

# Common Law Negligence and Check Fraud Loss Allocation: Has Common Law Supplemented or Supplanted the U.C.C.?

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## I. INTRODUCTION

Articles 3 and 4 of the Uniform Commercial Code ("U.C.C.") govern the obligations of parties involved in checking transactions: banks, drawers of checks, and recipients of checks.<sup>1</sup> Accordingly, these Articles contain a number of rules which allocate loss in cases involving check fraud. Typical examples of check fraud include the payment of a check over the forged signature of the check's drawer, payment of a check over the forged indorsement of the check's payee, and fraudulent alteration of a check by increasing the amount payable.

Other types of check fraud exist, however, and the U.C.C. does not clearly allocate loss in all cases.<sup>2</sup> In these cases, some courts choose to allocate loss in accordance with common law negligence principles. These courts use common law principles to "supplement" the U.C.C. by virtue of the authority provided by U.C.C. section 1-103.<sup>3</sup>

Some of the cases allocating loss under common law negligence principles have been criticized as supplanting rather than supplementing the U.C.C.<sup>4</sup> Instead of filling gaps, courts improperly decide cases under common law principles in order to avoid the result mandated by the U.C.C. which generally favors banks. Arguably, the common law negligence cases undermine the U.C.C. policies of providing certain and uniform rules for the resolution of commercial disputes.<sup>5</sup> The loss allocation scheme designed by the U.C.C. drafters is discarded in favor of a more equitable scheme favoring bank customers.<sup>6</sup>

The relationship between common law negligence and the U.C.C. check fraud loss allocation scheme raises a jurisprudential question regarding the role of courts in resolving disputes which are purportedly governed by a code. Must the court resolve the dispute solely by reference to the statutory scheme or is there room for decision making based on principles derived outside the U.C.C.?

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1. All references to the U.C.C. are to the 1987 official text, unless otherwise indicated.

2. See *infra* notes 91-114 and accompanying text.

3. U.C.C. § 1-103 provides: "Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions."

4. See Kronemyer, *Wrongful Application: A New Depositary Tort*, 101 *BANKING L.J.* 636 (1984); See also *infra* notes 176-85 and accompanying text.

5. See *infra* notes 59-65 and accompanying text.

6. *Id.*

Although the U.C.C. itself mandates the use of common law principles to supplement the Code,<sup>7</sup> some limits to the use of such principles must exist if the Code is to have any meaning.<sup>8</sup>

This Article examines the check fraud cases decided on common law negligence principles and discusses when courts should refer to those principles.<sup>9</sup> In most of these cases, it appears that the courts were justified in looking to common law because of the unclear way in which the Article 3 and 4 statutes are written. Whether the drafters intended to cover many of these cases is simply not that clear. It is appropriate for courts to look at these cases in light of the history and policies underlying the statutory provisions.<sup>10</sup> If the statutes, interpreted in light of their underlying policies, do not resolve the disputes, it is appropriate to look to common law.<sup>11</sup>

Cases decided on common law negligence principles add uncertainty to check fraud loss allocation. As Articles 3 and 4 are currently being revised, the drafters should consider statutory resolution of the problems which courts have decided under common law negligence principles.<sup>12</sup> The last part of this Article discusses some of the revisions currently under consideration which attempt to resolve issues which courts do not believe are resolved only by reference to the U.C.C.<sup>13</sup> The proposed revisions leave some questions unresolved, thus making it likely that check fraud cases will still be decided to some extent under common law principles rather than under the U.C.C.

## II. THE U.C.C.'S RULES OF LOSS ALLOCATION, THE RELATIONSHIP OF GENERAL PRINCIPLES OF LAW, AND THE NEED FOR CERTAINTY

Articles 3 and 4 initially allocate loss on a strict liability basis depending on the type of fraud involved. As noted above, in the event that a check is paid by the payor bank (the bank upon which the check is drawn)<sup>14</sup> without the drawer's authorized signature, the payor bank will normally bear the loss, assuming that the wrongdoer (or more importantly, the funds) cannot be found.<sup>15</sup>

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7. See *infra* notes 35-37 and accompanying text.

8. See *infra* notes 77-81 and accompanying text.

9. *Id.*

10. *Id.*

11. *Id.*

12. Articles 3 and 4 are currently being revised by their sponsors, the American Law Institute and the National Conference of Commissioners on Uniform State Laws. The draft of Articles 3 and 4 discussed in this Article is the draft considered at the meeting held by the National Conference of Commissioners on Uniform State Laws on July 13-20, 1990. U.C.C. arts. 3&4 (proposed July 13-20, 1990) [hereinafter, Proposed U.C.C. arts. 3&4]. For a discussion of issues and policies considered in the revision, see Rubin, *Policies and Issues in the Proposed Revision of Articles 3 and 4 of the UCC*, 43 BUS. LAW. 621 (1988).

13. See *infra* notes 197-224 and accompanying text.

14. U.C.C. § 4-105(b).

15. Since the drawer's agreement with the bank provides that checks will be paid only with authorized signatures of the drawer, any check that is paid without necessary authorized signatures is not properly payable, and the drawer's bank must recredit the amount paid to the drawer's account. U.C.C. § 4-401. See J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 18-3 (3d ed. 1988). The bank upon which a check is drawn is known as the "payor bank." U.C.C. § 4-105(b). Once the payor bank pays a check without the drawer's authorized signature, it cannot normally recover payment from parties other than the person perpetrating the fraud because of the "final payment rule" of U.C.C. section 3-418, which protects holders in due course and parties relying upon payment of the check. See J. WHITE & R. SUMMERS, *supra*, at §§ 17-2 to -3.

In the event that a check is paid without the authorized indorsement of the payee (the person to whom the check was payable) the loss will normally ultimately fall on the depository bank (the bank in which the check is first deposited)<sup>16</sup> if it cannot recover the funds from its depositor.<sup>17</sup> Likewise, if a check is paid over an unauthorized alteration, for example an unauthorized raising of the check's amount,<sup>18</sup> the loss will normally fall on the depository bank, again assuming that the funds cannot be recovered from the depository bank's depositor.<sup>19</sup>

The initial allocation of loss is shifted, however, in the event that one or more parties to the transaction are negligent or fail to act in accordance with reasonable commercial standards.<sup>20</sup> A party whose negligence "substantially contributes" to the making of an unauthorized signature or to a material alteration is precluded from asserting that unauthorized signature or alteration against a payor bank, provided that the bank acted in accordance with reasonable commercial standards of the bank's business in paying the check in question.<sup>21</sup> Likewise, if a customer fails to review bank statements or report losses from check fraud within certain time periods, the customer is barred from asserting certain losses, provided that the customer's bank has not acted negligently in paying the checks in question.<sup>22</sup>

The statutes allocating loss under Articles 3 and 4 are "supplemented" by decisions allocating loss under common law negligence. These decisions hold that the statutory loss allocation scheme is not comprehensive; the drafters of the U.C.C. did not intend to cover all cases of check fraud through the statutory scheme.<sup>23</sup> The decisions fill the perceived gaps by asking whether one of the parties breached a common law duty of due care apart from the specific duties mandated by the U.C.C.

An example of check fraud analyzed by some courts on negligence grounds involves checks payable to banks. A dishonest employee may convince the employer that the employer owes money to a bank and may convince the employer to draw a check payable to the bank. The employee then takes the check to the bank and persuades the bank to either cash the check for the employee or deposit the check in the employee's personal account. Some courts have held that the U.C.C. does not cover this situation and have found the bank facilitating

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16. U.C.C. § 4-105(a).

17. Checks not containing authorized indorsements and containing unauthorized alterations are also not generally properly payable under U.C.C. section 4-401. However, in those cases the payor bank has an action against the depository bank (the first bank which took the check from a depositor under § 4-105(a)) on a breach of warranty theory. U.C.C. § 4-207(1)(a), (c). See J. WHITE & R. SUMMERS, *supra* note 15, at § 15-9.

18. See U.C.C. § 3-407 and the official commentary thereto.

19. *Id.*

20. In addition, a party may be precluded from denying an unauthorized signature through ratification or otherwise. See U.C.C. § 3-404.

21. U.C.C. § 3-406.

22. U.C.C. § 4-406.

23. See *infra* notes 91-114 and accompanying text.

the employee's fraud to be negligent under common law principles.<sup>24</sup> These cases will be considered in more detail later in this Article.<sup>25</sup>

Other courts have held under similar circumstances that no common law duty of inquiry exists and that the bank can claim holder in due course status.<sup>26</sup> These courts believe that the U.C.C. answers this particular question. The issue is whether courts finding a common law duty are ignoring the statutory directive imposed by state legislatures in adopting the U.C.C.

#### A. *The Relationship Between the U.C.C. and General Principles of Law*

To understand the relationship between common law negligence and the statutory loss allocation scheme under Articles 3 and 4, it is important to understand the relationship between the U.C.C. and general principles of law. To what extent did the drafters of the U.C.C. intend general principles of law, including common law negligence principles, to be used in deciding disputes within the scope of the various Articles of the U.C.C.? Conflicting policies make the intended relationship between common law and the U.C.C. unclear.

As a starting point, U.C.C. drafters intended to promulgate a set of rules that would permit quick and inexpensive resolution of commercial disputes.<sup>27</sup> Included within the scope of this effort were transactions involving commercial paper, including check processing. The prevailing view at the time was that it was too expensive to resolve commercial disputes because of the different approaches courts took to similar problems.<sup>28</sup> Results differed depending on the jurisdiction, and rules governing commercial transactions were generally unknown to most people.<sup>29</sup> Each time a problem arose, it was necessary to hire a lawyer to engage in costly legal research.<sup>30</sup> It was difficult to structure transactions in advance because of uncertainty regarding the likely result in the event that disputes were to arise in the future.<sup>31</sup>

In order to facilitate resolution of commercial disputes, the drafters sought to draft a set of rules that would eliminate the need to resort to general principles of law outside the U.C.C. in as many cases as possible. Even in cases where the statutes did not expressly provide a result, the drafters provided that the U.C.C. should be "liberally construed and applied to promote its underlying purposes and policies."<sup>32</sup> The drafters hoped that the U.C.C. would be a "semi-permanent piece of legislation" and that its provisions would be "developed by the courts in the light of unforeseen and new circumstances and practices."<sup>33</sup>

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24. See *infra* notes 91-95 and accompanying text.

25. See *infra* notes 91-114 and accompanying text.

26. See *infra* note 96 and accompanying text.

27. 1 REP. OF THE LAW REV. COMM'N OF THE STATE OF NEW YORK FOR 1954 AND RECORD OF HEARINGS ON THE UNIFORM COMMERCIAL CODE 28-36 (1954) (statement to the Law Revision Commission by Professor Karl N. Llewellyn, Chief Reporter of the Code and Member of the Editorial Board).

28. *Id.* at 29.

29. *Id.* at 28.

30. *Id.* at 28-29.

31. *Id.* at 29.

32. U.C.C. § 1-102.

33. U.C.C. § 1-102 comment 1.

This section could be taken for the proposition that the U.C.C. is to be interpreted as a "true code," without reference to case law or policy outside that expressed in the U.C.C. itself.<sup>34</sup>

At the same time, the drafters realized that they would be unable to codify all rules needed to resolve commercial disputes, especially in a society so tied to common law. They realized that some questions would be answerable only through reference to rules developed outside the U.C.C. General principles of law and equity were left in place "unless displaced by the particular provisions of [the] code."<sup>35</sup> The U.C.C. lists as examples the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, and bankruptcy.<sup>36</sup> The commentary states, however, that this listing is not exclusive.<sup>37</sup>

The U.C.C. thus creates a tension between liberal construction of its express statutory provisions and established, general principles of law at variance with U.C.C. policies.<sup>38</sup> On the one hand, liberal construction encourages the application of statutory provisions in areas not specifically covered.<sup>39</sup> On the other hand, section 1-103 seems to expressly preserve existing general principles in areas not covered by the U.C.C.<sup>40</sup>

This tension between use of the express provisions of the U.C.C. and use of general principles of law is particularly great in the negotiable instruments area — especially in the parts of Articles 3 and 4 dealing with check fraud loss allocation. Article 3 was written not so much as a comprehensive code from which all disputes could be decided, but rather was written to resolve some of the specific problems that had arisen under its predecessor, the Negotiable Instruments Law ("N.I.L.") which itself was not a comprehensive code.<sup>41</sup> Gaps exist which are left for judicial resolution, perhaps by reference to general principles of law outside the U.C.C.<sup>42</sup> Both Articles 3 and 4 use inconsistent terminology and are difficult to apply.<sup>43</sup> Thus, there is a strong temptation to use more familiar, general principles of law in resolving negotiable instrument disputes.

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34. See Hillman, *Construction of the Uniform Commercial Code: UCC Section 1-103 and "Code" Methodology*, 18 B.C. IND. AND COMM. L. REV. 655, 656-60 (1977); Hawkland, *Uniform Commercial "Code" Methodology*, 1962 U. ILL. L.F. 291, 292-93, 299.

35. U.C.C. § 1-103.

36. *Id.*

37. U.C.C. § 1-103 comment 3.

38. See R. HILLMAN, J. McDONNELL & S. NICKLES, *COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE* ¶ 1.04 (1985) [hereinafter *COMMON LAW*]; Hillman, *supra* note 34, at 658-60.

39. See Hillman, *supra* note 34, at 658.

40. *Id.* at 658-59.

41. Daube v. Bruno, 493 So. 2d 606, 608 (La. 1986); Lawrence, *Misconceptions About Article 3 of the Uniform Commercial Code: A Suggested Methodology and Proposed Revisions*, 62 N.C.L. REV. 115, 120-21 (1983); Gilmore, *Legal Realism: Its Cause and Cure*, 70 YALE L.J. 1037, 1043 (1961).

42. For example, Article 3 describes several instances in which an instrument is deemed to be converted. U.C.C. § 3-419(1). The statute is not exclusive. The U.C.C. does not give any indication about which common law rules of conversion are displaced by the provisions of Article 3, and courts are left to decide. Lawrence, *supra* note 41, at 137-39.

43. See Whaley, *Forged Indorsements and the UCC's "Holder,"* 6 IND. L. REV. 45, 52-58 (1972); Melnikoff, *The Language of the Uniform Commercial Code*, 77 YALE L.J. 185, 192-93 (1967).

In addition, there is a strong relationship between tort and rules allocating loss under Articles 3 and 4.<sup>44</sup> To some extent, loss relating to forgeries and alterations is allocated by statute based on negligence.<sup>45</sup> Section 3-419 provides certain specific circumstances where a cause of action exists for conversion, including the payment of a check on a forged indorsement.<sup>46</sup> Section 4-402 provides that a payor bank is liable to its customer for damages "proximately caused" by wrongful dishonor of a check. The official commentary to that section notes that historically, liability for wrongful dishonor has been found under such tort theories as negligence and defamation.<sup>47</sup> The statutes thus require reference to tort principles in resolving many disputes involving check fraud.

