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Check Scams-The Facts Remain the Same, Only the Law Changes

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Check Scams—The Facts Remain the Same, Only the Law Changes

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I. INTRODUCTION

This Article will analyze a number of cases involving embezzlement by employees and agents using bank checks under the 1989 version ("Old article 3"), and the 1990 version ("Revised article 3"), of the Uniform Commercial Code (UCC).¹ As the title to this Article suggests,

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1. Revised article 3 has been adopted in 37 states and the District of Columbia. See generally the commercial codes of Alaska, Arizona, Arkansas, California, Colorado, Connecticut, the District of Columbia, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Dakota, Utah, Vermont, Virginia, Washington, West Virginia, and Wyoming.

employee stealing has been distressingly constant during the last century. Only the applicable law has changed—first placing the loss on one party, then the opposite party, and then attempting to apply a form of comparative fault.

Too often law professors (including the author), in describing these cases, stress the law as to the allocation of loss without confronting the fact that the “loss” will almost invariably fall on innocent parties (employers, drawees, and collecting banks), while the gain goes to the embezzlers. The purpose of this Article is to alert readers to the various schemes and indicate some ways of avoiding loss. In addition, it is hoped that this Article will encourage a different approach for evaluating cases in light of recent changes to the UCC.

II. FICTITIOUS PAYEES

A. *Introduction*

It is the rule, and has been for a long time, that if the drawer of a check issues it payable to the order of “John Jones,” the drawee-bank is liable if it pays the check to the wrong “John Jones”—even if there might be thousands of them in the United States.² The legal question is “to whom did the drawer intend that the check be paid?” Even where a thief named “John Jones” steals the check from the mails, the bank has the duty of paying the “right John Jones,” according to the intent of the drawer. Yet the drawee-bank has no real understanding of this intent (beyond the wording of the check) until the drawer says: “You paid the wrong John Jones.”

Early Common Law courts had held that if the drawer intended that some other John Jones be paid the check, such as a fictitious “John Jones”³ or a person who impersonated the real “John Jones” and deceived the drawer, then any loss should fall upon the drawer because the bank was merely carrying out the drawer’s intent. The drawer’s objective intent was determined to be payment to an impersonator who dealt face to face, or, for one reason or the other, nonpayment to the person named as payee on the check. Although these courts were articulating the legalism of intent, they were really saying that the rigid rule of absolute liability of banks must be tempered in those situations beyond their control.

Regardless of the motivation of the courts, the English Bills of Exchange Act of 1882 stated: “[w]here the payee is a fictitious or non-

2. This assumes that the drawer has not substantially contributed to the forgery by his negligence. U.C.C. § 3-406 (1990); U.C.C. § 3-406 (1989).

3. JOSEPH STORY, COMMENTARIES ON THE LAW OF BILLS OF EXCHANGE, §§ 56, 200 (3d ed., Boston, Little, Brown 1853).

existing person the bill may be treated as payable to the bearer."⁴ This section meant, of course, that the instrument need not be indorsed, and where it was, the indorsement would be treated as surplusage without legal effect. It was decided that the payee need not be a fictitious, non-existing person, but if the drawer intended the named payee, a real person, should have no interest in the check, the transaction was within the statute.⁵

Section 9 of the Uniform Negotiable Instruments Law (NIL) in the United States followed the English model:

The instrument is payable to bearer: . . .

3. When it is payable to the order of a fictitious or non-existing person, and such fact was known to the person making it so payable; or
4. When the name of the payee does not purport to be the name of any person; . . .⁶

The American Bankers Association perceived that subsection 3 was too narrow and recommended amending it to read:

The instrument is payable to bearer when it is payable to the order of a fictitious or non-existing or living person not intended to have any interest in it and such fact was known to the person making it so payable or known to his employee or other agent who supplies the name of such payee.⁷

The amendment clearly covered cases where the payee although a real person was not intended to have any interest in the instrument, and the cases where a dishonest employee or agent of the drawer supplied the name of the payee.

It is notable that neither the English Bills of Exchange Act nor the Negotiable Instruments Law attempted to deal with the question of impersonation. This omission was corrected in Old section 3-405 of the UCC:

- (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

4. Bills of Exchange Act, 1882, 45 & 46 Vict., ch. 61, § 7(3) (Eng.).

5. JOSEPH D. BRANNAN, *NEGOTIABLE INSTRUMENTS LAW*, 324-327 (Frederick K. Beutel ed., 7th ed. 1948); JOSEPH D. BRANNAN, *THE NEGOTIABLE INSTRUMENTS LAW ANNOTATED* 79-80 (Zechariah Chafee, Jr. ed., 4th ed. 1926). For additional studies in the area of check scams under the Old and Revised articles 3 and 4 of the UCC, see generally Donald J. Rapson, *Loss Allocation in Forgery and Fraud Cases: Significant Changes Under Revised Articles 3 and 4*, 42 ALA. L. REV. 435 (1991) and James S. Bailey, Comment, *Allocation of Loss for Forged Checks Under Articles 3 and 4 of the U.C.C. and the Proposed Revisions Thereto*, 22 PAC. L. J. 1263 (1991).

6. UNIF. NEGOTIABLE INSTRUMENTS LAW § 9, 3B U.L.A. 506 (1992).

7. WILLIAM E. BRITTON, *HANDBOOK ON THE LAW OF BILLS AND NOTES* 425 (2d ed. 1961).

- 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.⁸

The former rule deeming fictitious payee instruments to be bearer instruments was abandoned, and the law soon required an indorsement. The net result, however, remained the same. Subsection (c) of Old section 3-405(1) adopted the NIL section 9 amendment, and the current approach is found in Revised section 3-404.⁹

After more than a century of development, the Revised rule has come full circle in many respects. First, the declaration that “[a]ny per-

8. U.C.C. § 3-405 (1990).

9.

§ 3-404. Impostors; Fictitious Payees.

- (a) If an impostor, by use of the mails or otherwise, induces the issuer of an instrument to issue the instrument to the impostor, or to a person acting in concert with the impostor, by impersonating the payee of the instrument or a person authorized to act for the payee, an indorsement of the instrument by any person in the name of the payee is effective as the indorsement of the payee in favor of a person who, in good faith, pays the instrument or takes it for value or for collection.
- (b) If (i) a person whose intent determines to whom an instrument is payable (Section 3-110(a) or (b)) does not intend the person identified as payee to have any interest in the instrument, or (ii) the person identified as payee of an instrument is a fictitious person, the following rules apply until the instrument is negotiated by special indorsement:
 - (1) Any person in possession of the instrument is its holder.
 - (2) An indorsement by any person in the name of the payee stated in the instrument is effective as the indorsement of the payee in favor of a person who, in good faith, pays the instrument or takes it for value or for collection.
- (c) Under subsection (a) or (b), an indorsement is made in the name of a payee if (i) it is made in a name substantially similar to that of the payee or (ii) the instrument, whether or not indorsed, is deposited in a depository bank to an account in a name substantially similar to that of the payee.
- (d) With respect to an instrument to which subsection (a) or (b) applies, if a 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 substantially contributes to loss resulting from payment of the instrument, 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.

U.C.C. § 3-404 (1990).

son in possession of the instrument is its holder"¹⁰ seems to partially revive the old idea of bearer paper. Second, the revision abandons the idea that the intent of the employee who supplied the name of the payee to his employer governs; now it is the intent of the signer under Revised section 3-110 that controls. Third, subsection (c) has dispensed with the necessity of indorsement. Fourth, the minority view requirement that the indorsement must be an exact replication of the payee's name on the face of the instrument (the "mirror image" rule) has been rejected. Finally, a duty of exercising ordinary care is now imposed upon payor banks and takers of these instruments.¹¹

B. *Authorized Signing Employees Who Steal*

The fictitious payee caper can assume many forms. For example, in *Retail Shoe Health Commission v. Manufacturers Hanover Trust Co.*,¹² the administrator of an employee health fund prepared duplicate vouchers for medical benefits submitted by the fund's beneficiaries. Then, as an authorized signer, he issued duplicate checks payable to fictitious payees using forged indorsements, and deposited the checks in various banks.¹³ The fraud continued from 1972 to 1979, and apparently only his death interrupted the scam that diverted \$675,634 from the fund.¹⁴ Upon discovery, the fund sued the drawee bank and the depository bank, among others.¹⁵ The court took notice of the agreement between the fund and the drawee bank that required the fund to give written notice to the bank, within six months, of any forged indorsements or improper payments, and to commence any lawsuit within eighteen months.¹⁶ The court held that since most of the checks fell outside this period the suits were barred.¹⁷ Apart from the agreement, however, the court found that Old section 3-405 barred suits against both drawee and collecting banks.¹⁸ This case suggests that banks are well-advised to shorten the one year discovery and reporting period provided in Old and Revised section 4-406.

On occasion, an officer of the drawer and an outsider will conspire together to cheat the drawer. For example, in *Braswell Motor Freight Lines, Inc. v. Bank of Salt Lake*,¹⁹ Kendall (a person who had no connec-

10. U.C.C. § 3-404(b)(1) (1990).

11. U.C.C. § 3-404(d) (1990).

12. 558 N.Y.S.2d 949 (N.Y. App. Div. 1990).

13. *Id.* at 951.

14. *Id.* at 950.

15. *Id.* at 951.

16. *Id.*

17. *Id.* at 952.

18. *Id.*

19. 502 P.2d 560 (Utah 1972).

tion with the employer-drawer) opened a bank account in the name of Braswell Motor Freight Lines.²⁰ Kendall then had Wertz (an ex-convict), the assistant comptroller of Braswell Motor Freight Lines, Inc., draw checks payable to Braswell Motor Freight, omitting the "Inc." from Braswell's corporate name, which Kendall then deposited in the false account.²¹ The two crooks stole \$574,031.32 from the drawer-employer.²² The employer then sued the drawee-bank, and the court held that Kendall's and Wertz's actions fitted all parts of Old section 3-405: Kendall was an impostor, Wertz intended the payee to have no interest in the checks, and Wertz supplied the name of the payee intending the payee to have no interest in the checks.²³ The Editors' Note in the Uniform Commercial Code Reporting Service correctly notes the court's error in finding that Wertz's supplying the name of the payee to Kendall would satisfy Old section 3-405(c).²⁴ Subsection (c) requires the name be supplied to the maker or drawer,²⁵ Kendall was neither.

In addition, the court was also in error in stating that where "an agent of a drawer of a check supplies the name of a payee which he intends to have no interest therein, the check is deemed to be payable to bearer, and an endorsement of the payee's name on the check is not a forgery."²⁶ The court's obvious reference to Section 9(3) of the old amended NIL,²⁷ shows that old memories are hard to erase.

If an insurance company delivers blank insurance drafts to an independent agent with actual authority to complete and deliver them, it cannot recover against a merely negligent bank that pays on drafts prepared by a dishonest agent and payable to fictitious payees.²⁸ Even if the insurance company limits the agent's authority to drafts of \$250.00 or less, a bank is not liable for drafts to fictitious payees under Old section 3-405 which exceed that amount.²⁹

Old section 3-405(1)(a) provided that an indorsement by "any person in the name of a named payee is effective . . ."³⁰ A small number

20. *Id.* at 561.

21. *Id.*

22. *Id.* at 560.

23. *Id.* at 561-62.

24. *Braswell Motor Freight Lines, Inc. v. Bank of Salt Lake*, 11 U.C.C. Rep. Serv. (Callaghan) 1020, 1021 (Utah 1972).

25. U.C.C. § 3-405(c) (1989).

26. *Braswell Motor Freight*, 502 P.2d at 562.

27. UNIF. NEGOTIABLE INSTRUMENTS LAW § 9(3), 3B U.L.A. 506 (1992).

28. *Del Rio Discount, Corp. v. Commercial Bank*, 593 So. 2d 527 (Fla. 3d DCA 1991).

29. *General Accident Fire & Life Assurance Corp. v. Citizens Fidelity Bank and Trust Co.*, 519 S.W.2d 817 (Ky. 1975).

30. U.C.C. § 3-405(1)(a) (1989).

of courts interpreted the words "in the name of a named payee" to require that the indorsement be in the identical words of the payee named on the face of the check. This was known as the "mirror image" rule.³¹ This court-created rule seemed to be of dubious origin in light of Old section 3-110, which provided that an instrument was payable to order when it was payable to "any person therein specified with reasonable certainty,"³² and Old section 3-203 provided that when an instrument was made payable "to a person under a misspelled name or one other than his own he may indorse in that name or his own or both."³³ Why should accuracy in the use of names be important in one section and not in other sections of the code?

A recent New York federal court confronted the "mirror image" rule in a case where the fictitious payee was "Empire Paper & Envelope Co.," and the indorsement read:

For Deposit Only
Empire Paper & Envelope Co.,
Div. of Burke, Wainwright & Evans, Inc.³⁴

The check was deposited in the depository bank in the name of "Burke, Wainwright & Evans, Inc."³⁵ The court noted that a simple indorsement in the name of "Empire Paper & Envelope Co." would have been proper under Old section 3-405.³⁶ The narrow issue was whether the addition of "Div. of Burke, Wainwright & Evans, Inc." made the indorsement ineffective. The court, after review, held that the simple addition of the quoted words was insufficient to bar the application of section 3-405.³⁷ The court further held that the mere failure of the depository bank to exercise ordinary care in handling the check would not make the depository bank liable to the drawee bank.³⁸

A year later, the New York Court of Appeals addressed a similar fictitious payee scenario, likewise finding the mere negligence of a depository bank in a suit by the drawer irrelevant to its liability under Old section 3-405.³⁹ However, the court was confronted by a different situation. A manager in the dividend department of Prudential Insurance induced his employer to issue dividend checks to two fictitious compa-

31. See, e.g., *Wellman v. Lindell Trust Co.*, 534 S.W.2d 83 (Mo. Ct. App. 1976).

32. U.C.C. § 3-110(1) (1989).

33. U.C.C. § 3-204 (1989).

34. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. NCNB Nat'l Bank*, 695 F. Supp. 162, 163 (S.D.N.Y. 1988).

35. *Id.*

36. *Id.* at 164.

37. *Id.*

38. *Id.* at 164-65.

39. *Prudential-Bache Sec., Inc. v. Citibank, N.A.*, 536 N.E.2d 1118, 1126 (N.Y. 1989).

nies and deposited the checks in two New York banks.⁴⁰ The embezzler stole approximately \$18.9 million working with an outsider who handled the deposits in the two false accounts.⁴¹ In order to facilitate the scam, the crooks paid \$165,000 to two employees of the depository, Citibank.⁴² Prudential sued Citibank on the ground, among others, that Citibank was guilty of "commercial bad faith."⁴³ Citibank defended on the ground that these two employees were adverse agents of Citibank and their misdeeds should not be charged to Citibank.⁴⁴ Deciding on a narrow record of limited facts, the Court of Appeals stated:

There may well prove to be merit in Citibank's contentions that all involved employees were either adverse agents or at most negligent; indeed, the issues may even be subject to resolution by way of motion, short of trial. Moreover, plaintiff bears a heavy burden to sustain its assertions of bank dishonesty or - to use the *Brighton* test plaintiff advocates - of complicity by principals of the bank in alleged confederation with the wrongdoers. A showing short of the bank's bad faith will not suffice to shift the loss from plaintiff, where it has been squarely placed by the Legislature in UCC § 3-405(1)(c). Great though plaintiff's burden may be, however, its assertions of bad faith are sufficient at this time to withstand dismissal of the complaint.⁴⁵

Some of the scams could have originated as movie scripts. An ex-convict, recently released after serving nine years for theft and other offenses, was employed by the city of Phoenix under a government funded program to assist ex-convicts.⁴⁶ After starting in a nonsensitive area, he was assigned to prepare warrants to pay vendors to the city.⁴⁷ An accomplice opened a checking account in the name of Duncan Industries, and the ex-convict soon prepared two warrants payable to Duncan Industries each in the amount of \$514,320.40.⁴⁸ The duplicate warrant was deposited in the Duncan Industries account, and the accomplice then withdrew over \$441,000.00 from the account through cashier's checks made payable to coin and stamp or diamond and bullion dealers.⁴⁹

The court held that the loss fell on the City of Phoenix under Old

40. *Id.* at 1120.

