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On Line Financial Services: Liability for Error Or Malfunction in Stock Transactions Over Personal Computers

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I. INTRODUCTION: THE EMERGENCE OF FINANCIAL DATA PROCESSING NETWORKS

Data communication networks have proliferated largely as a result of the merging of data processing and communications technology. Originally, access to these networks was limited to institutions who could afford the large capital expenditures necessary to purchase and maintain a computer. However, with the development of the silicon chip and the ensuing production of the personal computer, access to data communications networks is now available on the consumer level. Commercial data-base vendors are expanding beyond the traditional markets of government, university libraries and large corporations — to sell information to individuals and small businesses. The result is an information revolution. Now, almost any computer can be connected to the phone system and therefore can communicate with large databases. All that the user needs is communications software and a modem, an inexpensive piece of electronic hardware that converts the computer's digital signals into tones that can be carried over phone networks.

While the benefits of such networks are obvious, increased consumer reliance on these communications networks inevitably will create legal problems. As data communication networks increasingly are used to accomplish financial transactions, the potential for...
system error, malfunction and the resulting loss will increase correspondingly.5 This potential for error in computer transmission may result in enormous loss of funds and consequential damages.6 One of the central legal questions surrounding such transactions is the fair and practical allocation of liabilities between service providers and users.

This Note focuses on the narrow issue of the liability of banks which provide electronic stock transactions. In order to provide a full range of financial services to their customers, many banks have recently expanded their services to offer discount brokerage services.7 In addition, many banks have begun to offer twenty four hour a day home banking and other electronic financial services to personal computer users.8 The combination of the bank's new role as a discount broker and the availability of stock trading and other financial transactions through electronic networks raises the issue of liability allocation for errors and malfunctions in electronic stock transactions.

After a brief discussion of the recent changes in banking law which have allowed banks to expand their available financial services into the discount brokerage field, this Note examines the electronic systems involved and the existing law governing the liability of banks as service providers in this area. This Note points out the inadequacy of existing legislation and suggests a policy for further regulation in this field.

II. HISTORICAL BACKGROUND

A. The Entry of Banks Into the Discount Brokerage Business

Several banks have recently entered or expressed their intent to engage in discount brokerage activities.9 This action comes as banks, in an effort to compete with other financial institutions, expand their services to meet the needs and demands of a growing consumer market.10 The recent involvement of banks in discount brokerage activities comes as a direct challenge to the general policy

5. Owen and Komarow, supra note 1.
6. Id.
8. Conant, Cook, and Marbach, supra note 2.
of federal banking law to keep investment banking separate from commercial activities. The Comptroller of the Currency has traditionally opposed any enlargement of the scope of banking activities on the grounds that depositor's investments should be protected by keeping banks from activities which would place these investments at too great a risk.11

In contrast to this policy, the Comptroller recently granted permission for two banks to enter the discount brokerage business through separately incorporated subsidiaries.12 In so doing, the Comptroller approved in principle, the direct involvement of banks in the discount brokerage business.13 This decision marks a loosening of the traditional policies which have barred banks from entering the securities industry. Although there is opposition to this expansion from the Securities Industry Association,14 the continued involvement of banks in the discount brokerage business seems assured.15 The result is that banks are now beginning to offer securities trading in addition to their other services.

B. The Nature of Financial Data Networks

Apart from the changes in the policies regulating the scope of banking transactions, changes are also taking place in the technical way in which these transactions are carried out. Many banks have recently extended their services to include the processing of financial transactions through electronic tellers and customer's personal computers. The following is a brief description of the electronic networks which banks are using to provide these services.

Financial data networks provide information through telephone lines for use on an end-user's personal computer. Information initially is gathered by the financial service provider and programmed into a large central computer. The information then is transmitted through telephone networks and is decoded and processed by a user's computer. Some systems provide only a one way flow of information, from the source to the end user.16 The

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11. The Comptroller of the Currency is the federal authority that regulates national banks. See National Banks, supra note 7, at 1306-13.
12. Id. at 1316.
13. Id. at 1317.
14. Id. at 1322.
15. "By the end of 1982 over a hundred banks had, either directly or indirectly entered the brokerage business." Id. at 1315.
16. An example of such a system is "Huttonline," offered by E.F. Hutton. This system provides stock prices and other financial information to investors. See Steidtmann, Brokerage Firms Go On Line, PC WORLD, March 1984, at 232.
ability of newer computers to receive and process several signals simultaneously, has led to interactive systems which provide two way communication between the service provider and the end user. Several users are now able to go “on line” with the central computer at the same time. The result is a star shaped network, the center of which is the service provider, in this case the bank, and at the several points are the end users, the investors.

Home computers used in conjunction with financial telecommunications networks have made possible increasingly more complex financial management in the home. Checks, notes, and cash payments are increasingly being replaced by data stream transactions. Paper records of the transactions only serve as evidence of a transfer accomplished entirely through electronic means.

