S142947

IN THE SUPREME COURT OF CALIFORNIA

ZENGEN, INC.,

Plaintiff and Appellant,

vs.

COMERICA BANK,

Defendant and Respondent.

COURT OF APPEAL
SECOND APPELLATE DISTRICT, DIVISION FIVE
CASE NO. B179022

ANSWER BRIEF ON THE MERITS

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I. INTRODUCTION AND SUMMARY OF ARGUMENT

Over a trillion dollars moves between business bank accounts by wire transfer every banking day. Each wire transfer takes three steps: (1) a customer's payment order to the bank; (2) the bank's transfer of funds pursuant to that order; and (3) the bank's payment (reimbursement) to itself from the customer's account.

To provide an efficient and smooth-functioning banking system, the entire wire transfer process, including the allocation of rights and responsibilities between customer and bank, is controlled by the detailed provisions of Article 4A of the Uniform Commercial Code, which has been adopted in all fifty states (in California as Division 11). Of significance to this case, California Commercial Code §11505 provides that if a customer intends to hold a bank liable for an allegedly improper wire transfer, the customer must give "notice of objection" to the bank's payment (reimbursement) to itself from the customer's account within one year. Prompt notice is required to enable timely investigation of payment disputes and to ensure certainty and stability in our banking system.

In this case, plaintiff Zengen, Inc.'s ("Zengen") chief financial officer, using his unsupervised control of Zengen's finances, embezzled $4.6 million by four unauthorized payment orders for wire transfers from Zengen's account at defendant Comerica Bank ("Comerica"). Zengen eventually advised Comerica that the *payment orders* were "unauthorized," but, while Zengen vigorously pursued avenues of redress against others, it never gave notice of objection to Comerica's *payments* (reimbursements) to itself from Zengen's account to cover the transfers. Zengen's first notice of objection to the *payment* (reimbursement) for the allegedly unauthorized funds transfers came two years later when it filed suit against Comerica on common law and Commercial Code claims.

A. The Issues

The undisputed facts give rise to the two primary issues now before this Court. In its Opening Brief, Zengen frames the issues to suit its position, but, in so doing, misstates the true issues before the Court. Those issues are:

First Issue[1]

Are an accountholder's common law tort and contract claims against a bank arising out of unauthorized payment orders for wire transfers preempted by the provisions of Division 11 of the California Uniform Commercial Code (Cal.U.Com.Code §11101, *et seq.*)?[2]

Second Issue

Does an accountholder's advice to its bank that "payment orders" were "unauthorized" satisfy the statutory requirement under Division 11 that an accountholder "object to the payment" for purposes of preserving the right to assert that the bank is not entitled to retain the payment?

B. Answers to the Issues

1. Common Law and Contractual Causes of Action Based Upon Matters Already Covered By, or Inconsistent With, Division 11 Are Preempted by the California Uniform Commercial Code

The express language of Division 11 provides that common law causes of action, based on allegedly unauthorized funds transfers, are

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[1] Zengen presents these issues in reverse order. Not only does the Court of Appeal opinion under review present the issues as stated here, it logically makes sense to address the preemption issue before the §11505 objection requirement. Once the common law claims are disposed of through preemption, all that is left is the UCC claim, which is governed by §11505.

[2] Article 4A of the Uniform Commercial Code was renumbered and adopted by the California Legislature as Division 11 of the California Uniform Commercial Code. Unless otherwise indicated, all further statutory references are to the California Uniform Commercial Code.

preempted in two broad areas: (1) where the common law claims would create rights, duties, or liabilities inconsistent with Division 11; and (2) where the circumstances giving rise to the common law claims are specifically covered by provisions of Division 11.[3] Allowing non-statutory claims, such as those alleged by Zengen, to proceed, would undermine the clarity and reliability of our banking system crafted by the Commercial Code.

2. A Statement that a Customer's Payment Order is "Unauthorized" is Not An Objection to the Payment Under Section 11505

Section 11505 requires that a customer notify the bank of its "objection to the payment" received from the customer for a funds transfer within one year, or forever be precluded from asserting that the bank is not entitled to retain the payment. Zengen frames the issue as whether something in addition to the objection is required, but that is not the issue. The key question of law here is: what is meant by the words "objection to the payment?" The answer is that the customer must object *to the bank's debiting of the customer's account* (or similar action taken by the bank to reimburse itself for the funds transfer).

Merely advising the bank that a *payment order* was unauthorized is qualitatively and effectively different from making an objection to an action taken by the bank, such as the bank's debiting of the customer's account. A payment order is not the same thing as the "payment" referred to in section

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[3] Cal.U.Com.Code §11102, Official Comment thereto; *Schlegel v. Bank of America* (Va. 2006) 628 S.E.2d 362; *Fitts v. AmSouth Bank* (Ala. 2005) 917 So.2d 818; *Corfan Banco Asuncion Paraguay v. Ocean Bank* (Fla. Ct.App. 1998) 715 So.2d 967, 971; *Aleo International, Ltd. v. Citibank, N.A.* (N.Y.Sup.Ct. 1994) 612 N.Y.S.2d 540, 541; *Hedged Investment Partners v. Norwest Bank of Minnesota* (Minn.Ct.App. 1998) 578 N.W.2d 765.

11505. The distinction is important, as section 11505 requires an objection to the debiting of the customer's account (the "payment"), not an objection to the payment order submitted by the alleged wrongdoer. *See* sections 11103, 11505 and the Comments thereto.

The drafters of section 11505 deliberately required an objection to the bank's actions, rather than the simple notification of "relevant facts," as the drafters chose to use elsewhere in the Code. (See Section III(B)(1), *infra*.) Given the drafters' expressly stated intent to use "precise and detailed rules" in order to ensure a stable and smooth-running banking system, the Court should follow the plain meaning of the statute as worded, and hold that advising a bank that a payment order is unauthorized is not an "objection to the payment" under section 11505.

II. STATEMENT OF FACTS AND PROCEDURAL HISTORY

Plaintiff and Appellant, Zengen, is a biopharmaceutical company formed in May 1999. (Joint Appendix ["JA"] 127:3-9.) Shortly after its incorporation, Zengen opened several bank accounts at Imperial Bank, which has since been acquired by Comerica Bank (the "Bank" or "Comerica"). Among the accounts was money market account number 88-012-298 (the "298 Account"). (JA 127:11-15; 195:7-196:19.) In connection with the opening of its accounts, including the 298 Account, a Business Signature Card and a Funds Transfer Authorization agreement ("FTA") were executed by Zengen's Chief Executive Officer, Johnson Liu, and its Chief Financial Officer, Fung Yen. Yen and Liu were Zengen's authorized signatories at that time. (JA 127:11-15; 128:15-22; 195:7-196:19; 240:23-245:17; 270-272; 354.) The FTA provided the security procedures agreed upon between Zengen and Comerica, which were to be followed in processing Payment Orders and Funds Transfers. (JA 243:22-245:4; 354.)

Between June 1, 2000, and September 1, 2001, Zengen faxed no fewer than thirty-three payment orders (entitled "Outgoing Wire Transfer

Requests") to Comerica, which varied widely in amount between $7,500 and $1,000,000 and which were requests by Zengen to wire funds from its Comerica accounts (including the 298 Account). (JA 128:7-14; 198:3-235:4; 237:10-12; 274-352.) All of the payment orders submitted by Zengen were submitted by fax and processed in the same manner, and all contained Johnson Liu's signature. Some also contained Fung Yen's signature. (JA 128:15-22; 198:3-235:4; 237:10-12; 274-352.)

From the time Zengen was formed until some time in June, 2001, Zengen's former CFO, Yen, was given complete, unsupervised, and unfettered control over Zengen's financial assets, including its bank accounts at Comerica. (JA 127:17-26; 252:22-25; 391:18-392:13.) Yen was also responsible for maintaining Zengen's financial records with no oversight. All financially-related mail addressed to Zengen was directed to him. (JA 127:17-26; 372:3-24; 384:21-24; 391:18-392:13.) Furthermore, no audits were performed for Zengen for 2000 or 2001 until late August, 2002. (JA 128:2-5; 460:25-462:11; 493-536.)