41. *Id.* at 1119.

42. *Id.*

43. *Id.*

44. *Id.* at 1121.

45. *Id.* at 1126.

46. *City of Phoenix v. Great Western Bank & Trust Co.*, 712 P.2d 966, 968 (Ariz. App. 1985).

47. *Id.*

48. *Id.*

49. *Id.*

section 3-405, and the alleged negligence of the bank in the opening and withdrawal stages was not relevant to the question of liability of the drawer depository bank.⁵⁰ This lack of care did not evidence bad faith by the bank.

This distinction between negligence and bad faith was frequently mentioned by the courts before the addition of Revised article 3,⁵¹ and will now assume added importance in light of Revised section 3-404(d).⁵²

C. *Cosigning Employees—One of Whom Is a Crook*

When checks are cosigned, the intent of the crooked cosigner determines whether the check is payable to a fictitious person.⁵³ Old section 3-405(1)(b) and (c), and comment 3, and Revised sections 3-404(b) and comment 2, case number 2, and 3-110(a), comment 1, call for this result. Revised article 3, however, has merely and needlessly complicated legal research.

D. *Crooked Nonsigning Employees Who Supply the Names of the Fictitious Payees*

The case of *Delmar Bank v. Fidelity & Deposit Co.*⁵⁴ nicely illustrates case development during a transitional state of the law. An insurance company employee wrongfully directed the company to issue

50. *Id.* at 970.

51. In *Prudential Ins. Co. v. Marine Nat'l Exch. Bank*, 371 F. Supp. 1002 (E.D. Wis. 1974), an insurance company employee and agent supplied the name of a policy holder and induced the company to issue a \$20,000 check to the order of the insured. The agent obtained the check, forged the policy holder's name, and transferred it to his alleged bookie who obtained payment on the check. *Id.* at 1003. The insurance company sued the bank, and the court held that any negligence of the bank would not be relevant under Old section 3-405, but that bad faith of the bank would be relevant. *Id.* *McCarthy, Kenney & Reidy, P.C. v. First Nat'l Bank*, 524 N.E.2d 390 (Mass. 1988), also followed the majority rule that the good faith, but not the negligence, of the drawee bank is relevant.

A drawee bank, however, that pays checks with either illegible indorsements or no indorsements at all, may raise a question of bad faith as a bar to the assertion of the fictitious payee rule. See *Kraftsman Container Corp. v. United Counties Trust Co.*, 404 A.2d 1288 (N.J. Super. Ct. Law Div. 1979). Under Old section 3-405, the Nebraska courts held that if the negligence of the depository bank is asserted by the drawer of the check, the negligence must be the proximate cause of the loss. *Travelers Indem. Co. v. Center Bank*, 275 N.W.2d 73 (1979). One Kentucky court has expressly followed this view. *Owensboro Nat'l Bank v. Crisp*, 27 U.C.C. Rep. Serv. 138 (Callaghan) (Ky. Ct. App. 1979).

The case of *Wymore State Bank v. Johnson Int'l Co.*, 873 F.2d 1092 (8th Cir. 1989), following the law of Nebraska, held that negligence of the depository bank may be used to as a defense to the utilization of Old section 3-405 in a fictitious payee case. The case presents an interesting analysis of the negligence aspects of the forger and the depository bank's actions.

52. For a discussion of comparative fault, see *infra* section VII.

53. *Wright v. Bank of California*, 81 Cal. Rptr. 11 (Cal. Ct. App. 1969).

54. 300 F. Supp. 496 (E.D. Mo. 1969).

twenty checks totalling \$24,600 as loan checks to an insured.⁵⁵ The employee then obtained possession of the checks and cashed them at a bank.⁵⁶ Four checks were issued during the time that the NIL was in effect in Missouri, and the remaining sixteen checks were issued under the old UCC.⁵⁷ The court held that since the employee supplied the name of the payee for the first four checks, they were payable to bearer under the NIL.⁵⁸ The remaining checks could have been indorsed by any person because they were payable to a fictitious person under Old section 3-405 of the UCC.⁵⁹ Therefore, regardless of which law applied, the loss fell on the insurance company.⁶⁰

Old section 3-405 has been labeled as "a banker's provision," intended to narrow the liability of banks and broaden the responsibility of their customers.⁶¹ However, on occasion, it can be a "banker's boomerang." A Texas bank's factoring department purchased accounts receivables of two corporations, under a factoring agreement requiring the bank to issue periodic checks to the two companies "for money collected."⁶² A bank employee submitted unauthorized forms requesting the issuance of checks to the two companies.⁶³ The employee intercepted the cashier's checks, forged the indorsements, and deposited a total of \$903,300 in the depository bank.⁶⁴ The court held that Old sections 3-405 and 3-418 (the finality of payment rule), completely barred recovery from the depository bank.⁶⁵

In *New Amsterdam Casualty Co. v. First Pennsylvania Banking & Trust Co.*,⁶⁶ a representative of a stockbroker devised a scheme of filling out unauthorized sell orders on customers' "cash accounts."⁶⁷ As stocks were sold he would intercept the confirmation slips so the customer would not learn of the sale. The representative would then obtain the checks by telling the company's cashier that he was meeting the customer and would deliver the checks.⁶⁸ After forging the customer's indorsement, he would either deposit them in his accounts, or cash them

55. *Id.* at 497.

56. *Id.*

57. *Id.* at 498.

58. *Id.*

59. *Id.*

60. *Id.*

61. J.J. WHITE & R.S. SUMMERS, *UNIFORM COMMERCIAL CODE* 639 (2d ed. 1980).

62. *Fidelity & Casualty Co. v. First City Bank*, 675 S.W.2d 316, 317 (Tex. Ct. App. 1984).

63. *Id.*

64. *Id.*

65. *Id.* at 319.

66. 451 F.2d 892 (3d Cir. 1971).

67. *Id.* at 893.

68. *Id.* at 894.

at check cashing agencies.⁶⁹

On "margin accounts," the representative would compute how much was owed to a customer, procure a check payable to that customer, and cash or deposit these checks.⁷⁰ He obtained \$88,213.82⁷¹ (which had some meaning during the early sixties). When a few customers discerned what the broker representative was doing, he bribed them into silence, allegedly giving more than \$20,000 to one customer alone.⁷²

The company's action against the drawee bank met with Old section 3-405 as a defense, on the theory that the representative supplied his employer with the names of the payees, and he did not intend that they would receive the checks or proceeds.⁷³ The court distinguished *Snug Harbor Realty Co. v. First Nat'l Bank*,⁷⁴ a factually similar case, because in *Snug Harbor* creditors of genuine invoices "supplied" their names while in *New Amsterdam*, the employee supplied the names of customers who were not actually owed anything thereby making the checks payable to "fictitious" payees.⁷⁵

Today, under Revised section 3-404, supplying the names would have no legal effect. However, with the amount of actual and apparent authority that the broker-representative had under *New Amsterdam*, he would seemingly fit under the "entrustment rule," discussed later in this Article.⁷⁶ The result should be the same with the loss falling upon the employer.

A recent case illustrates how a dishonest stockbroker can cheat both his employer and his customers.⁷⁷ A broker with the title of vice president of Shearson Lehman Brothers, Inc., was contacted by a representative of two corporations, requesting that the broker establish and manage three separate accounts.⁷⁸ The representative gave a check for \$460,150.23 made payable to ABP Investments.⁷⁹ There was no existing account at Shearsons, and the broker opened one in the ABP Investments name by forging the names of the customers.⁸⁰ The check was deposited and the stockbroker soon opened a post office box address in the name of ABP Investments without customer authoriza-

69. *Id.*

70. *Id.*

71. *Id.* at 893.

72. *Id.* at 895.

73. *Id.*

74. 253 A.2d 581 (N.J. Super. Ct. App. Div. 1969).

75. *New Amsterdam*, 451 F.2d at 897-98.

76. See *infra* section IV.

77. *Shearson Lehman Bros. v. Wasatch Bank*, 788 F. Supp. 1184 (D. Utah 1992).

78. *Id.*

79. *Id.* at 1186-87.

80. *Id.* at 1187.

tion.⁸¹ Over a period of eleven months, the broker induced Shearson to issue checks on the ABP account payable to ABP Investments, obtained them from the post office box, and deposited them (after he indorsed them) in his personal account.⁸² The stockbroker stole thirty-seven checks, totalling \$504,295.30, and the facts showed that the depository bank was very careless in depositing them.⁸³ Shearsons settled with their customers for \$1,208,903 and then brought suit against the depository bank.⁸⁴ The court held that the broker's conduct induced Shearson to issue the checks under Old section 3-405, and that the initial loss should fall on Shearson,⁸⁵ and also found that the negligence of the depository bank should not deprive it of the impostor rule protection. Shearson, which succeeded to its customer's claims by virtue of an assignment from their customers, could not recover from the depository bank as a "payee" of the fraudulently obtained checks.⁸⁶

If the same facts arose today, the intent of the Shearson official who signed the checks would control, and not the dishonest intent of the supplying stockbroker. On the other hand, the broker was not only a seller but a vice president, which might have been enough under the "entrustment doctrine" of Revised section 3-405.

The "padded payroll caper" can work even when the employer has separate payroll offices in different cities. In a recent South Carolina case⁸⁷ the payroll clerk in the branch office of a company ordered payroll checks from the company's main office. The checks were for employees either on leave, or who had recently left employment, and included supplemental checks to correct alleged errors in prior payroll payments.⁸⁸ The employees of the bank that cashed the checks testified to believing the clerk was authorized to cash the checks for those employees who could not come to the bank.⁸⁹ The testimony showed that the checks were not indorsed at the bank, the clerk never presented identification or authorization documents, and the bank failed to meet its own guidelines in cashing the checks.⁹⁰ The court nonetheless held that the negligence of the bank in the payment of these checks did not affect the fact that liability should fall upon the employer.⁹¹ Although the

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.* at 1188.

85. *Id.*

86. *Id.* at 1199.

87. *Stone Mfg. Co. v. NCNB of South Carolina*, 417 S.E.2d 628 (S.C. Ct. App. 1992).

88. *Id.* at 629.

89. *Id.*

90. *Id.*

91. *Id.* at 631.

decision is not entirely clear, it would appear that the payroll checks which were received by the clerk in the branch office were signed at the home office by someone else. If this analysis is correct, then today under Revised section 3-404 the intent of the unknown signer, and not that of the dishonest clerk, would control. However, the "entrustment rule"⁹² would again come into play, and would apparently place the resulting loss on the employer.

Both Revised sections 3-404 and 3-405 of the UCC advance the view that if a person paying an instrument or taking it for value or for collection fails to exercise ordinary care, and that failure substantially contributes to loss resulting from the fraud in paying the instrument, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure contributed to the loss.⁹³

Although these sections cover the fault of both the drawee (the payor bank) and the taking banks (depository and collecting banks), the comments to both sections seem confined to the lack of ordinary care of the latter, and no attention is devoted to lack of care of the former.⁹⁴ A pre-revision case may help to fill part of this hiatus. In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Chemical Bank*⁹⁵ an accounts payable employee of Merrill Lynch supplied the check issuing department with false invoices for New York suppliers.⁹⁶ Checks were issued to these suppliers (whose addresses were typed on the checks), and the employee (or his accomplices) opened accounts in the payees' names in California and Ohio banks.⁹⁷ The checks were then deposited with the out-of-state banks, and collected from Chemical Bank in New York.⁹⁸ When sued by Merrill Lynch, Chemical Bank impleaded the Federal Reserve collecting bank which asserted that Old section 3-405 protected them in this situation.⁹⁹ The court held that Old section 3-405 made these checks payable to the named payees and the forged indorsements were effective.¹⁰⁰ Insofar as the care of the drawee bank was concerned, the court held that the alleged failure to review the indorsements on the back of the checks did not impose any liability upon the drawee bank.¹⁰¹

92. Revised section 3-405. See *infra* section IV.

93. U.C.C. § 3-404 (1990); U.C.C. § 3-405 (1990).

94. The comparative fault concept is discussed *infra*, section VII.

95. 442 N.E.2d 1253 (N.Y. 1982).

96. *Id.* at 1255.

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.* at 1257.

101. *Id.*

While the indorsements were of an "irregular nature,"¹⁰² the court did not discuss the possible liability of the depositary banks. It would seem that Revised sections 3-404 and 3-405 have reraised the issue. Although it might not be required for a drawee bank to examine the indorsement chain on presented checks, it might well be incumbent upon depositary banks to raise the issue of corporate payees in New York having accounts in distant states and checks bearing irregular indorsements.

In analyzing alleged fictitious payee cases, it sometimes becomes necessary to distinguish the actual fictitious payee case from a situation that resembles, but is not, a fictitious payee transaction. For example, Mr. Jaquish, an employee in the trust department of Lincoln Bank, secured the execution of thirty-three cashier's checks payable to Groveland Bank.¹⁰³ Jaquish opened an account in the Groveland Bank in the name of "Terra Bella Stock Farm, Richard Jaquish and Phyllis Jaquish," by telling Groveland Bank that he was purchasing a farm in the area, and that he had inherited a large trust fund from a recently deceased grandmother.¹⁰⁴ He indorsed and delivered the checks to Groveland which deposited them in the newly opened account.¹⁰⁵ Before disappearing, Jaquish successfully embezzled \$333,829.74.¹⁰⁶ The plaintiff bonding company sued in the name of Lincoln Bank against Groveland Bank, and the defendant asserted the fictitious payee rule as a defense. The court held that Groveland was, of course, not fictitious, but a real payee.¹⁰⁷ "[T]he benefit of the statute runs to those who acquire an interest subsequent to the forgery of the endorsement; it does not improve the status of the named payee or of the person who actually executes the indorsement."¹⁰⁸ The court went on to find that since Lincoln Bank had no contractual relationship with Groveland Bank, it was incumbent upon Groveland Bank to inquire why checks were being issued to the order of Groveland without any indication as to whose account the checks were to be deposited.¹⁰⁹ Groveland received funds

102. The purported corporate signatures were, among other things, sometimes handwritten and often illegible. *Id.* at 1255.

103. *Federal Ins. Co. v. Groveland State Bank*, 354 N.Y.S.2d 220 (N.Y. App. Div. 1974). The facts in *Sun'n Sand, Inc. v. United California Bank*, 582 P.2d 920 (Cal. 1978), greatly resemble the facts in *Federal Insurance*, except the wrongdoer in *Sun'n Sand* altered the amounts of the checks after they were signed. Justice Mosk, in his confusing majority opinion, discussed section 3-405 but did allow recovery by the drawer against the payee bank. *Id.* at 678-79, 693.

104. *Id.* at 223.

105. *Id.*

106. *Id.*

107. *Id.* at 224.

108. *Id.*

109. *Id.* at 225.

belonging to Lincoln and "was obligated to retain such funds subject to direction of the owner."¹¹⁰

E. *Employee Who Decides to Steal After She Signs as Drawer or After She Supplies the Payees' Names*

It has been judicially noted that the old fictitious payee rule of section 3-405 would not apply if the indorser originally intended that the named payee receive the check, but then changed his mind and diverted the check.¹¹¹ Now, under Revised section 3-405 if the signer is an "entrusted person" he has the power to indorse the check no matter when his intention arose.¹¹²

Both the majority and dissenting opinions in *Dayton, Price & Co. v. First National City Bank*,¹¹³ imply that checks signed by the use of a facsimile signature of the drawer, if a dishonest employee formed the intent to steal after they were signed, would not fall under the fictitious payee rule.¹¹⁴

It can be fun in the classroom to discuss the "when did the thief decide to steal" question. Assume, however, a morally and financially impoverished employer is told by his lawyer "if your employee decided to steal after you signed the checks, then we can recover from the drawee bank, but if she intended to steal when she supplied the names of the payees on the checks, we have no right of recovery because of the fictitious payee rule." The employer then visits the former employee in jail and relays this information. The employer hints that if the employee testifies to forming her intent after the checks were signed by the employer, then the employer may be less than diligent in prosecuting the criminal charges against her. It is doubtful that the employee will be troubled about shaping her testimony, but should the law encourage perjury?