All home banking transactions on personal computers, are known as “electronic funds transfers” (EFT) and are regulated by the 1978 Electronic Funds Transfer Act (EFTA). While there are many restrictions on the services which may be offered by banks through EFT systems, the benefits of such services are generally recognized and the trend is toward the expansion of EFT services. As a result of the recent entry of banks into the discount brokerage business, one of the services which many banks have begun to offer recently is electronic stock trading.

Electronic stock transactions are similar in many respects to other home banking transactions. The end-user initially goes on line with the bank/broker by opening an account. The user then places his orders through his personal computer by entering the stock symbol and an order to buy or sell. This order is then transmitted to the bank/broker, and then directly to the trading floor for execution. Once the transaction has been completed, the user receives a confirmation over the screen, and later receives written con-

18. “The fledgling information utilities are hoping to cash in on a much larger market. One of the sure bets will likely be financial services—stock quotes, financial data, and news.” Conant, Cook, and Marbach, supra note 2. These services include payments and transfer of funds, as well as point of sale transactions. See Banking By Blip, 69 A.B.A.J. 263 (1982), see also Raysman and Brown, EFT and Duty of Care, 199 N.Y.L.J. 1, col. 1 (1982).
20. See Banking By Blip, supra note 18.
21. The Federal Reserve Board in August 1982 amended Regulation Y relating to bank holding companies, allowing them to expand their permissible data processing activities. That action followed approval of an application by Citicorp to engage in data processing and data transmission activities through its subsidiary, Citishare. Id.
22. Regarding the entry of banks into the discount brokerage service, see supra notes 10-16 and accompanying text.
firmation in the mail. The total time for an electronic stock trade is usually less than three minutes.\textsuperscript{23} Billing is done either through a credit card, or through the transfer of funds from another account. In addition to providing stock transactions, the service usually offers tax records maintenance, and automatic portfolio management. An investor may also place an order to buy or sell a stock automatically if that stock reaches a certain price.\textsuperscript{24}

In the immediate future, banks offering discount brokerage services will become the main providers of electronic stock trading. The appeal of discount brokerages is that their direct order entry cuts the salesman out and obviates the need for a full service broker.\textsuperscript{25} As many banks are rapidly entering the discount brokerage business and already have the systems available to offer home banking, it is certain that most banks will offer electronic stock trading. With this new service will come a potential liability in an area where regulation is insufficient and existing law is unclear.

III. CURRENT BANK LIABILITY IN ELECTRONIC STOCK TRANSACTIONS

Electronic stock transactions, like other electronic financial transactions, are subject to error and system malfunction.\textsuperscript{26} Error involves accounting or arithmetic errors, incorrect or unauthorized transactions, and failure to enter transactions that were properly conveyed to the bank/broker.\textsuperscript{27} System malfunction occurs when an electronic transaction system fails to operate properly.\textsuperscript{28} System malfunctions may produce errors, delay in transactions, or failure to accomplish the desired transaction. The slightest error or system malfunction could result in a substantial loss of profits and consequential damages to the investor.

An example illustrates the potential problems. A user opens an account with his bank and signs on with its full service home banking and discount brokerage service. He initially places an order to buy 1000 shares of IBM stock which is selling at $110 a share. His initial investment is $110,000. The user then places an

\textsuperscript{24} Id.
\textsuperscript{25} Id.
\textsuperscript{26} NAT'L COMM. ON ELECTRONIC FUND TRANSFERS, EFT IN THE UNITED STATES; POLICY RECOMMENDATIONS AND THE PUBLIC INTEREST, at 55 (1977) [hereinafter cited as FINAL REPORT].
\textsuperscript{27} Id.
\textsuperscript{28} Id.
order to sell the stock *if at any time* it increases to $120. The user specifies that the order continue subject only to his express cancellation. The user immediately receives confirmation of his order on his computer screen, and later receives written confirmation by mail.

Subsequently the user leaves town on a business trip. While he is away, IBM announces plans to build a new computer and its stock increases to $125. However, due to error or system malfunction, the bank fails to sell the user's stock. Before the user returns, IBM stock returns to $110. When the user returns from his travels, expecting to find a $15,000 profit, he is disappointed to learn that his order has not been executed. Upon notifying the bank he finds that his order was not placed because of a "computer malfunction." Frustrated and dissatisfied, the user files suit seeking $15,000 lost profits.

Assuming that both the user's computer and the telephone network operated properly and that the failure to complete the order in fact was due to error by the bank or computer malfunction, the question arises as to what extent the bank is liable for the lost profits. There is no clear answer. Because of the relatively recent entry of banks into the discount brokerage service, and the rapid technological developments which allow banks to offer electronic stock trading, the law which applies to this area has not been defined.

Although the EFTA regulates electronic fund transfers by banks,29 it is questionable whether this Act also applies to electronic stock transactions by banks. If EFTA is not applicable, then allocation of liability between banks and end users will rest on traditional common law contract principles.30 This section examines the possible application of EFTA to electronic stock transactions, the regulation of discount brokers by the Securities Exchange Commission and the National Association of Securities Dealers, and finally turns to the common law to resolve proper liability allocation between banks and customers in electronic funds transfers.