Adding to the temptation to use general principles of law in resolving disputes is the antipathy which some courts have for statutes. This antipathy may arise because some statutes do not age gracefully, and statutes, once enacted, are difficult to change or remove.<sup>48</sup> The U.C.C. was drafted in the 1940's but was not enacted until the 1950's and 1960's.<sup>49</sup> Some of the rules allocating loss in check fraud cases date back to the eighteenth century.<sup>50</sup> Changes in technology, such as increased use of computers and electronic funds transfers and the need to process a higher volume of checks more quickly, may make a strict application of Articles 3 and 4 inappropriate in the 1990's and beyond.<sup>51</sup>

An additional antipathy exists toward statutes which are viewed as special interest legislation.<sup>52</sup> According to Professor Grant Gilmore, one of the principal proponents and drafters of the U.C.C., Karl Llewellyn's<sup>53</sup> concept of the U.C.C. was to abrogate obsolete rules governing commercial law and to leave the courts free to improvise new rules to fit changing conditions and novel business prac-

44. See COMMON LAW, *supra* note 38, at ¶ 1.06(2).

45. A person may be precluded from denying the existence of an unauthorized signature or the making of a material alteration if his negligence substantially contributed to the making of the unauthorized signature or material alteration. U.C.C. § 3-406. See Whaley, *Negligence and Negotiable Instruments*, 53 N.C.L. REV. 1 (1974).

46. Section 3-419(1) states:

(1) An instrument is converted when

- (a) a drawee to whom it is delivered for acceptance refuses to return it on demand; or
- (b) any person to whom it is delivered for payment refuses on demand either to pay or to return it; or
- (c) it is paid on a forged indorsement.

47. U.C.C. § 4-402 comment 2.

48. See G. GILMORE, *THE AGES OF AMERICAN LAW 95-97* (1977); COMMON LAW, *supra* note 38, at ¶ 1.05.

49. G. GILMORE, *supra* note 48, at 86.

50. See J. WHITE & R. SUMMERS, *supra* note 15, at § 17-2. The author remembers one of his professor's comments that if the field of medicine had progressed at the same speed as the field of law, doctors would still be using leeches. There is some truth to this statement in the commercial paper area. See Gilmore, *Formalism and The Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441, 461 (1979) ("What Article 3 really is in [sic] a museum of antiquities—a treasure house crammed full of ancient artifacts whose use and function have long since been forgotten."). Interestingly, doctors are still using leeches. See Mares, *In Swansea, Wales, There's a Sucker Born Every Minute*, Wall St. J., Sept. 21, 1989, at 1.

51. For a discussion of the continued vitality of Articles 3 and 4 in a checkless society based on electronic funds transfers, see Vergari, *Articles 3 and 4 in an Electronic Fund Transfer Environment*, 17 SAN DIEGO L. REV. 287 (1980). A new Article 4A dealing with wire transfers was approved by the American Law Institute and the National Conference of Commissioners on Uniform State Laws in 1989.

52. See G. CALABRESI, *A COMMON LAW FOR THE AGE OF STATUTES 31-43* (1982) (conflicts among various special interest groups may cause legislative log jam which impedes needed changes to statutes, a log jam which can be broken through judicial intervention).

53. Professor Llewellyn was the Chief Reporter of the U.C.C.

tices.<sup>54</sup> This concept ran afoul of others, especially those representing banking interests, who wished a tightly drawn statute that would compel decision making.<sup>55</sup> According to some commentators, Article 4 was special interest legislation. It was pushed through by banking interests near the end of the drafting process and was not given a great deal of consideration.<sup>56</sup> Judges may be tempted to circumvent statutes which are viewed as being unfairly slanted to a party, such as banks, that had disproportionate access to the legislative process.<sup>57</sup>

Some limit to the use of general principles must exist if the purposes of the U.C.C. are to be honored. For example, if check fraud cases could always be decided on common law negligence principles at the court's option rather than in accordance with statutory directive, the U.C.C. loss allocation system would cease to have meaning. Parties would not be aware of their respective rights when a dispute arose without engaging in legal research, and resort to the U.C.C. would only be a starting point in the research effort. Costs of dispute resolution would rise as a result. In addition, because of uncertainty regarding the legal obligations of the parties, it would be difficult for parties to conduct business in a cost effective manner designed to avoid liability. The U.C.C. drafters' goal of providing certain rules for the conduct of business would be undermined substantially.

Unfortunately, the drafters of the U.C.C. did not clearly delineate where the statutes stop and the common law begins. For example, U.C.C. section 4-406(4) provides a statute of limitations for asserting rights against a bank that paid a check over an unauthorized indorsement, unauthorized drawer signature, or material alteration. The statute of limitations applies "[w]ithout regard to care or lack of care of either the customer or the bank."<sup>58</sup> Does this statute of limitations apply to causes of action sounding in negligence against a bank which negligently failed to detect a forged signature? Neither the statute nor the official commentary speaks directly to the issue. Courts have disagreed on this issue.<sup>59</sup>

A holding that the statute of limitations applies irrespective of whether the cause of action sounds in tort is consistent with the drafters' goal of providing answers to commercial law disputes in one place—the U.C.C. On the other hand, it may be that the drafters of the U.C.C. did not intend to bar all cases

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54. G. GILMORE, *supra* note 48, at 85.

55. *Id.*

56. See Beutel, *The Proposed Uniform [?] Commercial Code Should Not Be Adopted*, 61 YALE L.J. 334, 335 (1952) ("Article 4 on Bank Deposits and Collections is an unfair piece of class legislation maneuvered through the American Law Institute and the Commission on Uniform Laws by pressure groups favoring the bankers over their customers."); Gilmore, *The Uniform Commercial Code: A Reply to Professor Beutel*, 61 YALE L.J. 364, 377 (1952) (while generally defending the U.C.C., Professor Gilmore agreed with Professor Beutel that "Article 4 as it now reads should not be enacted . . .").

57. Some take the view that the check fraud loss allocation scheme of Articles 3 and 4 was written with the intent of slanting pre-U.C.C. law more in favor of banks. See McDonnell, *Bank Liability for Fraudulent Checks: The Clash of the Utilitarian and Paternalist Creeds Under the Uniform Commercial Code*, 73 GEO. L.J. 1399, 1409-13 (1985).

58. U.C.C. § 4-406(4).

59. See *infra* notes 150-75 and accompanying text.

involving negligent conduct under the relatively short statute of limitations provided by section 4-406(4).

Application of a longer, general statute of limitations governing negligence actions supports other U.C.C. policies of allocating loss to the party who most easily could have prevented the harm. In determining whether to decide cases under the U.C.C. or under general principles of law, courts must keep in mind that certainty, while an important policy, is not the only policy underlying the U.C.C. provisions allocating loss in check fraud situations.

### B. *Why Rules Providing Certain Results Are Important in Check Fraud Cases*

While certainty is not the only relevant policy, the need for certain rules in cases involving check fraud is great. The certainty policy supports deciding as many cases under the U.C.C. as possible. As Justice Brandeis once stated in a famous dictum, "it is more important that the applicable rule of law be settled than that it is settled right."<sup>60</sup> Check processing is increasingly a high speed process requiring that decisions of whether to honor or dishonor checks be made in short periods of time.<sup>61</sup> Sometimes customers will personally present checks to bank personnel and insist upon an immediate answer as to whether the checks in question will be deposited according to the customer's instructions. Bank personnel making these decisions are not typically schooled in the law, and it is thus important that rules exist permitting banks to promulgate policies which are easy to follow. In addition, many check fraud cases involve losses of relatively insignificant amounts. If it is necessary to litigate these disputes because of an uncertain rule regarding loss allocation, the costs of litigation may exceed the amount in controversy.<sup>62</sup> Parties suffering a loss may be reluctant to assert their rights because of the costs involved in litigating a case with an uncertain outcome.<sup>63</sup> This problem may be particularly great for smaller businesses which do not have in-house lawyers and which cannot pay a large re-

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60. *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting).

61. A payor bank is required to pay or dishonor a check before its "midnight deadline," which is midnight of the day following the bank's receipt of the check. U.C.C. § 4-104(1)(h). Failure to act before the midnight deadline causes the payor bank to be accountable for the check. U.C.C. § 4-302. Because of the pressure to process the high volume of checks received by the midnight deadline, many metropolitan area banks have ceased manually inspecting checks for indicia of fraud. *See Five Towns College v. Citibank*, 108 A.D.2d 420, 489 N.Y.S.2d 338 (1985) (discussing check processing practices in the New York metropolitan area). In addition, the payor is required to make an "expeditions return" to the bank of first deposit 12 C.F.R. §229.30 (1990).

62. In the context of consumer transactions, Professors Cooter and Rubin state:

The cost of making even a single factual determination would quickly surpass all but the most catastrophic losses on a consumer account. To determine that a consumer negligently left a checkbook in an open desk drawer or that a financial institution negligently cashed a check for a man with a pasted-on, Fu Manchu mustache demands at least one deposition, one set of interrogatories, and a one-day trial. The legal bill for even this modest fact-finding procedure would probably require a consumer to write a check that is substantially larger than the one at issue in the litigation.

Cooter & Rubin, *A Theory of Loss Allocation for Consumer Payments*, 66 TEX. L. REV. 63, 79 (1987) (footnotes omitted). *See also*, Comment, *The Fictitious Payee and the UCC-The Demise of a Ghost*, 18 U. CHI. L. REV. 281, 287 (1951) ("Commercial matters should not often go to an expensive jury trial with the result depending in part on the whims and antipathies of untutored jurymen.").

63. *See* Cooter & Rubin, *supra* note 62, at 79-80 (discussing the problem with respect to consumer check fraud loss).



tainer.<sup>64</sup> Certain rules permit the settling of disputes without the need to resort to litigation, particularly if meritless lawsuits and defenses are subject to sanction.

Certain rules permit parties to efficiently develop business procedures. In the check fraud area, if banks are aware that a certain practice will not result in the imposition of liability, the banks can determine whether the implementation of that practice is cost effective. For example, one question which has arisen is whether the failure to review drawer signatures on checks is a commercially reasonable practice on the part of payor banks.<sup>65</sup> If a rule exists one way or the other—it is or is not a commercially reasonable practice—banks can make a more informed decision as to whether to review the drawer's signature on a check. Likewise, a business might like to know to what extent it is necessary to safeguard its checks to prevent forgery before liability will be imposed on the business.<sup>66</sup> If the rules governing conduct are unclear or are difficult to find, banks and customers alike are left to guess whether their business practices will ultimately result in the imposition of liability in a check fraud case. This uncertainty may result in the formulation of inefficient business practices, that is, either too much spent in fraud prevention or too little. The costs of these inefficient practices may ultimately be passed on to businesses and consumers who use checks.

Decisions allocating loss in check fraud cases under common law negligence principles undercut the U.C.C. certainty policy. First, parties cannot look only to the U.C.C. to determine their obligations; they also must look to decisions based on common law. Second, any allocation of loss based on fault is likely to be uncertain. Different courts are likely to differ regarding questions of whether conduct is negligent in any particular case. As a result of these cases, costs of dispute resolution increase as it becomes necessary to litigate the question of negligence. Planning becomes problematic as the cases do not define clearly conduct which will be considered actionable negligence.

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64. *Id.* at 80-81.

65. The question ordinarily arises when a bank is seeking to assert its customer's negligence in substantially contributing to a forgery. Under U.C.C. section 3-406, the bank is not permitted to assert the customer's negligence if it has failed to act in a commercially reasonable fashion. Courts are divided as to whether failure to examine signatures is commercially unreasonable, even when evidence is produced that comparable banks fail to examine checks for signatures because of the cost and time involved. *Compare* Frankini v. Bank of America Nat. Trust & Sav. Ass'n, 31 Cal. App. 2d 666, 88 P.2d 790 (1939); Wilder Binding Co. v. Oak Park Trust & Sav. Bank, 173 Ill. App. 3d 34, 527 N.E.2d 354 (1988); First Nat'l Bank & Trust Co. v. Cutright, 189 Neb. 805, 205 N.W.2d 542 (1973); Medford Irrigation Dist. v. Western Bank, 66 Or. App. 589, 676 P.2d 329 (1984) with Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp., 848 F.2d 291 (1st Cir. 1988); Five Towns College v. Citibank, 108 A.D.2d 420, 489 N.Y.S.2d 338 (1985); Jacoby Transport Sys., Inc. v. Continental Bank, 277 Pa. Super. 440, 419 A.2d 1227 (1980); Vending Chattanooga, Inc. v. American Nat'l Bank & Trust Co., 730 S.W.2d 624 (Tenn. 1987).

66. Businesses are placed under some duty to properly supervise employees who have responsibility with respect to checks. The extent of that duty is uncertain under section 3-406. *See, e.g.,* George Whalley Co. v. National City Bank, 55 Ohio App. 2d 205, 380 N.E.2d 742 (1977) (hiring known gambler in sensitive position); Gresham State Bank v. O & K Constr. Co., 231 Or. 106, 370 P.2d 726 (1962) (failure to supervise office manager); Whaley, *supra* note 45, at 35; Hinchey, *An Analysis of Bank Defenses to Check Forgery and Alteration Claims under Uniform Commercial Code Articles 3 and 4: Claimants' Negligence and Failure to Give Notice*, 10 PEPPERDINE L. REV. 1, 15-19 (1982); Annotation, *Commercial Paper: What Amounts to "Negligence Contributing to Alteration or Unauthorized Signature" Under UCC § 3-406*, 67 A.L.R.3d 144, 169 (1975).

That cases decided on common law negligence principles add uncertainty to check fraud loss allocation does not necessarily mean that these cases are wrongly decided. In many cases, courts are faced with a statute which itself provides uncertain results or which does not clearly cover the dispute.<sup>67</sup> The U.C.C. loss allocation itself is uncertain, as loss is sometimes allocated to negligent parties, and negligence is not clearly defined in the statute or commentary.<sup>68</sup> In those cases, courts are faced with the difficult problem of allocating loss in a manner that not only takes into account the certainty policy but which also takes into account other policies discussed in the next section.

### C. Other Policy Considerations Relevant in Allocating Loss

Uniformity and certainty are not the only policies underlying the loss allocative scheme of Articles 3 and 4. Other policies identified by cases and commentators<sup>69</sup> include promoting transferability and use of checks,<sup>70</sup> placing loss on the best risk bearer,<sup>71</sup> and placing loss on the party who most easily could have prevented the harm.<sup>72</sup> Cases imposing liability on banks for failure to take steps to avoid loss encourage the use of checks by the public. Many of the cases decided on common law negligence principles place a burden on banks to prevent losses that might not have been prevented if the drawer of the check had used cash.<sup>73</sup> In addition, many of the cases decided on common law negligence principles allocate loss to banks as compared to small businesses, and thus, may place loss on the better risk bearer.<sup>74</sup> Small businesses may not be as capable as banks of obtaining insurance and otherwise spreading the loss to other customers.<sup>75</sup>

67. See *infra* notes 88-114 and accompanying text.

68. See U.C.C. §§ 3-404 and 3-406 and the official comments thereto.

69. For an analysis of the foregoing policies, see Cooter & Rubin, *supra* note 62, at 70-84; Phillips, *The Commercial Culpability Scale*, 92 *YALE L.J.* 228, 251-63 (1982); Comment, *Allocation of Losses From Check Forgeries Under the Law of Negotiable Instruments and the Uniform Commercial Code*, 62 *YALE L.J.* 417, 433-40 (1953).