F. *Crooked Employees Who Prepare Fictitious Payee Checks and Then Increase the Amounts Payable After the Checks Are Signed*

The recent case of *Washington Savings Bank v. First Fidelity Bank*¹¹⁵ involved a loan department employee at Washington who prepared cashier's checks. The employee gave one check for \$250,000 to

110. *Id.*

111. *Ostrom-Martin, Inc. v. First Nat'l Bank*, 155 B.R. 997, 1001 (Bkrcty. C.D. Ill. 1993).
Accord *Firemen's Ins. Co. v. Chase Manhattan Bank*, 424 N.Y.S.2d 83 (N.Y. Sup. Ct. 1979).

112. U.C.C. § 3-404 cmt. 2, case 1 (1990).

113. 406 N.Y.S.2d 823 (N.Y. App. Div. 1978).

114. *Id.* at 824-25; *see also* the questionable holdings in *Sun'n Sand*, 582 P.2d at 920.

115. 634 A.2d 149 (N.J. Super. Ct. App. Div. 1993).

her husband who deposited it in his account at Fidelity.¹¹⁶ The employee changed a second check for \$40,000, made payable to a loan applicant, to \$400,000 after it was signed by the applicant, and deposited it.¹¹⁷ The employee increased the amount of a third check from \$50,000 to \$500,000; like the second check, the amount line was blank when it was signed.¹¹⁸ The fourth check was raised from a small amount to \$250,000, while the employee also erased the name of the payee.¹¹⁹ On the fifth check, for \$840.00, the employee raised the value to \$205,840.00, and erased and changed the payee's name.¹²⁰ The final check was raised from \$340.00 to \$340,000, and the employee forged the name of this payee.¹²¹ The employee intended that none of the true payees was to have an interest in the checks. The drawer-drawee Washington Bank sued the depository-collecting Fidelity Bank for negligence and breach of warranty.¹²²

The appellate court affirmed the trial court's holding that all of the checks were governed by the "faithless employee, or fictitious payee rule" of Old section 3-405.¹²³ Further, the breach of warranty claim under Old section 4-207(1), based upon two checks with visible alterations, was dismissed because of the "egregious" misconduct of the drawer-drawee bank in signing checks for unspecified amounts and placing the employee in a position of making certain that the bank paid them.¹²⁴ the plaintiff did not pay the checks in good faith.¹²⁵

Some might quarrel with the court's characterization of naive conduct by the drawer-drawee bank as constituting bad faith on the question of breach of warranty by the presenting bank. A stronger case might be made that the depository bank as a good faith holder made no alteration warranties under Old section 4-207.

What would be the result if the same case were tried under Revised articles 3 and 4? Under Revised section 4-208, the depository bank would warrant to the drawer-drawee bank that the checks were not altered. The depository bank could then assert a defense that the alterations were caused by the negligence of the drawer-drawee bank, and that liability be allocated on a comparative fault basis. Considered in the assessment of fault would be the negligence of the depository bank in

116. *Id.* at 150.

117. *Id.*

118. *Id.*

119. *Id.* at 151.

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.* at 151.

124. *Id.* at 152.

125. *Id.*

opening an account for the husband of an employee of the drawer-drawee bank and allowing the deposit of obviously altered checks for large amounts into this new account.

On a more practical note, how could this kind of scam be avoided? An obvious answer, of course, is to refuse to sign checks that are incomplete in any respect and to insist that the amounts be written by a check-writing machine. Another way might be to program the drawer-drawee bank's computer to reject checks over a certain amount, and only two persons (a trusted officer and the programmer) would know the "magic" number. Rejected checks would then be subject to individual attention. While this approach would likely catch large checks like those involved in *Washington Savings*, it would not be effective if the crook were stealing small sums on a continuing basis.

G. *Genuine Invoice Payee Checks—When Is a Real Payee Fictitious and When Is a Fictitious Payee Genuine?*

Old section 3-405 of the UCC provided that "an endorsement by any person in the name of a named payee is effective if . . . an agent or employee of the . . . drawee has supplied him with the name of the payee intending the latter to have no such interest."¹²⁶ These seemingly innocuous words lose some of their clarity when an employee physically hands genuine invoices and corporate checks to an authorized corporate officer for signature, and intends to take the checks and forge the payee's name. Does this employee come within the provision?

A leading New York case¹²⁷ followed the comments to Old section 3-405 which addressed situations involving padded payrolls where the named payee on a check supplied by the crook had no right to the check. The comments failed to discuss the so-called genuine check in payment of a genuine invoice (or perhaps genuine payroll records for a real employee). The court relied on the comments and on two cases from other jurisdictions which held that when genuine invoices are submitted by real suppliers and the check is not payable to a fictitious person (or a person not intended to have an interest in the check), the indorsement is a forgery and the drawee and/or depositary banks are liable.¹²⁸ This view resulted from taking words of the Official Comment out of con-

126. U.C.C. § 3-405 (1989).

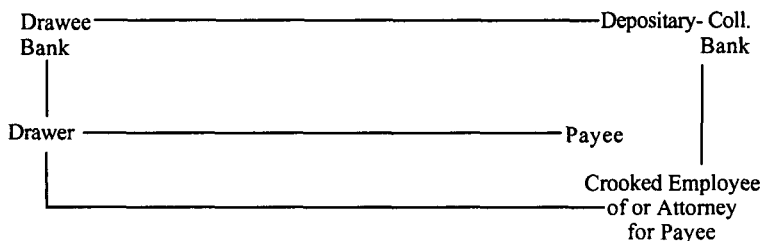
127. *Danje Fabrics v. Morgan Guar. Trust Co.*, 409 N.Y.S.2d 565 (N.Y. Sup. Ct. 1978). The fictitious rule is inapplicable where a true debt is owed to the payee. *New Amsterdam Casualty Co. v. First Pa. Banking & Trust Co.*, 451 F.2d 892, 898 (3d Cir. 1971); *Girard Bank v. Mount Holly State Bank*, 474 F. Supp. 1225 (D.N.J. 1979).

128. *Danje Fabrics*, 409 N.Y.S.2d at 568.

text.¹²⁹ The comment stressed that the risk from this type of fraud should be the employer's rather than the bank's, which has absolutely no way of determining in any particular case which checks represent payment for genuine invoices.

For better or worse, these types of cases are eliminated in states that adopted Revised section 3-404. Now, it is not the intent of the dishonest employee, but the intent of the check signer that controls. Secondly, the new "entrustment rule," discussed *infra*, places the risk of loss back on the employer, as the original comment to Old section 3-405 suggested.

H. *Crooked Employee of or Attorney for Payee Supplies Payee's Name to Drawer*



In the above diagram, the crook is not an employee of the drawer but an employee or attorney for the payee. Hence, neither Old section 3-405 nor Revised section 3-404 apply because they are designed to pertain in very limited circumstances. In addition, here a crook is not impersonating anyone, he is merely lying about his authority, and agency law, more than commercial law, applies.

129.

4. Paragraph (c) is new. It extends the rule of the original Subsection 9(3) to include the padded payroll cases, where the drawer's agent or employee prepares the check for signature or otherwise furnishes the signing officer with the name of the payee. The principle followed is that the loss should fall upon the employer as a risk of his business enterprise rather than upon the subsequent holder or drawee. The reasons are that the employer is normally in a better position to prevent such forgeries by reasonable care in the selection or supervision of his employees, or, if he is not, is at least in a better position to cover the loss by fidelity insurance; and that the cost of such insurance is properly an expense of his business rather than of the business of the holder or drawee.

The provision applies only to the agent or employee of the drawer, and only to the agent or employee who supplies him with the name of the payee. The following situations illustrate its application.

a. An employee of a corporation prepares a padded payroll for its treasurer, which includes the name of P. P does not exist, and the employee knows it, but the treasurer does not. The treasurer draws the corporation's check payable to P.

b. The same facts as (a), except that P exists and the employee knows it but intends him to have no interest in the check. In both cases an indorsement by any person in the name of P is effective and the loss falls on the corporation.

U.C.C. § 3-405 cmt. 4 (1989).

On too many occasions joint payee and fictitious payee problems become confusingly intertwined. For example, a dishonest lawyer representing a tort claimant forges the claimant's name on a general release form to induce an insurance company to issue a check made payable to the client and attorney as joint payees. The attorney forges the client's name, deposits the check, and then absconds with the proceeds. The client eventually learns of the fraud, and retains new counsel to assist her.

The new attorney is faced with paradoxical options. If the client objects to the amount of settlement, she may choose to proceed on the underlying cause of action against the defendant who is insured by the defrauded insurance company; however the statute of limitations may have run during the interim. The next alternative is to sue the insurance company on the settlement and claim that the insurance company did not pay the claimant, but rather the dishonest attorney. This approach can be disastrous. A court may hold that the claimant ratified the unauthorized settlement by suing on the payment, and is now bound. A variation of this approach was used by a New Jersey court that found where a defrauded client was reimbursed by a bar association security fund, and the fund sued the insurance company for conversion, there was no ratification by the fund and it could recover.¹³⁰

The question remains as to whether the issuer of an insurance check or draft is discharged on the underlying claim when an attorney forges the client's name on the instrument. Section 178(2) of the Restatement of Agency adopts the rule (founded on numerous common law cases): "If an agent who is authorized to receive a check payable to the principal as conditional payment forges the principal's endorsement to such a check, the maker is relieved of liability to the principal if the drawee bank pays the check and charges the amount to the maker."¹³¹

Another New Jersey case adopted this rule and discharged the issuer, but held that the release by ratification would not extend to the collecting bank in an action for conversion.¹³² A Florida case¹³³ expressly followed this rule, holding that when a drawer and drawee are the same company on an insurance draft (as distinguished from a check drawn by the insurance company on a bank) the drawer is released under the rule, but the same company as drawee is liable for payment on a

130. *Clients' Sec. Fund of the Bar v. Allstate Ins. Co.*, 530 A.2d 357, 361 (N.J. Super. Ct. App. Div. 1987).

131. *RESTATEMENT (SECOND) OF AGENCY* § 178(2) (1984).

132. *See generally* *Clarkson v. Selected Risks Ins. Co.*, 406 A.2d 494 (N.J. Sup. Ct. Law Div. 1979).

133. *Florida Bar v. Allstate Ins. Co.*, 391 So. 2d 238 (Fla. 3d DCA 1981).

forged indorsement.¹³⁴ An important lesson emerges from this apparent sophistry. An entity can avoid liability by choosing not to be both drawer and drawee, but instead being a drawer upon a separate entity: the bank. This approach was indirectly suggested in a prior Florida case which held that an attorney who forges his client's name to a settlement and insurance company's check has no power to settle the case without the client's consent.¹³⁵ Where the client does not ratify the forgery, but prevails against the original wrongdoer, the insurance company must pay the defrauded client on the judgment, but can then claim against the drawee bank on the original check because of the forgery of the client's name.¹³⁶

Can an attorney who forges his client's name on a settlement agreement and the ensuing checks (or drafts) be treated as an impostor under Old section 3-405 and Revised section 3-404? A recent case pointed out that the forging attorney is not impersonating anyone, least of all his client.¹³⁷ He is acting as an agent, but he is not disguising his identity and the impostor rule does not apply. Query: Would the new rule about impersonating an agent of a principal apply under Revised section 3-405? In the absence of any case authority, it is submitted that the agency-impostor approach should not be allowed, because the attorney is the agent-in-fact of the client. The dishonest lawyer is telling a falsehood about the extent of his authority, not the fact of his agency. On the other hand, can the fooled insurance company assert the "entrustment doctrine" under Revised section 3-405? This question is discussed in the entrustment portion of this Article.

The New York Court of Appeals expressly adopted section 178 of the Restatement of Agency in a case where an attorney was *authorized* in writing by his client to settle a case, and the attorney forged her name on a draft made jointly payable to the client and the attorney.¹³⁸ The court admitted that the cases were split on the power of an attorney to sign his client's name to checks and drafts, and noted in the usual case the defrauded client has recourse against the drawee bank in conversion for paying on a forged indorsement.¹³⁹

134. *Id.* at 239-40.

135. *Nehleber v. Anzalone*, 345 So. 2d 822, 822-23 (Fla. 4th DCA 1977).

136. *Id.*

137. *Clients' Sec. Fund of the Bar v. Allstate Ins. Co.*, 530 A.2d 357, 358 (N.J. Super. Ct. App. Div. 1987).

138. *Hutzler v. Hertz Corp.*, 347 N.E.2d 627 (N.Y. 1976).

139. *Id.* at 631-32.

I. *Crooked Employee of Drawer Forges Both the Drawer's Name and the Payee's Name—The "Double Forgery" Caper*

Diagram 1

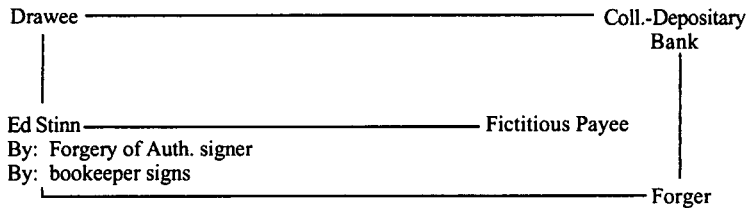
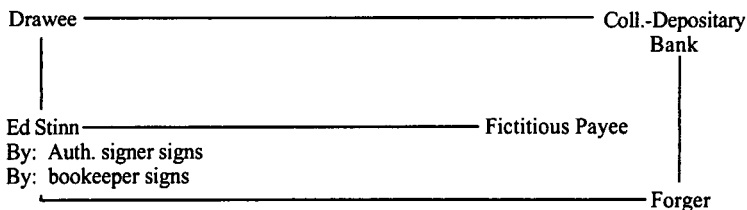


Diagram 2



The Ohio case of *Ed Stinn Chevrolet, Inc. v. National City Bank*¹⁴⁰ would make a lovely final examination question for a sadistic commercial law professor. A dishonest bookkeeper for Ed Stinn Chevrolet devised the two schemes diagramed above. In the first scheme, illustrated by Diagram 1, the bookkeeper forged the name of an authorized cosigner as drawer on the check. In the second scheme, set out in Diagram 2, the bookkeeper obtained her authorized cosigner's signature upon false representations regarding the purpose of the checks.¹⁴¹ The bookkeeper forged the indorsement of either an employee-payee or a totally fictitious person under both schemes, but in the first scenario she forged the name of her cosigner as well; hence Diagram 1 presents the "double forgery" caper. The bookkeeper deposited the proceeds from these checks into the "cash box," and she would then steal money from the cash box. The bookkeeper netted approximately \$284,000, but she made restitution of approximately \$108,000. The drawer sued the drawee bank for the difference.¹⁴²

A jury found the drawer eighty-five percent negligent and the

140. 503 N.E.2d 524 (Ohio 1987).

141. *Id.* at 526.