From mid-2000 to early 2001, Yen allegedly embezzled $4.6 million from Zengen. To accomplish the embezzlement, Yen formed a British Virgin Islands corporation which he named "Zengen, Inc." He then opened an account at ChinaTrust Bank in the name of this new corporation with an initial deposit of $1,000, with himself as the sole authorized signatory. (JA 128:7-13, 24-28; 129:2-24; 614:19-615:14.) Between July 11, 2000 and February 5, 2001, Yen delivered, and Comerica processed, four payment orders, which facially appeared to be signed and authorized by Johnson Liu on behalf of Zengen. As was customary, consistent with Zengen's and Yen's course of conduct, they were faxed to Comerica for processing and payment. These payment orders are the subject of this lawsuit. (JA 128:15-22; 129:21-24; 198:3-235:4; 237:10-12; 270-272; 278; 286; 321; 339; 354; 399:3-6; 466:8-15.) These four payment orders were submitted

among the more than thirty payment orders mentioned above, and requested Comerica to draw funds out of the 298 Account and to wire them to the "Zengen, Inc" account at ChinaTrust Bank in the amounts and on the dates as follows:

	Date	Amount
1.	July 11, 2000	$ 850,000
2.	September 11, 2000	$ 550,000
3.	November 28, 2000	$1,500,000
4.	February 5, 2001	$1,700,000.

(Collectively, the "Four Payment Orders") (JA 128:24-129:19; 198:3-21; 200:25-201:12; 202:3-203:6; 206:10-23; 214:16-22; 227:7-228:6; 277; 278; 280; 281; 286; 289; 307; 321; 332; 339; 354.)

The four funds transfers that resulted from the Four Payment Orders (the "Four Funds Transfers") appeared on Zengen's monthly bank statements, identified by date, dollar amount and two transaction numbers. Zengen acknowledges receiving the statements.[4] (JA 130:11-22; 156:1-157:17; 159-171; 378:10-380:19; 422-429.) Presumably because Zengen's account statements and transaction notices were addressed to Yen as the company's Chief Financial Officer, the latter's defalcation was not discovered immediately. Due to Yen's total control over Zengen's finances, Zengen's complete lack of oversight, and Zengen's failure to monitor its finances or obtain timely annual audits for 2000 and 2001, it is

[4] Zengen claims the monthly statement references to the Four Funds Transfers were "cryptic." Identification of transactions by date, dollar amount, and reference numbers is hardly cryptic. Additionally, as explained below, Comerica provided detailed information regarding each of the Four Funds Transfers in response to Zengen's inquiries in June and July of 2001. (See also *Zengen v. Comerica Bank* (2006) 137 Cal.App.4th 861, 879; 40 Cal.Rptr.3d 666, 677, FN. 11.)

easy to see how Yen was able to transfer millions of dollars in and out of Zengen's accounts without anyone noticing for almost a year.

Notwithstanding having received its bank statements, Zengen claims to have first learned that something was amiss on June 13, 2001. Zengen's Office Manager, Regina Samuel-Ramcharitar, worked with Tony Galvez of Comerica to uncover the unauthorized activity concerning the 298 Account. According to Zengen, "[b]y July 12, 2001, Samuel-Ramcharitar had specifically told Galvez that Zengen did not authorize the four wire transfers [at issue] and that it appeared that Yen had fraudulently transferred the money." (Opening Brief, p. 11.) By no later than August of 2001, when Zengen filed a report with the Los Angeles District Attorney's office which included details of the Four Payment Orders, Zengen had concluded that Yen had stolen money from the company via the wire transfers from the 298 Account to ChinaTrust Bank. By that time, Yen had disappeared with all of the company's financial records and could not be located. (JA 131:4-10; 131:19-27; 381:1-382:25; 385:12-386:11; 395:6-396:4; 420; 457:9-458:2; 459:1-24; 478-491; 726:26-30.)

More than two years after Comerica notified Zengen of the Four Funds Transfers, and eighteen months after Zengen claims to have first discovered the theft, on February 20, 2003, Zengen filed its complaint against Comerica for breach of contract, negligence, refund of payment pursuant to section 11204, return of deposit, and money had and received. Zengen's negligence cause of action was dismissed as a result of Comerica's demurrer. Zengen's First Amended Complaint then became the operative pleading.

Comerica filed a motion for summary judgment, which was granted. In doing so, the Superior Court ruled that the breach of contract and common count causes of action were preempted by the UCC. The court further concluded that Zengen could not prevail on its claim for refund

because it failed to notify Comerica of its objection to the payments within the time prescribed by section 11505 and was thus precluded from asserting that Comerica was not entitled to retain the payments. The Court of Appeal affirmed the Superior Court's rulings on the demurrer and motion for summary judgment. This Court granted review on the two issues set forth above.

III. ARGUMENT

In cases such as this one, where the entire lawsuit is based upon a single allegation of wrongdoing by the bank – that the bank processed, paid, and debited the plaintiff's account for allegedly unauthorized funds transfers in violation of the security procedures to which the bank and the plaintiff had agreed – the plaintiff's non-UCC causes of action are duplicative of a claim for refund of payment under sections 11201-11204. Additionally, non-UCC claims based solely on allegedly unauthorized funds transfers would create rights, duties, and liabilities inconsistent with Division 11. As a result, those causes of action are preempted by Division 11.

As for Zengen's one UCC-based cause of action, for refund under section 11204, Zengen's communications to Comerica did not include an objection to the payment, as that term is plainly defined under section 11505, resulting in the preclusion of Zengen's section 11204 claim.

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A. Division 11 Preempts Non-UCC Causes of Action Which Are Covered By or Are Inconsistent With Division 11

1. Division 11 Is The Sole Source Of Legal Authority Governing Funds Transfers

Division 11 applies to all funds transfers. (Cal.U.Com.Code §§11102 and 11108.)[5] The express language of Division 11 states that it is the sole governing body of law for rights, duties and liabilities associated with funds transfers, and expressly preempts all other principles of law or equity regarding funds transfers. The Official Comment to section 11102 explains how the drafters chose very precise language, intended to be the sole source of authority for funds transfers:

> In the drafting of Article 4A, a deliberate decision was made to write on a clean slate *and to treat a funds transfer as a unique method of payment to be governed by unique rules* that address the particular issues raised by this method of payment. A deliberate decision was also made *to use precise and detailed rules to assign responsibility, define behavioral norms, allocate risks and establish limits on liability, rather than to rely on broadly stated, flexible principles*. In the drafting of these rules, a **critical consideration was that the various parties to funds transfers need *to be able to predict risk with certainty*, to insure against risk, to adjust operational and security procedures, and to price funds transfer services appropriately**. This consideration is particularly important given the very large amounts of money that are involved in funds transfers.

[5] An exception, not relevant here, is that accounts opened for personal, family, or household purposes are governed instead by the Electronic Funds Transfer Act of 1978, 15 U.S.C. §1693, *et seq.*

> Funds transfers involve competing interests - those of the banks that provide funds transfer services and the commercial and financial organizations that use the services, as well as the public interest. These competing interests were represented in the drafting process and they were thoroughly considered. The rules that emerged represent a careful and delicate balancing of those interests *and are intended to be* ***the exclusive means of determining the rights, duties and liabilities of the affected parties in any situation covered by particular provisions of the Article****. Consequently, resort to principles of law or equity outside of Article 4A is not appropriate to create rights, duties and liabilities inconsistent with those stated in this Article.* (Emphasis added.)[6]

In unequivocal language, therefore, the legislature has stated its intent to provide an exclusive set of rules, including an exclusive set of remedies, pertaining to Funds Transfers, by which parties can govern their conduct. Witkin confirms the effect of the foregoing language: "The 1990 Legislature enacted Article 4A of the *Uniform Commercial Code* as Division 11 of the California Uniform Commercial Code, entitled 'Funds Transfers.' The focus of the Article is a type of payment, commonly referred to as a 'wholesale wire transfer,' which is used almost exclusively between business or financial institutions. Payments made by wire transfer, as distinguished from payments made by checks or credit cards, or from electronically-based consumer payments, require a separate body of law

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[6] When, as here, a provision of a state version of the UCC is identical to the provision of the official Code, a court can look to the official Code comments for guidance as to the meaning of the provision. *In re Vigil Bros. Const., Inc.* (Bankr. 9th Cir. 1996) 193 B.R. 513. "Frequently, if the provisions of the UCC do not directly resolve a dispute, the Official Comments that accompany the statute provide general guidance to the courts." (*In re Wiersma*, (Bankr. D.Idaho 2002) 283 B.R. 294, 300.)

that addresses the unique operational and policy issues presented by the method. ***It was therefore the intent of the drafters of Article 4A to provide a comprehensive body of law to govern the rights and obligations resulting from wire transfers.***" (4 Witkin, *Summary of California Law* (10th Ed.) Negotiable Instruments § 132, emphasis added.)