70. Checks are useful in society in that they provide a means of payment which provides an element of security to the drawer of the check superior to that provided by money. Checks are not as easily stolen and converted into value by a thief as is money. In order for checks to be useful, they must be readily acceptable to creditors as payment for indebtedness, *i.e.*, they must be transferable. For a discussion of the importance of rules promoting transferability of checks, see *United States v. First Nat'l Bank*, 131 F.2d 985 (10th Cir., 1942), *cert. denied*, 318 U.S. 774 (1943).

71. See, *e.g.*, *Fidelity & Casualty Co. v. Planenscheck*, 200 Wis. 304, 227 N.W. 387 (1929).

72. See, *e.g.*, *Keck v. Browne*, 314 Ky. 151, 234 S.W.2d 183 (1950).

73. For example, in padded payroll cases, if the drawer/employer simply gave cash to the faithless bookkeeper in order to meet the "padded" payroll, the bookkeeper could simply abscond with the excess cash and detection would be difficult. Through the use of checks, however, it is possible that a depository bank, through inquiry, can prevent the bookkeeper from improperly absconding. See *infra* notes 116-31 and accompanying text.

74. An example of such a case is *Commercial Cotton Co. v. United California Bank*, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985). See *infra* notes 157-60 and accompanying text.

75. It is unclear, however, that banks are better able to insure against loss from check fraud than are many of their business customers. Because of large deductibles on insurance policies available to commercial banks, much of the loss is probably not covered by insurance.

The following are statistics from The Surety Association of America regarding losses incurred by commercial banks which were covered by Standard Insuring Agreement D, which covers loss for forgeries and alterations. Also included are premiums earned by insurers for providing such coverage. Negative numbers indicate that recovery by insurers (through subrogation) during that particular year exceeded losses paid or reserved:

One theme applicable in all of the common law negligence cases is that courts are attempting to place loss on a party that the court believes could have

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<i>Year</i>	<i>Direct Earned Premiums</i>	<i>Direct Losses Incurred</i>
1976	\$12,953,890	\$6,551,342
1977	12,848,334	4,018,927
1978	13,428,078	3,857,951
1979	14,304,916	2,970,745
1980	13,443,756	5,536,629
1981	13,351,534	10,653,978
1982	12,550,815	13,933,689
1983	13,218,177	-3,480,679 (see above)
1984	13,260,463	2,888,953
1985	20,165,087	6,904,051
1986	30,981,333	2,970,618
1987	36,658,595	1,626,301
Total	207,164,978	58,432,505

Similar data relating to insurance carried by depositors for forgery follows:

<i>Year</i>	<i>Direct Earned Premiums</i>	<i>Direct Losses Incurred</i>
1976	8,315,722	4,529,090
1977	10,536,475	5,460,883
1978	10,353,017	4,110,492
1979	8,010,788	1,687,341
1980	6,871,460	2,113,544
1981	6,897,693	11,010,549
1982	9,764,134	13,034,474
1983	12,313,517	7,604,710
1984	11,984,840	6,165,125
1985	12,752,475	2,613,610
1986	13,311,270	1,240,337
1987	18,454,795	5,224,335
Total	129,566,186	64,794,490

Similar data relating to fidelity bond coverage for all companies follows:

<i>Year</i>	<i>Direct Earned Premiums</i>	<i>Direct Losses Incurred</i>
1976	226,260,290	137,398,885
1977	258,465,490	151,011,158
1978	297,411,410	154,234,967
1979	320,554,103	162,050,079
1980	343,838,753	178,452,311
1981	360,894,019	212,998,911
1982	360,947,854	283,440,775
1983	369,237,593	317,706,369
1984	402,444,713	343,899,250
1985	537,079,096	308,543,652
1986	803,019,640	249,268,302
1987	994,414,531	260,402,569
Total	5,274,567,492	2,759,407,228

avoided loss if due care had been used. In many of these cases, it can be argued that the U.C.C. provides a rule allocating loss irrespective of fault. Courts deciding cases under common law negligence principles reject the argument that the U.C.C. drafters intended to cover the case before the court on a strict liability basis. Use of a longer common law statute of limitations when a party is considered negligent is consistent with this theme.<sup>76</sup>

In cases where the U.C.C. does not allocate loss clearly, little harm is done by deciding the case under common law negligence principles. Loss allocation consistent with the policies of the U.C.C. is not necessarily accomplished by stretching the U.C.C. statutory provisions to cover situations not within the contemplation of the drafters at the time the U.C.C. was drafted.

Nevertheless, where the drafters clearly did contemplate the situation before the court and provided a loss allocation scheme, it is inappropriate for courts to use common law principles to alter the statutory scheme if the U.C.C. is to have any meaning. The problem for courts is in determining exactly which disputes were considered by the drafters or are analogous to those considered by the drafters when the U.C.C. loss allocation system was devised. The problem for drafters is in trying to draft statutes, with a greater degree of certainty, that more clearly allocate loss in the most common cases, while at the same time taking into account the other policies underlying loss allocation discussed above.<sup>77</sup>

#### D. *A Suggested General Approach for Courts in Deciding Whether to Decide Check Fraud Cases Under Common Law Principles*

In deciding whether a dispute involving check fraud should be resolved by reference to the U.C.C. alone or whether it should be decided under common law negligence principles, courts should first try to resolve the dispute under the U.C.C. and ask whether the drafters of the U.C.C. had considered the fact situation before the court and had intended the Article 3 and 4 allocation scheme to cover that situation.<sup>78</sup> This question is much easier to ask than to answer. In deciding this question, courts should consider the official commentary to the relevant statutory provisions. In addition, as Article 3 derives to a

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According to Robert G. Hepburn, Jr., Vice President of the Surety Association of America, much check fraud loss allocated to banks is absorbed by the bank rather than by the insurer because of the high deductibles on insurance coverage for these types of losses. Deductibles for other businesses depend on size and loss experience. Letter from Robert G. Hepburn, Jr. to the author (Aug. 24, 1988) (data on liability coverage).

This information indicates that recipients of checks and account holders may be in as good or better position than financial institutions to insure against check fraud through purchase of forgery insurance or fidelity bonds. This information may support the enactment of different rules governing loss allocation for businesses. Very small businesses, such as sole proprietorships, may behave more like consumers, however, and difficult line drawing questions are raised in the event that a separate loss allocation system for businesses is to be devised.

76. See *infra* notes 150-75 and accompanying text.

77. Lack of empirical evidence regarding which of the U.C.C. policies is more important in determining ultimate loss allocation makes this task a difficult one. See Rubin, *supra* note 12, at 647. To some extent, the drafters need to provide flexibility to courts to decide these cases depending on the facts of each case. Courts would be assisted through the provision of certain guidelines that should be considered and by answering some specific questions that have arisen in commonly arising cases. See *infra* notes 197-200 and accompanying text.

78. See Hillman, *supra* note 34, at 685-86.

great extent from the old Negotiable Instruments Law (N.I.L.) and the cases decided under it, courts can obtain some guidance from reviewing the cases deciding similar issues under the N.I.L.<sup>79</sup> If the court determines that the U.C.C. provides a scheme which was meant to exclusively govern situations such as the one before the court, the court should decide the case by reference to the U.C.C. rather than by reference to common law negligence principles, lest the common law supplant the U.C.C.

In many cases, however, it will not be clear to the court that the drafters intended to cover the case under consideration, largely because of the lack of precision of the rules allocating loss.<sup>80</sup> In these circumstances, the court should consider common law principles together with the statutes allocating loss and the policies underlying those statutes.<sup>81</sup> The court should do what it can to reach an appropriate balance of the policies underlying loss. The court should attempt to provide a rule governing conduct which will give guidance to parties in future cases, thus providing an element of certainty to checking transactions. At the same time, the court must take into consideration which party to the transaction was best able to prevent the loss and which party was best able to bear the risk of loss.

Ultimately, those responsible for the continuing vitality of the U.C.C., the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI), need to pay attention to fact situations that courts believe should be decided under common law negligence principles. These bodies should periodically amend the provisions of Articles 3 and 4 to provide for statutory loss allocation in cases which courts believe are not currently covered by the statutes. As shall be seen, the current revision effort addresses some of the specific questions that courts have found not answerable solely by reference to the U.C.C.<sup>82</sup>

### III. ANALYSIS OF SPECIFIC CHECK FRAUD CASES WHICH HAVE BEEN DECIDED ON COMMON LAW NEGLIGENCE GROUNDS

An examination of certain check fraud cases decided under common law negligence principles illustrates the difficulty of determining exactly which cases are covered exclusively by the U.C.C. and which cases are not. The analytical

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79. See Lawrence, *supra* note 41, at 123-24.

80. See *supra* notes 41-43 and accompanying text.

81. Professor Robert Hillman suggests a three-step priority system for analyzing cases within the scope of the U.C.C. When the U.C.C. is clear and the result is consistent with its overall policies, the statutory language should govern the case. If the U.C.C. provision is inconsistent with the overall policy, common law should be applied only if the common law rule is clearly consistent with U.C.C. policy. If the meaning of the U.C.C. is difficult to determine, the common law rule should supplement the U.C.C., unless the U.C.C. rejects the common law rule or the common law rule conflicts with U.C.C. policy. U.C.C. statutory language and policy is given priority over common law rules. See Hillman, *supra* note 34, at 685-95.

This priority system provides an appropriate balance between common law and the U.C.C. The problem in the check fraud area is that the policies underlying loss allocation conflict, and the language of the statutes is unclear. It is uncertain in many cases whether the drafters intended to cover certain cases. It is important to refer to the law preceding the enactment of Articles 3 and 4 to determine whether the drafters intended to cover the case under consideration. See Lawrence, *supra* note 41, at 123-24.

82. See *infra* notes 197-224 and accompanying text.

process used by courts in deciding that a case is or is not covered by the U.C.C. is not clear. Different courts faced with the same issue of whether a certain case is covered by the U.C.C. decide the issue differently.<sup>83</sup>

The following cases will be examined: 1) Cases involving checks payable to banks and other situations where funds are improperly diverted by the payee contrary to the drawer's wishes;<sup>84</sup> 2) Cases involving fictitious payees and padded payrolls where the depository bank is negligent in failing to discover the fraud;<sup>85</sup> 3) Cases where the depository bank seeks to assert the drawer's negligence in failing to prevent fraud;<sup>86</sup> and 4) Cases where a negligent bank seeks to assert the one year statute of limitations provided by section 4-406(4).<sup>87</sup> After the specific cases are discussed, the analysis used by the courts will be discussed in light of the proposed framework for analysis set forth above. The question will be asked whether courts are improperly circumventing the U.C.C. by deciding cases on common law principles to achieve a result which is more desirable than that dictated by the U.C.C. The answer in most cases is no.

#### A. Description of Common Law Negligence Cases

##### 1. Checks Payable to Banks and Other Situations Where Funds Are Diverted by a Payee Contrary to the Drawer's Wishes

One question that has arisen and which has been decided by some courts under common law negligence principles is under what circumstances, if any, does a bank receiving a check for deposit have a duty to ask the drawer of the check exactly who was intended to receive the proceeds of the check so as to prevent a misappropriation of funds? The U.C.C. does not provide a clear answer to the question. If the signatures on the check are authorized, including the indorsements, a bank taking the check for deposit without notice of any defense against or claim to it on the part of any person may be a holder in due course of the check.<sup>88</sup> No affirmative duty of inquiry is specifically required.<sup>89</sup> If the bank were found to be a holder in due course, the bank would be immune to claims of the drawer that the proceeds of the check were improperly appropriated.<sup>90</sup>

As mentioned above, a species of fraud discussed to a great extent in the reported cases involves a clever thief who convinces someone to draw a check payable to a bank in satisfaction of a debt supposedly payable to the bank. No debt is in fact owed to the bank. The thief then convinces the bank to permit

83. See *infra* notes 96-97 and accompanying text.

84. See *infra* notes 88-114 and accompanying text.

85. See *infra* notes 116-31 and accompanying text.

86. See *infra* notes 132-49 and accompanying text.

87. See *infra* notes 150-75 and accompanying text.

88. The requirements for a holder in due course are spelled out in U.C.C. §§ 3-302 to 3-304. See J. WHITE AND R. SUMMERS, *supra* note 15, at §§ 14-2 to 14-6.

89. A party is on notice of a claim or defense if the party has actual knowledge of it, if that party has received a notice or notification of it, or if from all the facts and circumstances known to the party, that person has reason to know of the claim. U.C.C. § 1-201(27).

90. A holder in due course takes an instrument free of all claims to it on the part of any person. U.C.C. § 3-305(1).

the thief to deposit the funds in the thief's personal account. The question then arises whether the bank accepting the deposit is somehow liable for permitting the thief to negotiate the check for his or her benefit or whether the bank may assert holder in due course status.

In *Allis Chalmers Leasing v. Byron Center State Bank*,<sup>91</sup> a Michigan appellate court held that a depository bank owed a duty of due care to the drawer of a check payable to the bank. In that case, one Deneen convinced the plaintiff to obtain a cashier's check payable to the defendant bank. The check was to pay off certain debts owed to the bank which were secured by vehicles plaintiff sought to purchase from Deneen. The bank apparently confirmed that it had a security interest in some of Deneen's vehicles and was aware that the plaintiff was giving Deneen checks or contemplating giving him checks to purchase vehicles. Plaintiff then obtained a cashier's check payable to the defendant and gave it to Deneen. Although the check bore a notation stating "Payment of invoice for Wreckers Leased to Breton Shell, Inc.," the bank permitted Deneen to deposit proceeds of the check in several accounts controlled by Deneen.<sup>92</sup> Only \$16,000 out of the \$114,737 check were applied to pay an existing loan secured by one of the vehicles to be sold. Ultimately, no vehicle titles were transferred to plaintiff and Deneen filed for bankruptcy.<sup>93</sup>

The appellate court upheld the trial judge's finding that the bank was negligent in permitting Deneen to obtain the bulk of the proceeds without first obtaining plaintiff's authorization. The court relied on an often cited rule that "[w]here a check is drawn to the order of a bank to which the drawer is not indebted, the bank is authorized to pay the proceeds only to persons specified by the drawer; it takes the risk in treating such a check as payable to bearer and is placed on inquiry as to the authority of the drawer's agent to receive payment."<sup>94</sup>

Defendant bank's argument that it was a holder in due course and thus immune from plaintiff's negligence action was rejected by the court. That the check was payable to the bank imposed a duty on the bank to inquire regarding the plaintiff's wishes.<sup>95</sup> In addition, the bank had been placed on notice that

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91. 129 Mich. App. 602, 341 N.W.2d 837 (1983).