**A. Liability Under the Electronic Funds Transfer Act**

In 1978 Congress enacted the Federal Electronic Funds Transfer Act, EFTA.31 This Act is concerned almost exclusively with

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29. *See supra* note 19.
30. The Uniform Commercial Code (UCC) has already been held not to apply to certain EFT situations. *See* Delbrueck & Co. v. Manufacturer's Hanover Trust Co., 609 F.2d 1047 (2d Cir. 1979) (While recognizing that some UCC provisions might apply by analogy, the UCC was held not to apply to interbank transfer of funds for commercial purposes because the Code does not specifically address the problems of electronic funds transfers.).
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transactions which involve individual consumers and banks. All transfers of funds through automatic teller machines, point of sale machines and home banking through home computers are regulated by this act. In general, the Act is a consumer protection law designed to protect the individual user from error attributable to his bank.

EFTA most likely does not apply to electronic stock transactions by banks acting as discount brokers. While the Act expressly applies to electronic funds transfers, an electronic funds transfer is defined as "any transfer of funds . . . which is initiated through an electronic terminal, telephonic instrument or computer . . . so as to order, instruct, or authorize a financial institution to debit or credit an account." The Act specifically states however, that the term "electronic fund transfer" expressly excludes any transaction the primary purpose of which is the purchase or sale of securities or commodities through a broker dealer registered with or regulated by the Securities and Exchange Commission. Banks acting as discount brokers are neither registered with nor regulated by the Securities Exchange Commission, therefore EFTA may be applied directly to electronic stock transactions. Direct application is unlikely however, because it is clear that the drafters of EFTA did not intend that it should apply in such situations.

But, even if EFTA is not applied directly, it is likely that its standards will be applied by analogy. The legislative history of the

32. (6) [The term "electronic fund transfer" means any transfer of funds, other than a transaction originated by check, draft, or similar paper instrument, which is initiated through an electronic terminal, telephonic instrument, or computer or magnetic tape so as to order, instruct, or authorize a financial institution to debit or credit an account. Such term includes, but is not limited to, point-of-sale transfers, automated teller machine transactions, direct deposits or withdrawal of funds, and transfers initiated by telephone . . . .] 15 U.S.C. § 1693(a)(6).

33. "(b) It is the purpose of this subchapter to provide a basic framework establishing the rights, liabilities, and responsibilities of participants in electronic fund transfer systems. The primary objective of this subchapter, however, is the provision of individual consumer rights." 15 U.S.C. § 1693(b).


37. Id.
Act states that one of its purposes was to assure that all electronic financial transactions would be subject to the same standards.\textsuperscript{38} The legislative history also indicates that the definition of electronic funds transfer was intended to give the Federal Reserve Board flexibility in determining whether new or developing electronic services should be covered by the Act.\textsuperscript{39}

Although it initially appears that electronic stock transactions were not intended to be regulated under EFTA, such transactions involve many of the same procedures as electronic funds transfers and so are likely to create similar types of problems. In determining whether EFTA should apply to a particular activity, one of the criteria suggested by the drafters was whether current laws provide adequate consumer safeguards.\textsuperscript{40} Since there are no consumer safeguards yet for electronic stock trading, it is reasonable to assume that courts may apply the standards of EFTA—either directly or by analogy—to disputes involving electronic stock transactions.

The liability of a bank for error or system malfunction is set out in section 1693 of EFTA.\textsuperscript{41} Under this section, a bank is liable for all actual damages proximately caused by its failure to transfer

\textsuperscript{38} S. REP. No. 95-915, 95th Cong. reprinted in 1978 U.S. CODE CONG. & AD. NEWS 9403, 9410-1411.
\textsuperscript{39} Id. at 9411.
\textsuperscript{40} Id. at 9411.
\textsuperscript{41} Section 1693h reads as follows:

\textbf{§ 1693h Liability of Financial Institutions}

\textbf{ACTION OR FAILURE TO ACT PROXIMATELY CAUSING DAMAGES}

(a) Subject to subsections (b) and (c) of this section, a financial institution shall be liable to a consumer for all damages proximately caused by—

(1) the financial institution's failure to make an electronic fund transfer, in accordance with the terms and conditions of an account, in the correct amount or in a timely manner when properly instructed to do so by the consumer except where—

(A) the consumer's account has insufficient funds

(B) the funds are subject to legal process or other encumbrance restricting such transfer;

(C) such transfer would exceed an established credit limit;

(D) an electronic terminal has insufficient cash to complete the transaction; or

(E) as otherwise provided in the regulations of the board;

(2) the financial institution's failure to make an electronic fund transfer due to insufficient funds when the financial institution failed to credit, in accordance with the terms and conditions of an account, a deposit of funds to the consumer's account which would have provided sufficient funds to make the transfer, and

(3) the financial institution's failure to stop payment of a preauthorized transfer from a customer's account when instructed to do so in accordance with the terms and conditions of the account.
the correct amount of funds, or failure to transfer funds in a timely manner. The bank similarly would be liable for damages due to any technical malfunction, unless the user knew of the malfunction at the time he attempted to make the transfer. The effect of section 1693 is to impose strict liability on the bank for direct damages caused as a result of error or malfunction in the bank's system. Returning to the example of the user who purchased the IBM stock, assuming EFTA were applicable, the bank would then be liable for the $15,000 lost profits.

