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Bank Accounts and Payment Transactions

The Law of Deposit Accounts Under UCC Articles 3 and 4

By Alvin C. Harrell

The bank-customer relation, while fundamentally one of debtor-creditor and agent-principal, also may involve the law of negotiable instruments (including ownership claims, holder and HDC status, liability on the instrument, and warranty claims), Article 4 rights and obligations,[1] provisions of the deposit agreement,[2] security interests[3] and various other UCC provisions.[4] A lawyer might logically conclude, then, that Articles 3 and 4 constitute a comprehensive law of bank accounts. But is that correct?

THE UCC AS A LAW OF BANK ACCOUNTS

UCC Articles 3 and 4 are not a law of deposit accounts *per se*, but their provisions govern many, perhaps most, deposit account issues. As noted here, a bank account is essentially an accounting ledger that registers transactions between a debtor (the bank) and creditor (the customer). Those transactions are effectuated by deposits and withdrawals from the account. Subject to various electronic exceptions governed by other law,[5] these deposits and withdrawals involve "items" under UCC Article 4[6] and in many cases these items are also "instruments" under UCC Article 3.[7] Article 3 provisions continue to apply after an instrument becomes an item under Article 4.[8] Articles 3 and 4 thus constitute a basic law of bank accounts, governing the deposit, collection, and payment transactions that are the essence and purpose of the deposit account relationship.[9]

ISSUES NOT COVERED BY THE UCC

Of course, Articles 3 and 4 do not comprehensively cover every aspect of the bank-customer relation. Among the issues not covered (or not covered exclusively) are: (1) creditor process, such as garnishment; (2) set-off, account freezes and some third-party claims;[10] (3) account ownership issues, *e.g.*, regarding joint tenancy accounts;[11] (4) security interests (governed partly by UCC Article 9[12]); (5) Bank Secrecy Act, privacy and money-laundering issues (subject to extensive federal law coverage); and (6) electronic payment issues. These issues are governed extensively by other law, though with varying degrees of uniformity, clarity, and simplicity (and therein lies one argument for a new uniform law of bank accounts). But current Articles 3 and 4 govern the basic bank-customer relation to a degree that may be surprising to some; and to this extent may be said to already constitute the basic law of deposit accounts.

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ARTICLE 3 AND 4 PROVISIONS GOVERNING DEPOSIT ACCOUNTS

Introduction

Article 4 Part 4 (Relationship Between Payor Bank and Its Customer) obviously governs deposit account issues and the bank-customer relation. These provisions are discussed in some detail elsewhere and that will not be repeated here.[13] But which other Article 3 and 4 provisions (aside from the usual negotiable instrument rules) directly cover bank account and bank-customer issues?

The 2002 amendments to the uniform text of Articles 3 and 4 at sections 3-416(a)(6), 3-417(a)(4), 4-207(a)(6), and 4-208(a)(4) (and related definitions at section 3-103), governing remotely-created consumer items (sometimes called "telephone drafts"), affect the bank's relation with its customers concerning unauthorized drafts. This has been largely superseded by amendments to Federal Reserve Board (FRB) regulations,[14] and is even being omitted from some proposed enactments of the 2002 amendments. However, it is another example of Article 3 and 4 provisions directed at the bank-customer relation.

Article 3

Elsewhere in Article 3, section 3-110 determines to whom an instrument is initially payable. This can be important in determining whether an instrument has been indorsed and is therefore properly payable by the payor bank under section 4-401. Section 3-114 (contradictory terms), section 3-115 (incomplete instruments), and section 3-117 (other agreements affecting the instrument) may have a similar effect and may affect the payor bank's rights under section 4-407.

