The Business Lawyer,* University of Maryland School of Law)

[50] See supra text accompanying note 40

[51] See E Gerald Corrigan, Are Banks Special?, 1982, FED RESERVE BANK OF MINNEAPOLIS ANN REP 5, 13. Certain non-bank products, such as money orders and traveler's checks, have also been successful in substituting for legal tender where the non-banks as subject to stringent state law requirements such as reserve requirements and investment restrictions.

exclusively by non-banks or non-bank affiliates of banks.[52] These payment products have a fine credit history. Even though issued by non-banks, it would be a mistake to consider the traveler's check business to be unregulated. The issuance of traveler's checks is subject to significant state regulation.[53] In addition, commercial law treats traveler's checks, whether issued by a bank or a non-bank, like negotiable instruments with similar payment characteristics.[54]

While it is clear that the new products will not have legal tender status absent an act of Congress, it is less clear whether these products will nevertheless be viewed, like current negotiable instruments and funds transfers, as the equivalent of legal tender.

Pro Tanto Discharge. Modern negotiable instruments law provides that when an instrument is taken for an underlying obligation, the obligation (i) is discharged if a bank is drawer, maker, or acceptor of the instrument (but discharge does not affect any obligation that the obligor may have as indorser), and (ii) in all other cases, the obligation is suspended until the instrument is due or, if it is payable on demand, until the instrument is paid.[55] If the instrument is timely dishonored, an action may be maintained against the drawer or maker on either the instrument or the underlying obligation, discharge of the underlying obligor on the instrument also discharges him or her on the underlying obligation.

When a person accepts one of these new payment products to extinguish some indebtedness, it will be important for that person to know whether the indebtedness is discharged or only suspended. To illustrate the point, under current law, indebtedness is permanently eliminated if a cashier's check is taken.[56] On the other hand, if a personal check or a traveler's check is taken, that obligation is merely suspended until final payment.[57] If the personal check is not finally paid but is dishonored and returned, the indebtedness will be restored.

Article 4A. In a wholesale funds transfer, the underlying obligation of the originator to the beneficiary is discharged when the beneficiary's bank accepts a payment order for the benefit of the beneficiary unless (i) the means of payment were prohibited under a contract between the originator and the beneficiary; (ii) the beneficiary, within a reasonable amount of time, notified the originator of its refusal to accept the payment, (iii) the funds were not used by the beneficiary, and (iv) the beneficiary would suffer a loss that could have been avoided if payment had been made by a means complying with the contract.[58] When the beneficiary's bank accepts a payment order for the beneficiary, the obligation of the beneficiary's bank to pay the beneficiary replaces the obligation of the originator to pay the beneficiary.[59] The rationale for refusing to discharge the underlying obligation in the rare instances described in (i) through (iv)

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[52] As of January 1996, there was $8.5 billion outstanding on U.S. denominated traveler's checks of non-bank issuers. FEDERAL RESERVE BULLETIN, April 1996, at A14.

[53] Industry Group of Money Transmitters, The Services They Provide and the High Technology Challenge of the Future, (March 26, 1996)(on file with The Business Lawyer, University of Maryland School of Law)

[54] UCC 3-104(i)(1995) It is also noteworthy that traveler's checks are included by the Board of Governors in the monetary aggregates for monetary policy purposes. See Federal Reserve Bulletin, supra note 52, at A14. This reflects the family resemblance between the traveler's check and a demand deposit. Also, a traveler's check, cashier's check, money order, or other officer's check issued by a bank in the usual course of business is statutorily defined as a "deposit" in the Federal Deposit Insurance Act, 12 USC 1813(1)(1994)

[55] UCC 3-310

[56] id 3-310(a)

[57] id 3-310(b)(1)

[58] id 4A-406(b)

[59] id 4A-406 cmt 2

above is that the originator, by making the funds transfer, imposes a credit risk (the beneficiary's bank) on the beneficiary that the beneficiary had specifically contracted away.[60]

Once again, a delivery of legal tender provides a useful point of reference. Assume that *A* sells Blackacre to *B* for $1 million, and at the closing, *B* pays the purchase price to *A* with federal reserve notes. *A* takes the federal reserve notes and deposits them with *A's* bank, thereby obtaining a claim against the bank in the sum of $1 million. Between the time the currency is received from B and the time it is deposited m the bank, *A* will have credit risk against his sovereign and, at the same time, a huge personal security risk It is likely that a wire transfer resulting in a $1. million claim against *A's* bank would have suited *A* much better because *A* would have avoided the personal security risk and really did not need the comfort of a claim against the sovereign (which *A* quickly exchanged for a claim on A's bank when *A* made the deposit).