142. *Id.*

drawee bank fifteen percent negligent, and since Stinn's negligence exceeded the bank's negligence, awarded him nothing.¹⁴³ An appellate court reversed, stating that comparative negligence was not to be used in a breach of contract action, and deducting the amount of checks that exceeded the statutory one year limit for reporting, awarded \$176,000 to Stinn.¹⁴⁴

The bank appealed, and the Ohio Supreme Court, in the "devilishly complex appeal,"¹⁴⁵ addressed the question of whether the court should emphasize the forgery of the cosigning drawer or the forgery of the payees' indorsements. The court held, under *Perini Corp. v. First National Bank*,¹⁴⁶ that the forgery of the drawer's signature was crucial, and remanded the case for a determination of damages due to the drawer corporation.¹⁴⁷

The court also held that the second scheme (Diagram 2) was governed by Old section 3-405, and the bank was not liable for cashing the checks.¹⁴⁸ Finally, the court opined that in a Diagram 1 scenario, recovery could not be had from the drawee because, in effect, the bookkeeper was stealing cash that was within the possession of the drawer,¹⁴⁹ and not from the proceeds of these checks. The court equated the facts in this case with those of a Pennsylvania case:

Interestingly, appellant draws our attention to a Pennsylvania case which could have served as a pattern for [the bookkeeper's] scheme in this instance. In *Wiest v. First Citizens Nat'l Bank, supra*, a dishonest bookkeeper stole cash from her employer and later shielded the embezzlement by forging a check drawn on the employer's inactive bank account and depositing it into the boss' active account. As in this case, office records were dummied by the worker to coincide with deposits. . . . Holding in favor of the bank, the *Wiest* court . . . stated . . . "The funds transferred by the embezzling employee from the plaintiff's inactive bank account to the active office bank account were not removed from the dominion and control of the plaintiff. Certainly it would be illogical to adjudge that the plaintiff is entitled to recover monies which he has received and which he has either retained or used."¹⁵⁰

The Ohio Supreme Court also held that recovery could not be had

143. *Id.* at 527.

144. *Id.*

145. *Id.* at 528.

146. 553 F.2d 398 (5th Cir. 1977).

147. *Ed Stinn Chevrolet*, 503 N.E.2d at 538.

148. *Id.*

149. *Id.* at 536-37.

150. *Id.* at 537 n.15 (citing *Wiest v. First Citizens Nat'l Bank*, 3 U.C.C. Rep. Serv. 875 (Pa. Ct. C.P. 1966)).

on any checks which exceeded the one year deadline of Old section 4-406.

What would be the result if an equally talented bookkeeper replicated the behavior of the bookkeeper in *Ed Stinn Chevrolet* today? Taking the easier problem first, it would seem that Revised section 4-406 would apply the same one year rule to the late reporting of the cosigner forgeries on the checks. The one year rule should not have any affect as to the indorsements because Revised section 4-406 eliminated the reporting requirement for indorsements.

Likewise, if the court utilizes the same application of proceeds of the checks, the drawer should have no recourse, and the fact that a jury finds a plaintiff contributorily negligent should have no bearing.

In *Ed Stinn Chevrolet*, which followed the rule of *Perini Corp. v. First National Bank*,¹⁵¹ both the drawer's and payee's signatures were forged, and recovery was allowed to the drawer based on the forgery of his signature rather than the forgery of the fictitious payee's signature. What happens, however, if the drawer's signature is forged, but the check is paid without anyone indorsing the name of the fictitious payee? Does this fact situation fall within *Perini*? In a well analyzed case, the Sixth Circuit held:

Application of the *Perini* rule requires that the four fictitious payee checks be treated as if they bore only forged drawer's signatures. Although the drawee is negligent in paying a check that lacks the indorsement of a named payee, the drawer's loss is caused by the forged drawer's signatures. The drawer did not intend payment to any payee, so no payee can appear and demand payment. The danger guarded against by the requirement of a proper indorsement is absent. It is irrelevant whether the payee is real or fictitious and whether the indorsement is forged, missing, or otherwise defective.¹⁵²

J. *Crooked Employee of Drawer Forges Payee's Name with a Restrictive Indorsement*

Any discussion of the fictitious payee caper would be incomplete without a discussion of *Underpinning & Foundation Constructors, Inc. v. Chase Manhattan Bank*.¹⁵³ In this case, an accounting department employee of Underpinning prepared false invoices from companies with which it had current business relationships.¹⁵⁴ The employee (alone or

151. 553 F.2d 398 (5th Cir. 1977).

152. *National Credit Union Admin. v. Michigan Nat'l Bank*, 771 F.2d 154, 160 (6th Cir. 1985).

153. 414 N.Y.S.2d 298 (N.Y. 1979), *expressly followed*, *State of Qatar v. First Am. Bank*, 880 F. Supp. 463 (E.D. Va. 1995).

154. *Id.* at 299.

with others) placed restrictive indorsements (such as "For Deposit Only") on the checks issued to pay the false invoices, signed the payees names, and either cashed the checks or deposited them in accounts in the names of persons other than the named payees.¹⁵⁵ The employee allegedly stole over a million dollars.¹⁵⁶ Underpinning sued the depository bank, not the drawee bank, and the court held that although there was conflict in the cases of New York and other states as to whether a drawer would normally have a cause of action against a depository bank, where the depository bank ignores a restrictive indorsement, the drawer may sue.¹⁵⁷ The unclear holding that the indorsement was "effective,"¹⁵⁸ was explained by the court:

Had the forger in this case not forged a check with a restrictive indorsement, it would appear that the loss might properly be placed upon the drawer alone. A restrictive indorsement, however, imposes a new and separate duty upon a transferee to pay the check only in accord with the restriction. In this case, the restrictive indorsement required that the checks be deposited only in the accounts of the respective restrictive indorsers, the named payees. This was not done and the failure to do so serves as a basis for liability independent of any liability which might be created by payment over a forged indorsement alone.¹⁵⁹

This statement contains a patent ambiguity: if the accounts of the "respective restricted indorsers" means that these persons must have had an account in the bank and that they did not, then there was no possible way for the depository bank to act in accordance with the restrictive indorsements. On the other hand, if the forgers opened accounts in the bank in the name of the payees, would this have satisfied the quoted language?

Underpinning did not answer these questions, but in the case of *Spielman v. Manufacturers Hanover Trust Co.*¹⁶⁰ the court explained that:

In *Underpinning*, the checks were restrictively indorsed "for deposit only", followed by the stamped name of the payee. The payees had no account in the depository bank, however, and we found a violation of the restrictive indorsements because the depository did not, *indeed it could not*, deposit the proceeds in the accounts named as it had been directed to do. Instead, in clear violation of the indorsements, the depository either credited the checks to the account of the forger

155. *Id.*

156. *Id.*

157. *Id.* at 302.

158. *Id.* at 301.

159. *Id.* at 303.

160. 456 N.E.2d 1192 (N.Y. 1983).

or paid cash to him. Thus, it failed in its obligation to deposit the checks to the account of the payee as the indorsement required.¹⁶¹

A fair reading of the above quotation might indicate that even if the forger opened accounts in the name of the named payees, and deposited the checks into these accounts, the court might still have held that the bank did not act consistently with the indorsement, giving the drawer a cause of action against the depository bank. In *Spielman*, a dishonest litigator falsely induced his client to draw a check payable to the law firm of opposing counsel.¹⁶² The dishonest attorney indorsed the check:

Pay to Special Account
#012-043478 [Acct. of dishonest attorney]
s/ Pitney, Hardin & Kipp [alleged payee law firm]
For Deposit Only
Special Account 012-043478¹⁶³

The court held that these facts were not controlled by *Underpinning* because the indorsements were effective even though the customer was identified by account number rather than by name.¹⁶⁴ The depository bank followed directions and was not liable to the defrauded drawer client.

In comparing the degree of fault in the two cases, it would seem that the employees of the depository in *Underpinning* totally disregarded the restrictive indorsements, while the *Spielman* employees tried to carry out a confusing indorsement and placed the funds in the numbered account. The lack of clear direction in Old section 3-405 of the UCC invited this bifurcated approach. Revised section 3-404 seems to clarify, at least in part, the problem of the account name versus account number. Revised section 3-404(c) provides that if the check *whether or not indorsed* is deposited in the depository bank to an account in a name substantially similar to that of the payee, it is proper.¹⁶⁵ *Underpinning* suggests that if the forger had an account in the name of the named payee, deposited the checks without indorsement, and the bank employees applied the checks to the named account, the drawer would have no cause of action against the depository bank. Under the facts of *Spielman*, if the forger deposited the checks without indorsement, the bank would have to deposit them in the account of Pitney, Hardin & Kipp (the opposing counsel), not under the numbered account of the dishonest lawyer, to avoid liability to the drawer. But under the specific

161. *Id.* at 1194 (emphasis added).

162. *Id.* at 1193.

163. *Id.* at 1194.

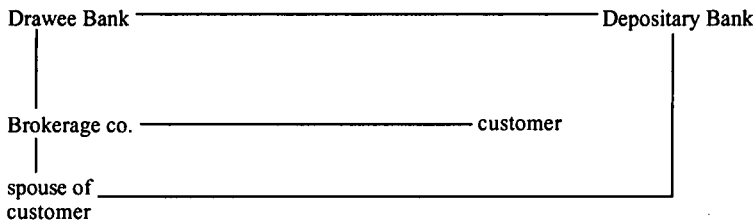
164. *Id.*

165. U.C.C. § 3-404(c) (1990).

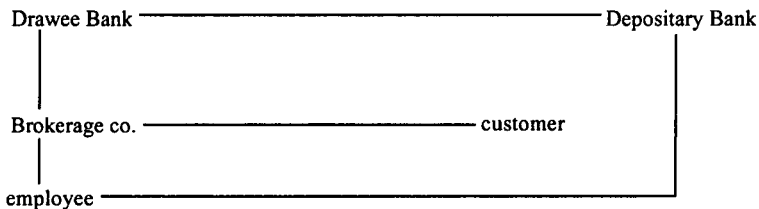
facts of *Spielman*, where the dishonest lawyer did not sign his name but used his account number as a substitute, would the result be the same?

K. *Can Payees Recover from Drawee and/or Depository Banks Under the Fictitious Payee Doctrine?*

"Snow diagram"



"McAdam diagram"



Both of the above diagrams represent cases where customers have stock accounts in stockbrokers' companies. A dishonest employee or a dishonest spouse induces the companies to issue checks made payable to the name of the payee-customers. The dishonest employee or spouse indorses the check and deposits it in the depository bank which collects from the drawee-payor bank. Upon discovery of the defalcations, the payees seek to bring suit against the presumably solvent drawee, collecting bank, or both. Normally, if the customer is not guilty of any wrongdoing (as would be the usual case), she would have an action against the brokerage company for the return of "her" money. The brokerage company would then sue the drawee bank and be met by the fictitious payee defense.

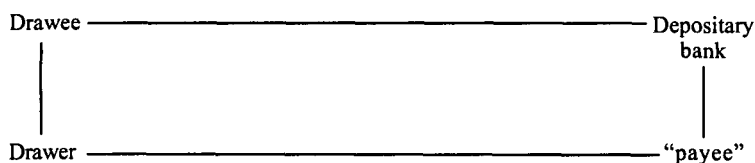
However, if, for some reason, the payee desires to sue the drawee and/or depository bank directly and to by-pass the brokerage company, does she have standing to do so? At least two courts have answered that

question affirmatively.¹⁶⁶ The *McAdam* case set out various theories as to why the payee should have standing, and *Snow* followed them. Unfortunately, neither case paid any attention to a simple question: where and when did the payee acquire a property interest in the check? The payee in *Snow* never had possession or delivery of the checks issued to her estranged husband who did not purport to impersonate her or be her agent.¹⁶⁷ In *McAdam*, the broker was the supposed agent of the customer, a legal status sufficient to show possession, but this aspect was not discussed.¹⁶⁸ Both courts agreed that the payees could not be barred from suing by the fictitious payee defense, which was designed to preclude the drawer, not payee, from recovery.

It would seem that in both cases, if the brokerage company had assigned its rights to the payees, they would have received clear right to sue without property right worries.

III. IMPERSONATION SCAMS

A. *Crook Impersonates the Payee*



Impersonation schemes differ from fictitious payee scenarios in one main aspect: the impersonator is not an employee or agent of the drawer, but an outsider who dons the trappings of a payee.

166. *McAdam v. Dean Witter Reynolds, Inc.*, 896 F.2d 750 (3d Cir. 1990); *Snow v. Byron*, 580 So. 2d 238 (Fla. 1st DCA 1991).

167. *Snow*, 580 So. 2d at 239.

168. *McAdam*, 896 F.2d at 753.

Neither Old section 3-405 nor Revised section 3-404 devote any real effort to defining the words impostor or impersonation except to state the latter could be accomplished by use of the mails or otherwise.

Old § 3-405:

(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;

Rev. § 3-404:

(a) If an impostor, by use of the mails or otherwise, induces the issuer of an instrument to issue the instrument to any impostor, or to a person acting in concert with the impostor, by impersonating the payee of the instrument or a person authorized to act for the payee, an indorsement of the instrument by any person in the name of the payee is effective as the indorsement of the payee in favor of a person who, in good faith, pays the instrument or takes it for value or for collection.

Not evident from a quick comparison of the two sections is the different definitions of forgery. Under Old section 3-405, if the "impostor" pretended to be an agent of the payee, the impersonation would be ineffective and any indorsement of the payee's name would be forgery. Conversely, under Revised section 3-404 if an "impostor" pretends to be the agent of the payee and a check is issued "to the order of the payee," anyone can indorse the payee's name and it will not be a civil forgery but an effective endorsement.

Shube v. Cheng is a classic impostor case.¹⁶⁹ Mr. and Mrs. Shube contracted to purchase a home from Mr. and Mrs. Cheng; Apple Bank financed the sale and took back a purchase money mortgage.¹⁷⁰ The closing was attended by the buyers, the sellers (allegedly the Chengs), and at least eight other clerks and attorneys.¹⁷¹ The closer for the title abstract company demanded identification of "Mr. Cheng," and "he" produced only an insurance card and credit card, alleging "he" did not drive and did not have a driver's license.¹⁷² The sellers' attorney also vouched for the identification of "Mr. Cheng."¹⁷³ The Apple Bank check was indorsed, deposited with Citibank, and paid by Apple before

169. 596 N.Y.S.2d 335 (N.Y. Sup. Ct. 1993).

170. *Id.* at 336.

171. *Id.*

172. *Id.*

173. *Id.*

the signature was found to be a forgery.¹⁷⁴ Apple brought suit against Citibank, and the Shubes sued the “sellers’” attorney and the title closer.¹⁷⁵ The court held that Old section 3-405 was a complete defense to Apple Bank’s breach of warranty suit against Citibank as the depository bank, noting that Apple Bank’s attorney attended the closing and was present at the identification of “Mr. Cheng,” and thus Apple Bank was in a better position to detect the fraud than was Citibank.¹⁷⁶ The results were nightmarish. The Shubes did not get title, the real Chengs were left with a mortgage clouding their title, the buyers sued the “sellers’” attorney, the title company lost its money, and the title company’s closing clerk probably lost his job.

A Pennsylvania case foreshadowed the *Cheng* result.¹⁷⁷ A husband was the administrator and sole heir of his mother’s estate, which included a house.¹⁷⁸ His estranged wife arranged, through her attorney and a real estate broker, for a mortgage to be placed on the house without his knowledge.¹⁷⁹ Before the mortgage closing the wife appeared in her attorney’s office with a man whom she introduced as her husband but who was an impostor.¹⁸⁰ After the wife and “husband” signed the mortgage papers, she announced he would not attend the mortgage closing.¹⁸¹ At closing, when the attorney and the real estate broker told the title company’s clerk that they saw the husband sign the mortgage, the clerk notarized the signature of the “husband.”¹⁸² The title company’s check was then delivered to the wife, who signed her name, forged her husband’s name, and cashed it.¹⁸³ The court held the impersonation triggered Old section 3-405, and that the signature of the husband was not a forgery.¹⁸⁴ Neither the attorney nor the real estate broker had any personal knowledge of the real husband’s identity, yet they foolishly relied upon the hearsay identification. Even more foolishly, the notary clerk acknowledged the “husband’s” signature by relying on the attorney and real estate broker. But could the title company recover against the attorney, as the *Cheng* sellers attempted?