Section 3-116 (joint and several liability) and section 3-419 (accommodation parties) are examples of Article 3 provisions that may affect the depositary bank's ability to enforce dishonored checks against parties liable on the instrument,[15] and also may affect whether an item is properly payable by a payor bank under section 4-401. Section 3-118 (Statute of Limitations) likewise may affect these issues.[16]

In Article 3 Part 2, the rules governing indorsement (*e.g.*, sections 3-204, 3-205, and 3-206) may determine whether an item is properly payable under section 4-401, and also may relate to the issue of liability on the instrument (*e.g.*, allowing recovery of an overdraft by the depositary bank) under section 3-415. Lots more can be (and has been) said about the impact of these provisions on the collection and payment of items by banks (and hence deposit account transactions). Section 3-207 (reacquisition) enables a depositary bank to reassert a prior holder status as a means to collect an overdraft created by a returned (dishonored) item.[17]

In Article 3 Part 3, in addition to the important HDC rules,[18] section 3-301determines who is entitled to enforce an instrument, again implicating the properly payable standard for payor banks at section 4-401. Likewise section 3-308 has an important effect on procedural (burden of proof) issues relating to the enforcement of such items.

Sections 3-309, 3-310, 3-312, and 3-412 impact a bank's liability on the bank checks it issues (cashier's checks, money orders, teller's checks, and certified checks[19]). While not directly a bank account issue, these checks come with that territory and are considered a part of the law of bank accounts.

Article 3 Part 4 deals with the liability of parties to negotiable instruments, including basic issues such as the rules governing signatures (section 3-401), agents (section 3-402), forgeries (section 3-403), imposters and fictitious payees (section 3-404), and employees who forge their employer's indorsements (section 3-405). Basic estoppel principles are further codified at section 3-406, and alterations are governed by 3-407. All of these rules relate to common bank account transactions, and problems, *e.g.*, the issue of properly payable under section 4-401.

The remainder of Article 3 Part 4 (sections 3-408 – 3-419) deals with liability on the instrument, which as noted affects the ability of a depositary bank to recover overdrafts caused by returned items, and also may affect whether an item is properly payable by the payor bank.[20] Section 3-420 (conversion) uniquely affects deposit account issues, *e.g.*, by making a depositary bank liable for accepting deposit of an item with a forged indorsement.

Article 3 Part 5 applies directly to the payor bank-customer relation, supplementing the Article 4 Part 3 rules (and section 4-215) on final payment, payor bank "accountability," dishonor, and the midnight deadline. Article 3 Part 4 defines "presentment" (section 3-501),

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"dishonor" (section 3-502), and evidence of dishonor (section 3-505); it also defines and imposes notice of dishonor requirements (section 3-503); and it provides excuses for a failure to give notice of dishonor (section 3-504). These provisions are relevant to whether an item is properly payable by the payor bank under section 4-401, whether the payor bank has properly dishonored an item under section 4-301 or has become accountable under section 4-302, and whether the depositary bank can enforce the liability of the parties to a returned item under sections 3-414 and 3-415.

Article 3 Part 6 (Discharge and Payment) similarly relates to the bank-customer relation, by providing for discharge of the liability of all parties to the instrument upon its payment by the payor bank, subject to specified exceptions.[21] This means that a payor bank does not become the holder of an item that it pays,[22] as payment discharges all liability on the instrument and no one is subsequently entitled to enforce it.[23] The payor bank is therefore limited to recourse against its customer under section 4-401 and the deposit agreement, unless there is a breach of warranty or restitution claim against prior holders.[24] As between the payor bank and its customer, this largely imposes the risk of paying an improper item on the payor bank, subject to possible preclusions on the customer.[25] This represents a fundamental element of the bank-customer relation.

"Article 4 relates directly and obviously to the bank-customer relation..."

Section 3-602 also includes the Article 3 adverse claims procedure, designed to provide an orderly legal regime covering third party claims without undue interference in the payments system. While section 3-602 speaks in terms of claims to instruments (for that is the limit of Article 3's scope), it is made applicable in appropriate Article 4 cases by section 4-102(a). So a court could apply section 3-602 to third party claims against a bank account, directly or perhaps by analogy in the right kind of case.[26] While the precise scope of section 3-602 may not be clear in the context of claims against the deposit account (as opposed to an item drawn against it), there is undoubtedly an important role for that section to play in terms of the bank-customer relation.

The remainder of Article 3 Part 6 (Tender of Payment; Discharge by Cancellation or Renunciation; Discharge of Secondary Obligors) may affect the bank-customer relation, though that effect is likely to be at the periphery of the relationship.