2. **Division 11 Preempts Non-UCC Claims Which Are Either Inconsistent With, Or Are Covered By, Division 11**

The Official Comment to section 11102 provides a clear and unequivocal explanation of the preemptory effect of Division 11, stating that it is "intended to be the **exclusive** means of determining the rights, duties and liabilities of the affected parties in *any situation covered by particular provisions of the Article*. Consequently, resort to principles of law or equity *outside of Article 4A* is not appropriate to create rights, duties and liabilities *inconsistent* with those stated in this Article." (§11102, Official Comment, Para. 4, emphasis added.)

By the express language of Division 11, therefore, common law causes of action, including breach of contract, negligence, and tort claims, based on allegedly unauthorized funds transfers, are preempted in two broad areas: (1) where the common law claims would create rights, duties, or liabilities inconsistent with Division 11; and (2) where the circumstances giving rise to the common law claims are specifically covered by provisions of Division 11.

The scope of the preemptory effect of Division 11 is a matter of first impression in California courts. Courts in other jurisdictions which have also adopted Article 4A, however, have now issued a litany of opinions addressing the issue, and have unanimously confirmed that the statute means what is says -- that claims inconsistent with, or already covered by, Article 4A are preempted. (*Schlegel v. Bank of America* (Va. 2006) 628

S.E.2d 362 [common law claims based on unauthorized funds transfers preempted]; *Fitts v. AmSouth Bank* (Ala. 2005) 917 So.2d 818 [common law causes of action for breach of contract, negligence, and others, based upon unauthorized funds transfer are pre-empted by Article 4A]; *Corfan Banco Asuncion Paraguay v. Ocean Bank* (Fla.Ct.App. 1998) 715 So.2d 967, 971 [negligence claim preempted]; *Hedged Investment Partners v. Norwest Bank of Minnesota* (Minn.Ct.App. 1998) 578 N.W.2d 765 [contractual duties *going beyond the scope* of Article 4A not preempted]; *Centre Point Merchant Bank Ltd. v. America Express Bank Ltd.* (S.D.N.Y. 1996) 913 F. Supp. 202, 204 [telex instruction to debit account and reinvest funds was not "payment order" under Article 4A and common-law claim based thereon was not preempted, whereas common law claims based on transfer of funds pursuant to fraudulent payment order *was* preempted]; *Sheerbonnet, Ltd. v. American Express Bank, Ltd.* (S.D.N.Y. 1995) 951 F.Supp. 403 ["[t]he exclusivity of Article 4A is deliberately restricted to any situation covered by particular provisions of the article"]; *Aleo International, Ltd. v. Citibank, N.A.* (1994) 160 Misc.2d 950, 951 [negligence claim preempted].

In one of the first cases to interpret the code, the Florida Court of Appeal, in *Corfan Banco Asuncion Paraguay v. Ocean Bank* (1998) 715 So.2d 967, 971, held that Article 4A preempted the plaintiff's negligence claim, and stated: "**The uniformity and certainty sought by the statute for these transactions could not possibly exist if parties could opt to sue by way of pre-Code remedies where the statute has specifically defined the duties, rights and liabilities of the parties.**" (Emphasis added.) And, in *Aleo International, Ltd. v. Citibank, N.A., supra,* 612 N.Y.S.2d 541, a New York court dismissed the plaintiff's negligence claims, holding that Article 4A did not include any provision for a cause of action for negligence.

In the most recent of the cases on point, *Schlegel v. Bank of America* (2006) 628 S.E.2d 362, the Supreme Court of Virginia confirmed the earlier holdings, and clarified the difference between situations where Article 4A does preempt common law claims, and situations where it does not. *Schlegel* involved a funds transfer made pursuant to allegedly unauthorized payment orders, and the receiving bank's subsequent freezing of the transferred funds without refunding them to the customer's account. Pointing out that the plaintiff's common law claims involved two separate transactions – (1) the alleged unauthorized funds transfers from the plaintiff's bank, and (2) the subsequent freezing of the transferred funds by the receiving bank – the court in that case held that the claim for unauthorized funds transfers was expressly preempted by Article 4A, while the claim for freezing the funds was not. (*Id.* at 370.)

The *Schlegel* court cited *Fitts v. AmSouth Bank* (Ala. 2005) 917 So.2d 818 in support of its opinion. In *Fitts*, a case involving facts very similar to this case, the court found common law causes of action for breach of contract, negligence, and others, were preempted by Article 4A, and the plaintiff's failure to object to the bank's debiting of plaintiff's account within one year barred the plaintiff's entire action under 4A-505. (*Id.* at 823-825.)

The *Fitts* court held that the language in Article 4A, and the comment thereto, "suggests that if the situation made the basis of a dispute is addressed in Article 4A, then the provisions of Article 4A provide the exclusive rights and remedies of the parties involved." *Id.*, at 824 (citing *Corfan Banco Asuncion Paraguay v. Ocean Bank* (Fla.Ct.App. 1998) 715 So.2d 967, 971.) The *Fitts* Court went on to hold: "Because the situation made the basis of the Fittses' common-law claims – that AmSouth made an improper funds transfer – is unequivocally addressed in the particular provisions of Article 4A, we conclude that those common-law claims are

displaced by Article 4A and that the Fittses' exclusive remedy for that claim must be found in Article 4A." (*Ibid.*)

There are still more cases in which plaintiffs' attempts to chart courses around Article 4A also have failed. In *Moody National Bank v. Texas City Development Ltd.* (Tex. Ct. App. 2001) 46 S.W.3d 373, the plaintiff alleged that the bank misinformed it about the status of a wire transfer. The trial court directed verdict in favor of the bank on several common law claims, including breach of contract, but declined to direct a verdict on a claim for negligence. Reversing in part, the Texas Court of Appeals held that Article 4A precluded the common law negligence claim, and, therefore, a directed verdict should have been entered on that claim as well. Because "the conduct complained of was clearly related to the funds transfer," Article 4A's preclusion of common law claims applied "even though the precise nature of the mistake the bank made [was] not specifically set out in the statute." (*Id.*, at 378-79.)

Similarly, in *Impulse Trading, Inc. v. Norwest Bank Minnesota, N.A.* (D. Minn. 1995) 907 F. Supp. 1284, the court held Minnesota's version of Article 4A to bar a bank customer's claims for negligence, conversion and wrongful setoff relating to funds transfers. The only claim that was not displaced was one that did "not relate directly to the funds transfer." (*Id.* at 1289.)

3. Zengen's Non-UCC Claims Are Preempted by Division 11

Zengen's only claim of wrongdoing against Comerica is that Comerica wrongfully accepted and executed unauthorized payment orders for funds transfers from Yen, which were facially in accordance with Zengen's FTA, but which were allegedly unauthorized by Zengen. (JA 53:1-55:5.) Based upon that sole allegation, Zengen alleged four non-UCC-based causes of action against Comerica. (JA.1-12; 46-62.) In its

Complaint and First Amended Complaint, in response to written discovery, in deposition, and in its Opposition to Comerica's Motion for Summary Judgment, Zengen admitted that there is no other basis for its four non-UCC causes of action beyond Comerica's acceptance and execution of unauthorized payment orders. (JA 1-12; 46-62; 614:19-615:14; 653:3-7.)

a. **The Alleged Acts are Specifically Covered Under Sections 11201-11204**

Zengen's claim for refund, and the analysis of whether Comerica may be liable for such a claim, is covered *entirely* by sections 11201-11204. Section 11204 sets forth the general rule regarding when a bank will be liable for an unauthorized funds transfer:

> If a receiving bank accepts a payment order issued in the name of its customer as sender which is (i) not authorized and not effective as the order of the customer under Section 11202, or (ii) not enforceable, in whole or in part, against the customer under Section 11203, the bank shall refund any payment of the payment order received from the customer to the extent the bank is not entitled to enforce payment and shall pay interest on the refundable amount calculated from the date the bank received payment to the date of the refund.