An Oklahoma case addressed this question.¹⁸⁵ James F. Beard, Jr.,

174. *Id.*

175. *Id.* at 337.

176. *Id.* at 339.

177. *Philadelphia Title Ins. Co. v. Fidelity-Philadelphia Trust Co.*, 212 A.2d 222 (Pa. 1965).

178. *Id.* at 223.

179. *Id.*

180. *Id.*

181. *Id.*

182. *Id.*

183. *Id.*

184. *Id.* at 226.

185. *A.M. Covington v. Penn Square Nat’l Bank*, 545 P.2d 824 (Okla. Ct. App. 1975).

a purported oil company employee, contacted prospective purchasers of an oil lease.¹⁸⁶ The lessees inquired with the oil company which confirmed employment of a man named "Baird."¹⁸⁷ Mr. Baird told the lessees that he spelled his name with an "I," and was presented with cashier's checks payable to James Baird.¹⁸⁸ He then told the bank cashier that his name was misspelled, indorsed the check both ways,¹⁸⁹ and eventually, the checks were paid. The purchasers of the cashier checks sued the depository banks, but the court held that as they dealt directly with the impostor, they should bear the loss.¹⁹⁰ The court did not apply the "mirror image" rule.

Three recent cases warrant discussion at this point. In the first, a "financial advisor" induced a client to purchase a single premium annuity policy of insurance.¹⁹¹ The advisor applied in the client's name, opened a post office box as the mailing address of the client, and corresponded with the insurance company by using the client's name.¹⁹² After receiving two checks disbursing funds to the client, the advisor signed the client's name, indorsed his name, deposited the checks in his account, and embezzled the proceeds.¹⁹³ The parties to the suit agreed that the advisor corresponded with the insurance company on numerous occasions by using the name of the client.¹⁹⁴ The drawee bank sued the depository bank of the advisor.

When the drawee bank sued the depository bank, the court found the "[T]he record is so replete with such references that there can be no argument that [the advisor] assumed the identity of [the client] in all of his communications with Fidelity and did not merely forge [the client's] signature."¹⁹⁵ The court granted summary judgment to the depository bank under the impostor rule of Old section 3-405.¹⁹⁶ The case illustrates an impersonation "by use of the mails or otherwise," and shows the difficulty in detecting a scam before completion. The case seemed to indicate that the premium for the annuity was in excess of \$80,000, a policy size perhaps justifying the use of face-to-face communication and a handwriting sample to identify the insured.

In the second case, Mr. England contacted Asher Corporation

186. *Id.* at 825.

187. *Id.*

188. *Id.*

189. *Id.*

190. *Id.* at 826.

191. *Dominion Bank v. Household Bank*, 827 F. Supp. 463 (S.D. Ohio 1993).

192. *Id.* at 465.

193. *Id.*

194. *Id.* at 465-66.

195. *Id.* at 467.

196. *Id.* at 468.

regarding a lease-back transaction for equipment.¹⁹⁷ England claimed to be the operator of Hawks Sales Corporation, and gave Asher the telephone number of his receptionist who answered "Hawks Sales Corporation."¹⁹⁸ England also supplied phony financial statements of Hawks Sales Corporation and of the alleged president, Harvey Hawks.¹⁹⁹ Asher issued checks to Hawks Sales Corporation which England had restrictively indorsed and deposited by a third party.²⁰⁰ Asher assigned its rights to an assignee who sued the third party and his depository bank.²⁰¹ The trial court granted summary judgment for the third party and depository bank, holding the checks were made payable to an impostor and the loss therefore fell on Asher, the drawer of the checks.²⁰² The appellate court found controverted facts and remanded.²⁰³ In a well reasoned analysis of the difference between impersonating a person and impersonating an agent of a person, the court stated:

Here, it is undisputed that someone posed as Harvey Hawks when that person signed Harvey Hawks's name to the various documents. Therefore, applying § 3-405(1)(a) to this uncontroverted fact, an imposture occurred if Asher was induced to issue the instruments by the documentation which contained the forged signature of Harvey Hawks, either individually or in his capacity as an authorized agent of Hawks Sales Corporation.²⁰⁴

In the third case, a life insurance company, unable to locate one Patricia Butler, beneficiary under a policy, deposited the \$75,000 in proceeds with the county clerk.²⁰⁵ Mickey June Jones, impersonating Patricia Butler, employed a small law firm to represent her.²⁰⁶ A trial court ruled that Patricia Butler was entitled to the \$75,000, less poundage, or a balance of \$73,254.31, and ordered the county clerk to issue a voucher to Patricia Butler and deliver it to her lawyer.²⁰⁷ The next day, one of the lawyers accompanied "Patricia Butler" to the North Side State Bank (NSSB) which honored the voucher and issued a cashier's check to Patricia Butler.²⁰⁸ The bank did not require Patricia Butler to produce

197. *Intelogic Trace Texcom Group, Inc. v. Merchants Nat'l Bank*, 626 N.E.2d 839 (Ind. Ct. App. 1993).

198. *Id.* at 841.

199. *Id.*

200. *Id.*

201. *Id.* at 841-42.

202. *Id.*

203. *Id.* at 847.

204. *Id.* at 845.

205. *North Side State Bank v. Board of County Commissioners*, 23 U.C.C. Rep. Serv. 2d 800, 801 (Okla. 1994).

206. *Id.*

207. *Id.* at 801-02.

208. *Id.* at 802.

identification. Her lawyer represented that his client was Patricia Butler and that he had documentation to that effect, and he indorsed the voucher as a guarantor.²⁰⁹ "Patricia Butler" mis-indorsed the check as "*Patrica* Butler," and North Side State Bank cashed it. The bank, upon discovery of the impersonation, sued the Board of County Commissioners. The trial court granted summary judgment in favor of the Board,²¹⁰ and the Supreme Court of Oklahoma affirmed, holding that the impostor doctrine did not apply in this case.²¹¹

The scenario in which the voucher came into existence and reached the lawyer's hands *clearly does not* bring the case under the impostor rubric. It was issued in the *regular course of* courthouse business. No impostor here fraudulently induced the Court Clerk to issue and hand over a voucher to the *wrong person*. Neither can we view the earlier false in-court self-identification of the client as Patricia Butler to create an impostor scenario in the UCC sense of the term. The court's order *directed payment to a correctly named beneficiary*—also identified as a defendant in the case-by voucher to be issued and delivered to her counsel of record—an officer of the court.

NSSB [the bank] *cash[ed] the critical voucher upon a forged endorsement*. Because the impostor rule is not invocable, the endorsement by the client—a forgery—could not be effective to pass title to a holder in due course. The client's position vis-a-vis the bank was that of a *stranger* who sought to cash a check. *Before giving value and issuing its cashier's check NSSB had the duty to identify her as the named payee of the depositary voucher*.

Neither can the impostor rule operate in favor of NSSB qua drawer of the cashier's check. The rule protects, *not the drawer*, but *only those* who take from a drawer, as issuer of the item, in circumstances that call for the impostor rule's application. NSSB must hence bear the loss from the forged endorsements on both the *court fund voucher* and on its own *cashier's check*.

We hold that NSSB cannot invoke in this case the impostor rule against the Board. NSSB's acquaintance with the lawyer did not relieve that bank from its duty to secure a valid endorsement from the voucher's named payee. NSSB should have verified the payee's identity rather than rely on the representations of the purported payee's lawyer.²¹²

With all due respect to the court, this confidence woman, "by use of the mails or otherwise," impersonated Patricia Butler. In doing so, she fooled everyone who dealt with her. The holding on the impostor rule is

209. *Id.*

210. *Id.* at 803.

211. *Id.* at 809.

212. *Id.*

just obviously wrong.²¹³ It is interesting to note that five of the justices concurred in the opinion while four others concurred in the result, whatever it was.²¹⁴ This case deserves considerable criticism.

B. *Crook Expressly or Impliedly Represents that He Is an Agent for Another*

It was relatively clear under Old section 3-405 that the word “‘impostor’ refers to impersonation, and does not extend to a false representation that the party is the authorized agent of the payee. The . . . drawer who takes the precaution of making the instrument payable to the principal is entitled to have his indorsement.”²¹⁵

This statement seems perfectly clear in a factual vacuum, but becomes muddled when applied to a common case. For example, a husband applies for a loan by mail and forges his wife’s signature on the promissory note and mortgage or security agreement to secure the loan. If afterwards the loan officer is examined concerning the loan approval and closing, he will probably say “I thought the husband was mailing the papers on behalf of the other spouse, and I never considered the possibility of forgery.” There may not be an express representation of agency, but the agency factor is certainly implied. Is there an “impersonation” under Old section 3-405? A review of decisions on the subject indicates different perspectives.

In a recent case, a couple (apparently from Ohio) were in Massachusetts when the husband wrote an Ohio bank to arrange for a loan.²¹⁶ The couple were longtime customers of the Ohio bank, and the loan officer knew them personally.²¹⁷ The husband forged his wife’s name on the loan application papers and on the promissory note, and the Ohio bank issued a check payable to both.²¹⁸ The husband again forged his wife’s name when cashing the check with a Massachusetts bank.²¹⁹ The Massachusetts bank, when sued by the Ohio bank defended on the theory that the husband had impersonated the wife and under Old section 3-405 anyone could indorse the wife’s name.²²⁰ A majority of the court, after reviewing cases from New York and Florida, held that:

The only inquiry is whether Bauerband [the husband], as an impostor,

213. The author has no quarrel with the part of the decision which dealt with sovereign immunity. *See id.* at 810.

214. *Id.*

215. U.C.C. § 3-405 cmt. 2 (1989).

216. *Minster State Bank v. Baybank Middlesex*, 611 N.E.2d 200, 200 (Mass. 1993).

217. *Id.*

218. *Id.*

219. *Id.*

220. *Id.*

by the use of the mails or otherwise induced Minster [the Ohio bank] to issue the check to him in the name of the payees. By his conduct in signing the wife's name to the promissory note and submitting it to Minster, he was holding himself out as Michelle Bauerband [his wife] in writing. In acknowledging that she will pay the note and that she had received a copy of it, Bauerband was purporting to be Michelle when he forged her name and sent the note to Minster. He was impersonating her, not in the literal "in person" sense, but "by use of the mails or otherwise," as stated in § 3-405 (1)(a). In signing Michelle's name to the note, Bauerband implicitly was indicating that he was Michelle.²²¹

The dissenting judge was of the view that "[a] person can only impersonate another person; he cannot 'impersonate' an activity. Bauerband 'misrepresented his wife's participation. He did not 'impersonate' it, and he did not impersonate her."²²² The majority's opinion correctly noted that a divided Florida court, faced with substantially the same facts, had held that a husband who forged his wife's name was not an impersonator.²²³ The Florida court noted that the "husband did not represent . . . that he was the authorized agent for his wife."²²⁴ In addition, the deceived issuing bank had no previous dealings with the wife and only the husband appeared at the mortgage closing.²²⁵ If anything, the facts in the Massachusetts case are stronger against the issuing bank than in the Florida case. Judge Letts's dissenting view in the Florida case focused on the dominant intent of the issuing bank to deal not only with the wife but also with the husband who was impersonating her in a calculated fraudulent scheme as the basis for estoppel against the issuing bank which more clearly occasioned the loss than did the collecting bank.

Today, under Revised section 3-404(a), would the husband be implicitly representing to the naive issuing banks to be "a person authorized to act for the payee" such that his actions would fall within the broad agent-impostor rule?

In *Franklin National Bank v. Shapiro*,²²⁶ a wife allegedly arranged (through the mail) for a joint-liability home improvement loan without the knowledge of the husband, whose name was forged on the loan checks.²²⁷ The court characterized the transaction as an impersonation

221. *Id.* at 202.

222. *Id.* (O'Connor, J., dissenting).

223. *Broward Bank v. Commercial Bank*, 547 So. 2d 687, 689 (Fla. 4th DCA 1989).

224. *Id.* at 688.

225. *Id.*

226. 7 U.C.C. Rep. Serv. (Callaghan) 317 (N.Y. Sup. Ct. 1970).

227. *Id.*

case under Old section 3-405, and the loss fell on the drawer.²²⁸

The "joint payee caper" is found in elementary loan transactions as well as sophisticated commercial affairs. For example, a couple lent a well-known real estate broker money for an investment that proved profitable to all concerned.²²⁹ The broker proposed another investment to be financed by the husband and wife, and presented them with a promissory note allegedly signed by both the broker and her husband.²³⁰ The broker directed the wife/lender (her husband was absent) to issue a check jointly to the broker and her husband, and after the broker's unexpected death it was revealed that she forged her husband's signature on both the promissory note and check.²³¹ The husband and wife sued the broker's estate and the drawee bank. The trial court found that the couple intended both the broker and her husband to receive the proceeds of the check, and that they were entitled under Old section 3-116(b) to the genuine signatures of both the broker and her husband to be on it.²³² The appellate court affirmed, finding the drawee bank liable, but making no mention of the impersonation doctrine.²³³

Old section 3-405 has been put to some strange uses. In one case, a husband and his relative applied for a business loan.²³⁴ Both signed a promissory note and the husband forged his wife's signature on both the note and the resulting cashier's check.²³⁵ The wife never knew about the loan until default, when the lender sued the husband, his wife, the relative, and the depository bank on its alleged breach of warranty on the wife's signature.²³⁶ The court held that the lender-bank never intended that the wife have any interest in the check's proceeds, and hence there was no actionable forgery, nor any breach of warranty.²³⁷

If a lender intends the proceeds of a loan to go to a husband, but prepares a promissory note in the name of husband and wife jointly, and a check is issued to them jointly, where the husband forges his wife's name, the lender may not be able to recover from the drawee bank because of this intent. If Old section 3-405 applies, the forged signature of the wife on the check was effective for she was not intended to have any interest in the check proceeds, and even if she is deemed to have some minimal interest, the case may be covered not by the UCC but by

228. *Id.*

229. *Perley v. Glastonbury Bank & Trust Co.*, 368 A.2d 149, 150 (Conn. 1976).

230. *Id.* at 150.

231. *Id.* at 151.

232. *Id.* at 151.

233. *Id.* at 155.

234. *American Nat'l Bank v. Seidel*, 622 S.W.2d 19 (Mo. Ct. App. 1981).

235. *Id.* at 20.

236. *Id.*

237. *Id.* at 21.

pre-Code cases. In all of these situations, the lender has no recourse against the drawee bank.²³⁸

The impersonation rule and the joint payee rule commonly apply in the "blue collar" purchases of trucks and cars, where a member of a credit union, a bank patron, or a customer of an automobile financing company presents to a lender an allegedly agreed-to purchase contract between the borrower and an auto dealer whose indorsement has been forged. The lender issues a jointly payable check and delivers the check to the borrower who forges the dealer's name. When the check is eventually paid and the lender brings suit against the drawee bank, the bank invokes the protection of the impostor rule under Old section 3-405.