B. Potential Regulation of Banks by the Securities Exchange Commission and National Association of Securities Dealers

Thus far, banks have entered the discount brokerage business only through subsidiaries and holding companies. Recent decisions by the Comptroller of the Currency, however, seemingly approve the direct national bank entry into the field of discount brokerage. The brokerage business is an area traditionally regulated by the Securities Exchange Commission (SEC), and the National Association of Securities Dealers (NASD). It is not clear, however, if banks are subject to the same regulations as brokers. Banks specifically are excluded from the definition of "broker" in the Securities Exchange Act of 1934. Consequently, banks are not subject to the regulatory scheme promulgated and enforced by

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(b) A financial institution shall not be liable under subsection (a)(1) or (2) of this section if the financial institution shows by a preponderance of the evidence that its action or failure to act resulted from—
   (1) an act of God or other circumstances beyond its control, that it exercised reasonable care to prevent such an occurrence, and that it exercised such diligence as the circumstances required; or
   (2) a technical malfunction which was known to the customer at the time he attempted to initiate an electronic fund transfer or, in the case of a preauthorized transfer, at the time the transfer should have occurred.

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(c) In the case of failure described in subsection (a) of this section which was not intentional and which resulted from a bona fide error, notwithstanding the maintenance of such procedures reasonably adapted to avoid any such error, the financial institution shall be liable for actual damages proved.

42. Even where the action or failure to act was a bona fide error, and the bank used reasonable procedures to avoid this error, the bank will be liable for the actual damage suffered by the user. 15 U.S.C. § 1693(h) (c).
44. S. REP. No. 92-915, supra note 38, at 9431.
45. National Banks, supra note 7, at 1322-1323.
46. Id. at 1317.
Several commentators have suggested that this exemption may result in the inadequate protection of investors. Recently, the SEC has proposed legislation which would subject banks engaging in securities activities to the full range of regulation by the SEC. The effect would be to regulate banks' liability for error in securities transactions in the same way that brokers are currently regulated. As such, it is important to examine current regulatory schemes creating liability for brokers' errors or failures to complete securities transactions.

The stated purpose of broker regulation under the Securities Exchange Act of 1934 was to "protect the public and investors against malpractice in the securities and financial markets." Its provisions primarily were designed to bring integrity to the trading of securities by eliminating undesirable practices, such as fraud and mismanagement, and thereby protect the public. To achieve these ends, the Securities Exchange Commission (SEC) was empowered to regulate all broker-dealers directly.

The task of directly regulating all broker-dealers soon proved to be too onerous for the SEC and accordingly, Congress amended the SEA in 1938 to allow regulation by permitted qualified associations. These self-regulatory associations were to promulgate rules

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48. Banks are not required to register as brokers with the SEC and so are exempt from the elaborate reporting requirements involved in registration. See N. Wolfson, R. Phillips, & T. Russo, Regulation of Brokers, Dealers and Securities Markets, ¶ 1.01-21. Banks also do not face the choice of either registering with the National Association of Securities Dealers, (NASD) or submitting to comparable regulation by the SEC. Id., at 12.03.

49. See Evans, Regulation of Bank Securities Activities, 91 Banking L. J. 611, 614 (1974) (SEC commissioner noting lack of investor protection); Securities Industry Association, Bank Securities—Activities, 14 San Diego L. Rev. 751, 790, ("Among the standards and safeguards inapplicable to banks and unavailable to their brokerage customers, are those relating to. . . prompt execution").


51. Id.

52. Id.

53. Prior to the enactment of the Securities Exchange Act of 1934, broker liability for error was determined entirely under common law tort and contract rules. These rules remain as a possible alternative to statutory regulation and will be discussed in the next section. See infra notes 76-84 and accompanying text.

54. 1964 U.S. CODE CONG. & AD. NEWS 3016.


which met SEC standards, and to discipline members who violated these rules. The only association yet to be registered in this capacity is the National Association of Securities Dealers, Inc. (NASD).\textsuperscript{57} In order to assure uniformity, the SEA was again amended in 1964 to give the SEC broader powers to alter or supplement NASD rules, as well as the power to review or set aside actions of the NASD.\textsuperscript{58} The result has been an “uneasy balance” of regulation between the SEC and the NASD.\textsuperscript{59}

1. Regulation by the Securities Exchange Commission

An evaluation of the liability of broker error begins with a focus on regulation under the SEA. Although the SEA was enacted to protect investors, its primary concern is the integrity of broker-dealers.\textsuperscript{60} Accordingly, the main focus of the act is on disclosure and anti-fraud provisions; broker error and negligence are not directly addressed. This focus leaves the investor very limited in his avenues of recovery under the SEA. In order to recover his lost profits or damages, the investor must demonstrate that the broker’s error constituted fraud. There are two possible theories which might allow recovery under the anti-fraud provision of SEA rule 10b-5.\textsuperscript{61}

First, the investor may allege that the broker’s error constituted a breach of fiduciary duty to the investor. In addition, the burden is on the investor to prove that he acted in reliance on the broker’s advice and that he placed such confidence in that advice that there was no arms-length transaction.\textsuperscript{62} While this is applicable to full-service brokers who manage an investor’s portfolio, it is hardly applicable to a discount broker who merely processes orders for a customer — especially when orders are placed entirely through a computer. Since there is little, if any, verbal communication between the broker and the investor, it would be impossible to show either (1) that a fiduciary duty existed, or (2) that the broker had knowledge that his error constituted fraud.