Article 4

Article 4 relates directly and obviously to the bank-customer relation, devoted as it is to the essential deposit, collection, and payment functions of deposit accounts. Again, these issues are discussed extensively elsewhere,[27] so they need be noted only briefly here, with an emphasis on the Article 4 provisions broadly affecting bank accounts and the bank-customer relation.

Section 4-102 is an example, incorporating Article 3 (and thus the law of negotiable instruments) into the bank-customer relation (see section 4-102(a)) and providing a choice of law rule (focused on the situs of the bank) to cover most bank account issues (see section 4-102(b)).[28] Section 4-103 then recognizes the role of party autonomy, allowing variation of Article 4 provisions by agreement of the parties (excepting duties of good faith and ordinary care and limitations on liability).[29] Section 4-

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103(b) and (c) recognize the effects of FRB regulations and operating circulars, and section 4-103(d) emphasizes that reasonable banking procedures are not disapproved merely because they are not approved or specified in Article 4. Section 4-103(e) specifies the measure of damages for a failure to exercise ordinary care or good faith. These rules relate directly to the bank-customer relation with regard to deposit accounts, as do the definitions at sections 4-104 and 4-105.

The remainder of Article 4 Part 1 is similarly applicable to bank accounts. Section 4-106 governs the status of the bank as to "payable through" items; section 4-107 determines whether a branch office is treated as a separate bank for some purposes; section 4-108 determines whether items are received within a given banking day; section 4-109 excuses the bank for certain delays; section 4-110 governs electronic presentment; and section 4-111 is the Article 4 statute of limitations (three years).[30] All of these are essentially bank account issues.

Article 4 Part 2 focuses on the bank-customer relation in the context of depositary and collection transactions (*i.e.*, where the bank is acting as a depositary or intermediary bank). These provisions comprehensively govern the rights and duties of collecting banks with regard to the deposit and collection of items through the bank collection system.

Section 4-201 establishes the agency status of collecting banks and the provisional status of deposit transactions. Section 4-202 imposes a duty of ordinary care, which can be met by the collecting bank acting within its midnight deadline. Section 4-203 deals with the effects of customers' (and others') instructions, and sections 4-204 and 4-206 govern the methods of sending and presenting items. Section 4-205 allows a depositary bank to be the holder (and thus a HDC) of an unindorsed item.

Sections 4-207 through 4-211 deal with warranties and security interests in deposited items, and section 4-212 deals with presentment by notice of certain collection items. Section 4-213 governs the medium and time of settlement, and section 4-214 recognizes the bank's right of charge-back for deposited items that are dishonored. Section 4-215 determines when an item is finally paid (*e.g.*, when provisional settlement under section 4-201 becomes final payment under 4-215).

> "These provisions comprehensively govern the rights and duties of collecting banks..."

Article 4 Part 3 governs the bank-customer relation in the context of payment (as opposed to deposit) transactions, *i.e.*, where the bank is acting as a payor bank in the bank-customer relation. Here the issues are whether the bank has properly dishonored items that were presented for payment but were not paid (section 4-301[31]), whether the bank has become accountable for items not properly dishonored within the midnight deadline (section 4-302), and whether notice to the bank of a stop-payment order, legal process or set off came too late to prevent payment of an item presented to the bank (section 4-303). All of these are distinctly and directly deposit account issues.

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Article 4 Parts 1-3 thus relate directly to the bank-customer relation in the conduct of deposit account transactions, a relation focused on the deposit and payment of items in or on bank accounts. Article 4 Part 4 is focused even more directly on the bank-customer relation (and is even titled as such), dealing with such obvious bank account issues as: the bank's entitlement to charge its customer's account (section 4-401); bank liability for wrongful dishonor (section 4-402); stop payment orders (section 4-403); payment of stale checks (section 4-404); death or incompetence of the customer (section 4-405); the customer's duty to discover and report forgeries and alterations (section 4-406); and subrogation of the bank to the rights of others when it is caught in the middle of payment disputes (section 4-407). Article 4 Part 5 then deals with the collection of documentary drafts.