Analysis of an unauthorized transfer issue under section 11204, therefore, begins with section 11202, which provides:

> (a) A payment order received by a receiving bank is the authorized order of the person identified as the sender if that person authorized the order or is otherwise bound by it under the law of agency.
>
> (b) If a bank and its customer have agreed that the authenticity of payment orders issued to the bank in the name of the customer as sender will be verified pursuant to a security procedure, a payment order received by the

> receiving bank is effective as the order of the customer, whether or not authorized, if (i) the security procedure is a commercially reasonable method of providing security against unauthorized payment orders, and (ii) the bank proves that it accepted the payment order in good faith and in compliance with the security procedure and any written agreement or instruction of the customer restricting acceptance of payment orders issued in the name of the customer. The bank is not required to follow an instruction that violates a written agreement with the customer or notice of which is not received at a time and in a manner affording the bank a reasonable opportunity to act on it before the payment order is accepted.[7]

Section 11203 provides additional rules applicable to circumstances in which an unauthorized payment order is still effective under Section 11202(b). Therefore, analysis of a funds transfer under sections 11201 through 11204 provides a very specific scheme for allocation of loss. In fact, this allocation of loss is so integral to the structure of Article 4A that it may not be varied by contract. (*Regatos v. North Fork Bank* (N.Y.Ct.App. 2005) 5 N.Y.3d 395, 403.) The circumstances of this case thus fall squarely within the provisions of sections 11201-11204.

b. **Zengen's Non-UCC Claims Would Create Rights, Duties, and Liabilities Inconsistent with Division 11**

Zengen's non-UCC causes of action are preempted by Division 11 because allowing them to stand would create rights, duties, and liabilities that conflict with those under the UCC. Although parties may be free to enter into contracts which reasonably alter rights, duties, or liabilities under

[7] California Uniform Commercial Code §11201 provides a detailed definition of what constitutes a "security procedure" for purposes of the liability analysis under §11202.

the UCC, there are no contracted-for rights, duties, or liabilities created by the express terms of the contracts here which are any different than those under the UCC. There are, however, different rights, duties, and liabilities created by statute, such as the statute of limitations, which apply to breach of contract claims and which are in conflict with the provisions of the UCC. It is such rights, duties, and liabilities that the legislature clearly intended to be preempted by the UCC.

Specifically, the following are some of the ways in which Zengen's non-UCC causes of action would create rights, duties, and liabilities inconsistent with Division 11:

Division 11 Provisions	Zengen's Non-UCC Causes of Action
1. One year statute of repose to preserve the right to seek reimbursement of payment. (Cal.U.Com.Code §11505.)	1. No statute of repose.
2. 90 day statute of repose if a party wants to recover interest. (Cal.U.Com.Code §11204.)	2. No statute of repose
3. Specific requirements for security procedures, and a detailed scheme of allocation of risk and liability. (Cal.U.Com.Code §§11201-11204.)	3. No statutory requirements for security procedures or allocation of risk and liability.

4. Three year statute of limitations. (Code Civ.Proc. §338.)	4. Four year statute of limitations for breach of contract and common counts. (Code Civ.Proc. §337.)
5. No equitable defenses (such as intervening causes). (Cal.U.Com.Code §11204; See *Corfan Banco, supra*, at 971, Fn. 5.)	5. Equitable defenses available (such as contributory negligence).

It is clear, therefore, that where, as here, the only alleged breach of contract is the bank's debiting of the customer's account for an unauthorized funds transfer, a breach of contract claim would give rise to rights, duties, and liabilities that are inconsistent with those provided under Division 11.

c. Only Those Contractual Duties Going Beyond Those in the Code Are Not Preempted

Although it *is* conceivable that Zengen could bring a breach of contract cause of action in connection with a funds transfer, such a claim may be brought *only if* Zengen based that cause of action on the terms of a contract which imposed duties upon Comerica *beyond* the duties already imposed or contemplated under Division 11. (*Hedged Investment Partners v. Norwest Bank of Minnesota, supra* 578 N.W.2d 765; *Fitts v. AmSouth Bank, supra* 917 So.2d 818.) That is not the case here.

The situation in this case is precisely the situation covered by particular provisions of Division 11. In substance, Zengen's Second Cause of Action is not one for breach of contract at all, but is instead a duplicate cause of action for refund of payment under section 11204. The contracts upon which Zengen purports to base this claim are the "Bank-Depositor

Agreement," or "Signature Card," and the FTA (collectively, the "Contracts"), copies of which are attached to Plaintiff's First Amended Complaint ("Complaint"). (JA 57-60; 652:23-653:7.)

Zengen alleged that Comerica: "'accept[ed]' and 'execut[ed]' the Payment Orders *as those terms are used in Sections 11209(a) and 11301(a), respectively*, of the Uniform Commercial Code, or otherwise wire transfer[ed] funds from the Second Money Market Account to the Zengen, B.V. Account, and charg[ed] the amounts of the Payment Orders against the Second Money Market Account." (Emphasis added.) (JA 53:13-17.) There is no question that this contractual duty allegedly breached by Comerica is, by Zengen's own pleading, the same duty imposed by UCC Division 11. In contrast, Zengen does not point to a specific term or provision of the Contracts *not* covered under the UCC, which was allegedly breached by Comerica. Moreover, the Signature Card itself adopts the rights, duties, and liabilities under the UCC when it states: "this account...shall be governed by applicable banking laws, customs and regulations..." (JA 58.)[8]

At least four other courts have held breach of contract claims based upon unauthorized funds transfers to be preempted by Article 4A. (*Schlegel v. Bank of America, supra* 628 S.E.2d 362; *Hedged Investment*

[8] Zengen also alleged that Plaintiff never authorized wire transfers out of the 298 Account. (JA 53:7-12.) This allegation was conclusively rebutted by Zengen's own admission that it intended the 298 Account to be subject to the Funds Transfer Agreement, as well as Zengen's subsequent actions in submitting numerous admittedly legitimate, and authorized, Payment Orders for funds transfers out of the 298 Account (including Funds Transfers for as much as $600,000 and $1,000,000). (*Zengen v. Comerica, supra*, at 667, FN1; JA 128:7-14; 198:3-235:4; 237:10-12; 245:9-17; 274-354.) As a result, as both lower Courts found, there is no material issue of fact regarding Zengen's authorization of funds transfers out of the 298 Account.

Partners v. Norwest Bank of Minnesota, supra 578 N.W.2d 765; *Fitts v. AmSouth Bank, supra* 917 So.2d 818; *Moody National Bank v. Texas City Development Ltd., supra* 46 S.W.3d 373.) Furthermore, the court in *Corfan Banco Asuncion Paraguay v. Ocean Bank, supra* 715 So.2d 967, addressed similar circumstances in reaching its conclusion that the UCC preempted the plaintiff's negligence claim. Although the present case involves a breach of contract cause of action, the fact critical to the *Corfan Banco* court's decision was that "[t]he duty claimed to have been breached by Ocean Bank in its negligence count is exactly the same duty established and now governed by the [UCC.]" (*Id.* at 971.) In the present case, the duty allegedly breached by Comerica is exactly the same duty established and now governed by the UCC. Zengen's breach of contract claim, therefore, is an action explicitly covered by the UCC and is preempted by the UCC.

Virtually every banking relationship, under which funds transfers may occur, is subject to written agreements between a bank and its customers. If, in order to get around the preemptive effect of Division 11, parties could simply refer to the existence of a written contract, without alleging the breach of terms independent of the provisions of the UCC, there would be no purpose in adopting Division 11, and the Comments thereto.