\textsuperscript{57} The membership of the NASD includes virtually all broker dealers engaged in the general securities business. See Lowenfels, Private Enforcement in the Over-The-Counter Securities Markets, Implied Liabilities Based on NASD Rules, 51 CORN. L.Q. 633, 634 (1965).


\textsuperscript{59} JAFFE, BROKER-DEALERS AND SECURITIES MARKETS, A GUIDE TO THE REGULATORY PROCESS (1977) at 8.

\textsuperscript{60} Loss, SECURITIES REGULATION (1961) at 1500.

\textsuperscript{61} In both cases, the investor must show that the broker breached a duty and in so doing made an intentional misrepresentation. The difficulty comes in showing “scienter,” knowledge on the part of the broker. Id.

\textsuperscript{62} Haley & Co., 37 S.E.C. 100, 106 (1956).
Secondly, an investor may assert that a broker was negligent in processing his order and that such negligence triggers the 10b-5 anti-fraud provision. The Supreme Court however, has specifically held that mere negligence is not sufficient to sustain a cause of action under 10b-5. While "recklessness" has been held in some jurisdictions to trigger a 10b-5 cause of action, recklessness is measured by the severity of the misconduct and generally requires willful disregard. A broker's mere failure to place an order probably would not constitute such recklessness, and thus the investor would be unable to maintain an action for fraud.

In sum, there is no real protection for the investor in computerized stock transactions with a discount broker under the SEA.

2. Regulation by the National Association of Securities Dealers

Apart from SEA regulations, a broker may be liable under the Rules of Fair Practice as enacted and enforced by the NASD. The standards for business conduct of a broker are set forth in Article III and require that a member shall observe both the high standards of commercial honor and just and equitable principles of trade. While this provides general principles for conduct, a further section regulating books and records provides that each member shall keep and preserve accurate books, accounts, records, memoranda, and correspondence in conformity with the rules of the NASD.

In maintaining proper records under the NASD rules, a broker is charged with a duty to use reasonable care to maintain records so that everyday operations are not impaired. The fact that record keeping functions actually may be performed by another party does not relieve the broker of liability. If these rules were applied to error in electronic securities transactions, the broker bank would be liable for all electronic orders not properly recorded and completed.

Unfortunately, with only rare exceptions, the NASD rules do

70. Id.
not provide for private causes of action. While the NASD as a self-regulatory agency is set up by brokers to create rules of conduct and to discipline members who fail to meet those standards, the focus of the NASD is not specifically to protect the investing public. Rather, the purpose of the NASD is to professionalize the securities industry and to benefit that industry.

Although in a few instances, private causes of action have been allowed for violations of NASD rules, the general trend is away from an expansion of such rights. Accordingly, while the NASD rules allow public investors to file complaints which may trigger an investigation of the broker, the penalty for misconduct will generally be a fine and/or suspension of the broker. Thus, while the NASD potentially sets up rules for broker liability for computer error, in reality there is generally no recovery for an aggrieved investor. Thus, in the example cited above, the frustrated user might be able to see that the broker is reprimanded, but he would be unable to recover his $15,000 lost profits.

C. Liability Under Common Law

1. Broker Liability

Prior to the enactment of the SEA, a broker’s liability was determined entirely by contract principles. These principles remain an alternative theory of recovery for error or malfunction in electronic stock transactions. It has long been recognized that a broker is liable for damages to an investor resulting from failure to purchase or sell as ordered unless performance is waived by the investor, or the failure to act occurs through no fault of the broker.

The law in this area is sparse, however, two cases are specifically on point. In Wotkyns v. Wm. R. Staats Co., an investor contracted with his broker to sell 50 shares of stock if the stock reached a specified price. In the two months following the receipt of this

71. For a study of these exceptions see Comment, Implied Civil Liability Arising From Violation of the Rules of The National Association of Securities Dealers, 8 Loy. L.A.L. Rev. 151 (1975).


73. Id. at 1382.

74. NASD RULES OF FAIR PRACTICE, Penalties for Violations of the Rules, Art. V, § 2301, ¶ 1, supra note 66.


76. White v. Merrill Lynch Pierce Fenner & Smith, Inc., 218 A.2d 655, 90 N.J. Super. 555 (1966) (Investor could not recover for broker’s failure to rescind order when, on the day after order was filled, trading in corporation’s securities was suspended.).

order, the stock reached the price several times, nevertheless the broker failed to sell the shares. The investor subsequently sued, and the court held the broker liable for failure to sell. The California Court of Appeals specifically found that there was no waiver on the part of the investor, and that the measure of damages for such breach of contract was the difference between the market price of the securities at the date when the broker promised to sell them, and the market price at the time later, when the customer reasonably should have taken affirmative steps to mitigate his own loss.