Obviously Article 4, supplemented by Article 3, is a comprehensive bank collection code (at least as to Article 4 "items"). Because these deposit, collection, payment and dishonor transactions form the heart of the bank-customer relation, and the purpose of bank accounts generally, this can be regarded as the statutory foundation for deposit account transactions, *i.e.*, the primary law of bank accounts.

WHAT ISN'T COVERED?

Clearly Articles 3 and 4 cover extensive swaths of the bank-customer relation, including the fundamental elements of deposit and payment (and therefore bank account) transactions. So what is left, outside of Articles 3 and 4, for other bank deposit-related laws to cover? Well, the six categories of issues noted *supra* at notes 10-12. But each of these deserves further scrutiny, before concluding that something is missing from the current arrangement of these laws that requires a further codification of the law of bank accounts.

Creditor process (such as garnishment or other variations of attachment) represents a means for third parties to assert a claim against the bank's obligation to repay deposited funds to its customer. This is essentially attachment of a chose in action, and is a traditional part of the law of creditor remedies. As such, it is subject to extensive regulation under established debtor-creditor laws, consumer protection statutes and even the U. S. Constitution.

This area of debtor-creditor law is quite well-developed, easily pre-dating UCC Articles 3 and 4 and the law of bank deposits generally. While it is largely a matter of state law, and with its many state and local variations is an area of law that would benefit from greater uniformity, it is largely a matter of local interest and procedure; moreover, it is also extensively covered by federal law and fits within an overall, comprehensive package of state and federal debt collection laws. It would be a major undertaking, and perhaps not entirely productive, to seek the severance of the debtor-creditor laws governing garnishment of bank accounts from the broader body of garnishment, attachment, and debtor-creditor laws and procedures in order to graft it separately onto the law of bank accounts.

But what about set-off, account freezes and the like? Surely these are uniquely deposit-related issues that need to be addressed as part of a more comprehensive law of bank accounts. Well, yes and no. First, it should be reiterated that a bank account is not "money" in any except the broadest lay sense. It is a form of debt, an obligation to repay money pursuant to the deposit contract and other law (primarily UCC Articles 3 and 4). Until that obligation to repay is breached, there is no actionable event. Thus, an uncommunicated "hold" or "freeze" on a deposit account has no more external effect than if any other debtor wakes up one morning and decides that he or she is going to default on some future payment. In other words, an uncommunicated account "hold" or "freeze" causes no damages except those already covered under UCC section 4-402 (wrongful dishonor). This argues against the need for a separate statute or cause of action covering such holds.

Nor is an account freeze a form of conversion, because money loaned to a debtor (here, the bank) becomes the property of the debtor and one cannot convert his or her own property.[32] Thus an account freeze is essentially an internal bank accounting procedure, with no impact on the bank's customer unless and until it results in a wrongful dishonor or other breach of contract.[33] When that occurs, Article 4 (and in particular section 4-402) comes into play and resolves most issues. Thus account freeze controversies usually revolve around wrongful dishonor issues, and are decided (or should be) under section 4-402.[34] This seems an adequate basis for resolving these issues, and

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suggests that separate coverage outside Article 4 is not appropriate or needed.

But what of set-off? This again is a long-standing remedy, predating the law of bank accounts and existing as part of a broader area of debtor-creditor law. But for practical reasons set-off issues often arise in the context of bank accounts. Should there be additional, separate rules governing these issues?

As with garnishment, the basic elements of the law of set-off are well established.[35] Elements such as mutuality, maturity of the debts, identity of the parties, and the differences between treatment of general and special deposits are well settled and understood.[36] Perhaps the issue that has been the most nagging is that of priority, *e.g.*, as between a bank making set-off against a general account (or a special account) known to contain funds being claimed by a third party (*e.g.*, a garnishor or an Article 9 secured party claiming the bank account as proceeds). Again, however, these issues are easily resolved under current law, either in the form of traditional case law distinctions[37] or (in the case of security interests) by the 1998 UCC Article 9 revisions.[38] There does not appear to be much left over in the way of unaddressed or unresolved priority issues. The same is true with regard to security interests in deposit accounts, now mostly covered by Article 9.[39]

Bank Secrecy Act, privacy and related issues are governed extensively by other law (including federal law that would pre-empt any contra state law), and electronic payments are likewise the subject of separate, comprehensive legal coverage. While improvements in these areas could certainly be made, in terms of simplicity, clarity and perhaps even uniformity, it is not clear that a law governing the traditional bank-customer relation is the place to do it.