92. The facts of the case do not clearly discuss the meaning of the notation on the check.

93. Deneen was convicted of several criminal offenses as well. 129 Mich. App. at 605, 341 N.W.2d at 839.

94. *Id.* at 606, 341 N.W.2d at 839 (citing 9 C.J.S. *Banks and Banking* § 340). See also *Sun 'n Sand v. United California Bank*, 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978); *Arvada Hardwood Floor Co. v. James*, 638 P.2d 828 (Colo. Ct. App. 1981); *Douglass v. Wones*, 120 Ill. App. 3d 36, 458 N.E.2d 514 (1983); *Bullitt County Bank v. Publishers Printing Co.*, 684 S.W.2d 289 (Ky. App. 1984); *Bank of Southern Maryland v. Robertson's Crab House*, 39 Md. App. 707, 389 A.2d 388 (1978); *PWA Farms, Inc. v. North Platte State Bank*, 220 Neb. 516, 371 N.W.2d 102 (1985); *Kaiser-Georgetown Community Health Plan, Inc. v. Bankers Trust Co.*, 110 Misc. 2d 320, 442 N.Y.S.2d 48 (N.Y. Sup. Ct. 1981).

95. The court quoted with approval language from *Sun 'n Sand v. United California Bank*, 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978), an important case in this area involving a faithless employee who negotiated a check drawn by her employer payable to a bank for her own benefit:

We hold simply that the bank may not ignore the danger signals inherent in such an attempted negotiation. There must be objective indicia from which the bank could reasonably conclude that the party presenting the check is authorized to transact in the manner proposed. In the absence of such indicia the bank pays at its peril.

*Id.* at 695-96, 582 P.2d at 937, 148 Cal. Rptr. at 346.

Deneen was not properly negotiating the checks when he instructed the bank to deposit the proceeds in his account. The plaintiff had asked the bank whether it had title to or a security interest in the vehicles Deneen was to sell to the plaintiff. The bank had been notified that plaintiff was contemplating giving checks to Deneen for the purchase of certain vehicles. The notation on the check, "Payment of invoice for Wreckers Leased to Breton Shell, Inc.," also gave notice to the bank that Deneen's instructions regarding disposition of the proceeds were not authorized by the plaintiff.

Banks have argued that checks payable to banks are payable to the bearer of the check; frequently a depositor at one bank will request that bank to close its account and draw a check payable to another bank for the purposes of opening a new account at the other bank. To require banks to inquire of the drawer every time a check payable to a bank is negotiated would be overly burdensome and would unnecessarily slow the banking system. Some courts have agreed and have held that banks permitting parties to negotiate checks payable to the bank for the parties' own benefit without inquiry are not liable.<sup>96</sup> The weight of authority appears to be with the position that a bank has a duty to inquire under these circumstances.<sup>97</sup>

Cases allocating loss in situations involving checks payable to banks on common law negligence principles are not examples of cases where judges are ignoring statutory directive in order to allocate loss according to the judges' sense of equity. While the U.C.C. provides for some circumstances in which a bank takes a check at its peril without inquiry,<sup>98</sup> nothing is said about checks payable to the bank itself. Cases decided prior to the enactment of the U.C.C. held that banks have a duty of inquiry in these cases.<sup>99</sup> As the rules allocating loss in check fraud cases are to a great extent based on pre-U.C.C. law, one might expect that the drafters would speak more clearly in the event that they

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96. Northern Trust Co. v. Chase Manhattan Bank, 582 F. Supp. 1380 (S.D.N.Y.), *aff'd*, 748 F.2d 803 (2d Cir. 1984) (per curiam); J. Gordon Neely Enters. v. American Nat'l Bank, 403 So. 2d 887 (Ala. 1981); Lasley v. Bank of Northeast Arkansas, 4 Ark. App. 42, 627 S.W.2d 261 (1982); Trail Leasing, Inc. v. Drovers First American Bank, 447 N.W.2d 190 (Minn. 1989) (bank found to be holder in due course and thus not liable for negligence claim).

97. See also City Nat'l Bank v. Crocker Nat'l Bank, 150 Cal. App. 3d 290, 197 Cal. Rptr. 721 (1983) (involving cashier's checks). However, where a check containing a forged drawer signature was payable to "Security Pacific National Bank A/C No. 260 049 569 GC Associates," Security Pacific was found not to be liable for permitting deposit into the referenced account without inquiring of the drawer and without inquiring regarding the authority of the indorser to transact business in the name of G.C. Associates. Fireman's Fund Ins. Co. v. Security Pac. Nat'l Bank, 85 Cal. App. 3d 797, 149 Cal. Rptr. 883 (1978). The court distinguished *Sun 'n Sand v. United California Bank* by stating that this case involved a forged drawer's signature while *Sun 'n Sand* did not. *Id.* at 814, 194 Cal. Rptr. at 895. U.C.C. § 3-418 provided a comprehensive loss distributive scheme for forged drawer signature cases (the "final payment rule") which squarely placed the risk of loss on the drawee bank, not the bank of first deposit. An action for common law negligence was thus displaced by the U.C.C. in this instance.

98. See U.C.C. § 3-304.

99. See *Sun 'n Sand v. United California Bank*, 21 Cal. 3d 671, 694, 582 P.2d 920, 935-36, 148 Cal. Rptr. 329, 345 (1978). The court discusses the historical underpinnings of the rule and refers to such pre-Code cases as *Pacific Finance Corp. v. Bank of Yolo*, 215 Cal. 357, 10 P.2d 68 (1932) and *Sims v. United States Trust Co.*, 103 N.Y. 472, 9 N.E. 605 (1886).



intended to eliminate any duty of inquiry for a payee bank. No such statement is contained in the statutes or official commentary.<sup>100</sup>

Allocating loss to payee banks in these cases is consistent with general U.C.C. check fraud loss allocation rules if it is assumed that banks are negligent in failing to inquire when presented with a check payable to the bank. Check fraud losses are generally initially allocated to one of the banks involved in the processing of the fraudulent check. Under the U.C.C., that loss may be shifted to one of the non-bank parties if that party negligently facilitated the fraud.<sup>101</sup> Even if one of the non-bank parties was negligent, however, the loss is shifted back to the bank if it was negligent as well.<sup>102</sup> In these cases, courts hold that banks are in the last position to prevent loss through determining the authority of the person presenting the check payable to the bank to negotiate that check for that person's benefit. While the drawer of the check payable to the bank might also prevent loss through dealing more carefully with the person inducing the drawer to draw a check payable to the bank, a seemingly small burden is placed on the bank receiving that check by requiring the bank to ask for further instructions from the drawer regarding the proper disposition of the check's proceeds.<sup>103</sup> The burden might be analogized to the burden placed on a depository bank to make certain that checks indorsed "For Deposit Only" are deposited in the designated account.<sup>104</sup>

A related question is whether certain irregularities on the payee line of the check raise a duty of inquiry on the part of the depository bank. For example, if a \$25,000 check is payable to "Continental Finance Systems-Wells Fargo Escrow Trust Account" and is then negotiated into a non-escrow account of Continental Finance Systems at a different bank, has the depository bank acted negligently in permitting such a negotiation? In *Joffe v. United California Bank*,<sup>105</sup> a California appellate court held that the depository bank, the Bank of

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100. The U.C.C. requirements for holder in due course status are a combination of objective and subjective factors. U.C.C. § 3-302(1)(b) requires a holder in due course to take the instrument in good faith, which is a subjective, honesty in fact standard. U.C.C. § 1-201(19). The holder in due course must also take "without notice . . . of any defense against or claim to [the instrument] on the party of any person." U.C.C. § 3-302(1)(c). A person has notice of a fact when he has actual knowledge of it, he has received notice of it or "from all the facts and circumstances known to him at the time in question he has reason to know that it exists." U.C.C. § 1-201(25). Thus, the standard is objective in that whether the holder has notice is judged from the perspective of a reasonable person in the holder's position. Whether the knowledge that a check is payable to a bank imparts notice of a claim by the drawer is questionable. The provisions of U.C.C. § 3-304 regarding when a purchaser of an instrument has notice of a claim or defense are not exclusive and do not answer this question.

101. These cases are similar to unauthorized indorsement cases as in both cases the person presenting the check to the depository bank is not authorized to negotiate the check for that person's benefit. The U.C.C. generally allocates loss to the depository bank in those situations (assuming that the depository bank is unable to recover from its customer, the depositor). See *supra* notes 16-17 and accompanying text.

102. See *supra* notes 20-22 and accompanying text.

103. It is difficult for courts on a case-by-case basis to determine the magnitude of the duty imposed. It is difficult to determine how many times a customer presents a bank with a check payable to the bank. If banks believe that such a duty is burdensome, it would be worthwhile for them to present data regarding the cost of imposing such a burden. It would be appropriate for the NCCUSL and the ALI to consider such data in determining whether a rule requiring inquiry should be made explicit.

104. This type of indorsement is considered a "restrictive indorsement" under U.C.C. § 3-205 and the depository bank is required to handle the check pursuant to instruction in order to be a holder in due course under U.C.C. § 3-206(3).

105. 141 Cal. App. 3d 541, 556, 190 Cal. Rptr. 443, 451 (1983).

America, was required to notify the drawer before it permitted Continental Finance Systems to deposit the above-mentioned check into its account at the Bank of America. The court rejected the argument that the U.C.C. covered this situation and that it was unnecessary to refer to common law negligence principles. It held that the words "Continental Finance Systems-Wells Fargo Escrow Trust Account" were not merely words of description under U.C.C. section 3-117 which could be ignored by the depository bank.<sup>106</sup> A cause of action was stated for negligence and was not displaced by the U.C.C. loss allocation rules.<sup>107</sup>

However, courts do not hold that all discrepancies between the name stated on the payee line and the party seeking to negotiate the check give rise to a duty of inquiry. In *Campbell v. Bank of America*, another California appellate court reversed a jury verdict against a bank for negligently paying checks bearing an irregular indorsement.<sup>108</sup> In that case, checks were made payable to an entity known as MVTL but were indorsed and deposited by a related entity known as MVTL-North. Both MVTL and MVTL-North were principally owned and operated by the same individual who had authorized the indorsement and deposit of the checks. The court found that since the indorsements were authorized by MVTL, the payee of the check, no cause of action for negligence was stated. This case is arguably contrary to *Joffe* in that Continental Finance Systems was authorized to indorse the check involved in that case as well. *Campbell* is distinguishable from *Joffe*, however, in that the check payable to MVTL provided that entity with an absolute right to divert proceeds in accordance with its wishes while the check in *Joffe* indicated on its face that Continental was a fiduciary and that the check was for a specific purpose.

As is the case with checks payable to banks, the U.C.C. does not provide clear guidance as to the duties of banks when presented with checks containing discrepancies between the named payee and the indorsement. Section 3-117 indicates that a check payable to a person with additional words describing the person as a fiduciary, such as a check payable to John Doe, Trustee of XYZ Trust, is payable to the individual named.<sup>109</sup> The official commentary, however, indicates that a bank taking such a check will be on notice of the payee's fiduciary position and under some circumstances will be on notice of breach of fiduci-

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106. U.C.C. § 3-117 provides:

An instrument made payable to a named person with the addition of words describing him

(a) as agent or officer of a specified person is payable to his principal but the agent or officer may act as if he were the holder;

(b) as any other fiduciary for a specified person or purpose is payable to the payee and may be negotiated, discharged or enforced by him;

(c) in any other manner is payable to the payee unconditionally and the additional words are without effect on subsequent parties.

While a check payable with words of description may be negotiated by the named payee without reference to the words of description, the person receiving the check from the payee will not qualify as a holder in due course of the check if that person has knowledge of the named payee's negotiation of the check for that person's own benefit in violation of the fiduciary duty. U.C.C. § 3-117 comment 2.

107. *Joffe*, 141 Cal. App. 3d at 557, 190 Cal. Rptr. at 452.

108. 190 Cal. App. 3d 1420, 235 Cal. Rptr. 906 (1987).

109. U.C.C. § 3-117 comment 2.

ary duty.<sup>110</sup> Section 3-304 states that a taker of a check will be on notice of a claim against the instrument if that taker has knowledge that a fiduciary has negotiated the check in payment of or as security for the fiduciary's own debt or in any transaction for his own benefit or otherwise in breach of duty.<sup>111</sup> Mere knowledge that the person negotiating the instrument was a fiduciary does not of itself give the taker of the check notice of a defense or claim.<sup>112</sup>

The statutes do not address the duties of a bank when a check payable to a fiduciary as such is deposited to an account other than a fiduciary account. Such was the case in *Joffe*. The statutes do not provide an exclusive listing of which events will put a depository bank on notice of possible fraudulent conduct thus requiring further inquiry on the part of the bank.<sup>113</sup> Allocating loss to a depository bank for failing to inquire in cases such as *Joffe* is consistent with the U.C.C. loss allocation rules of generally placing loss on a bank if both a bank and a non-bank customer fail to take prudent steps to prevent loss. The drawer of a check payable to a fiduciary arguably could have prevented the loss by better choosing the fiduciary. Likewise, the bank presented with a check payable to a fiduciary and designated for a specified fiduciary account could make certain that the check was deposited into the designated account. If both parties are considered negligent, the loss is allocated to a bank under the U.C.C. loss allocation scheme.<sup>114</sup>

As with checks payable to the depository, banks may argue that placing such a burden of inquiry is inappropriate in this age of high speed, high volume check processing. The costs of monitoring deposits of checks payable to fiduciaries may exceed the losses avoided as a result. Principals are perhaps in a better position to prevent loss under these circumstances. It is difficult to ascertain the burden of such a duty. It is equally difficult to determine the amount lost through improper negotiation by fiduciaries. If banks are able to produce evidence regarding the high cost of such a burden, it might be appropriate for the drafters to make clear that no duty of inquiry exists in these cases.<sup>115</sup> The U.C.C. does not currently answer the question one way or the other.

## 2. Fictitious Payees and Padded Payrolls

Another common variety of fraud involves the creation of padded payrolls by a faithless bookkeeper. For example, a bookkeeper in charge of payroll might create phony employment records indicating that fictitious persons have performed work and are owed pay. The bookkeeper will then prepare checks payable to these fictitious persons and have the checks signed by the authorized

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110. *Id.*

111. U.C.C. § 3-304(2).

112. U.C.C. § 3-304(4)(e).

113. In cases decided under the N.I.L., courts tended to apply an objective test of notice and imposed a duty of inquiry on depositories in cases where the fiduciary relation appeared on the face of the instrument. J. OGDEN, *THE LAW OF NEGOTIABLE INSTRUMENTS* § 156 (5th ed. 1947).

114. See *supra* notes 21-22 and accompanying text.

115. In considering this question, the drafters of the proposed revisions to Article 3 rejected the position that banks are not placed on notice when a check payable to a principal is placed in a non-fiduciary account. See *infra* notes 209-10 and accompanying text.

signer for the employer who undertakes no independent verification of the employees' existence. The bookkeeper proceeds to "forge" the indorsement of the fictitious employee and deposits the checks into his or her personal bank account. The bank receiving the check undertakes no investigation and sends the check on for collection. The check is ultimately paid by the employer's bank—the payor bank. When the scheme is ultimately discovered, the proceeds of the fraudulent checks are long gone.