In a similar action, a broker was ordered by an investor to sell certain shares held in an account. The broker failed to sell at the time the order was placed, and later sold at a substantially lower price resulting in a loss to the investor. The investor brought suit. The Illinois Court of Appeals held, as a well settled rule, that a customer who has a margin account with a broker at any time may order the sale of the securities in his account, and if the broker fails to sell on such a direction the broker is liable for the resulting loss. The measure of damages in this case was the difference between the price of the shares at the time the sale was ordered, and the price at the time the sale was completed.

The effect of applying these principles to electronic stock transactions would be to place the liability for lost profits on the bank/broker if the investor could prove (1) that he placed an order with the bank, (2) that the bank failed to act upon it, and (3) that such failure resulted in lost profits to the investor. The bank would have a defense if it could prove that the investor waived his enforcement rights or that the failure to act was due to computer malfunction beyond the bank's control.

Under common law, in the case of the user who purchased the IBM stock, the bank would be liable for the lost $15,000 if the investor could show that he placed an order which the bank failed to process and the bank would have a defense if it could show that the computer had malfunctioned through no fault of its own.

2. Bank Liability Under Negotiated Service Contracts

The second area of contract law which might be applied to er-

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78. Id. at 547.
79. Id. at 549.
81. Id. at 525 (citing Markham v. Jaudon, 41 N.Y. 235; Knowlton v. Fitch, 52 N.Y. 288).
82. Id. at 525.
83. See supra text accompanying notes 76, 77.
ror or malfunction in electronic stock transactions relates to electronic fund transfers by banks which are not regulated by EFTA. In contrast to the statutory scheme provided for the consumer under EFTA, there is no legislation which regulates banks electronic fund transfers at the commercial level. As a result, an individual bank must contractually address questions of liability when agreeing to electronically transfer funds for businesses. Evra Corp. v. Swiss Bank Corp. sets forth some basic principles regarding bank liability for error or system malfunction where service is subject to the terms of a negotiated contract.

In Evra, a Chicago scrap dealer chartered a ship for two years at a fixed rate with semimonthly payments. The payments were to be made periodically by an electronic transfer of funds to the shipowner's bank in Switzerland. Because of rising charter rates, the shipowner was eager to cancel the contract. When a default arose because Swiss Bank failed to comply with the wire order to transfer funds, the shipowner proceeded to cancel the contract. The scrap dealer sued the bank for over $2 million in lost profits due to the contract cancellation.

The court found that Swiss Bank had inadequate safeguards to prevent the loss or the mishandling of messages received, and additionally, that Swiss Bank was aware that its safeguards were inadequate. Nevertheless, on appeal the court held that the bank's liability did not extend to the lost profits. The court stated that "electronic funds transfers are not so unusual as to automatically place a bank on notice of extraordinary consequences if such a transfer goes awry." The court reasoned that the bank simply did not have enough information to foresee the consequences of its failure to process the payment. Applying the rule of Hadley v. Baxendale, the court held that only foreseeable damages can be recovered on a showing of negligence and that unforeseeable consequential damages are not recoverable for the negligent handling of electronic funds transfers.

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84. See supra note 30.
85. Evra Corp. v. Swiss Bank Corp., 673 F.2d 951 (7th Cir. 1982).
86. Id. at 953.
87. The specific error which caused the failure was not determined, but the possibilities included: 1) the telex machine at Swiss Bank was out of paper, so the telex machine was unable to reprint the payment order, 2) whoever received the telex failed to deliver it to the banking department. It was noted however, that the telex machine did signal that it had received the message. Id. at 953.
88. Id. at 956.
90. Evra 673 F.2d at 958.
The effect of this decision is to allow the parties to contractually allocate liability, and, in the absence of a contract, to protect the bank from liability for unforeseeable consequential damages. However, lost profits resulting from error or malfunction in electronic stock transactions are actual or direct damages, which flow proximately from the failure to complete the transaction and are foreseeable at the time that the order was placed. The bank is constantly on notice of the amount of damages which will occur as a result of its failure to act.

Accordingly, if the above contract principles are applied to electronic stock transactions, banks will limit their liability for error and malfunction in the original service contract. A similar limitation of liability has long been recognized in the area of common carriers—such as telephone and telegraph companies. For example, in one case a man delivered $200 to Western Union with instructions to transmit the money to a friend who was to bet the money in a horserace. Western Union failed to deliver the money in time to place the bet. The horse won, and the man was deprived of $1450 winnings. When the man sought to recover from the Western Union, the court held that the telegraph company had no notice or knowledge of the purpose for which the money was being transmitted, and so was only liable for the charges made in transmitting the telegram.

Unlike the telegram case, in electronic stock transactions it is apparent exactly how the funds are to be used and the damages that will result from an error or malfunction on the part of the bank.