This leaves the laws governing ownership of bank accounts, *e.g.*, joint tenancy issues. This is often cited as an example of needed law reform, and often is at the heart of the bank-customer relation. Indeed, Article 3 currently provides important guidance as to some such issues,[40] though this is limited to instruments and does not extend to bank accounts generally (except possibly by implication or analogy).

"Bank Secrecy Act, privacy and related issues are governed extensively by other law..."

But once again these issues are part of a broader law, in this case the law of property, that is well developed and largely predates bank deposit laws.[41] It would be at least cumbersome, and possibly counter-productive, to sever these basic property law concepts from their roots in order to create a new and separate property law of bank accounts. In this regard it should be noted yet again that a bank account is not property of the customer in any tangible sense; rather it is a chose in action, a creature of contract law evidencing a debtor-creditor relation. While state property law concepts generally translate well to this context in this instance, and other state laws (such as banking codes) may help bridge the gap between property and contract law concepts, it remains relevant that joint tenancy law and related concepts have a long history in the law of property and may not be easily removed from that context. Arguably it is not something to be done without careful consideration and compelling evidence of need.

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CONCLUSION

Two general observations from all of this remain to be said in conclusion. First, the need for a further codification of the law of bank accounts, being so ably asserted by some notable authorities in the field,[42] may not be so apparent as it first seems. While many of us would like to see development of a clear, simple, uniform and comprehensive law of bank accounts, to complement UCC Articles 3 and 4 (and 9), as usual with such things it is easier said than done. Articles 3 and 4 already constitute a law of bank accounts, and it may be that some of the reasons why certain related issues are outside Articles 3 and 4 retain some validity. As always, caution is warranted when considering changes to a payments system that has worked so well for more than three centuries and continues to do so to this day.

Second, despite the seemingly inevitable trend toward increasing federalization (and regulation) of traditional state law issues, and the comprehensive authority of federal agencies to thusly expand their own authority, the law of bank accounts and payment transactions remains largely the province of state law. In the case of bank accounts and traditional checking transactions, this means UCC Articles 3 and 4, which constitute the basic law of bank accounts and continue to govern the large majority of traditional issues in payment transactions. Ultimately, long-term trends may change this, but for now Articles 3 and 4 remain the primary law of bank accounts.