Furthermore, Zengen's alleged breach of contract cause of action is based upon a term which Zengen alleges is implied in every contract between a bank and a customer. (Opening Brief, p. 36.) Accepting this as true, and if Zengen's argument that Division 11 does not preempt an alleged breach of that term, then every single claim for unauthorized wire transfers under Division 11 would also give rise to a related breach of contract claim. Given the very specific statement of intent by the drafters of Article 4A -- that it is intended to be the sole source of authority for determining the rights, duties, and liabilities between the parties in a funds

transfer case -- to allow a breach of contract claim to run alongside every section 11204 claim would destroy the carefully crafted scheme.

4. Zengen's Cited Authority is Inapposite

The cases on which Zengen relies are not on point. *Sheerbonnet, Ltd. v. American Express Bank* (S.D.N.Y. 1996) 951 F. Supp. 403, addressed a situation *not* covered by the UCC in which the defendant bank intentionally chose to credit a transfer to the frozen account of an insolvent bank, and then used the proceeds for its own benefit as a setoff against the insolvent bank's debt to the defendant. The district court in *Dubai Islamic Bank v. Citibank, N.A.* (S.D.N.Y. 2000) 126 F. Supp. 2d 659, 666, refused to grant a Rule 12(b)(6) motion to dismiss "at this early stage of the litigation" given the "evolving" case law at that time on Article 4A exclusivity. The court did not, as Zengen claims, "adopt the plaintiff's statement that 'a bank is not immune from common law liability arising from its tortious conduct simply because wire transfers may be involved.'" (Opening Brief, p. 31.) Instead, the court in that case did *not* rule out the possibility of a later summary judgment on the basis of preemption, and the ruling on the motion to dismiss came before other cases that have provided further guidance on the relationship between Article 4A and inconsistent common-law claims.

B. Failure to Timely Object to Payment to the Bank for an Unauthorized Funds Transfer Precludes a Claim for Refund of Payment Under Section 11204

Pursuant to section 11505, a customer is precluded from asserting a claim for refund of payment for a funds transfer if the customer has not objected to the payment – that is the debiting of his/her account -- within one year after the customer received notification of the debit:

> If a receiving bank has received payment from the customer with respect to a payment order issued in the name of the customer as sender

> and accepted by the bank, and the customer received notification reasonably identifying the order, the customer is precluded from asserting that the bank is not entitled to retain the payment unless the customer notifies the bank of the *customer's objection to the payment* within one year after the notification was received by the customer. (Emphasis added; See also *Schlegel v. Bank of America, supra* 628 S.E.2d 362; *Fitts v. AmSouth Bank, supra* 917 So.2d 818; *Hedged Investment Partners, L.P. v. Norwest Bank Minnesota, N.A., supra* 578 N.W.2d at p. 769, Fn. 1 [35 U.C.C. Rep. Serv. 2d (Callaghan) 608.])

Zengen seeks to have the Court shift a burden to the bank, which is clearly allocated by Division 11 to the customer. Specifically, Zengen argues that "Section 11505 gives the customer one year within which to discover the unauthorized payment order and put the bank on notice of the unauthorized payment order." (Opening Brief, p. 22.) This is incorrect. Section 11505 gives the customer one year to "object to the payment." As explained below, the "payment" is not the same thing as a "payment order," and the customer is required to *object*, not merely notify the bank of the relevant facts (such as an unauthorized payment order).

1. Section 11505 Requires a Customer to Object to a Specific Action Taken by the Bank – *The Debiting of the Customer's Account*

The notice requirement of section 11505 is not a simple notice requirement such as that imposed by section 4406 with regard to checks, or even the notice requirement in section 11204 with regard to interest on funds transfers. Sections 4406 and 11204 require the customer first to notify the bank of only the "relevant facts" surrounding an alleged unauthorized check or funds transfer in order to bring a claim on the check or recover interest on a refund of the funds transfer. *Those sections do not*

require the customer to object to any particular actions of the bank. In contrast, section 11505 expressly requires the customer to timely notify the bank of a very specific objection – *to the bank's debiting of the customer's account*:

> This section is in the nature of a statute of repose for *objecting to debits* made to the customer's account...Under 4A-505...the obligation to refund may not be asserted by the customer ***if the customer has not objected to the debiting of the account*** within one year after the customer received notification of the debit. (Cal.U.Com.Code §11505, Official Comment, emphasis added.)

There are three primary acts involved in any given funds transfer: (1) a payment order is submitted to the bank; (2) the bank transfers funds in accordance with the payment order's instructions; and (3) the bank reimburses itself for the funds transferred by debiting the customer's account (or obtaining payment from the customer via some other method). (Cal.U.Com.Code §§11103 and 11104, and Official Comment thereto.) This third act is the "payment" referred to in section 11505, and is the act to which the customer must object within one year. (Cal.U.Com.Code §11505 and Official Comment.)

A customer who notifies the bank of relevant facts surrounding an unauthorized payment order, or even the resulting funds transfer, but says nothing to the bank to object to the bank's debiting of the customer's account, has not satisfied section 11505. Zengen, therefore, is incorrect in its assertion that section 11505 requires a customer to simply notify the bank that the bank has accepted an unauthorized payment order. [Opening Brief, p. 17.]

a. **Authority for this Rule**

The language of section 11505, and the Comment thereto, is unambiguous. Likely for this reason, there is very little case-law, and very few treatises, interpreting this section. There are, however, the following authoritative sources related to the objection requirement under section 11505:

(1) **Section 11505**

"[T]he customer is precluded from asserting that the bank is not entitled to retain *the payment* unless the customer notifies the bank of the customer's objection *to the payment* within one year after the notification was received by the customer." (Emphasis added.)

(2) **Official Comment to Section 11505**

"Under 4A-505, however, the obligation to refund may *not* be asserted by the customer if the customer has not objected *to the debiting of the account* within one year after the customer received notification of the debit." (Emphasis added.)

(3) **Cases Referring to Section 11505**

The Minnesota Court of Appeal, in *Hedged Investment Partners v. Norwest Bank of Minnesota, supra* 578 N.W.2d at p. 769, found that "objection to the payment" means a claim by the customer that the bank is not entitled to retain payment: "[4A-505] precludes a customer from claiming *that a bank is not entitled to retain payment* unless *the claim* is made within one year of notification." (Emphasis added.) The lower court in *Hedged Investment Partners* had determined that the bank in that case was notified of the customer's claim against the bank in October, 1995, and held that the customer could not recover losses that occurred before October, 1994. (The appellate court did not alter that ruling.) (*Ibid.*)

The Alabama Supreme Court in *Fitts v. AmSouth Bank, supra* 917 So.2d at p. 824 stated that the plaintiffs in that case "did not *contest the funds transfer* until some two years [after notice of the transfer]." (Emphasis added.) Earlier in the same opinion, in reciting the facts of the case, the court stated:

> "It is undisputed that Fred Fitts learned of AmSouth's transfer of $85,000 to the third account on George's instruction, at the latest, in mid-May 2001. Fitts *did not object to the transfer, and he filed no formal complaint with AmSouth* at that time....[¶] On April 23, 2003, almost two years after he first learned of the transfer of the $85,000 to the third account, Fred Fitts completed an affidavit of forgery, *making a claim against AmSouth* for the $85,000." (*Id.*, at 821, emphasis added.)

Both of these cases held that the plaintiffs' claims for unauthorized funds transfers were barred due to their failure to satisfy the objection requirement under 4A-505; and, the language used in both of these opinions indicates that the action required of the customer is some form of claim, complaint, or other action *adverse to the bank*. The customer, therefore, must do more than simply notify the bank of a potential problem with a payment order -- it must object specifically to the *bank's actions* in debiting the customer's account.

(4) **Treatises**

Lawrence's *Anderson on the Uniform Commercial Code*, Third Edition, Volume 7, Section 4A-505:7, states:

> When the sender claims that the receiving bank is not entitled to receive payment, the sender must notify the bank of his or her objection within the one-year period described above.
>
> Article 4A makes no provision as to the content of this notice. The sender would be well

> advised to be as specific as the sender can be as to the basis for its claim that payment was improper.
>
> PRACTITIONER'S TIP: The importance of ensuring that a sufficient notification is sent cannot be minimized, as a sender would be precluded from asserting the claim of wrongful payment if the sender does not satisfy the requirement of notifying the bank of 'his objection' within the one-year period.