An Alabama appellate court took a very sophisticated approach to this question. The court first noted that comment 2 to Old section 3-405 considered "impostor" to mean impersonation and not false representation of agency that the party is the authorized agent of the payee.²³⁹ The court went on to state that there was no evidence that the drawer dealt with the crook as an impersonator of the dealer or that he represented himself as the dealer's agent.²⁴⁰ The court rejected the bank's view that the crook, in supplying the forged contract allegedly signed by the dealer, represented that he was a purchaser and, by forging the dealer's signature, became an impersonator.²⁴¹ The court stated:

In this case Mathis [the crook] merely misrepresented to the drawer that he was purchasing an automobile and secured a loan through such misrepresentation. He strengthened his misrepresentation by a forged purchase order but he never led the drawer to believe that he had any authority to negotiate the check on behalf of Pierson [the dealer], and the drawer never intended that Mathis should do so. Had there been no forged purchase order and the drawer had issued its check upon oral representation alone of Mathis, there could be little argument that the drawer would be entitled to the endorsement of Pierson. Thus, as we see it, this is not a case for the application of the "impostor rule" but is a matter of misrepresentation implemented by forgery of the purchase order. There was no intent, fictional or otherwise, by the drawer that Mathis should supply the endorsement of Pierson Chevrolet, Inc. The drawer was entitled to such endorsement and the responsibility was upon the collecting bank . . . to exercise reasonable commercial standards in accepting it for payment.²⁴²

A delightful double impostor scheme was displayed in a Texas

238. See generally *Gordon v. State Street Bank & Trust Co.*, 280 N.E.2d 152 (Mass. 1972).

239. *East Gadsden Bank v. First City Nat'l Bank*, 281 So. 2d 431, 433 (Ala. Civ. App. 1973).

240. *Id.* at 433-34.

241. *Id.* at 434.

242. *Id.*

case, where a prospective purchaser of a "front loader" applied for a purchase money loan.²⁴³ The lender inspected the machine and approved the loan conditioned on obtaining a note with the signatures of both the purchaser and a guarantor.²⁴⁴ The purchaser/debtor delivered the note and directed the lender to prepare a draft payable to the sellers. Shortly thereafter, a man representing himself to be "J. L. Williams" appeared at the lender's office and tendered a bill of sale allegedly signed by the two sellers. "Without requiring any identification, Southwestern [the lender] accepted the bill of sale and delivered the draft to the supposed J. L. Williams."²⁴⁵ Still later, the *debtor* presented the draft, supposedly indorsed by the two sellers, and deposited the draft in his account without the depository bank requiring any indorsement of him.²⁴⁶ The draft was paid by a cashier's check to the depository which issued a cashier's check to the debtor. The debtor made three payments and then defaulted.²⁴⁷ The "front loader" was a stolen machine, and no trace of the sellers was found. The lender sued the debtor, guarantor, and two other parties. The court held that "J. L. Williams" was both an impostor and also an impostor of J. L. Williams; "an impostor may impersonate a fictitious person."²⁴⁸

It is interesting to note that no one ever questioned how the debtor, who was to use the check to pay for the machine, ended up with possession of the check after the "sellers" allegedly indorsed it. This magical progression should have excited the suspicion of someone.

When a crook applies for a purchase money car loan, supplies a phony sales contract allegedly signed by the dealer, and is issued a cashier's check in the joint names of "buyer" and "dealer," this is not an impersonation case. The word impersonation "does not extend to a false representation that a party is the authorized agent of the payee,"²⁴⁹ and when the issuer makes the check payable to the dealer he is entitled to a genuine indorsement of that dealer.

Assume a man applies for a loan to purchase a car from his father-in-law, the issuing bank issues the check in the name of the debtor and the father-in-law, and the debtor then forges the father-in-law's signature on the check.²⁵⁰ This might not qualify as an impostor case because the

243. *Fair Park Nat'l Bank v. Southwestern Inv. Co.*, 541 S.W.2d 266, 267 (Tex. Civ. App. 1976).

244. *Id.* at 268.

245. *Id.*

246. *Id.*

247. *Id.*

248. *Id.* at 269.

249. *Valley Bank & Trust Co. v. Zions First Nat'l Bank*, 656 P.2d 425, 427 (Utah 1982).

250. *See Franklin Nat'l Bank v. Chase Manhattan Bank*, 328 N.Y.S.2d 25 (N.Y. Sup. Ct. 1972). *Accord Bank & Trust Co. v. Federal Reserve Bank*, 454 F. Supp. 488 (W.D. Okla. 1977).

debtor did not impersonate the father-in-law, and may not qualify as a fictitious payee case because the bank ascertained that the father-in-law existed, and it intended that he receive the loan proceeds. Under this view, the depositary bank would be liable to the lending bank.²⁵¹

Under Old section 3-405, it was well established that if an individual impersonated the agent of another, the impersonating agent would not have the power to indorse the principal's name.²⁵² Revised section 3-404 changed this rule, but how will the revised law treat the case of an embezzling actual agent? For example, the general manager of a car dealership had actual authority to transfer sales and leasing contracts to a bank that would issue cashier's checks in payment to the dealership.²⁵³ The manager devised a scheme of assigning fictitious sales and leasing agreements to the bank, and depositing the cashiers' checks in a local bank account.²⁵⁴ While he initially made payments on the fictitious contracts to delay the day of reckoning, eventually his activities were discovered.²⁵⁵ The court found the dealer was an agent of the payee, not an agent of the drawer, and therefore the fictitious payee rule under the old Code was inapplicable.²⁵⁶ On the same facts today, if a court found the dealer's conduct amounted to impersonation, a court might pin the loss on the depositary bank due to breach of warranty. Perhaps neither the drawer bank nor the depositary bank would be guilty of any actual negligence in the issuance and payment of the checks. Should the rule be any different when the drawer is not a bank but a finance company suing its drawee bank which has cross-claimed against the depositary bank?

The impersonation scenario can be very byzantine. For example, a "Dan Palmer," purporting to be an agent for Monarch Investment Company of Colorado, sold Mr. Neibauer a stolen backhoe for \$6,500.²⁵⁷ Palmer took Neibauer's personal check payable to Monarch to the drawee bank and exchanged it for a cashier's check payable to Monarch Investment.²⁵⁸ Palmer then took the cashier's check to Monarch Coin Corporation in Salt Lake City, Utah, and he asked to exchange it for \$6,500 in gold coins.²⁵⁹ A Monarch Coin employee telephoned an employee at the issuing bank, who inquired if the check was being used to purchase the backhoe. The Monarch Coin employee testified that she

251. *Franklin Nat'l Bank*, 328 N.Y.S.2d at 27.

252. *Thornton & Co. v. Gwinnett Bank & Trust Co.*, 260 S.E.2d 765 (Ga. Ct. App. 1979); *Seattle-First Nat'l Bank v. Pacific Nat'l Bank*, 587 P.2d 617 (Wash. Ct. App. 1978).

253. *Seattle-First Nat'l Bank*, 587 P.2d at 621.

254. *Id.* at 621-22.

255. *Id.* at 621.

256. *Id.* at 624.

257. *Valley Bank v. Monarch Inv. Co.*, 800 P.2d 634, 635 (Idaho 1990).

258. *Id.* at 634-36.

259. *Id.* at 636.

told the bank she was calling from "a coin company and I am calling on that,"²⁶⁰ but ultimately exchanged the check for the coins. Meanwhile, the backhoe was delivered without a bill of sale.²⁶¹ Neibauer directed the bank to stop payment, and the backhoe was returned to the true owner.

The court held that Dan Palmer impersonated that he was an agent for Monarch, not Monarch itself, and therefore, the drawee bank was not entitled to deduct the amount of that check from Neibauer's account.²⁶² However, the drawee bank which exchanged Neibauer's personal check for a cashier's check was liable to the Monarch Coin Company, a holder in due course.²⁶³

The opinion in *Monarch Investment* begins: "This is a tale of two checks."²⁶⁴ The court could have stated: "This is a tale of two checks that ends with the irony that the careless purchaser of stolen equipment puts the risk of loss on a naive bank." The purchaser of the backhoe was fooled by a con man, but does not suffer loss because the con man impersonated that he was an agent of a company rather than a person. A quirk in the law saved the victim of a scam, and placed the loss on a naive bank.

What would happen today? Under Revised section 3-404, "Dan Palmer" could impersonate an agent of the payee, Monarch Investment, and effectively indorse for the company. The result would be total loss to the purchaser with no loss to the bank.

In a recent case from New York, a con man induced an investor to draw checks totalling \$650,000.00, payable to a fictitious entity as part of a "Ponzi" scheme.²⁶⁵ The defrauded drawer sued three banks which asserted that the con man was an agent of the drawer under Old section 3-405. The court denied summary judgment to the banks because of outstanding factual questions.²⁶⁶ Had Revised section 3-404 been in effect, the issue would have been: did the con man represent that he was authorized to act on behalf of an impersonator under subsection (a)?

The case of *Thompson Maple Products, Inc. v. Citizens National Bank*²⁶⁷ illustrates a case that was correctly decided on one theory, and that could be correctly and similarly decided on a new theory of the law.

Thompson made bowling pin blanks from maple logs, brought to

260. *Id.*

261. *Id.*

262. *Id.* at 638.

263. *Id.* at 639-40.

264. *Id.* at 635.

265. *Morrow v. Apple Bank for Savings*, 599 N.Y.S.2d 31 (N.Y. App. Div. 1993).

266. *Id.* at 33.

267. 234 A.2d 32 (Pa. Super. Ct. 1967).

its mill by log haulers.²⁶⁸ One of these haulers, a "trusted friend" of the Thompson family, obtained blank "scaling slip" forms from employees of Thompson, recorded fictitious deliveries to the mill on behalf of local log owners and submitted the signed "scaling slips" to the Thompson bookkeeper.²⁶⁹ Checks made out to the alleged log owners were then wrongfully cashed or deposited by the hauler who fraudulently obtained over \$100,000.²⁷⁰ When the drawer sued the drawee bank for wrongfully paying checks with forged indorsements, the trial court found that the drawer company was negligent in providing "scaling slips" to its "trusted friend."²⁷¹ The appellate court affirmed the judgment for the bank on the same grounds, but seemed to compare the hauler to an agent for the *drawer* under Old section 3-405(1)(c), who caused the loss to fall upon the employer.²⁷²

In deciding the *Thompson* case today, a court could say that where the hauler impersonated that he was "authorized to act" for the log owners, he would have the power under Revised section 3-404(a) to effectively indorse their names, with the loss of the forgery again falling upon the drawer. One major advantage of the new law is that it should not require the expense of a full-blown trial to arrive at the same result.

268. *Id.* at 33.

269. *Id.*

270. *Id.* at 32.

271. *Id.* at 33-34.

272. *Id.* at 36.

IV. THE NEW ENTRUSTMENT DOCTRINE

Diagram A

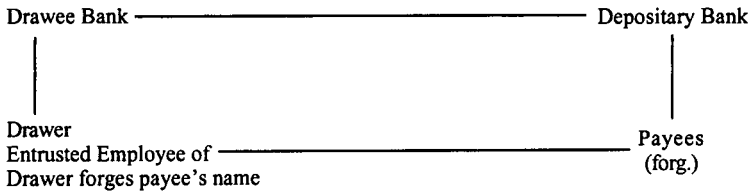
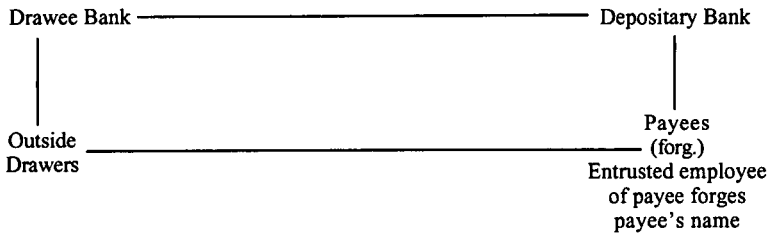


Diagram B



As represented by the above two diagrams, where an employee forges the names of payees on checks that her employer signed as drawer (Diagram A), or she forges her employer's name as payee of checks received (Diagram B), either forgery was historically treated the same; the loss falls on the drawee and depository banks unless the employer's negligence in the hiring and/or supervision process substantially contributed to the loss under Old section 3-406. In addition, negligence in detecting and reporting the losses might bar an employer under the time limitations provisions of Old section 4-406. In both foregoing cases, if the employee was careful to open accounts in the names of the payees in the depository banks, it was unlikely that both the depository and drawee banks would be able to prevent the fraud, thereby imposing risk and liability without wrongdoing.

The drafters of Revised article 3 have tried to level the playing field by initially placing the loss on the entrusting employer, who may be able to pass on some or all of the loss to banks that fail to exercise ordinary care and substantially contribute to the loss.

Under Revised section 3-405, an employer bears the loss in both of

the above diagrams if she entrusts her employee with "responsibility" for any one or more of the following processes:

- (i) to sign or indorse instruments on behalf of the employer,
- (ii) to process instruments received by the employer for book-keeping 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,
- (vi) to act otherwise with respect to instruments in a responsible capacity.²⁷³

The seemingly awesome, all-encompassing breadth of number six is immediately curtailed by language stating that "'[r]esponsibility' does not include authority that merely allows 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."²⁷⁴

To summarize, any employee entrusted with any of the six "functions" listed above has the power both to indorse her employer's name as payee of incoming checks and to sign the names of payees on outgoing checks. To mitigate the opportunities of the employee to steal, it would seem advisable for the employer to use an outside accounting firm to handle bookkeeping duties. Unfortunately, Revised section 3-405(a)(1) defines the word "employee" as including "an independent contractor and employee of an independent contractor retained by the employer."²⁷⁵ Of course, such an employer would have a cause of action against the accounting firm in the event of loss.

Where using an outside accounting firm would not be feasible, the author's students usually suggest the purchase of a surety bond to cover defalcations by the employee. A potential \$100,000 deductible, combined with a costly premium, hardly makes surety bonds a panacea.²⁷⁶

Corporations that directly pay the credit card bills (or other bills) of their employees should take note of a recent case.²⁷⁷ A New York corporation maintained a bank account at Chemical Bank for the payment

273. U.C.C. § 3-405(a)(3) (1990).

274. *Id.*

275. U.C.C. § 3-405(a)(1) (1990).

276. The drafters of Revised section 3-405, comment 1 agree with the students. U.C.C. § 3-405 cmt. 1 (1990).

277. *Gino's of Capri, Inc., v. Chemical Bank*, 592 N.Y.S.2d 682 (N.Y. Sup. Ct. App. Div. 1993).

of employees' withholding taxes. The corporation's independent accountant wrongfully used checks appropriately signed for deposit in the tax account and totalling \$317,932.81 to pay his credit card bills at Chem Credit Services and Chemical Bank Delaware, affiliates of Chemical Bank.²⁷⁸ Chemical Bank applied the checks to the accountant's personal credit card debts, and when the fraud was discovered, the corporation sued Chemical Bank.²⁷⁹ The court held in accord with prior authority that Chemical Bank was a holder in due course of the checks, being without notice of the accountant's use of another's checks to pay his own bills.²⁸⁰ The court noted that Chemical Bank, rather than its affiliated companies, was named payee, but found this to be common practice when drawers leave off parts of an official name, such as "Co." or "Inc."²⁸¹

How could this case be approached today under Revised article 3? The terse facts of this case indicate the accountant would meet the definition of an "employee" (independent contractor) "entrusted" with the preparation of the withholding checks, giving dishonest accountant (or his accomplice) the power to indorse checks and to place the loss upon the corporation. The result should be the same.

This fraud could easily have been prevented if the check signer clearly typed or wrote the purpose of the various checks before delivery to the accountant for mailing. Better yet, by giving the accountant the check preparation function but requiring a corporate official to double-check the purpose of the checks (and make notation on them) before mailing, the company would be better protected. Of course, no precautions protect an employer where all the employees conspire to steal together.

A variation of the situation where an employer pays employee debts with company checks was presented in another New York case.²⁸² A company manager issued company checks payable to his personal creditors, but bearing creative variations of their names, such as "Metropolitan Oprtg. Co.," for Metropolitan Opera Association, Inc. and "Ame-rex Corp.," for American Express Company.²⁸³ Checks totalling \$162,538.65 were embezzled in this manner.²⁸⁴ The employer corporation sued the various payees, but the court held that where it is common

278. *Id.*

279. *Id.*

280. *Id.* at 683.