IV. ACTIONS FOR ERROR OR MALFUNCTION IN ELECTRONIC STOCK TRANSACTIONS

The applicable law in the emerging field of electronic stock transactions is...
transactions is unclear. Accordingly, an attorney faced with the challenge of recovering for loss due to error or malfunction must first show what law applies to electronic stock transactions, and then prove the bank’s liability. The attorney will want to assert a basis of liability which most favors his client’s position. It is suggested that an attorney should first argue that the bank is strictly liable under the standards of the Electronic Funds Transfer Act. If he is unable to convince the court that EFTA applies, either directly or by analogy, he may thereafter argue that the bank is liable under contract principles.

A. Strict Liability Under EFTA

It initially appears that electronic stock transfers were not intended to be regulated under the EFTA. A bank faced with the threat of strict liability will inevitably argue that EFTA does not apply. As noted previously, EFTA expressly excludes any transaction the primary purpose of which is the purchase or sale of securities or commodities through a broker dealer registered with the Securities and Exchange Commission. However, EFTA does not foreclose the possibility of recovery for bank error or malfunction as it only excludes from its coverage the sale of securities regulated by the Securities Exchange Commission. Since banks are neither registered with nor regulated by the Securities Exchange Commission, electronic stock transactions made through banks should not be excluded from regulation under EFTA. Additionally, the coverage of EFTA specifically was intended to be flexible in order to allow the application of uniform standards to new or developing electronic financial transactions. As electronic stock transactions are both new and developing, EFTA should be extended to cover error or malfunction within this emerging field.

A second argument for the application of EFTA to electronic stock transactions is the factual similarity between these transactions and electronic funds transfers. In both situations the relationship of the bank to the service user is similar. Unlike stock transactions through full service brokerages, which involve a great amount of interaction between the investor and the broker, electronic stock transactions through banks involve little, if any, inter-

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95. See supra notes 35-37 and accompanying text.
96. Id.
97. Id.
98. See supra note 39 and accompanying text.
99. See supra notes 23-25 and accompanying text.
action between the bank and the investor. The investor, in placing an order electronically, relies upon the bank to process the order. Although there is on-screen as well as written confirmation of an order, it is unlikely that there will be any verbal communication between the bank and the investor after the initial service contract is signed. Once the investor receives confirmation, he must assume that his order has been placed.

This lack of interaction between user and bank, and user reliance on bank systems was foreseen by the drafters of EFTA. Accordingly, the drafters specifically addressed the issue of the parties' rights in electronic transactions which involved little or no verbal communication between the customer and the financial institution. The factual similarity of electronic stock transactions and electronic fund transfers, and the fact that the drafters of the EFTA specifically recognized the unique relationship between the bank and the customer, together provide further support for the extension of EFTA to error or malfunction in electronic stock transactions.

In addition, the application of EFTA to electronic stock transactions properly would place the burden of proof on the bank to defend its handling of the transaction. EFTA imposes this burden on the bank because of the presumption that damages due to bank error in funds transfers were clearly foreseeable at the time the parties entered into the contract. Similarly, in bank errors involving electronic stock transactions, the investor will inevitably suffer losses which were specifically within the contemplation of the parties at the time they entered into the service contract. Thus, a presumption may be made that actual damages will result from bank error in electronic stock transactions and accordingly, the burden of proof should be shifted to the bank, as in EFTA.

101. Id. at 9405.
102. See supra notes 41-44 and accompanying text.
103. The principle has been applied to wrongful dishonor of checks under U.C.C. § 4-402 (1977). When a bank wrongfully dishonors its customer's business check there arises a presumption that the customer's credit and business standing is thereby harmed. The function of this presumption is to remove from the customer the duty of going forward with the evidence on this particular injury or harm and thereby avoid a directed verdict against him if evidence on the issue is not produced. The primary reason for the recognition of this presumption is that a wrongful dishonor renders the existence of some harm to the customer's credit and business standing so probable that it makes legal sense to assume the existence of such harm unless and until the adversary comes forward with some evidence to the contrary. American Fletcher Nat'l Bank & Trust Co. v. Flick, 252 N.E.2d 839, 845-6 (Ind. App. 1969).
A final argument in applying EFTA to stock transaction losses due to system error or malfunction is the unequal ability of the parties to bear the loss. The drafters of EFTA felt that where a bank made an error in an electronic fund transfer, it should be liable for the loss. While recognizing that such an imposition might raise the price of overall EFT services, the drafters felt that such increase would be negligible and that because of its ability to distribute this liability cost to all users the bank was in a better position to bear the loss than a single investor. This rationale applies with equal force to electronic stock transactions.\(^\text{104}\)

If EFTA is not applied to electronic stock transactions, liability will be determined by common law contract principles. The bank, having a greater bargaining position, inevitably will include provisions which will limit or deprive the user of rights in the event of error or malfunction. As these disclaimers of liability and waivers of rights are available under contract principles,\(^\text{105}\) the only effective way to create cost spreading is to legislate bank liability. Since the bank is better able to bear the loss attributable to error or malfunction in electronic stock transactions, EFTA should be extended to make the bank strictly liable where such loss is due to bank error.