U.C.C. section 3-405 appears to allocate loss in these cases to the employer by stating that the indorsement is effective.<sup>116</sup> The underlying policy, according to the official comments, is that the employer is in a better position than the depository or payor bank to supervise its employees and prevent loss or is in a position to protect itself through the purchase of fidelity insurance.<sup>117</sup> An issue exists, however, as to whether a bank can use the section 3-405 defense if it has been negligent in failing to detect the fraud. The statute itself does not indicate that a party's negligence is relevant. Because of the official commentary's position that the employer should bear the loss and the seemingly strict liability language of the statute, the statute has been referred to as a "banker's provision" designed to completely immunize banks from liability in the impostor-fictitious payee-padded payroll situations.<sup>118</sup> Some commentators have argued that the section should be construed in accordance with other statutes allocating loss in considering the negligence of the banks involved together with the culpability of the drawer.<sup>119</sup>

By contrast, sections 3-406 and 4-406 indicate that failure to act in accordance with reasonable commercial standards bars a party from asserting defenses available under those sections. Section 3-406 bars a person whose negligence substantially contributes to the making of an unauthorized signature or material alteration from asserting that signature or alteration against a holder in due course or drawee or other payor who pays the check in accordance with reasonable commercial standards.<sup>120</sup> Section 4-406 requires a bank customer to review bank statements and return checks and bars the customer from asserting certain unauthorized signatures or alterations if unauthorized signatures or al-

116. Section 3-405 provides:

(1) An indorsement by any person in the name of a named payee is effective if

(a) an impostor by use of the mails or otherwise has induced the maker or drawer to issue the instrument to him or his confederate in the name of the payee; or

(b) a person signing as or on behalf of a maker or drawer intends the payee to have no interest in the instrument; or

(c) an agent or employee of the maker or drawer has supplied him with the name of the payee intending the latter to have no such interest.

(2) Nothing in this section shall affect the criminal or civil liability of the person so indorsing.

117. U.C.C. § 3-405 comment 4.

118. J. WHITE & R. SUMMERS, *supra* note 15, at § 16-5.

119. *Id.* See also Comment, *The Effect of Bank Misconduct on the Operation of the Padded Payroll Preclusion of U.C.C. § 3-405*, 27 UCLA L. REV. 147, 174 (1979).

120. Section 3-406 provides:

Any person who by his negligence substantially contributes to a material alteration of the instrument or to the making of an unauthorized signature is precluded from asserting the alteration or lack of authority against a holder in due course or against a drawee or other payor who pays the instrument in good faith and in accordance with the reasonable commercial standards of the drawee's or payor's business.

See also U.C.C. § 4-406(3).

terations reflected in the returned checks or statements are not reported to the customer's bank in a timely manner.<sup>121</sup> Under section 4-406(3), however, the payor bank is not permitted to assert the customer's failure to timely review and report unauthorized signatures or alterations if that bank fails to use ordinary care.

Case authority exists on both sides of the issue of whether the bank's negligence precludes application of section 3-405. One case holding that section 3-405 does not preclude a common law negligence action is *E.F. Hutton v. City National Bank*.<sup>122</sup> In that case an employee of E.F. Hutton apparently had checks prepared payable to eighteen different payees and obtained the authorized signature of a Hutton officer on the checks.<sup>123</sup> Over a one year period, he negotiated these eighteen checks (ranging from \$10,000 to \$81,598 and totaling \$638,598) at City National Bank. The California appellate court held that the complaint stated a cause of action for negligence. The complaint alleged that City National Bank knew or should have known that the individual presenting the checks was a fiduciary of Hutton and that the amount and number of checks payable to third parties placed the bank on notice of suspicious circumstances which raised a duty of inquiry.<sup>124</sup> Common law negligence supplemented the U.C.C. under section 1-103.<sup>125</sup>

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121. Section 4-406 provides:

(1) When a bank sends to its customer a statement of account accompanied by items paid in good faith in support of the debit entries or holds the statement and items pursuant to a request or instructions of its customer or otherwise in a reasonable manner makes the statement and items available to the customer, the customer must exercise reasonable care and promptness to examine the statement and items to discover his unauthorized signature or any alteration on an item and must notify the bank promptly after discovery thereof.

(2) If the bank establishes that the customer failed with respect to an item to comply with the duties imposed on the customer by subsection (1) the customer is precluded from asserting against the bank

(a) his unauthorized signature or any alteration on the item if the bank also establishes that it suffered a loss by reason of such failure; and

(b) an unauthorized signature or alteration by the same wrongdoer on any other item paid in good faith by the bank after the first item and statement was available to the customer for a reasonable period not exceeding fourteen calendar days and before the bank receives notification from the customer of any such unauthorized signature or alteration.

(3) The preclusion under subsection (2) does not apply if the customer establishes lack of ordinary care on the part of the bank in paying the item(s).

(4) Without regard to care or lack of care of either the customer or the bank a customer who does not within one year from the time the statement and items are made available to the customer (subsection (1)) discover and report his unauthorized signature or any alteration on the face or back of the item or

does not within 3 years from that time discover and report any unauthorized indorsement is precluded from asserting against the bank such unauthorized signature or indorsement or such alteration.

(5) If under this section a payor bank has a valid defense against a claim of a customer upon or resulting from payment of an item and waives or fails upon request to assert the defense the bank may not assert against any collecting bank or other prior party presenting or transferring the item a claim based upon the unauthorized signature or alteration giving rise to the customer's claim.

122. 149 Cal. App. 3d 60, 196 Cal. Rptr. 614 (1983).

123. *Id.* The facts regarding how the employee managed to obtain the checks are not that clear. In order for section 3-405 to have application, however, the employee must have convinced the authorized signer for the drawer to sign the checks payable to the fictitious payee. If he stole checks payable to persons for whom the checks were intended, section 3-405 would have no application.

124. *Id.* at 69, 196 Cal. Rptr. at 619-20.

125. *Id.*

Other courts have denied the application of the section 3-405 defense because the check's indorsement was not exactly that of the payee or because of a bank's failure to act in accordance with reasonable commercial standards.<sup>126</sup> Yet other courts, faced with similar fact patterns and the same statute, deny that simple negligence (short of bad faith) is a factor to be considered and strictly apply section 3-405, placing the risk of loss on the employer/drawer.<sup>127</sup>

One could argue that *E.F. Hutton* is an example of courts supplanting the U.C.C. with common law. Under pre-U.C.C. law, if a check was made payable to the order of a fictitious person and such fact was known to the person making it so payable, the check was payable to bearer.<sup>128</sup> The comments to section 3-405 indicate an intent to broaden the scope of prior law in this area and to allocate loss strictly to the employer in padded payroll cases.<sup>129</sup> Had the drafters intended that the bank's negligence be considered in allocating loss in these cases, the statute would have been drafted similarly to sections 3-406 and 4-406 which expressly consider whether the drawee acted reasonably.<sup>130</sup> In addition, the policy of providing certainty is furthered by not requiring an inquiry as to whether a bank was negligent in not uncovering the padded payroll scheme.

The statute, however, does not expressly deal with the question of the depository bank's negligence in failing to inquire. Section 3-304(2) places the bank on notice of a claim to a check if it is aware that a fiduciary is negotiating the check in payment of his own debt. The deposit of a number of checks of a significant amount payable to a third party into the personal account of an employee of the drawer would seem to impart notice that a criminal act might be occurring. Taking the bank's negligence into account in these cases would be

126. *Owensboro Nat'l Bank v. Crisp*, 608 S.W.2d 51 (Ky. 1980) (narrow interpretation of impostor rule); *Twellman v. Lindell Trust Co.*, 534 S.W.2d 83 (Mo. Ct. App. 1976) (indorsement not exact); *Hydroflo Corp. v. First Nat'l Bank*, 217 Neb. 20, 349 N.W.2d 615 (1984) (negligence precludes § 3-405); *Travelers Indemnity Co. v. Center Bank*, 202 Neb. 294, 275 N.W.2d 73 (1979) (suggesting that negligence may preclude application of § 3-405); *Underpinning & Foundation Constructors, Inc. v. Chase Manhattan Bank*, 46 N.Y.2d 459, 386 N.E.2d 1319 (1979) (improper payment over restrictive indorsement precluded application of § 3-405); *Titan Air Conditioning Corp. v. Chase Manhattan Bank*, 61 A.D.2d 764, 402 N.Y.S.2d 12 (1978) ("gross negligence" in permitting faithless bookkeeper to deposit checks precluded application of § 3-405); *Bd. of Higher Education v. Banker's Trust Co.*, 86 Misc. 2d 560, 383 N.Y.S.2d 508 (1976) (gross negligence equivalent to bad faith and precludes application of § 3-405); *Dykstra v. Nat'l Bank of South Dakota*, 328 N.W.2d 862 (S.D. 1983) (bank precluded from asserting § 3-405 where it witnessed forgery); *Seattle-First Nat'l Bank v. Pacific Nat'l Bank*, 22 Wash. App. 46, 587 P.2d 617 (1978) (indorsement in name of "Sumner Motors" when payee was "Sumner Motors, Inc." precluded application of § 3-405). For more discussion on cases limiting application of § 3-405, see *Triantis, Allocation of Losses From Forged Indorsements On Checks and Application of § 3-405 of the Uniform Commercial Code*, 39 OKLA. L. REV. 669 (1976).

127. *Western Casualty & Surety Co. v. Citizens Bank*, 676 F.2d 1344 (10th Cir. 1982); *Continental Bank v. Wa-Ho Truck Brokerage*, 122 Ariz. 414, 595 P.2d 206 (1979); *Gen'l Accident Fire & Life Assurance Corp. v. Citizens Fidelity Bank & Trust Co.*, 519 S.W.2d 817 (Ky. 1975); *Gordon v. State Street Bank & Trust Co.*, 9 U.C.C. Rep. Serv. 697 (1971) (Mass. App. Div. 1971); *McCarthy, Kenney & Reidy v. First Nat'l Bank*, 2 U.C.C. Rep. Serv. 2d 977 (Mass. Super. 1986); *Consolidated Public Water Supply Dist. v. Farmers Bank*, 686 S.W.2d 844, (Mo. App. 1985); *Kraftsman Container Corp. v. United Counties Trust Co.*, 169 N.J. Super. 488, 404 A.2d 1288 (1979); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Chemical Bank*, 57 N.Y.2d 439, 442 N.E.2d 1253, 456 N.Y.S.2d 742, (1982); *Hicks-Costarino Co. v. Pinto*, 23 U.C.C. Rep. Serv. 680 (N.Y. Sup. 1978); *Fidelity & Casualty Co. v. First City Bank*, 675 S.W.2d 316 (Tex. Ct. App. 1984); *Braswell Motor Freight Lines v. Bank of Salt Lake*, 28 Utah 2d 347, 502 P.2d 560 (1972).

128. N.I.L. § 9(3).

129. See U.C.C. § 3-405 comment 4.

130. See *supra* notes 120-21 and accompanying text.

consistent with the U.C.C. rules allocating loss to a bank in the event that both a bank and a non-bank party are negligent. Perhaps the employer is negligent in not properly supervising employees in the padded payroll cases, but the bank may also take steps to avoid loss by inquiring of the drawer regarding the proper disposition of the check proceeds.<sup>131</sup> While the evidence indicates that the drafters probably intended the padded payroll defense of section 3-405 to be absolute, it cannot be said that cases imposing a common law negligence duty of care on depository banks in these situations are examples of judges improperly ignoring clear statutory directive.

### 3. *Cases Where the Depository Bank Seeks to Assert the Drawer's Negligence as a Defense*

As stated above, U.C.C. section 3-406 specifically allocates loss to a negligent party unless the drawee or other payor fails to act in accordance with the reasonable commercial standards of the drawee's or payor's business.<sup>132</sup> In the case of a forged indorsement or alteration, however, the drawee or other payor will normally be able to shift the loss to the bank which first took the check (the depository bank).<sup>133</sup> A problem arises when the drawee pays a check over a forged indorsement, reimburses its customer, the drawer, and then sues the bank of first deposit on a breach of warranty of good title.<sup>134</sup> Is the depository bank entitled to raise the customer's negligence as a defense in the action brought by the drawee bank or, in the alternative, may the bank of first deposit sue the customer on a common law negligence theory?

It is useful to compare the loss allocation mechanism of section 4-406 to that provided by section 3-406. Under section 4-406, a bank's customer is precluded from asserting certain unauthorized signatures and alterations unless the customer uses reasonable care in examining bank statements and cancelled checks made available to the customer.<sup>135</sup> In addition, section 4-406(4) provides what appears to be an absolute statute of limitations for unauthorized signatures and alterations.<sup>136</sup> As is the case with section 3-406, the bank may not assert the defenses of section 4-406, other than the statute of limitations, if it

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131. A problem faced by depository banks in these cases is in determining whether or not the person presenting the checks is a fiduciary of either the payee or the drawer of the check. The bank's records may indicate that the person presenting the check, presumably a customer of the bank, is employed by the drawer or the payee. The teller taking the check over the counter may not be aware of this fact. Imposing a duty on the bank to inspect records each time a check is presented would have a tendency to delay check processing and might increase costs. Whether the delay and attendant costs would be justified by reduction of loss due to fraud is problematic. This discussion relates to the question of what constitutes negligent conduct, not whether the bank's conduct, assuming that it is negligent, should be considered in allocating loss in these cases. For discussion of factors which are considered in determining negligence, see McDonnell, *Bank Liability for Fraudulent Checks: The Clash of the Utilitarian and Paternalist Creeds Under the Uniform Commercial Code*, 73 GEO. L.J. 1399 (1985); Whaley, *Negligence and Negotiable Instruments*, 53 N.C.L. Rev. 1 (1975).

132. See *supra* note 120 and accompanying text.

133. See *supra* notes 14-19 and accompanying text.

134. U.C.C. §§ 3-417(1)(a) and 4-207(1)(a).

135. See *supra* note 121 and accompanying text.

136. One year from the time the statement and items are made available to the customer for the customer's unauthorized signature or for alterations and three years from that date for unauthorized indorsements.

has failed to use ordinary care.<sup>137</sup> Unlike section 3-406, section 4-406 expressly provides that a depository bank may assert the 4-406 defenses in a warranty action if the payor bank has improperly failed to assert them. A question arises as to whether the drafters intended to deprive depository banks of the 3-406 defense.

Once again, the courts faced with similar fact patterns and identical statutory authority are divided as to whether the depository bank can assert the drawer's negligence in a warranty action. An example of a case permitting the depository bank to sue the drawer on a common law negligence theory via U.C.C. section 1-103 is *Girard Bank v. Mount Holly State Bank*.<sup>138</sup> In that case, the payor bank, Girard Bank, brought an action for breach of warranty of title against Mount Holly State Bank on a check containing a forged indorsement. The court recognized that the drawer's failure to review bank statements and report forgeries and alterations as required by U.C.C. section 4-406 may be asserted by the collecting bank<sup>139</sup> but that the warranty provisions of section 4-207 do not incorporate section 3-406 as a possible defense in a warranty action.<sup>140</sup> Section 3-406 does not permit a direct tort action against the drawer whose negligence contributed to the forgery.<sup>141</sup> However, the court believed that this was an appropriate situation for the supplementation of the U.C.C. with common law negligence principles. The purpose of the loss allocative scheme was to place loss with the negligent party. Thus, the depository bank would have to be permitted to sue the drawer in tort for negligence.<sup>142</sup>

Other courts have disagreed and have held that the depository bank must bear the loss, irrespective of the drawer's negligence in facilitating the forged indorsement or alteration.<sup>143</sup> In these cases, it seems strange to permit the depository bank to assert the drawer's negligence under section 4-406 while denying the bank the opportunity to assert negligence under section 3-406.<sup>144</sup> A couple of hypotheticals demonstrate the anomalous results provided by the two sections. In case 1, assume that over a four month period a faithless employee

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137. U.C.C. § 4-406(3).