The author thus agrees the focus of 4A-505 is the customer's objection *to the bank's actions* in debiting its account, not an objection to the actions of a third party.

(5) **Similar Statutes**

A statute analogous to section 11505 is the Government Tort Claims Act ("GTCA"), which requires the filing of claims and prescribes limited time frames in which the claims may be filed in order to preserve the right to bring an action against a governmental entity. The purpose of the GTCA is to give the public entity the opportunity to investigate the facts while the evidence is fresh, as well as to settle meritorious cases without the need for litigation. (*Powell v. City of Long Beach* (1985) 172 Cal.App.3d 105, 111.) Furthermore, the prompt presentation of a claim for money permits the recipient public entity to make appropriate fiscal planning decisions. (*City of Ontario v. Superior Court* (1993) 12 Cal.App.4th 894, 902-903.)

Like the GTCA, section 11505 does not merely require a customer to notify the bank of relevant facts. Instead, the customer must affirmatively object to the bank's actions, just as a claimant against the government must timely serve a claim on the government fairly describing what the governmental entity is alleged to have done. (*Shoemaker v. Myers* (1992) 2 Cal.App.4th 1407, 1426). Furthermore, it is well-settled that claims statutes must be satisfied even in the face of the public entity's

actual knowledge of the circumstances surrounding the claim. Such knowledge – standing alone – constitutes neither substantial compliance nor basis for estoppel. (*City of San Jose v. Superior Court* (1974) 12 Cal.3d 447, 455.) Similarly, a customer who simply notifies the bank of the circumstances surrounding an allegedly unauthorized payment order and resulting funds transfer, as was the case here, has *not* complied with section 11505. Comerica's knowledge of the fact that the Four Payment Orders were allegedly unauthorized in no way put Comerica on notice that Zengen was asserting a claim against the bank, and does nothing to help Zengen's compliance with the statute.

b. **Mere Notification of Relevant Facts is Not Enough**

The drafters of 4A-505 could have chosen a more lenient, less specific, notification requirement, such as the "relevant facts" notification requirement under section 4406. They did not. Instead, they drafted a very specific, unambiguous, requirement that a customer notify the bank of the customer's objection to the bank's actions in debiting the customer's account. Unless the customer does so within one year, it is precluded from seeking a refund of the payment from the bank.

A venerable rule of statutory construction dictates that "[t]he plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.'" (*United States v. Ron Pair Enters.* (1989) 489 U.S. 235, 242 (citation omitted); *Regency Outdoor Advertising, Inc. v. City of Los Angeles* (2006) 39 Cal.4th 507, 524.) The literal application of Division 11 certainly does not produce results that are at odds with the drafters' intention given their comment that "[a] deliberate decision was also made to use precise and detailed rules to assign responsibility, define behavioral norms, allocate risks and establish limits

on liability, rather than to rely on broadly stated, flexible principles." (Cal.U.Com.Code § 11102 Official Comment, emphasis added.)

c. A Customer's Statement that a Payment Order was "Unauthorized" Does Not Imply that the Customer Considers the Bank Liable for a Refund of Payment

In upholding the Superior Court's finding that Zengen failed to timely object to the payment for the Four Funds Transfers, the Court of Appeal stated, "the critical 'fact' which Zengen was required to communicate to the Bank was that the Bank was liable for the fraudulent transfers." (*Zengen, Inc. v. Comerica Bank, supra*, 137 Cal.App.4th at 876.) Zengen argues, however, that a comment to the bank that a given payment order was unauthorized satisfies the notification requirement under section 11505 because, in stating that a payment order was unauthorized, the customer *implies* that the bank is liable to the customer for reimbursement of the payment. (Opening Brief, pp. 17-19.) Not only does Zengen's argument fly in the face of the clear language of section 11505, it is a leap in logic.

Say, for example, a customer utilizes a personal identification number ("PIN") as part of a security procedure to transmit payment orders to a bank. An employee of the customer uses the PIN to transmit a payment order to the bank, directing the bank to send funds to an account set up by the customer under false pretenses, and thereby embezzling the funds. Later the customer, aware of what happened, aware that it was the customer's own negligence that allowed the employee access to the PIN, and aware that it, and not the bank, must bear the loss, notifies the bank that the payment order was unauthorized so that the bank will no longer accept payment orders bearing that same PIN. Such notification of an unauthorized payment order does *not* imply that the customer considers the bank liable for the loss. Nevertheless, under Zengen's theory, Zengen

would equate that notice to an "objection" and thus have the bank conduct a full investigation, and take all necessary action to preserve evidence, just in case the customer changes its mind and decides to bring a claim against the bank years later. Clearly, such a requirement of the bank under these circumstances would be unreasonable.

2. There Are Good Reasons for the Specific Objection Requirement Under Section 11505

In addition to the plainly articulated purpose of Article 4A, stated by the drafters in the Official Comments, courts have found that the purpose of section 11505 is to "promote finality of banking operations and to give the bank relief from unknown liabilities of potentially indefinite duration." (*Regatos v. North Fork Bank* (N.Y.Ct.App. 2005) 5 N.Y.3d 395, 403.) Zengen even pointed out in its brief that "the underlying purpose of a statue of repose is 'to prevent the unexpected enforcement of stale claims concerning which persons interested have been thrown off their guard by want of prosecution.'" (Opening Brief, p. 18, citing *Manguso v. Oceanside Unified School District*, (1979) 88 Cal.App.3d 725, 730.) Clearly then, the primary purpose behind section 11505 is to provide banks with notice that a claim is being made against them for reimbursement of funds under Division 11. This allows banks to take appropriate action at or near the time of the subject funds transfers to mitigate its losses, pursue wrongdoers, and otherwise protect its rights.

a. Exposure to a Loss Affects Many Aspects of a Bank's Highly Regulated Business

When banks are exposed to a potential loss, they are required by law, regulation and accounting practice to set up "loss reserves." Literally, this means an exposed bank must set aside funds to cover some or all of the potential loss, and such reserves are unavailable to the bank for any other purpose. Not only does a loss reserve have an immediate negative impact

upon the bank's balance sheet and stock price, but it has a longer term effect upon other areas of the bank's operations. For example, a bank's "legal lending limit" is negatively impacted when funds previously available are set aside in a loss reserve – which means that the amount of money a bank can lend to a borrower is lessened. For obvious reasons, therefore, banks do not want to place funds in a loss reserve unless doing so is justified.

This is yet another reason the drafters of section 11505 carefully chose language requiring a customer to actually object to the bank's actions, rather than simply notify the bank of the relevant facts. If banks are required to set up loss reserves every time a customer mentions a potential problem, or other facts, regarding a funds transfer, there would be a dramatic impact on banks' business. However, as the drafters clearly contemplated, if the rule is that a bank need not set up a loss reserve unless it is relatively certain that a claim against it is forthcoming, then banks can better determine what funds should or should not be placed in reserve.

b. **Investigation of a Claim of Refund for an Unauthorized Funds Transfer Can Be Complicated and Expensive**

As set forth above, sections 11201-11204 provide a detailed scheme of rights, duties, and liabilities regarding funds transfers, and set forth the analysis to be employed in determining whether a bank is liable for an allegedly unauthorized funds transfer. Without going through that analysis, there is no way to determine whether a bank is liable for an allegedly unauthorized funds transfer. A proper investigation of an unauthorized funds transfer, for which a customer is seeking a refund, therefore, requires a bank to conduct a full investigation, take statements of bank personnel, locate, segregate, and preserve documents, interview witnesses (including the customer), and perhaps even consult with counsel, with regard to *each*

of the elements in the liability analysis under sections 11201-11204. Requiring a bank to take such actions every time a customer notified it that a *payment order* is unauthorized, and regardless of whether the customer made any statements to indicate that it was seeking a refund or otherwise objected to any action taken by the bank, would be cost-prohibitive and unreasonable.