1. *See, e.g.,* Article 4 Part 4.
2. *See* § 4-03.
3. Under Article 4 (*see, e.g.,* § 4-210), and Article 9 (*see, e.g.,* §§ 9-102(a)(29), 9-104, 9-109, 9-203, 9-304, 9-309(7), 9-310(b)(8), 9-312, 9-314, 9-327, 9-332, 9-340, and 9-341).
4. *E.g.,* the adverse claims procedure at § 3-602.
5. *E.g.,* Article 4A, Federal Reserve Board Regulation E. Regulation E is discussed elsewhere in this Symposium.
6. *See* § 4-104(a)(9).
7. *See* § 3-104.
8. *See* § 4-102(a).
9. *See generally* Fred H. Miller and Alvin C. Harrell, "The Law of Modern Payment Systems and Notes" ¶ 9.05 (2002) ("The Basic Law of Bank Accounts").
10. *But see* §§ 3-602 (adverse claims) and 4-303 (legal process, set off). *See also* § 9-340 (set-off).
11. *But see* § 3-116 (joint and several liability).
12. *See supra* note 3.
13. *See, e.g., supra* note 9, Ch. 9.
14. *See, e.g.,* 70 Fed. Reg. 71218 (Nov. 28, 2005), amending FRB Regulations CC and J; Alvin C. Harrell, "Price v. Neal Revisited, UCC and FRB Revisions Impact Bank Accounts and Transactions," 61 Consumer Fin. L. Q. Rep. 309 (2006). This issue is also discussed elsewhere in this Symposium. See Charles Cheatham, "Fed's Warranty of Authorization for Telephone Checks, *infra* this issue.
15. *See also* §§ 3-408 - 3-417. *See Miller and Harrell, supra note 9.*
16. *See also, e.g.,* the time limit periods in § 4-111, and §§ 3-312, 3-141 — 3-417, 4-104(a)(10), 4-202, 4-215, 4-301, 4-302, 4-303, 4-403, 4-404, 4-405, and 4-406.
17. *See Miller and Harrell, supra note 9.*
18. *E.g.,* sections 3-302 - 3-308.
19. *See also* §§ 3-104, 3-408, 3-409 - 3-414.
20. This may also affect the bank's subrogation rights under § 4-407.
21. *See* §§ 3-601 and 3-602.
22. *See* §§ 1-201(a)(21)(A), 3-201.
23. *Id. See also* §§ 3-201, 3-301, 3-408 - 3-415.
24. *See* §§ 3-416, 3-417, 4-207, 4-208, 3-418 and 4-302.
25. *E.g.* §§ 3-401 - 3-408, § 4-406. *See also* § 4-407 (possible bank subrogation rights).
26. *See also* § 4A-503 (similar rule as to third party claims against Article 4A wire transfers).
27. *See, e.g.,* Miller and Harrell, *supra* note 9, Chs. 8 and 9.
28. On choice of law, *see also* UCC § 1-301, and §§ 9-301 - 9-307.
29. Section 4-103(a). *See also* § 1-302. This deference to private autonomy has been the focus of some criticism by scholars who prefer a more regulatory approach. *See, e.g.,* A. Brooke Overby, "Check Fraud in the Courts After the Revisions to U.C.C. Articles 3 and 4," 57 Alabama L. Rev. 351 (2005).
30. *Cf.* § 3-118. *See also supra* note 16.
31. *See also* Article 3 Part 5.
32. *Cf.* § 3-420.
33. Of course, the impact in bankruptcy may be different because of the automatic stay and related issues. *See, e.g.,* 11 U.S.C. §§ 361-363. In addition, communication of an account freeze may constitute an anticipatory repudiation of the deposit contract under contract law.
34. Cases seemingly to the contrary are typically focused on the notion that the bank's behavior was so egregious as to constitute an independent tort. The reasoning of such cases is often a bit loose but in essence typically follows a wrongful dishonor pattern. *See, e.g., Beshara v. So. Nat. Bank,* 928 P.2d 280 (Okla. 1996); *Twin City Bank v. Isaacs,* 672 S.W.2d 651 (Ark. 1984).
35. *See, e.g.,* Miller and Harrell, *supra* note 9, ¶¶ 9.05 and 9.06.
36. *Id. See also, e.g.,* Alvin C. Harrell, "Security Interests in Deposit Accounts: A Unique Relationship Between the UCC and Other Law," 23 U.C.C. L.J. 153, 155-65 (1990).
37. *See, e.g., Walter v. National City Bank of Cleveland,* 330 N.E.2d 425 (Ohio 1975).
38. *See supra* note 3. These revisions generally were effective July 1, 2001.
39. *See id.,* and § 9-109(a), (c)(10), (c)(13); Miller and Harrell, *supra* note 9, ¶ 9.06[4].
40. *See* §§ 3-110, 3-116.
41. *See, e.g.,* R. David Whitaker, "Special Considerations Related to Joint Deposit Accounts," 47 Consumer Fin. L.Q. Rep. 138 (1993); Miller and Harrell, *supra* note 9, ¶ 9.05[2][c].
42. *See, e.g.,* Joseph H. Sommer, *Why Worry About Bank Accounts* (unpublished manuscript) (2006). At this writing the National Conference of Commissioners on Uniform State Laws, in conjunction with the Permanent Editorial Board of the UCC, has established a study committee to consider whether further codification in this area of law is warranted.

ABOUT THE AUTHOR

Alvin C. Harrell is a professor of law at OCU School of Law and president of the Home Savings and Loan Association of Oklahoma City. He is a co-author of a dozen books, including "The Law of Modern Payment Systems and Notes" (with Professor Fred H. Miller). Professor Harrell chairs the UCC Legislative Review Subcommittee of the Oklahoma Bar Association. He also chairs an ABA UCC Committee Task Force on State Certificate of Title Laws, and is the Reporter for the Uniform Certificate of Title Act (UCOTA).