281. *Id.*

282. *Hartford Accident & Indem. Co. v. American Express Co.*, 518 N.Y.S.2d 93 (N.Y. Sup. Ct. 1987).

283. *Id.* at 95.

284. *Id.*

for employers to pay their employees' debts with corporate checks, the payees were holders in due course in spite of the minor errors in their names.²⁸⁵ The court reasoned that these creditors had no knowledge that the signer of the checks was improperly using his employers' funds to pay his past debts, but seemed to suggest that if the employee was using his employer's checks to pay simultaneously for present value, the payee might well have sufficient notice of a defalcation.²⁸⁶

A better system for employers who are paying employee business expenses is to issue reimbursement checks clearly identifying the nature of the payment. This procedure might curtail the foregoing practices and satisfy the Internal Revenue Service in the process.

In *State v. Barclays Bank*,²⁸⁷ a business employed an independent accountant to prepare state income tax returns, and gave him checks to pay the respective taxes.²⁸⁸ The accountant forged the indorsement of the State, and deposited the checks in his own account.²⁸⁹ When they were eventually paid, the taxing authorities sued the depository and drawee banks for honoring the checks.²⁹⁰ The court held that absent the property interest that would accompany delivery of the checks, the State had no cause of action.²⁹¹ This holding is followed in Revised section 3-420(a) which states that an action for conversion may not be brought by a payee "who did not receive delivery of the instrument either directly or through delivery to an agent or a copayee."²⁹² Why the State sought recovery from the depository and drawee banks, rather than the drawer, is a mystery.

Under Revised article 3, *Barclays Bank* would not be a fictitious payee case because the intent of the check signer, not the dishonest accountant, would determine its nature.²⁹³ On the other hand, since the accountant was an independent contractor, he might well come within the entrustment doctrine of Revised section 3-405, and would have the power to embezzle these funds.

There are two "attorney-defalcating" cases that deserve attention. In a case from Missouri, Mrs. Bagby retained an attorney "for the primary purpose of obtaining an appointment of guardianship for her two minor children so that certain shares of Sears, Roebuck stock could be

285. *Id.* at 96-97.

286. *Id.* at 97.

287. 563 N.E.2d 11 (N.Y. 1990).

288. *Id.* at 12.

289. *Id.*

290. *Id.*

291. *Id.* at 15.

292. U.C.C. § 3-420(a) (1990).

293. U.C.C. § 3-110(a) (1990).

issued to them . . . ,”²⁹⁴ from their father’s probate estate.²⁹⁵ Merrill Lynch, at the attorney’s unauthorized direction, opened an account in Mrs. Bagby’s name, without ever seeing her.²⁹⁶ The stock was delivered to Merrill Lynch; the attorney obtained a court order authorizing its sale.²⁹⁷ The checks issued to Mrs. Bagby by Merrill Lynch were mailed to the attorney, who forged Mrs. Bagby’s name and absconded with the proceeds.²⁹⁸ Mrs. Bagby sued Merrill Lynch, which sued the drawee bank for conversion, which, in turn, sued the collecting banks for indemnification based upon their indorsement warranties.²⁹⁹ The court held that Merrill Lynch (which had settled with Mrs. Bagby) could recover against the drawee bank because, although Merrill Lynch had breached the New York Stock Exchange rule about knowing your customer, its issuance and delivery of the checks to Mrs. Bagby’s attorney did not substantially contribute to the forgery.³⁰⁰ The drawee could, in turn, recover from the collecting banks.³⁰¹

In the second case,³⁰² the holder of three life insurance checks totaling \$135,000, the proceeds of her deceased husband’s life insurance policies, alleged that “[o]ne Emanuel Pavsner, who at that time served as plaintiff’s attorney, was authorized to deposit the checks in a bank account bearing her name. Instead of doing so, Pavsner forged [the widow’s] indorsement on the instruments and deposited them in his personal account maintained at defendant Chemical Bank.”³⁰³

The attorney absconded with the proceeds, and the widow brought suit against the depositary bank. The court held that she could waive a time barred conversion action and still sue the bank under quasi contract principals.³⁰⁴

In both of these cases, clients initially cheated by their attorneys had recourse against other solvent parties. Could these widows today be forced to bear the loss? In both cases, the attorneys, as independent contractors, deposited checks (*Hechter*) and handled stock and stock proceeds (*Bagby*). It could be argued today that under the entrustment doctrine of Revised section 3-405, the loss should fall on the clients

294. *Bagby v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 491 F.2d 192, 195 (8th Cir. 1974).

295. *Id.* at 194.

296. *Id.* at 195.

297. *Id.*

298. *Id.*

299. *Id.* at 194.

300. *Id.* at 197.

301. *Id.* at 199.

302. *Hechter v. New York Life Ins. Co.*, 385 N.E.2d 551 (N.Y. 1978).

303. *Id.* at 552.

304. *Id.* at 553.

rather than banks which have little, if any, opportunity to prevent this kind of fraud.

The facts of a New York case today could fit neatly under the fictitious payee doctrine, as well as under the "new" entrustment doctrine.³⁰⁵ An employee of the New York City Board of Higher Education had the "duty to prepare requisitions for checks to be issued . . . for scholarships and other payments to students, to prepare the checks, to have them signed by authorized personnel, and to send the checks to their recipients."³⁰⁶ Sometimes she retained possession of the checks, and soon forged their indorsements and cashed them at the drawee bank. Depositions of bank employees revealed that the woman would often cash a number of checks with different payee names, and the bank never inquired as to her authority.³⁰⁷ The bank's tellers knew that she was not the payee on these checks, and that she was an employee of the drawer. The court held that the gross negligence and bad faith of the drawee, if proved at trial, would affect the bank's liability.³⁰⁸ Cases like this one were surely considered by the draftsmen of Revised article 3.

The adoption of the entrustment rule, along with Revised section 3-420 (which eliminates the language of Old section 3-419(3)), should signal the partial demise of *Cooper v. Union Bank*,³⁰⁹ a case that has engendered so much critical comment.

In *Cooper*, an attorney employed a former client as his secretary-bookkeeper, despite a gambling addiction.³¹⁰ The employee forged indorsements on twenty-nine incoming checks payable to either the lawyer or his clients, cashed or deposited the checks, and embezzled the proceeds.³¹¹ Upon discovering the scheme, the attorney sued the drawee-payor banks and the collecting banks.³¹²

The California Supreme Court held that when the drawee-payor bank paid these checks it was not paying the identifiable check proceeds, but it was paying its own funds.³¹³ When the attorney-payee sued the collecting banks, he ratified the collection of the proceeds from the drawee-payor bank to the collecting banks, and when the collecting banks previously paid the forger, they were paying their own funds, not

305. Board of Higher Education v. Bankers Trust. Co., 383 N.Y.S.2d 508 (N.Y. Sup. Ct. 1976).

306. *Id.* at 510.

307. *Id.* at 511.

308. *Id.*

309. 507 P.2d 609 (Cal. 1973).

310. *Id.* at 618.

311. *Id.* at 612.

312. *Id.*

313. *Id.* at 615.

the proceeds of the checks.³¹⁴ Using this “off-again-on-again” proceeds approach, the court bypassed the Old section 3-419(3) obstacle and placed liability on the collecting banks.³¹⁵

If *Cooper* were considered under Revised article 3, the rationale would be much simpler. The employee would appear to be an “entrusted” person under section 3-405, with the power to indorse checks made payable to her employer. Any discussion of proceeds would be totally eliminated, and the loss would fall on the employer, except where a failure by the payor or collecting banks to exercise ordinary care substantially contributed to the loss.

But one nagging problem would remain: how do we handle those checks that were made payable to the clients by third persons—the so-called “incoming” checks? Those checks cannot (in most cases) be treated as fictitious payee checks, nor are they expressly covered by the entrustment rule. The “negligence” sections of 3-406 and 4-406 would be applicable, and the California courts could still use the proceeds rule, if it was still in force.

V. WRONGFUL COLLECTION OF JOINT PAYEE (OR JOINT SPECIAL INDORSEE) CHECKS

Old section 3-116 of the UCC provided, in a backhanded manner, that an instrument payable to the order of two or more persons “if not in the alternative is payable to all of them,” and may not be discharged except by all of them.³¹⁶ The Official Comment to section 3-116 described the different wording in alternative and joint payees.³¹⁷ It seems clear under the comment that a check made payable to “John Smith and Henry Jones” would be payable to joint payees. But how about a check made payable to “John Smith/Henry Jones?” The last paragraph of the comment suggests an instrument made payable to A and/or B, is payable in the alternative to A, or to B, or to A and B together.³¹⁸ The comment does not address the common format “payable to A/B.”

314. *Id.* at 619.

315. *Id.* at 619-20.

316.

3-116. Instruments Payable to Two or More Persons An instrument payable to the order of two or more persons

(a) if in the alternative is payable to any one of them and may be negotiated, discharged or enforced by any of them who has possession of it;

(b) if not in the alternative is payable to all of them and may be negotiated, discharged or enforced only by all of them.

U.C.C. § 3-116 (1989).

317. U.C.C. § 3-116 cmt. (1989).

318. *Id.*

The virgule, or "slash" (/), is found in some modern dictionaries to mean the word "or."³¹⁹ If the volume of recent case law is any indication, this definition of the virgule is not widely known among laymen. For example, in a recent case a con man induced the payee of a cashier's check to specially indorse it to "Fidelity/JHL & Associates," and signed for JHL & Associates exclusively.³²⁰ The payee testified that she intended that both special indorsees would have to indorse,³²¹ but the court properly held that the indorsement was in the alternative, and that the depository bank was not liable for conversion.³²²

Other courts have decided similarly:

The virgule is normally used to separate alternatives. Thus, a bank exercising reasonable care and acting in good faith would necessarily interpret a check drawn to two payees whose names are separated by a virgule as being drawn payable to the payees in the alternative Such a check is functionally identical to one drawn payable to two payees in the manner "A or B".³²³

It is common for drawers to issue checks made payable to two or more "joint" payees. For example, insurance companies issue settlement checks made jointly payable to a plaintiff and his lawyer, banks issue checks jointly to building contractors and their suppliers, and insurance companies issue checks to insureds and their secured lenders. These transactions anticipate that two (or more) joint payees will indorse, and each party will receive its respective share of the proceeds. Too often, however, a joint payee forges his copayee's name or simply cashes the check in the absence of the copayee's indorsement. What are the rights and liabilities of the various parties in the check collection chain?

A recent Massachusetts case provides a partial answer. In *GMAC v. Abington Casualty Insurance Co.*,³²⁴ an insurance company issued a settlement check jointly to the insured and to GMAC, the secured lender. The check was delivered to the insured, who promptly cashed it

319. See AMERICAN HERITAGE DICTIONARY 759 (2d College Ed. 1983). But see FUNK & WAGNALLS STANDARD COLLEGE DICTIONARY 1497 (1974 ed.) (defining the virgule as indicating "two alternatives, as in *and/or*, . . .).

320. *Mumma v. Ranier Nat'l Bank*, 808 P.2d 767, 767 (Wash. Ct. App. 1991).

321. *Id.*

322. *Id.* at 769.

323. *Dynalectron Corp. v. Union First Nat'l Bank*, 488 F. Supp. 868, 869 (D.D.C. 1980). See also *Ryland Group, Inc. v. Gwinnett County Bank*, 258 S.E.2d 152, 153 (Ga. Ct. App. 1979); *Brown Strober Bldg. Supply Corp. v. Living House, Inc.*, 433 N.Y.S.2d 724 (N.Y. Dist. Ct. 1980); *Miron Rapid Mix Concrete Corp. v. Bank Hapoalim*, 432 N.Y.S.2d 776, 778 (N.Y. Sup. Ct. 1980).

324. 602 N.E.2d 1085 (Mass. 1992).

without the indorsement of GMAC.³²⁵ GMAC received none of the proceeds, and sued the insurance company, rather than the insured or the drawee bank.³²⁶ The court held, under prevailing case law, that delivery of a joint payee check to one of the payees constitutes delivery to the other.³²⁷ Under Old sections 3-116 and 3-603, however, such a negotiable instrument could not be discharged by the actions of only one payee, and where the underlying obligation for which the check was issued was not discharged, GMAC could sue on that obligation.³²⁸ Finally, the court held that under Old section 3-804, GMAC could sue as the owner of a lost instrument.³²⁹

The court regretfully recognized that its decision could result in circuitous litigation; if GMAC prevailed, the insurance company would be forced to bring a conversion action against the drawee bank for paying a check missing an indorsement.³³⁰ The court suggested that GMAC should have sued the drawee bank directly, as the true owner under Old section 3-419.³³¹ When the facts of *GMAC* inevitably arise again, the result on the issue of dual delivery should be the same under Revised section 3-420.

What happens if both the depository and drawee banks overlook the absence of an indorsement by one of two joint payees? Can the drawee return the check to the depository bank after paying it? These facts occurred in a Texas case where the payees were "Engineered Metal Works and E.G. Smith Construction."³³² Engineered Metal Works indorsed the check and deposited it in the depository bank, which presented the check to the drawee bank.³³³ The drawee bank paid the check, and it returned it with the drawer's monthly statement.³³⁴ When the drawer complained about the missing indorsement, the drawee attempted to return the check to the depository bank by a "late return" letter.³³⁵ The letter was refused and the drawee sued for breach of warranty. The court held under Old section 3-116, that the check was improperly presented without both indorsements, and that the payment

325. *Id.* at 1086.

326. *Id.*

327. *Id.* at 1087.

328. *Id.* at 1088.

329. *Id.* at 1089.

330. *Id.* With all due respect, the true cause of action would be for breach of contract under section 4-401.

331. *Id.*

332. *Longview Bank & Trust Co. v. First Nat'l Bank*, 750 S.W.2d 297, 298 (Tex. Ct. App. 1988).

333. *Id.*

334. *Id.*

335. *Id.*

by the drawee bank did not preclude it from returning the check and asserting a claim against the depositary bank under sections 4-213 and 4-302.³³⁶

Joint payees drafts from insurance companies present difficult problems when payable to husband and wife who are estranged. In one case, a couple's mobile home and furnishings were destroyed by fire.³³⁷ The husband signed the claim forms in the names of his wife and himself, even though the couple was separated.³³⁸ The insurance company issued \$16,000 worth of drafts jointly payable to husband and wife along with proof of loss forms.³³⁹ The husband cashed the drafts by forging the wife's name, and she eventually sued the insurance company.³⁴⁰ The court held that Old section 3-116 required the indorsement of both payees, that neither spouse was automatically authorized to sign for the other, and that the company was guilty of conversion under section 3-419.³⁴¹ The decision suggested the wife had standing to sue because of the delivery of the draft to the husband, but failed to address the obvious property issue: Since the husband had no actual or apparent authority to sign for his estranged wife, how did delivery to the husband give the wife a property right in the drafts?

If a check is made payable to an attorney and her client, section 3-116 would normally require joint indorsements. However, a retainer contract in a recent case gave an attorney the authority to sign for the client as joint payee provided the attorney deposited the check in a escrow account.³⁴² The attorney indorsed his client's name, but embezzled the proceeds. The court held that the lawyer "was authorized to make a general endorsement despite the condition that [the check] subsequently be deposited into an escrow account. Because the conversion . . . of the proceeds cannot be held to retroactively render an otherwise valid endorsement a forgery," the payor bank was not liable to the client.³⁴³ The attorney certainly violated a condition subsequent and undertook a forgery, however, these arguments were not raised. In addition, no UCC citations were used in the court's decision.

Some of the difficulties presented by joint payee checks were nicely illustrated in a case where a check was made payable to:

336. *Id.* at 301. In light of a recent case, *Sun Bank v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 637 So. 2d 279 (Fla. 5th DCA 1994), this "right" of chargeback after final payment seems dubious. A breach of warranty claim is more appropriate.

337. *Quintana v. Allstate Ins. Co.*, 378 N.W.2d 40 (Minn. Ct. App. 1985).