In short, several factors point to the regulation of bank error or malfunction in electronic stock trading under the provisions of EFTA. Although it initially appears that EFTA was not intended to regulate electronic stock transactions, the lack of regulation of banks by the SEC combined with the flexibility of EFTA support the notion of potential regulation under EFTA. Additionally, the factual similarity of the electronic stock transaction to the electronic funds transfer is an important supporting factor. Furthermore, the burden of proof should be on the bank since potential damages due to error or malfunction are foreseeable at the time of contracting. Finally, the bank is better able to bear the loss through cost spreading. The intent of EFTA was to allow flexibility in determining whether new electronic services should be covered by the act. Accordingly the coverage of EFTA should be extended to cover electronic stock transactions and, in the case of error or malfunction, banks should be held strictly liable.

### B. Liability Under Contract Principles

If strict liability is not available under the provisions of EFTA,

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105. See supra note 92.
an attorney seeking recovery for loss through error or malfunction in an electronic stock transaction will have to argue by necessity that recovery is available under contract principles.

Unlike most bank transactions which involve debit and credit matters, an electronic stock transaction inevitably involves the issue of potential profits. Error or malfunction in an electronic stock transaction therefore necessarily will involve loss of profits. Lost profits have traditionally not been allowed under contract principles unless they were within contemplation of the parties at the time they entered into the contract. The rule may be simply stated that lost profits must be foreseeable to be recoverable.

However, unlike traditional bank matters in which lost profits arise as a consequence of an error or malfunction, lost profits in an electronic stock transaction are a direct result of the error. Because the investor orders the bank to sell at a certain price, both parties are on notice as to the amount of profit which might be lost. Loss of profit in electronic stock transactions is therefore foreseeable, and as a result, the damages resulting from an error or malfunction in electronic stock transactions should be recoverable under contract principles.

Even if a contract allocates the liability of error to the investor, such a provision should not be recognized, as it would be against public policy. Although waivers of rights and disclaimers of damages are allowed under contract principles as a recognition of the parties rights to allocate the risks of the contract, the National Commission on Electronic Fund Transfers viewed as unequal the bargaining power between EFT providers and most customers. It therefore rejected private contract as an appropriate vehicle for establishing rights and liabilities and concluded that the rights and liabilities of the parties should be governed by statute so as to provide uniform rules for all electronic fund transactions. The underlying policy was to provide maximum protection for the consumer while maintaining sound business practices which will benefit

107. Lost profits are one form of consequential damages, and consequential damages are usually not recoverable unless they were foreseeable at the time the parties entered into the contract. Hadley v. Baxendale, 9 Ex. 341, 156 Eng. Rep. 145 (1854).
108. See e.g., Evra Corp. v. Swiss Bank Corp., 673 F.2d 951 (7th Cir. 1982).
109. FARNSWORTH, supra note 106 at 335.
110. FINAL REPORT, supra note 26, at 55.
111. Id.
112. Id.
the public at large.\textsuperscript{113}

Liability allocation in electronic stock transactions must begin with the fact that the bank has a greater bargaining position and if allowed to contractually allocate their liability, will, through exculpatory clauses, effectively disclaim liability for error or malfunction.\textsuperscript{114} While bargaining may be an effective procedure between merchants acting at arm's length, the majority of users of electronic stock trading will be consumers who have neither the time nor the sophistication to negotiate a contract with a bank.

Although users of an electronic stock trading system likely are somewhat more sophisticated than users of EFT in general, it is unfair to assume that they would understand the impact of a liability limitation clause in the event of an error on the part of the bank, or if they did understand that they could strike a better bargain elsewhere. For the same reasons set forth by the Commission on Electronic Fund Transfers, disclaimers and waivers should not be allowed in electronic stock transactions.\textsuperscript{115} To allow such exculpatory clauses would be to allow the bank to contract away its liability for error or malfunction and to impose on the investor a burden which he did not bargain for. Such an imposition would be against public policy.

V. CONCLUSION

Several factors point to the conclusion that bank liability for error or malfunction in electronic stock transactions should be strictly imposed under the EFTA. Error inevitably will cause damages which were within the contemplation of both the bank and the investor at the time of contracting. The bank is on notice that any error will cause loss to the investor, and should be held strictly liable for its error. Since EFTA already imposes strict liability on banks for error or malfunction in electronic funds transfers—a transaction factually similar to electronic stock transactions—it is logical to extend its coverage to electronic stock transactions.

Nevertheless, if the courts fail to extend EFTA protection to electronic stock transactions, it may be strongly argued that common law contract principles should be applied to protect investors. In order to provide such protection a court must be convinced that the damages were foreseeable at the time the initial contract was

\textsuperscript{113} \textit{Id.}

\textsuperscript{114} \textit{See supra} note 94.

\textsuperscript{115} \textit{Final Report, supra} note 26 at 55.
entered into and any contractual limitation of the bank's liability was contrary to public policy.

Electronic stock trading by banks is likely to eventually dominate the discount brokerage business and may become the standard method by which stocks are traded. The efficiency and capability offered by electronic stock trading are attractive features to any serious investor. The service may well become indispensable. Banks have the assets and network capability to dominate this service and become "the only game in town." The investor will be forced to play by the bank rules unless a means can be developed to assure investors of recovery in the event of bank error or malfunction.