For example, in the stolen PIN hypothetical described above, if the bank were required to investigate and preserve evidence and information to defend against a potential claim of refund by the customer, it would need to collect and preserve all account records, records of communications with the customer involving every transaction for which the PIN was used (whether or not authorized), interview the customer and its employees, contact the beneficiary's bank to which the funds were transferred and demand return of those funds, interview the beneficiary's bank personnel, demand copies of account records from the beneficiary's bank, possibly close the customer's accounts and cease doing business with the customer, and possibly hire counsel to file or defend against legal action. Obviously, if the customer is not going to make a claim for refund against the bank, all of these actions are unnecessary.

c. **A Full Investigation and Preparation of a Defense Was Unwarranted in this Case Given that Zengen Never Objected to Comerica's Actions**

The PIN hypothetical is virtually identical to the facts of this case. Instead of a PIN, Zengen had a signature and callback security procedure pursuant to the FTA. Otherwise the facts are the same. Zengen notified Comerica of the "unauthorized" payment orders so that Comerica would not process any more payment orders from Yen. Almost simultaneously, Zengen changed the signature cards, removing Yen as an authorized signatory. Although it could have, Zengen did *not* object to Comerica's

debiting of Zengen's account, or to any other actions taken by Comerica within one year of any of the Four Funds Transfers.

Had Zengen objected to Comerica's actions, Comerica would have proceeded with an investigation and preparation of its defense (if any). Specifically, Comerica would look into whether Yen had authority to present the Four Payment Orders under traditional agency principles. If not, Comerica would then investigate the facts behind the security procedure, whether it was followed in processing the Four Funds Transfers, and whether it was commercially reasonable.[9] If so, Zengen may be precluded from asserting a claim against Comerica for those Funds Transfers, *even if they were unauthorized*. (Cal.Com.Code §11202(b).) Comerica would have also acted to preserve its records, interviewed employees, contacted ChinaTrust Bank, pursued action against Yen, and taken all other actions necessary to prepare itself for a claim of refund asserted, or to be asserted, by Zengen.

The PIN example, and indeed the facts of this case, therefore, show that preserving evidence and accurate information regarding a *potential* claim for refund is a complicated matter, given that evidence and information related to every step of the analysis under sections 11201-11204 must be preserved. The cost, in both time and money, of doing so in every such instance would be extremely high. The specific language chosen by the drafters of section 11505 takes this into account, and is inconsistent with Zengen's position.

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[9] In its Opening Brief on the Merits, Zengen incorrectly states the facts regarding the security procedure and whether it was followed. [Opening Brief, pp. 27-28.] The lower Courts in this case held Zengen's claims to be barred by the section 11505 statute of repose. As a result, the specific security procedure, and whether it was followed, was never at issue.

The reasons behind the requirement under section 11505 that a customer must, within one year, notify the bank of the customer's objections to *the bank's* actions in debiting its account are thus obvious, and are exemplified in the present matter: failure to timely notify a bank of a customer's objection to the debiting of its account seriously hinders the bank's ability to remedy the alleged wrongful actions, and causes prejudice to the bank in its ability to defend an action by the customer or to seek recovery from the wrongdoer.

Simply telling the bank, as Zengen did, that the customer believed a payment order was unauthorized is not the same as objecting to the bank's actions in debiting the customer's account. Zengen seeks to have the Court ignore this important distinction and the critical statutory directive under section 11505.

3. Whether Section 11202(b) is an Affirmative Defense is Irrelevant to Section 11505.

Zengen focuses a substantial portion of its brief on the question of whether section 11202(b) amounts to an affirmative defense, and follows its argument with hypothetical examples involving a security procedure and others lacking a security procedure. These arguments are made to show what, Zengen claims, was a mistake by the Court of Appeal. Zengen is mistaken and the hypothetical examples are misplaced.

Zengen claims the Court of Appeal erred when it refused to recognize section 11202(b) as an affirmative defense. The argument regarding pleading and proof requirements has nothing to do with the notification provisions under section 11505. Zengen argues, in essence, that by notifying a bank that a payment order was unauthorized, the customer is telling the bank that the customer considers the bank to be liable because the bank bears the burden of proving that the unauthorized payment order is nevertheless effective. The fundamental problem with

Zengen's argument is that section 11505 does not call for a customer to notify the bank that a *payment order* was unauthorized. In plain language, it calls for the customer to *object to the bank's debiting of the customer's account* – nothing more, nothing less. As this Court pointed out recently, "if the language of a statute is unambiguous, the plain meaning controls and resort to extrinsic sources to determine the Legislature's intent is unnecessary." (*Regency Outdoor Advertising, Inc. v. City of Los Angeles* (2006) 39 Cal.4th 507, 524.) Section 11505 is crystal clear in what a customer must do to preserve its right to claim a refund of payment under section 11204. As a result, Zengen's resort to an extrinsic analysis of the burden of proof of the parties under Division 11 is unnecessary.

4. Zengen Failed to Notify Comerica of an Objection to Comerica's Debiting of Zengen's Account Within One Year of Notification of the Transfers

Two lower courts in this case, on *de novo* review, found no triable issues of fact with regard to notice of the funds transfers by Comerica to Zengen or what was said between the parties thereafter. Based upon these undisputed facts, the Courts found that there was no triable issue of fact with regard to Zengen's failure to timely object to Comerica's debiting of its account in compliance section 11505. Both of those rulings were correct.

a. For Two Years, Zengen Pursued Yen, Not Comerica

Upon learning of the Four Funds Transfers, Zengen might have voiced its objection to the debiting of its account, and might have demanded that Comerica refund the amount of the funds transfers, but Zengen never took any such action. Zengen chose, instead, to pursue different courses of action, aimed at pursuing the true culprit -- Yen. When

officers at Zengen discovered Yen's alleged defalcation of corporate funds, purportedly in June, 2001, Zengen took the following actions:

(1) Filed a written, criminal complaint to the Los Angeles District Attorney against Yen (JA 133:3-12; 383:2-384:19; 410:17-19; 455:16-458:2; 478-491; 622:24-623:8);

(2) Made written demand upon ChinaTrust Bank for turnover of account records and return of all funds held in the Zengen account at ChinaTrust (JA 132:17-28; 396:5-22; 399:7-11; 469:7-24; 548; 616:15-617:27; 642; 645-646);

(3) Investigated the whereabouts of Yen (JA 133:3-12; 383:2-384:19; 410:17-19; 455:16-458:2; 478-491; 622:24-623:8);

(4) Hired independent, forensic accountants to review Zengen's financial records and investigate the extent of Yen's alleged embezzlement (JA 132:12-15; 381:1-382:25; 459:1-4; 620:2-621:23);

(5) Discussed, during corporate board meetings, what actions should be taken to try and recover the allegedly stolen money (JA 132:2-9; 467:4-468:19; 538-546; 618:15-619:28);

(6) Hired outside counsel to advise Zengen of its rights and claims (JA 133:13-23; 542-546; 592-608.); and,

(7) Filed a civil action in Federal District Court, in October, 2002, against Yen (but no one else) for recovery of the money allegedly lost via the Four Funds Transfers. (JA 133:13-23; 592-608.)

b. **For Two Years, Zengen Failed to Object to the Payment to Comerica, and Failed to Make Any Claim Against Comerica**

The most significant action taken by Zengen following discovery of the last of the Four Funds Transfers was actually its failure to act – ***for more than two years following the last of the Four Funds Transfers, Zengen never once objected to Comerica's debiting of the 298 Account***, nor did Zengen request or demand from Comerica a refund of the money collected from the 298 Account via the Four Funds Transfers. (JA 134:9-17; 254:15-262:5; 400:24-401:2; 408:1-409:12; 410:11-16; 454:2-17; 618:15-619:28.)

As highlighted in the Court of Appeal's Opinion, all of Zengen's actions, listed above, taken while never once requesting that Comerica refund the stolen funds or otherwise telling Comerica that it considered Comerica to be responsible for the loss, are "simply inconsistent with its position in this lawsuit that the Bank was required to refund to it the $4.6 million stolen by Yen, and that it notified the Bank of that fact within one year of its discovery of the theft." (*Zengen, Inc. v. Comerica Bank* (2006) 137 Cal.App.4th 861, 878 [40 Cal.Rptr.3d 666, 676].)