138. 474 F. Supp. 1225 (D.N.J. 1979) (applying New Jersey law).

139. See U.C.C. § 4-406(5).

140. The court recognized that some commentators and courts have permitted the depository bank to assert the drawer's negligence in a warranty action to prevent the drawee bank from waiving its customer's negligence (good from a customer relations perspective) and thus shifting the loss to the bank of first deposit. See Whaley, *supra* note 45, at 21; Comment, *Check Forgeries: Variations of Rules of Liability Based on Fault — UCC Defense Sections 3-406 and 4-406*, 12 *Ariz. L. Rev.* 417 (1970). Cases suggesting that the collecting bank may assert the customer's negligence in a warranty action or a direct action brought against it by the drawer include: *Ins. Co. of North America v. Purdue Nat'l Bank*, 401 N.E.2d 708 (Ind. Ct. App. 1980); *Stone & Webster Eng. Corp. v. First Nat'l Bank & Trust Co.*, 345 Mass. 1, 184 N.E.2d 358 (1962); *Canadian Imperial Bank of Commerce v. Federal Reserve Bank*, 64 Misc. 2d 959, 316 N.Y.S.2d 507 (N.Y. Sup. 1970); *Fidelity & Deposit Co. v. First Nat'l Bank*, 98 Wis. 2d 474, 297 N.W.2d 46 (1980).

141. 474 F. Supp. at 1239. Official comment 5 to section 3-406 provides that "[t]his section does not make the negligent party liable in tort for damages resulting from the alteration."

142. 474 F. Supp. at 1239-40.

143. *First Nat'l Bank v. Plymouth-Home Nat'l Bank*, 553 F. Supp. 448 (D. Mass. 1982); *Mellon Nat'l Bank & Trust v. Merchants Bank*, 15 U.C.C. Rep. Serv. 691 (S.D.N.Y. 1972); *Manufacturers' Trust Co. v. Harriman Nat'l Bank Trust Co.*, 146 Misc. 551, 262 N.Y.S. 482 (Sup. Ct. 1932) (pre-U.C.C. alteration).

144. A payor bank may not sue a depository bank under a warranty claim if it failed to raise any defenses it had under § 4-406. U.C.C. § 4-406(5).



stole checks drawn on the employer's account payable to someone else, forged the payee's indorsement, and deposited the check in the employee's bank account. While the employer/drawer negligently failed to supervise the employee, it did review its bank statements with reasonable care but failed to detect the forged indorsements. In case 2, assume that the faithless employee materially altered employer's checks payable to the faithless employee by increasing the amount payable. In case 2, the employer/drawer properly supervised the employee but failed to review its bank statements. Assume that in both cases, the payor bank restored the amount lost to the employer's account in the interest of customer relations and sued the employee's bank, the depository bank, on a breach of warranty theory. Assume also that all banks acted in accord with reasonable commercial standards. In case 1, the depository bank would arguably have no defense as it is not a drawee or other payor entitled to assert the section 3-406 defense. The payor bank, the employer's bank, could have asserted that defense but chose not to do so. Section 4-406 does not apply, as that section requires the drawer to discover only *his* unauthorized signature and material alterations.<sup>145</sup> In case 2, the depository bank cannot assert the section 3-406 defense but may be able to avoid liability on checks altered by the employee more than fourteen days after the initial altered checks were returned to the employer/drawer.<sup>146</sup> The payor bank sacrificed its right to proceed on a warranty theory with respect to those checks when it failed to raise its defense under section 4-406(5). Both cases involve employers who were either negligent in supervising employees or in reviewing bank statements, but in only one case is loss placed on the negligent party.

Perhaps the reason why section 4-406's defenses are available to the depository bank in the event the payor fails to assert them while section 3-406's defense is not is because the section 4-406 defenses are more certain.<sup>147</sup> A payor bank can more easily discover whether or not the customer reasonably reviewed bank statements and reported losses in a timely manner than whether the customer acted in a "negligent" manner.<sup>148</sup> Thus, the payor bank can be excused if it decides not to pursue a questionable 3-406 defense it might have against its customer, but it cannot be excused if it fails to pursue a readily ascertainable section 4-406 defense. This rationale does not support a rule which would prevent a depository from asserting the customer's negligence in an action brought against the customer or in defending a direct action brought against it by the payor bank's customer. If the purpose of the statute is to allocate loss to the negligent party, the collecting bank should always be able to assert the party's negligence subject to the harmed party's right to assert the collecting bank's

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145. U.C.C. § 4-406(1).

146. U.C.C. § 4-406(2)(b).

147. Note that while the section 3-406 defenses can be asserted by a holder in due course, the section 4-406 defenses are assertable only by the payor bank. The duty is owed by the customer to its bank. Compare U.C.C. §§ 4-406(2) and (4) with U.C.C. § 3-406.

148. The official commentary to section 3-406 indicates the unwillingness of the drafters to define with any precision conduct which would be considered negligent under that section.

failure to use reasonable commercial standards in accepting for deposit the check containing a forged indorsement or material alteration.<sup>149</sup>

#### 4. *The U.C.C. Statute of Limitations and Its Application in Negligence Cases*

As noted above, section 4-406(4) of the U.C.C. bars any claim by a customer against his bank for any checks paid over the customer's forged signature or for any loss due to material alteration unless the customer notifies the bank within one year after the statements and forged or altered checks are made available to the customer.<sup>150</sup> The customer must additionally report any forged indorsement within three years after the check containing the forged indorsement and the statement have been made available.<sup>151</sup> If the customer fails to report these losses within the specified period of time, the U.C.C. allocates loss to that customer irrespective of "care or lack of care of either the customer or the bank."<sup>152</sup>

Some courts have held that this preclusion does not apply where a bank has been negligent in handling a forged or altered check. In *Sun 'n Sand v. United California Bank*,<sup>153</sup> the California Supreme Court held that the section 4-406(4) preclusion applied only to warranty claims under the U.C.C.<sup>154</sup> In that case, the depository bank sought to raise the one year preclusion on altered checks while the drawer sought to apply the longer three year statute of limitations in California for injury to property.<sup>155</sup> The court found that the shorter preclusion was appropriate for warranty claims because of the U.C.C.'s general absolute allocation of liability to banks for forged signatures and indorsements. However, for losses resulting from negligent conduct on the part of bank, the longer tort statute of limitations applied.<sup>156</sup>

Several years later, a California appellate court found that the one year preclusion of section 4-406(4) did not apply to forged drawer signature cases in which the payor bank negligently paid the forged check. In *Commercial Cotton Co. v. United California Bank*,<sup>157</sup> the payor bank admitted that it was negligent in failing to detect the forged signatures on a \$4,000 check which had been

149. An issue exists as to whether the collecting bank's negligence should be considered under a comparative or contributory negligence standard. The *Girard Bank* court analogized the negligence cause of action to section 3-406, thus making the collecting bank's failure to act in accordance with reasonable commercial standards a complete bar to its claim. 474 F. Supp. at 1241. Arguably, in a common law negligence action in a comparative negligence jurisdiction, the test should be one of comparative negligence.

150. See *supra* note 121.

151. *Id.*

152. U.C.C. § 4-406(4).

153. 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978).

154. CAL. COM. CODE § 4406(4) applies a one year statute of limitations to forged indorsements as well as to forged maker signatures and alterations.

155. *Sun 'n Sand*, 21 Cal. 3d at 698, 582 P.2d at 939, 148 Cal. Rptr. at 348. The statute of limitations for injury to property cited was CAL. CIV. PROC. CODE § 338(3).

156. *Sun 'n Sand*, 21 Cal. 3d at 697, 582 P.2d at 939, 148 Cal. Rptr. at 348. It should also be noted that California has a separate one year statute of limitations for actions on forged or raised checks and on checks containing forged indorsements. CAL. CIV. PROC. CODE § 340(3). The *Sun 'n Sand* court held that this particular section applied only to warranty actions as well, not to actions based on negligence. *Id.*

157. 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985).

reported lost four years before payment.<sup>158</sup> Nonetheless, the bank denied liability to its customer on the basis of section 4-406(4) because the customer failed to examine its statements and report the forgery for a year and one-half after the relevant statement and check were provided to it.<sup>159</sup> The court, referring to *Sun 'n Sand*, held that the one year preclusion did not apply and sustained a jury verdict which included punitive damages of \$100,000 for the bank's bad faith action in raising the one year defense.<sup>160</sup>

The circumvention of the section 4-406 limitations period is not limited to California courts. The United States Court of Appeals, Seventh Circuit, applying Illinois law, permitted a customer to state a cause of action for payment over a forged indorsement outside of the three year period of section 4-406(4).<sup>161</sup> The cause of action alleged that the bank was negligent and acted in bad faith in permitting a known fiduciary to cash checks for his own benefit.<sup>162</sup> Arguably, these allegations, if proven, might indicate dishonesty in fact on the part of the bank, more than the mere negligence alleged in *Sun 'n Sand* and *Commercial Cotton*. The court of appeals held that 4-406(1) only applies to items "paid in good faith."<sup>163</sup>

These cases hold that the language of section 4-406(4), which states that the preclusion exists "[w]ithout regard to care or lack of care of either the customer or the bank,"<sup>164</sup> refers only to U.C.C. imposed duties. The drafters of the U.C.C. did not consider all situations. According to these courts, a bank owes duties to its customers apart from those specifically mandated by the U.C.C.; if one of those duties is breached, the one year/three year statute of limitations provided by section 4-406(4) does not apply. For example, the

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158. *Id.* at 514, 209 Cal. Rptr. at 552-53.

159. *Id.* at 515, 209 Cal. Rptr. at 554.

160. *Id.* at 515, 209 Cal. Rptr. at 553-54. It seems that the bank made a mistake in admitting that it had negligently paid the check in question. Unlike *Sun 'n Sand* where checks were negotiated over the counter, the check in *Commercial Cotton* was negotiated through the bank collection system. The signatures on the check were not compared to the signature card on file. Given the volume of checks handled by the banking system today and the desirability of speed in processing checks so as to make funds more readily available, there is an issue as to whether failure to examine signatures is negligent conduct. See *supra* notes 64-65 and accompanying text. Even if United California Bank were negligent in failing to examine the check carefully, there is authority for the position that the one year rule of section 4-406(4) applies. *Pine Bluff Nat'l Bank v. Kesterson*, 257 Ark. 813, 520 S.W.2d 253 (1975); *Indiana Nat'l Corp. v. Faco, Inc.*, 400 N.E.2d 202 (Ind. App. 1980).

The case additionally raises the issue of whether punitive damages are appropriate in what are essentially contract cases. *Commercial Cotton* successfully argued that by raising a spurious defense, United California Bank had tortiously breached the implied covenant of good faith and fair dealing. For a case holding that tort punitive damages recovery is not appropriate in check processing cases, see *H.B.A. Fur Corp. v. Manufacturers Hanover Trust Co.*, 38 U.C.C. Rep. Serv. (Callaghan) 955, 956 (N.Y. Sup. 1984).

161. *Appley v. West*, 832 F.2d 1021 (7th Cir. 1987).

162. *Id.* at 1030-31. Another case suggesting that an action may be maintained alleging bad faith outside of the three year period of section 4-406(4) is *Kraftsman Container Corp. v. United Counties Trust Co.*, 169 N.J. Super. 488, 404 A.2d 1288 (1979) (case involving fictitious payees under § 3-405).

163. 832 F.2d at 1032. The court recognized *Brighton, Inc. v. Colonial First Nat'l Bank*, 176 N.J. Super. 101, 422 A.2d 433 (1980) as standing for the position that section 4-406 cannot be circumvented by suing in tort for negligence. The *Brighton* court distinguished *Sun 'n Sand v. United California Bank* by stating that section 4-406(4) only applied to contests between a bank and its customer, not between a drawer and a collecting bank. 176 N.J. Super. at 111, 422 A.2d at 438. This ignores the *Sun 'n Sand* court's finding that a collecting bank may assert the 4-406 defenses in an action brought against it directly by the drawer. 21 Cal. 3d at 684, 582 P.2d at 929, 148 Cal. Rptr. at 338.

164. See *supra* note 121.

U.C.C. does not expressly provide a duty of inquiry when checks payable to banks are presented by a third party for the benefit of that party.<sup>165</sup> The U.C.C. also does not expressly set forth a duty on the part of the bank to at least inspect the face of checks to make certain that a signature appears which at least looks like the authorized signature of the customer.<sup>166</sup> According to some courts, such duties exist under common law negligence principles. These courts hold that the negligence statute of limitations should govern these disputes.

A review of prior drafts of this section and the commentary to those drafts demonstrates the drafters' desire to impose liability strictly after the 4-406(4) time period expired. Early drafts imposed liability strictly on the customer if the customer failed to use reasonable care in reviewing bank statements and reporting errors to the bank within specified time periods.<sup>167</sup> The commentary indicated that the time periods ran "without regard to whether the bank was negligent or failed to exercise ordinary care in the payment of the items charged to the customer's account."<sup>168</sup> The commentary went on to state that liability should be absolute because "it can always be contended that an alteration or forgery should have been detected."<sup>169</sup> This provision was subject to criticism and was subsequently changed to take the bank's negligence into account with respect to certain of the time periods.<sup>170</sup> The one year/three year period of section 4-406(4) remained an absolute bar, however. In permitting actions based on common law negligence for altered or forged checks after the one year period of section 4-406(4), cases such as *Sun 'n Sand* and *Commercial Cotton* effectively eliminate the language "without regard to care or lack of care."<sup>171</sup>

The cases applying a longer statute of limitations to check fraud cases decided under common law negligence principles are defensible only if there exists a good reason to permit a longer period to sue for breach of a common law duty than for breach of the duties imposed by the U.C.C. Does it take longer for an injured party to discover the breach of the common law duty than to discover a breach of a U.C.C. duty? Is breach of a common law duty more blameworthy than breach of a U.C.C. duty, thus meriting an additional period of exposure to liability?

The duties imposed by the common law cases are similar to those imposed by the U.C.C. The 4-406(4) statute of limitations limits liability in cases involving unauthorized drawer signatures, indorsements, and material alterations. The duties imposed by the U.C.C. in these cases require banks to discover the defalcation. If a bank fails to discover the defalcation, it is liable except in some limited cases.<sup>172</sup> Cases such as *Sun 'n Sand* and *Commercial Cotton* place a

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165. See *supra* notes 87-114 and accompanying text.

166. As noted above, there is a dispute among courts as to whether failure to inspect checks for unauthorized signatures is a reasonable commercial practice. See *supra* note 65 and accompanying text.

167. U.C.C. § 4-406 (1952).

168. U.C.C. § 4-406 comment 3 (1952).

169. *Id.*

170. U.C.C. § 4-406 (1956 recommendations).

171. See *supra* notes 164-66 and accompanying text.

172. See *supra* notes 14-22 and accompanying text.

common law duty of due care upon banks to discover forged signatures and alterations.<sup>173</sup>

It is difficult to argue that it is more difficult for injured parties to discover breaches of common law duties in these cases than it is to discover breaches of the U.C.C. duties. In fact, if a bank negligently failed to discover a forged signature, it is more likely that the injured party could have discovered it as well. For example, the payor bank in *Commercial Cotton* was considered negligent for failing to examine a check containing a signature that looked nothing like the drawer's authorized signature.<sup>174</sup> The drawer could have more easily discovered this forgery than an expert forgery undetectable by a bank exercising due care.