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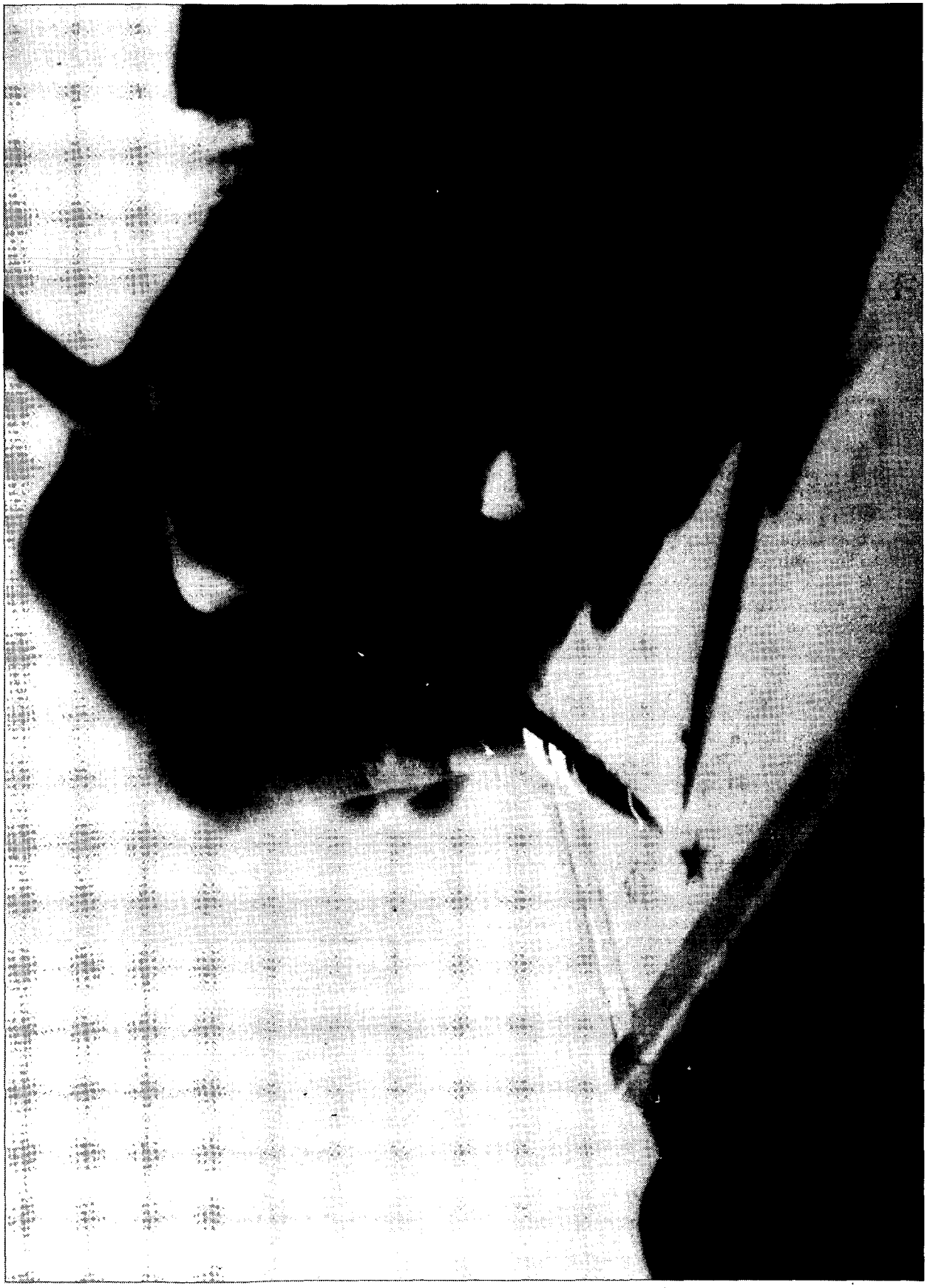

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