Contrary to Zengen's argument, the evidence actually suggests that Zengen *intentionally* refrained from objecting to Comerica's actions. Zengen hired *three* separate sets of attorneys to pursue Fung Yen, both civilly and criminally, and to seek recovery of any funds left in the accounts at ChinaTrust Bank. (JA 457:9-458:2; 469:8-24; 547-548.) Furthermore, shortly after discovery of Yen's theft, at a board meeting with Zengen's outside counsel present, Zengen passed a resolution to authorize its officers and directors to, among other things, continue the investigation of the theft and potential recovery from Yen, and to enlist counsel "to advise the Corporation as to the exposure, if any, of Imperial Bank and/or China Trust

Bank with regard to their roles in the defalcation..." (Zengen's August 30, 2001, board meeting minutes; JA 542-544.) These facts are like those in *Fitts*, where the plaintiff, having failed to object to the payment within one year, testified that, upon learning of the unauthorized transfer, he "was not worried about it and that he 'didn't have to have the money at that time.'" *Id.*

Whether a deliberate decision or an oversight, the undisputed fact remains that Zengen failed to object to Comerica's debiting of the 298 Account until the date Zengen filed the present lawsuit, on February 20, 2003 -- more than two years after Comerica notified Zengen, in a monthly statement, of the debit for the last of the Four Funds Transfers, and certainly more than one year after Zengen concedes that it requested and received *actual* notice of all Four Funds Transfers.

c. **Zengen's Communications With Comerica Never Involved an Objection to the Debiting of the 298 Account**

There is no question that, shortly after Zengen discovered Yen's alleged defalcation, Zengen contacted Comerica and discussed the subject Funds Transfers. Zengen's own personnel, however, testified that those communications and discussions involved requests for bank records and discussion of the ChinaTrust Account opened by Yen. (JA 385:6-386:11; 402:14-405:3; 431-433; 451:16-452:1; 618:15-619:28.) Most of those communications took place while Zengen's accountant was trying to recreate its financial records after Yen left and took the financial records with him, and in connection with the accountant's request for copies of the banking records. (JA 131:11-132:15; 381:1-382:25; 385:6-386:11; 402:14-405:3; 431-433; 451:16-452:1; 459:1-4; 467:4-468:19; 538-546; 618:15-619:28; 620:2-621:23.)

Significantly, however, at no time during the first year after the Fourth Funds Transfer did Zengen so much as imply that Comerica was responsible for the Four Funds Transfers, or that Zengen objected to any actions by Comerica. (JA 134:9-17; 254:15-262:5; 400:24-401:2; 408:1-409:12; 410:11-16; 454:2-17; 618:15-619:28.) In fact, Zengen's own counsel sent Comerica at least two letters, in February and March, 2002, requesting copies of Zengen's account records, and *never* stated any objection to Comerica's debiting of the 298 Account. (JA 133:24-134:8; 157:18-158:4; 172-178.) Therefore, even when Zengen advised Comerica that it believed Yen had stolen money from Zengen, there was no reason for Comerica to believe that it had done anything wrong, that Zengen was objecting in any way to Comerica's debiting of its account, or that Zengen was seeking recovery of the alleged losses from Comerica.

Statements by Zengen to Comerica that Zengen believed its own CFO had embezzled money from it, without any other statement that Zengen objected to Comerica's debiting of its account, or even that Zengen believed Comerica to be responsible for the allegedly unauthorized funds transfers, do not satisfy the requirements of section 11505. Both lower courts agreed with this interpretation of section 11505. The Superior Court stated: "Plaintiff failed to object *to the bank's role* in the transfers within a year." (Emphasis added.) (JA 907:28.) The Court of Appeal confirmed this interpretation, stating: "...the critical 'fact' which Zengen was required to communicate to the Bank was that the Bank was liable for the fraudulent transfers." (*Zengen, Inc. v. Comerica Bank, supra.* 137 Cal.App.4th 861, 877 [40 Cal.Rptr.3d 666, 675].)

The undisputed evidence, therefore, proved that, prior to the filing of this lawsuit, for more than *two years* after the last of the Four Funds Transfers, Zengen failed to comply with the objection requirement under

section 11505. Zengen is thus barred from bringing this action against Comerica as a matter of law.

d. **Zengen's Own Admissions Prove it Could Not Have Objected Within One Year**

Zengen claims, on the one hand, that it objected to the payment for each of the Four Funds Transfers when, by July 12, 2001, Zengen had advised a Comerica employee that Zengen did not authorize the Four Payment Orders. (Opening Brief, pp. 10, 11, 17, and 18.) Yet, in Zengen's Opening Brief on the Merits, Zengen states that it did not know if Yen had stolen the money from the first three of the Four Funds Transfers until August, 2002, and that Zengen did not want to upset its banking relationship with Comerica, or prematurely demand a refund out of fear of being accused of a "bad faith" demand. (Opening Brief, p. 25.) These conflicting statements beg the question: if Zengen did not know if Yen had stolen the money from the first three Funds Transfers, and deliberately chose not to demand a refund, until after August, 2002, then how can Zengen claim it objected to any action taken by the bank prior to that date? The simple answer is, Zengen has clearly admitted that it did *not* timely object to the payment for those funds transfers.

e. **Significant Events, Which Affected Comerica's Rights, Occurred During the Two Years After the Four Funds Transfers, Further Exemplifying the Purpose of Section 11505**

As a result of Zengen's failure to timely object to the payments for the Four Funds Transfers, for *two years* Comerica had no reason to believe that Zengen would seek reimbursement of the payments for the Four Funds Transfers from Comerica. Comerica was thus denied the opportunity to take action to mitigate its losses, if any, within a reasonable time after the funds transfers. In fact, had Zengen objected to the first of the Four Funds

Transfers (for $850,000) after receiving the July 31, 2000, monthly statement identifying it, Comerica could have stopped the other three Funds Transfers, and saved Zengen (and potentially others) $3,750,000.

Had Comerica been advised of Zengen's objection to Comerica's actions, as is required under section 11505, it could have investigated and pursued Yen shortly after Yen's actions occurred. Indeed, had Comerica known that Zengen would seek reimbursement from it, Comerica may have taken actions to prosecute Yen that Zengen, for whatever reason, did not take. Instead, more than two years passed before Zengen advised Comerica that it was seeking a refund of payment. By then, significant witnesses were difficult or impossible to locate, and Yen had at least two years to conceal his assets and disappear overseas. (JA 372:3-4, 382:7-25; 384:21-25, 391:16-392:2; 398:10-23; 445:4-24.)

Furthermore, during those two years, significant events occurred that Zengen now seeks to take advantage of in its action against Comerica. Specifically, a Zengen shareholder, Helena Chu, sued Zengen in connection with Yen's sale of Zengen stock to her (the "Chu Lawsuit"). Zengen settled that action, allegedly giving Ms. Chu value for her stock and paying her a large sum of money. Zengen now claims that at least $2,900,000 of the $4,600,000 total amount of damages claimed by Zengen against Comerica is attributable to the Chu Lawsuit. (Opening Brief, pp. 12-13.) Since Zengen never advised Comerica that it believed Comerica to be responsible for the $4,600,000 in Funds Transfers, Comerica was denied the opportunity to be involved in the Chu Lawsuit, and the defense and settlement thereof.

It is precisely for these types of circumstances that Division 11 imposes the objection requirement upon bank customers. For these reasons, Zengen's failure to object within one year bars its right to seek reimbursement from Comerica.

IV. CONCLUSION

This Court should hold that in cases where, as here, a plaintiff's claims are based on unauthorized funds transfers, Division 11 preempts all non-UCC causes of action. This Court should also hold that in order for a customer to bring a claim for refund of payment under section 11204, the customer must, within one year of notification of an unauthorized funds transfer, notify the bank of its objection to the bank's debiting of its account or, if there is some other form of reimbursement provided to the bank for the funds transferred on the customer's behalf, to those actions of the bank in collecting payment from the customer. Finally, this Court should hold that notifying a bank that a given payment order was unauthorized does not satisfy this requirement.

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