The drafters of the U.C.C. did not consider parties merely failing to use due care to be more blameworthy and thus worthy of more significant exposure for failing to detect unauthorized signatures or alterations. It appears that the desire was to draft a certain rule which absolutely allocated liability after a certain period of time, irrespective of a party's negligence. It might be appropriate to extend the period in the event that a party acted dishonestly in a transaction, as such conduct would be more blameworthy.<sup>175</sup> It is probably inappropriate, however, to permit a party to extend the U.C.C. statute of limitations where the allegation is merely one of negligence.

#### B. *An Assessment of the Common Law Negligence Cases*

Some of the cases decided on common law negligence principles have been characterized as "paternalistic" in that they seek to place loss on banks rather than on customers because banks are better able to bear the risk of loss.<sup>176</sup> Some of these cases illustrate judicial protection of the entrepreneur,<sup>177</sup> who may not realize the risk of check fraud to the same extent as a bank or seasoned business person. In protecting the bank customer through imposing a duty of due care on banks in addition to those duties imposed by the U.C.C., courts recognize a "special relationship" between banks and customers akin to a fiduciary relationship. The bank is responsible for protecting the customer from loss:

A bank is an institution of a quasi public character. It is chartered by the government for the purpose, *inter alia*, of holding and safely keeping the money of individuals and corporations. It receives such money upon an implied contract to pay the depositor's

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173. If anything, the duty imposed by these cases is less burdensome than the duty imposed by the U.C.C. Presumably, if banks carefully inspected checks but failed to discover defalcations no liability would exist for violation of a common law duty to use due care. Under the U.C.C., however, if a bank fails to detect an unauthorized signature, no matter how much care is used, liability will generally be imposed on the bank.

174. The account required only one signature while the check contained two unauthorized signatures. 163 Cal. App. 3d at 514, 209 Cal. Rptr. at 552-53.

175. The Seventh Circuit's decision in *Appley v. West* is perhaps appropriate under this rationale. Parties should be permitted a longer period of time to sue if another party has acted dishonestly. The allegation in *Appley* was that the bank acted in bad faith. 832 F.2d at 1030.

176. McDonnell, *Bank Liability for Fraudulent Checks: The Clash of the Utilitarian and Paternalist Creeds Under the Uniform Commercial Code*, 73 GEO. L.J. 1399, 1432-33 (1985).

177. *Id.* at 1427.

checks upon demand. Individual and corporate business could hardly exist for a day without banking facilities.<sup>178</sup>

Given this view, some courts place a duty of due care on banks perhaps altering the loss allocation framework devised by the drafters of the U.C.C. For example, the court in *E.F. Hutton v. City National Bank* held that a depository bank was under a duty to inquire whenever checks over a certain amount payable to a third party were negotiated by the drawer's fiduciary for the fiduciary's benefit.<sup>179</sup> If the depository bank failed to inquire under these circumstances, it would not be permitted to assert the padded payroll defense of section 3-405. As stated above, the drafters arguably intended to strictly allocate loss to the drawer in the E.F. Hutton/padded payroll situation, the view being that the drawer was in a better position than the depository to prevent the loss.<sup>180</sup>

The common law negligence cases impose duties of care without considering the magnitude of the duty imposed.<sup>181</sup> That is, are the costs of complying with the duty imposed justified by losses saved as a result? For example, the court in *Commercial Cotton v. United California Bank* imposed liability on the payor bank for negligently failing to detect an unauthorized signature.<sup>182</sup> Because of the costs involved in inspecting checks for forgeries and the need to process a high volume of checks in a short period of time, many banks do not manually inspect checks for unauthorized signatures.<sup>183</sup> It is unclear whether manual inspection of checks for unauthorized signatures would result in loss reduction commensurate with the cost and delay involved in such inspection and is thus unclear whether the duty to inspect imposed by some courts is appropriate.<sup>184</sup>

The common law negligence cases can be criticized because they add uncertainty to check fraud dispute resolution. For example, if the U.C.C. statute of limitations is applied without regard to negligence it is clear that a customer's claim that its signature has been forged is barred after one year. If the customer is permitted to circumvent the U.C.C. statute of limitations by suing in negligence, uncertainty arises as to exactly when the claim is barred. Resolution of the dispute becomes more costly. First, the question must be asked as to whether the jurisdiction recognizes a common law cause of action in these cases which would permit extension of the statute of limitations. Second, the question must be asked as to whether the bank was negligent in paying the check over a forged signature. In deciding this question, a court should properly consider the cost imposed by the duty of care imposed and the benefits resulting from the imposition of a duty. This is an uncertain inquiry, particularly for courts mak-

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178. *Patterson v. Marine N. Bank*, 130 Pa. 419, 433, 18 A. 632, 633 (1889) (case involving wrongful dishonor); see also *Commercial Cotton Co. v. United California Bank*, 163 Cal. App. 3d at 516, 209 Cal. Rptr. at 554; HILLMAN, McDONNELL & NICKELS, COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE ¶ 15-3 (1985).

179. See *supra* notes 116-31 and accompanying text.

180. See *supra* notes 116-19 and accompanying text.

181. See *supra* note 131.

182. See *supra* notes 150-75 and accompanying text.

183. See *supra* note 160.

184. See McDonnell, *supra* note 57, at 1401-03.

ing decisions on a case-by-case basis.<sup>185</sup> A case which under the U.C.C. could be easily resolved can now be resolved only after potentially costly litigation.

This uncertainty arises, however, not because courts are exceeding their authority and ignoring clear statutory directive. Uncertainty arises because the U.C.C. provisions do not provide clear guidance as to allocation of loss in all cases. For example, the statutes do not state whether a bank has an obligation to inquire as to the drawer's wishes when a check is presented payable to the bank. Rather than trying to stretch the U.C.C. statutory provisions to cover a situation which arguably was not considered by the drafters, courts reasonably attempt to resolve these questions under common law principles.

In addition, the U.C.C. itself allocates loss in some cases on the basis of negligence.<sup>186</sup> This allocation requires inquiry into whether parties have used due care. It is unclear in many cases whether a court will consider conduct to be negligent.<sup>187</sup> The drafters were aware that promulgation of a comprehensive laundry list detailing conduct which should result in imposition of loss would be impossible and not desirable.<sup>188</sup> The trier of fact needs some flexibility in deciding who should bear the risk of loss in a particular case, the certainty policy notwithstanding. Given the uncertain allocation of loss under U.C.C. provisions, the cases allocating loss under common law negligence principles probably do not add much additional uncertainty.

Policies other than certainty are important in allocating loss, and courts deciding cases on negligence principles at least attempt to decide these cases consistent with some of these policies. In particular, these courts attempt to allocate loss to the party who was in the best position to prevent the loss. In addition, the decisions placing loss on banks place loss on the banks at least partly because of the view that banks are in a better position to bear the loss than customers, either through the purchase of insurance or otherwise.<sup>189</sup> Of course, it is arguable in many of these cases that the court has not properly allocated the loss consistent with these policies. In *E.F. Hutton*, it is unclear that the drawer of the checks, a large brokerage firm, was not in as good a position as the depository bank to protect against or insure against loss.

In analyzing the common law negligence cases under the standards proposed in section II. D above, it appears that in many cases courts were justified in applying common law negligence principles rather than simply trying to decide the case under the U.C.C.<sup>190</sup> The cases involving checks payable to banks and improper negotiation of checks by fiduciaries properly use common law negligence principles to fill a gap in the U.C.C. These cases are consistent with

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185. It is not necessarily the case that courts are in the best position to engage in balancing all of the policies relevant in determining loss allocation. The legislature, aided by the drafters of the U.C.C., may be in a better position to do so, at least in commonly arising cases. See Calabresi & Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 YALE L.J. 1055, 1081 (1972).

186. See U.C.C. §§ 3-406 and 4-406.

187. The guidance provided by section 3-406 is unclear. See the official commentary.

188. U.C.C. § 3-406 comment 3.

189. *Sun 'n Sand*, 21 Cal. 3d at 695, 582 P.2d at 936, 148 Cal. Rptr. at 345-46.

190. This is not to say that the cases were properly decided. As noted above, it is unclear that the duty of care imposed by many courts is justified. All that is meant is that courts did not ignore strict statutory directive in deciding many of these cases under common law principles.

comparable cases decided prior to the U.C.C.'s adoption.<sup>191</sup> The U.C.C. drafters did not indicate an intent to overrule those cases. Likewise, permitting a depository bank to sue a drawer on common law negligence principles in cases involving unauthorized indorsements and alterations seems consistent with the overall policy of the U.C.C. and cures an unexplainable anomaly in the drafting scheme.<sup>192</sup> The cases permitting a party to sue a depository bank for negligence in spite of the defense afforded by U.C.C. section 3-405 also seem consistent with U.C.C. policy of allocating loss to a bank if both parties have failed to use due care.<sup>193</sup>

Cases permitting negligence causes of action outside the U.C.C. limitations period for claims based on alterations and unauthorized signatures appear contrary to the intent of the drafters as evidenced by the statutory language and history of section 4-406.<sup>194</sup> As stated above, the drafters intended this limitations period to provide a certain allocation of loss after a period of time, irrespective of parties' care or lack of care. It is hard to think of compelling arguments as to why parties should be permitted to sue outside the U.C.C. limitations period by characterizing their cause of action as a tort cause of action rather than an action based on the U.C.C.

The most significant goal of the U.C.C.'s initial proponents, i.e. providing a uniform set of rules from which disputes could be resolved without reference to other rules of law,<sup>195</sup> would be furthered if the U.C.C. drafters could provide more guidance to courts as to when common law principles should apply and when the U.C.C. should apply without reference to those principles. For example, the U.C.C. limitations period could state or its commentary could state whether or not the drafters intend to cover all cases regarding claims relating to unauthorized signatures and alterations. In some of these commonly occurring cases, such as those involving checks payable to banks, the drafters are probably in a better position than courts on a case-by-case basis to provide a rule regarding whether a duty to inquire exists. The drafters can perhaps analyze whether a duty to inquire is justified or under what circumstances such a duty should exist.<sup>196</sup> The next section analyzes changes currently proposed to Articles 3 and 4 which attempt to answer some of the questions answered by the common law negligence cases.

#### IV. PROPOSED REVISIONS TO LOSS ALLOCATION SCHEME

Any revisions to Articles 3 and 4 should make more clear which of the cases discussed above are covered and which cases are left for decision under general principles of law and equity. While it is not possible for a statutory drafter to read the future, the well-drafted statute sensibly considers issues which have come into litigation during the twenty to twenty-five years preceding

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191. See, e.g., *Federal Savings & Loan Ins. Corp. v. Kearney Trust Co.*, 151 F.2d 720 (8th Cir. 1945).

192. See *supra* notes 132-49 and accompanying text.

193. See *supra* notes 116-31 and accompanying text.

194. See *supra* notes 150-75 and accompanying text.

195. See *supra* notes 27-31 and accompanying text.

196. See *supra* note 104.



the drafting.<sup>197</sup> Issues not contemplated by the drafters are properly left for decision by the courts under the broad policies underlying the statutory enactment and under general principles of law and equity.<sup>198</sup> Articles 3 and 4 should address the question of whether a bank has a duty of inquiry when checks payable to the bank are presented to it. Likewise, does a duty of inquiry exist when a check is presented and a discrepancy exists between the indorsement and the payee's name? Is the depository bank's negligence a factor in allocating loss in padded payroll cases? The ability of a depository bank to assert the negligence of a drawer of a check should be considered. In addition, the drafters should state whether the statute of limitations contained in section 4-406(4) is intended to apply to cases involving unauthorized signatures and alterations where a negligence cause of action is stated.

Proposed revisions to Articles 3 and 4 currently under consideration answer many of the questions discussed above. The revisions answer some of the specific questions which have troubled courts under current law and seek to add some certainty by more clearly allocating loss to employers for defalcations caused by employees. The basic rules regarding loss allocation remain the same; that is, generally the loss for a forged drawer signature will fall on the payor bank, while the loss for a forged indorsement or alteration will fall on the bank of first deposit.<sup>199</sup> The proposed revisions also continue to allocate loss to businesses in padded payroll situations, expanding liability to the businesses in cases where indorsements on incoming checks are forged by employees responsible for processing checks.<sup>200</sup>

One specific proposed change is designed to make more clear when a bank will be liable for permitting someone to negotiate a check payable to the bank for that person's benefit.<sup>201</sup> Under the proposal, if a bank permits a known fiduciary, defined to include certain employees,<sup>202</sup> to negotiate a check payable to the bank for the known benefit of the fiduciary, the bank will be subject to the claim of the rightful owner of the check. The statute is limited to circumstances where the taker of the check knows that the person presenting the check is a fiduciary of the drawer, which may limit its application.<sup>203</sup> Presumably, courts should find that a bank "knows"<sup>204</sup> that a fiduciary has personally benefitted from a transaction if the bank has given the fiduciary cash or a cashier's check payable to the fiduciary for the check payable to the bank, although the answer

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197. G. GILMORE, *supra* note 48, at 96.

198. *Id.*

199. See proposed §§ 3-417 and 3-418, *supra* note 12; Rubin, *supra* note 12, at 646-56.

200. See *infra* note 211.

201. Proposed § 3-307(d), *supra* note 12, states:

If the instrument is made or drawn by or on behalf of the represented person to the taker as payee, the taker has notice of the breach of fiduciary duty if the instrument is (i) taken in payment of or as security for a debt known by the taker to be the personal debt of the fiduciary, (ii) taken in a transaction known by the taker to be for the personal benefit of the fiduciary, or (iii) deposited to an account other than an account of the fiduciary, as such, or an account of the represented person.

202. Proposed section 3-307(a), *supra* note 12, defines "Fiduciary" as "an agent, trustee, partner, corporation officer or director, or other representative owing a fiduciary duty with respect to the instrument."

203. In many cases, the bank may be unaware of the relationship between the person presenting the check and the person drawing the check. The proposed section would not appear to deal with those situations.

204. "Knows" is defined under the U.C.C. as actual knowledge. U.C.C. § 1-201(25).

is not entirely clear.<sup>205</sup> The proposed section provides that the bank would have notice of breach of fiduciary duty if the check payable to it were deposited to an account other than an account of the fiduciary, as such, or an account of the represented person. Providing the fiduciary with cash or a cashier's check would seem to impart every bit as much notice of breach as a deposit to the fiduciary's personal account, but the section could be made more clear by stating that if the fiduciary either takes cash or has the funds represented by the check deposited into his or her personal account, the taker bank is on notice of breach of the fiduciary duty.<sup>206</sup>

The problem with this proposed revision is that it requires an inquiry into what the bank named as payee knew and when it knew it. It is unlikely that tellers taking a check payable to a bank over the counter know much about the person presenting the check; if someone at the institution is aware of the presenter's fiduciary status, is the institution bound by that knowledge?<sup>207</sup> Litigation over this question might be costly. Perhaps a better way to treat these cases would be to consider the indorsement unauthorized unless the check is negotiated to pay a debt owed by the drawer to the payee bank, the check is deposited into an account in the name and under the control of the drawer or the proceeds of the check are directed by the payee bank in accord with written authorization from the drawer. Whether the person presenting the check payable to the bank is a fiduciary of the drawer should not be of importance; that the check is payable to the bank should be sufficient to place the bank on notice. In the event the indorsement were considered unauthorized, loss would be allocated in accordance with the rules governing forged and unauthorized indorsements.<sup>208</sup> The proposed revisions leave open the question as to whether a duty of inquiry exists when a check payable to a bank is presented by someone other than a known fiduciary.