These are the commercial facts of life that have caused large commercial transactors to learn to love the wire transfer. What is less well known is the benefit to the party making the wire transfer, *B* in our example. *B* becomes indebted to *A* m the sum of $1 million when title to Blackacre is conveyed. Using legal tender to make payment the debt is discharged upon tender of the federal reserve notes by *B* to *A,* with all the attendant security risks to B until the moment of tender of the currency, when those risks pass to *A* In contrast, under Article 4A of the UCC, the debt is generally discharged when A's bank accepts an incoming payment order, which can occur even if A's bank does not credit A's account in the sum of $1 million. If acceptance by A's bank does not occur for any reason, *B* is lawfully entitled to his or her money back.[61]

Article 2—Barter

Perhaps the most cumbersome way in which a person can satisfy an obligation is through barter. Barter is not really a payment method but it is commonplace for parties looking to trade goods and services. Barter transactions are covered by Article 2 of the UCC. Pursuant to section 2-304 of the UCC, in a sales contract, "the price can be made payable in money or otherwise. If it is payable in whole or in part in goods each party is a seller of the goods which he is to transfer."[62] Under Article 2 of the UCC, the seller is able to reclaim goods from an insolvent buyer who takes possession of the goods but fails to tender payment.[63]

Some of the differences between Article 2 of the UCC and Article 4A of the UCC were illustrated in a recent Second Circuit decision. In the case of *Koreag, Contr0le at Revision S A v Refco F/X Assocs,, Inc (in re Koreag),*[64] the Second Circuit treated a foreign exchange transaction involving U *S* dollars and foreign money as the barter of commodities instead of an exchange of claims on banks denominated in the currencies of the respective sovereigns. Only one of the parties satisfied its obligation under the foreign exchange agreement. This was accomplished through the transfer by wire of U S dollars to a U S account for the benefit of the other party. The beneficiary of the transfer became insolvent prior to satisfying its obligation under the agreement to deliver the foreign currency. Applying Article 2 of the UCC, the Koreag court determined the originator of the U S dollar transfer was a seller of U.S dollars and, as such, had the right to reclaim the US dollars from the insolvent buyer.

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[60] id 4A-406 cmt 3

[61] id 4A-402(c)(d)

[62] id 2-304(1) Thus, it is possible to have a sale of goods between two parties where both are sellers.

[63] id 2-702

[64] 961 F.2d 341, 356 (2d Cir 1992)

Had the court analyzed this transaction under Article 4A of the UCC, the payment to the beneficiary would have been final and not revocable. The originator of the wire transfer would not have been able to recover the funds paid and would have been forced into the position of a general creditor of the estate pursuing a claim for the insolvent's breach of the foreign exchange contract.

An initial question the Task Force considered was whether the use of the new payment products should be viewed as a barter instead of a payment. If the new products are not used to make a payment but instead to effect a barter, the credit transferred using the new products might be subject to reclamation. The Task Force believes the expectation of both the developers and users of these products is that "value" will be exchanged for goods and services and the exchange of value will constitute a payment and not a trade.[65]

As a legal arid policy matter, it is less clear whether the factors that fostered the use of bank credit instead of legal tender are present with respect to the new payment products. At a minimum, all of the commercial law issues that have been resolved in the context of transferring bank credit present themselves with the use of the new payment products. This requires an examination of what happens when one of the new payment products is actually used to make a payment.

[65] If stored value is to be used as payment in lieu of money, the application of the criminal restriction on the issuance of obligations intended to be used in lieu of money will need to be considered. 18 USC 336, see Thomas P Vartanuan et al, BNA's Banking Report, Sept. 23, 1995. at 465-470