In cases involving checks payable to known fiduciaries (such as Continental Finance Company as trustee for XYZ Trust Account) or to persons and account numbers (such as X Corp.-Acct. 234567, Bank of Y), the proposed revisions provide that the check is payable to the fiduciary (e.g., Continental Finance Corp.) or the named person (X Corp.) whether or not the check is deposited in a trust account or the designated numbered account.<sup>209</sup> Under the proposed revisions, a depository bank is on notice of breach of fiduciary duty if

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205. Cf. U.C.C. § 3-304 comment 5 ("The purchaser may pay cash into the hands of the fiduciary without notice of any breach of the obligation.").

206. Requiring a bank to inquire when a check payable to it is negotiated for the benefit of someone other than the bank would not seem to be too terrible a burden to place. Many of the cases discussed involve face-to-face transactions where a bank officer actually examines the checks. This situation is unlike the forged maker signature cases where due to automated processing, a bank officer is unlikely to look at the forged check and even if the check were to be examined, actual detection of the forgery would be problematic.

207. The bank may have information regarding the employer of the person presenting the check in its files and may "know" institutionally that the person is thus a fiduciary. The bank employees dealing with the person presenting the check will not know this information unless they check the records of the person presenting the check. Requiring that the records be checked in these cases may slow check processing.

208. See *supra* notes 16-17 and accompanying text.

209. Proposed section 3-110(c)(1), *supra* note 12, provides, *inter alia*,  
If an instrument is payable to an account and the account is identified only by number, the instrument is payable to the person to whom the account is payable. If an instrument is payable to an account identified

the check is deposited in an account other than the account of the fiduciary, as such, or the account of the person represented.<sup>210</sup> This provision essentially codifies the decision in *Joffe v. United California Bank*. Questions remain, however, as to the duty of inquiry, if any, which exists when discrepancies exist between the indorsement and the name of the payee. An additional duty of inquiry may be found to exist in those cases under common law negligence principles.

Proposed revisions currently under consideration impose liability on an employer for "fraudulent indorsements" made by employees responsible for the safekeeping and preparation of checks.<sup>211</sup> This provision, together with proposed section 3-404 regarding impostors and fictitious payees, expands liability for

by number and by the name of a person, the instrument is payable to the named person, whether or not that person is the owner of the account identified by number.

Proposed section 3-110(c)(2), *supra* note 12, provides:

(2) If an instrument is payable to:

(i) a trust, estate, or a person described as trustee or representative of a trust or estate, the instrument is payable to the trustee, the representative, or a successor of either, whether or not the beneficiary or estate is also named;

(ii) a person described as agent or similar representative of a named or identified person, the instrument is payable either to the represented person, the representative, or a successor of the representative;

(iii) a fund or organization that is not a legal entity, the instrument is payable to a representative of the members of the fund or organization; or

(iv) an office or to a person described as holding an office, the instrument is payable to the named person, the incumbent of the office, or a successor to the incumbent.

210. Proposed § 3-307(b), *supra* note 12, provides:

(b) If the instrument is payable to the fiduciary, as such, or to the represented person, the taker has notice of the breach of fiduciary duty if the instrument is (i) taken in payment of or as security for a debt known by the taker to be the personal debt of the fiduciary, (ii) taken in a transaction known by the taker to be for the personal benefit of the fiduciary, or (iii) deposited to an account other than an account of the fiduciary, as such, or an account of the represented person.

In addition, subsection (c) provides:

If the instrument is made or drawn by the fiduciary, as such, payable to the fiduciary personally, the taker does not have notice of the breach of fiduciary duty unless the taker knows of the breach of fiduciary duty.

211. Proposed § 3-405, *supra* note 12, provides:

(a) This section applies to fraudulent indorsements of instruments with respect to which an employer has entrusted an employee with responsibility as part of the employee's duties. The following definitions apply to this section:

(1) "Employee" includes, in addition to an employee of an employer, an independent contractor and employee of an independent contractor retained by the employer.

(2) "Fraudulent indorsement" means (i) in the case of an instrument payable to the employer, a forged indorsement purporting to be that of the employer, or (ii) in the case of an instrument with respect to which the employer is drawer or maker, forged indorsement purporting to be that of the person identified as payee.

(3) "Responsibility" with respect to instruments means authority (i) to sign or indorse instruments on behalf of the employer, (ii) to process instruments received by the employer for bookkeeping purposes, for deposit to an account, or for other disposition, (iii) to prepare or process instruments for issue in the name of the employer, (iv) to supply information determining the names or addresses of payees of instruments to be issued in the name of the employer, (v) to control the disposition of instruments to be issued in the name of the employer, or (vi) to otherwise act with respect to instruments in a responsible capacity. "Responsibility" does not include the assignment of duties that merely allow an employee to have access to instruments or blank or incomplete instrument forms that are being stored or transported or are part of incoming or outgoing mail, or similar access.

(b) For the purpose of determining the rights and liabilities of a person who, in good faith, pays an instrument or takes it for value or for collection, if an employee entrusted with responsibility with respect to the instrument or a person acting in concert with the employee makes a fraudulent indorsement to the instrument, the indorsement is effective as the indorsement of the person to whom the instrument is payable if it is made in the name of that person. If the person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure substan-

employers to include forged indorsements on checks made payable by third parties to the employer in addition to current exposure in the padded payroll-impostor-fictitious payee cases.<sup>212</sup> The proposal no longer requires the indorsement of the payee to be exact in the padded payroll-impostor-fictitious payee cases, as some cases have held under current law.<sup>213</sup> In the event that proposed section 3-405 applies and the bank paying or taking the check in deposit is negligent, liability is divided on a comparative negligence basis.<sup>214</sup> Negligence is determined by the reasonable commercial standards of the person's business, and with respect to a payor bank that is not also the depository bank, failure to examine an item processed by automated means is not negligence if the failure to examine did not violate the bank's prescribed procedures and the procedures do not vary unreasonably from general banking usage not disapproved by Article 3 or Article 4.<sup>215</sup> This revision basically takes the position of *E.F. Hutton v. United California Bank* on this issue and should obviate the need to decide padded payroll cases under common law negligence theories.

New section 4-406(6) continues to require a customer to report alterations or unauthorized signatures of the customer, and continues the one year preclusion in the event such alterations or unauthorized signatures are not reported within one year from the time the relevant statement of account is provided to the customer, without regard to care or lack of care of either the customer or the bank.<sup>216</sup> The proposed section no longer contains a bar for failure to report forged indorsements. The section does not require the customer to detect forged indorsements. The statute of limitations for suing on a forged indorsement is contained in proposed sections 3-118(g) and 4-111 and is three years after accrual of the cause of action. Neither the proposed statutes nor the official commentary clearly indicates the intent of the drafters to include or exclude common law negligence causes of action within the scope of these statutes of limitation.

The proposed revisions make clear that depository banks are permitted to assert the defenses under proposed sections 3-404, 3-405, 3-406 and 4-406,<sup>217</sup> thus making it unnecessary for a depository bank to sue a negligent party in

tially contributes to loss resulting from the fraud, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss. (c) Under subsection (b) an indorsement is made in the name of the person to whom an instrument is payable if (i) it is made in a name substantially similar to the name of that person or (ii) the instrument, whether or not indorsed, is deposited in a depository bank to an account in a name substantially similar to the name of that person.

212. Compare U.C.C. § 3-405.

213. See *supra* note 126 and accompanying text.

214. Proposed §§ 3-404(d), 3-405(b), *supra* note 12.

215. Proposed § 3-103(a)(7), *supra* note 12.

216. Proposed section 4-406, *supra* note 12, has been revised to require only that a bank make available statements of account to the customer rather than statements and physical items. The purpose of this revision is to facilitate check truncation, where the actual checks themselves are provided only upon the customer's request. See Rubin, *supra* note 12, at 632-38.

217. Proposed §§ 3-417(c) and 4-208(3), *supra* note 12. See also proposed § 4-406(6), *supra* note 12. It should be noted that proposed § 3-406 is much like current § 3-406; both are general negligence statutes. Proposed § 3-406 adopts the comparative negligence formula of proposed §§ 3-404 and 3-405.

tort, as the court permitted in *Girard Bank v. Mount Holly State Bank*.<sup>218</sup> These defenses are also available to depository banks sued for conversion by the payee of the check after payment on a forged indorsement.<sup>219</sup> For the reasons expressed above, this proposal makes sense.<sup>220</sup> Defenses available to the payor bank in forged indorsement cases should be available to the depository bank as well.<sup>221</sup>

The overall effect of the revisions is to make changes at the margin and not completely overhaul the loss allocation mechanism.<sup>222</sup> Specific provisions have made answers to some questions more clear, such as whether negligence of the depository bank is a factor in allocating loss in padded payroll situations. Areas of uncertainty remain, however, which could be resolved through more clear statements by the drafters. Where the drafters intend the U.C.C. to be comprehensive and disapprove of decisions allocating loss under common law principles rather than under the U.C.C., the commentary to the statutes should indicate such an intent. For example, some reference should be made in section 4-406 whether parties may circumvent the one year statute of limitations by suing in negligence. Likewise, when checks are payable to banks, is there a common law duty of inquiry apart from the specific circumstances described in proposed section 3-307? Unless the U.C.C. is more clear on these issues, dispute resolution and planning will be more uncertain and costly. Parties will not be certain whether the U.C.C. alone provides the answer as to their respective obligations in a given case.

It might be possible for Articles 3 and 4 to contain an absolute statement to the effect that the loss allocation scheme contained in those Articles is exclusive, and that no cause of action sounding in common law negligence is allowed.<sup>223</sup> Such a provision is probably not desirable, at least not without a complete, more comprehensive revision of Articles 3 and 4. While the U.C.C.

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218. See *supra* notes 132-49 and accompanying text.

219. See proposed §§ 3-404, 3-405 and 3-406, *supra* note 12. The proposal does not permit direct action for conversion by the drawer of the check, who must resort to an action against the payor bank which can then sue the depository on a warranty theory. Proposed § 3-420 comment 1, *supra* note 12. The drafters believe that the defense provided by section 3-405 will "substantially" reduce forgery losses incurred by depository banks, even without the existence of the current shield provided by section 3-419(3). Proposed § 3-420 comment 3, *supra* note 12.

220. It may be difficult for the depository bank to know whether it has an available defense since it is unconnected with the party asserting the claim. The depository will have to engage in discovery to determine whether the payor bank's customer was negligent or was otherwise precluded from asserting the claim against the payor under proposed sections 3-404 to 3-406 and 4-406.

221. See *supra* notes 146-49 and accompanying text.

222. See Rubin, *supra* note 12, at 623-32.

223. The current effort to revise Articles 3 & 4 was preceded by the ill-fated attempt to promulgate the Uniform New Payments Code which would have been a much more significant change in the law of payments. One of the proposals of the drafters of the Uniform New Payments Code was to eliminate negligence actions as a means of circumventing U.C.C. defenses available to banks in check fraud cases:

§ 210: *Exclusivity of Causes of Action and Defenses*

The causes of action against and defenses of account institutions on unauthorized orders set forth in Part D are exclusive and none other shall be permitted, but this Section shall not itself limit the rights and liabilities of parties on the underlying obligation.

The commentary to this proposed section indicated the intent of overruling cases such as *Sun 'n Sand v. United California Bank*. The Uniform New Payments Code strengthened defenses available to banks in check fraud cases, except in the case of consumer transactions of less than \$500. The Uniform New Payments Code ultimately

policies of providing certain and uniform rules would perhaps be furthered through such a rule, a certain amount of flexibility would be lost. As technology relating to the payments system changes, the ingenuity of thieves will probably bring about new methods of defrauding parties in payments transactions.<sup>224</sup> Courts will need flexibility in resolving new disputes which arise, which may necessitate reference to common law principles. With respect to commonly arising disputes, however, the U.C.C. should provide a comprehensive loss allocation scheme providing the analysis needed to resolve such disputes.

## V. CONCLUSION

The rules regarding loss allocation for check forgery and alteration are not the finest pieces of work put forth by the drafters of the U.C.C. The provisions are outdated and unclear. They do not provide answers to many of the questions which arise in check fraud cases. Frustrated by this lack of clarity, courts have resorted to the more comfortable but amorphous concepts of common law negligence; either "filling gaps" left by the U.C.C. or in some cases ignoring what appear to be applicable strict liability provisions in favor of finding liability on the basis of fault.

The cases deciding check fraud disputes under common law negligence principles for the most part appear to supplement rather than supplant the loss allocation provisions of the U.C.C. These cases are decided under common law principles because of gaps in the statutes arising through uncertain drafting and uncertain intent of the drafters. Only a few of the cases appear contrary to a statutorily directed result—"supplanting" the allocation of loss provided by the U.C.C.

When a court is faced with a check fraud dispute, the starting point in resolving the dispute is the U.C.C. The court must determine, however, whether the drafters provided an answer to the dispute. The statutory language, official commentary, and history of the provisions must all be consulted. If the statutory scheme does not appear to provide the answer, the dispute is properly resolved through use of the policies underlying the statutory scheme together with common law principles. While this analysis may lead to uncertain results in many cases, it is more appropriate than simply attempting to stretch a statutory provision to cover a case which was not contemplated at the time the provision was drafted.

Ultimately, what is needed is more direction from the U.C.C. itself, at least in resolving the most common disputes. The drafters need to consider these disputes and draft provisions which more clearly provide courts with the appropriate analysis to resolve these disputes while balancing the competing policies underlying check fraud loss allocation. The U.C.C. founders' goals of providing

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failed to gain approval, perhaps because of the division between banking representatives and those seeking to protect customers of banks. See McDonnell, *supra* note 57, at 1434-35.

224. For example, a type of fraud reported in recent cases involves alteration of the magnetic ink numbers at the bottom of checks so that the check is delayed in processing. By the time the depository bank discovers that the check is fraudulent, the funds have disappeared. The U.C.C. does not clearly deal with this situation. See Leary & Fry, *MICR Fraud: A Systems Approach to Foiling the Felon's Fun*, 40 U. MIAMI L. REV. 737, 739 (1986).

certain and uniform rules may be something of a "will 'o the wisp,"<sup>225</sup> but they are worthy goals, especially in an area such as check processing which requires inexpensive and rapid means of resolving disputes.

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225. Summers, *General Equitable Principles Under Section 1-103 of the Uniform Commercial Code*, 72 *Nw. U.L. REV.* 906, 944 (1978).