338. *Id.* at 42.

339. *Id.* at 41.

340. *Id.* at 42.

341. *Id.* at 44.

342. *Rohrbacher v. Bancohio Nat'l Bank*, 567 N.Y.S.2d 431, 432 (N.Y. App. Div. 1991).

343. *Id.* at 433.

Stockport Farm Supply [first line]
L.P.S [second line]³⁴⁴

The check was stamped with the rubber stamp indorsement "For Deposit Only, Stockport Farm Supply," and deposited in the defendant's bank.³⁴⁵ No one at the bank inquired as to what the initials "L.P.S" stood for, in spite of the fact that Stockport Farm Supply had overdrawn its account thirty-four times in the preceding year and a half.³⁴⁶

The court held that the fact that the payees were listed on two separate lines indicated that the check was made payable jointly and not in the alternative.³⁴⁷ Further, the bank did not act in a commercially reasonable fashion under Old section 3-419(3), because while the payee was ambiguous, the bank made no inquiry.³⁴⁸

When a joint payee is allowed to collect on a check without the indorsement of the other payee, a showing by the depository bank that the cashing payee also drew a check on its account payable to the other joint payee for the amount owing, is a valid defense to a conversion action by the nonsigning payee. Further, it is not necessary to trace the funds, dollar for dollar, from the check proceeds to payment to the other payee.³⁴⁹ This view is related to the case-created exception to section 3-116, that a paying bank can defend payment on a forged or omitted joint payee indorsement by showing the intended person received the check proceeds.³⁵⁰

A drawee that pays on individually indorsed joint payee checks is likewise not liable to the drawer if it can show that the drawer actually suffered no loss, or that any loss suffered would have occurred, even if the drawee bank had exercised ordinary care.³⁵¹ The drawee bank's payment on a check places the burden on the bank to show that its conduct did not cause the loss.³⁵²

Additional perils of joint payee checks are illustrated in a recent Minnesota case. An "experienced construction lender" presented five jointly payable cashier's checks to a home builder.³⁵³ The lender intended that the copayee title company would pay mechanic lien claim-

344. Van Lunen v. State Cent. Sav. Bank, 751 F. Supp. 145, 147 (S.D. Iowa 1990).

345. *Id.*

346. *Id.*

347. *Id.* at 148.

348. *Id.*

349. First Indep. Bank v. Stottlemeyer & Shoemaker Lumber Co., 384 So. 2d 952, 954 (Fla. 2d DCA 1980).

350. Sullivan v. Wilton Manors Nat'l Bank, 259 So. 2d 194, 195 (Fla. 4th DCA 1972).

351. Sanwa Business Credit Corp. v. Continental Ill. Nat'l Bank, 617 N.E.2d 253, 258 (Ill. App. Ct. 1993).

352. *Id.* at 259.

353. Lassen v. First Bank Eden Prairie, 514 N.W.2d 831, 834 (Minn. 1994).

ants for two homes, but the builder deposited the checks without the title company indorsement.³⁵⁴ When the builder defaulted on the loans, the lender foreclosed on the homes, and discovered extensive mechanics' liens on the properties.³⁵⁵ The lender sued the drawer-drawee of the checks for honoring them without the title company indorsements. The court held that the bank was not liable for conversion because the lender was not the holder of the checks,³⁵⁶ but stated the bank would be liable for payment in violation of the joint payee requirement to the extent that the lender could show it was foreseeable that the proceeds of the checks would be wrongfully applied.³⁵⁷ Further, in the absence of bad faith, the bank could not be liable for more than the face amount of the five checks.³⁵⁸

It is strange that an "experienced construction lender" delivered the checks to the builder rather than to the "deep-pockets" title company, which would have charged the lender a relatively small sum for disbursing funds as compared to the losses (proceeds of checks, attorney fees, etc.) suffered by the lender in this case.

The foregoing cases illustrate the basic flaw in the joint payee scenario; the joint payee approach encourages the very problems it seeks to solve. In theory, neither joint payee can frustrate the rights of the other. In practice, one joint payee, by forgery or by ignorant cooperation of a less than diligent bank, is able to cash the check and abscond with the proceeds. Insurance companies, for example, should deliver joint payee checks to secured lenders rather than individual insureds, who may be tempted beyond their endurance to be dishonest. Let the "deep-pocket" secured lending institution disburse the proceeds between itself and the insureds.

The joint payee problem becomes more acute when checks are issued both to financially shaky general contractors and their equally unstable subcontractors or materialmen, because the first payee in possession may perpetrate a fraud. Unfortunately, even in the legal profession there have been many instances of lawyers forging their clients' signatures on joint payee checks. Accordingly, we need to develop some secure, inexpensive system of disbursing proceeds to "joint" payees who have diverse interests and flexible morals.

354. *Id.*

355. *Id.*

356. *Id.* at 838-39.

357. *Id.* at 838.

358. *Id.* at 837.

VI. MISCELLANEOUS CHECK DEPOSITING SCAMS

In the case of *First Rome Bank v. Reese Oil Co.*,³⁵⁹ an oil company hired the wife of the executive vice president of First Rome Bank, and authorized her to open mail, post customers' accounts, fill out customers' receipts, make out deposit slips and take them to the bank, and reconcile monthly bank statements.³⁶⁰ The president of the company had, on occasion, cashed corporate checks stamped for deposit only, and the employee proceeded, without authority, to do the same.³⁶¹ When the oil company discovered the \$20,000 embezzlement loss, it sued First Rome Bank.³⁶² At trial, it was shown that First Rome's teller manual stated that checks made payable to a corporation should never be cashed; however, the bank president testified that the manual was a guideline for practices and procedures, but the preferences of the bank's customers were also an important consideration.³⁶³ The trial court granted partial summary judgment in favor of the oil company, and the appellate court reversed on the grounds that the employee had actual authority to place restrictive indorsements on checks made payable to the company.³⁶⁴ The case was remanded to decide whether it was commercially reasonable for the bank to have cashed these checks, although failing to follow its own manual was not enough, by itself, to impose legal liability upon the bank.³⁶⁵

A similar case arose in Arkansas.³⁶⁶ A lumber yard apparently authorized its bookkeeper to deposit checks at a depository bank and to accept part of these checks in cash by notating "less cash" on deposit slips.³⁶⁷ When the bookkeeper retired, his successor continued the system, embezzling \$74,897.78 over twelve years.³⁶⁸ The embezzling bookkeeper stole money from the cash drawer, and would replenish the cash with the "less cash" deductions from deposits.³⁶⁹ The trial court held the bank negligent in allowing the "less cash" deductions, but found contributory negligence, along with the estoppel and laches generated by the long delay in discovering the loss, barred the depositor's recovery.³⁷⁰ In addition, the bank had not converted the depositor's cash payments

359. 426 S.E.2d 384, 384 (Ga. Ct. App. 1992).

360. *Id.* at 384-85.

361. *Id.* at 385.

362. *Id.*

363. *Id.*

364. *Id.* at 386.

365. *Id.*

366. *J.W. Reynolds Lumber Co. v. Smackover State Bank*, 836 S.W.2d 853 (Ark. 1992).

367. *Id.* at 854.

368. *Id.* at 855.

369. *Id.*

370. *Id.* at 856-57.

based on the established practice between the parties.³⁷¹

It is submitted, with all due respect, that the court could have held (in accord with *Ed Stinn Chevrolet*³⁷²) that inasmuch as the employee did not steal the funds received, but deposited them in the cash drawer, she stole from the employer after the employer had actual possession of the cash. As a result, the "less cash" payments were not the cause of the loss; the embezzlement from the cash drawer was the cause, and should not be blamed on the bank.

In a recent California case,³⁷³ a small, closely held company, gave its bookkeeper, Mr. Yip, actual authority to deposit checks payable to the company into the company account.³⁷⁴ Yip opened two unauthorized accounts at two different banks, the first in the off-name of "Oswald's Machine Equipment Co."³⁷⁵ Three months after opening the account, he furnished the depository bank with a forged "corporate resolution" authorizing the account.³⁷⁶ Yip then opened another account in another bank in the off-name of "Oswald Equipment."³⁷⁷ He used deposit indorsement stamps to deposit checks payable to his employer in the two accounts embezzling over one million dollars.³⁷⁸ The employer, Oswald Machine and Equipment, Inc., sued both banks. The trial court granted summary judgment to both banks on the theory that Yip, being authorized to deposit his employer's checks, was authorized to deposit in the false accounts, with the loss falling on his employer.³⁷⁹ The appellate court reversed, holding that the extent of this authority was a question of fact, in light of the employer's conversion claim under Old section 3-419 (1)(c).³⁸⁰

The cited section (which protected depository banks from liability beyond the proceeds still remaining in its hands, unless the bank was not in good faith or did not act in accordance with reasonable commercial standards) has been generally repealed via Revised section 3-420(c).³⁸¹ In addition, if *Oswald Machine* was decided under Revised section 3-405, the bookkeeper would have the power to indorse the corporate name and deposit checks in accounts "in a name substantially similar to

371. *Id.* at 857.

372. 503 N.E.2d 524 (Ohio 1987).

373. *Oswald Mach. & Equip., Inc. v. Yip*, 13 Cal. Rptr. 2d 193 (Cal. Ct. App. 1992).

374. *Id.* at 194.

375. *Id.*

376. *Id.* at 195.

377. *Id.*

378. *Id.*

379. *Id.*

380. *Id.* at 196.

381. *See* U.C.C. § 3-420 cmt. 3 (1990).

the name of that person.”³⁸² Of course, subsection (b) would require a comparison of the employer’s fault in hiring and supervising a crooked employee, balanced against the bank’s negligence in opening the account and allowing deposit of the check.³⁸³

An Iowa case further illustrates the dangers in the depositing process.³⁸⁴ The dishonest manager of an auto supply store was authorized to deposit, but not draw, checks in the company account. The employer furnished a rubber stamp for indorsement that did not have the words “For Deposit Only” or other restrictive language, but merely included the name and address of the employer company.³⁸⁵ The manager personally cashed checks at the depository bank by either rubber stamp or written indorsement and, on occasion, instructed his bookkeeper to cash checks and give him the proceeds.³⁸⁶ The bank never questioned the authority of the manager, and eventually claimed holder in due course status when sued by the store.³⁸⁷ The court held that the signature stamp was, at best, ambiguous, and that the bank’s employees should have inquired about the authority of the manager to cash the checks.³⁸⁸ The decision seemed to stress that handwritten indorsements were unusual for a business and should have excited further inquiry.³⁸⁹ Further, the court held that under Old section 3-419(3), the bank’s failure to question the manager’s authority to make cash withdrawals from presented corporate checks was commercially unreasonable, rendering section 3-406 inapplicable.³⁹⁰

In this case, the very negligent owner of the business prevailed against the very negligent bank, but at what cost? The store recovered approximately \$25,000, but it had to go through a trial and an appeal to the Iowa Supreme Court. In addition, the unsuccessful bank had to pay for attorneys’ fees and court costs. This case could have been avoided if each of the parties had used a modicum of care in the conduct of their respective businesses.

In a related case, a sales manager opened an unauthorized checking account in the name of the corporation, for diverting customers’ checks.³⁹¹ His actions did not fall under the fictitious payee rule because these checks were already coming to the corporation, and the

382. U.C.C. § 3-405(c) (1990).

383. U.C.C. § 3-405(b) (1990).

384. *Waukon Auto Supply v. Farmers & Merchants Sav. Bank*, 440 N.W.2d 844 (Iowa 1989).

385. *Id.* at 845.

386. *Id.*

387. *Id.* at 846.

388. *Id.* at 849.

389. *Id.*

390. *Id.* at 850.

391. *Hydroflo Corp. v. First Nat’l Bank*, 349 N.W.2d 615, 617 (Neb. 1984).

manager had nothing to do with their origin.³⁹² While the depository bank could be liable for negligence, today the bank could invoke Revised section 3-405, if the manager had been entrusted with one or more of the processes mentioned in that section.³⁹³

One of the newest scams originated in Louisiana. A Louisiana bank, fearful that wrongdoers would be able to cash lost customer checks made payable to "cash," instructed its customers to make their checks payable to the order of the bank and then to indorse them at the bank counter.³⁹⁴ When an employee of a bank client learned of the bank's instruction, he indorsed his employer's checks (which the employer had drawn for deposit with the bank), and cashed them at the bank.³⁹⁵ The bank asserted that it was a holder in due course, but the Louisiana court held that the bank knew that the employee was not authorized to sign for his employer and was therefore liable.³⁹⁶ The court pointed out the ironical fact that it was the bank's efforts to prevent fraud that allowed this very fraud to happen.³⁹⁷

VII. COMPARATIVE FAULT

Old Sections 3-405 and 3-406 of the UCC did not provide for any concept of relative fault governing fictitious payees and impersonations. Only Old section 4-406 made a grudging acknowledgment of the concept by providing that if a customer failed to exercise timely, ordinary care in the examination of his returned checks and provide timely notice of forgeries and alterations to the drawee bank, he would be precluded from recovery unless he could establish a lack of ordinary care on the part of the bank in paying the items.³⁹⁸

This former approach has been abandoned in Revised articles 3 and 4 which introduce the concept of comparative fault. Now under sections 3-404(d), 3-405, and 4-406, the trier of fact is invited to compare the fault of the "party bearing the loss" and the "taker" or "payor" of the item,³⁹⁹ and "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."⁴⁰⁰ The concept of ordinary care for a

392. *Id.* at 620-21.

393. See U.C.C. § 3-405 (1990).

394. *South Rayne Water Corp. v. Bank of Commerce & Trust Co.*, 619 So. 2d 158, 159 (La. Ct. App. 1993).

395. *Id.*

396. *Id.* at 160.

397. *Id.*

398. U.C.C. § 4-406 (1989).

399. U.C.C. §§ 3-404(d), 4-406 (1990).

400. U.C.C. § 3-405(d) (1990).

bank is given a definition that is favorable to banks in Revised section 3-103(a)(7):

In the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general banking usage not disapproved by this Article or Article 4.⁴⁰¹

The comment to this subsection points out that this "particular rule applies primarily to Section 4-406" ⁴⁰² Comment 4 to section 4-406 points out:

The term "ordinary care" used in subsection (e) is defined in Section 3-103(a)(7), made applicable to Article 4 by Section 4-104(c), to provide that sight examination by a payor bank is not required if its procedure is reasonable and is commonly followed by other comparable banks in the area. The case law is divided on this issue. The definition of "ordinary care" in Section 3-103 rejects those authorities that hold, in effect, that failure to use sight examination is negligence as a matter of law. The effect of the definition of "ordinary care" on Section 4-406 is only to provide that in the small percentage of cases in which a customer's failure to examine its statement or returned items has led to loss under subsection (d) a bank should not have to share that loss solely because it has adopted an automated collection or payment procedure in order to deal with the great volume of items at a lower cost to all customers.⁴⁰³

There may be a latent danger in the "no duty to examine" approach if an unsophisticated court should incorrectly apply it where a customer makes a timely complaint to her drawee-payor bank about a forgery of her name as drawer on a check, and the bank denies a duty to examine the customer's signature under Revised section 3-403.

Returning to the notion of comparative fault, as the comments to Revised sections 3-404 and 3-405 stress, the drawer of a fictitious and/or impersonation check may have a cause of action against the depository bank. The text of 3-404(d) includes the person "paying the instrument or taking it for value or for collection."⁴⁰⁴ It would seem that the holding in *Stone & Webster Eng'g Corp. v. First Nat'l Bank and Trust Co.*,⁴⁰⁵ that a drawer of a check cannot sue a depository bank where the drawer's employee forges the payee's name and collects the proceeds,

401. U.C.C. § 3-103(a)(7) (1990).

402. U.C.C. § 3-103 cmt. 5 (1990).

403. U.C.C. § 4-406 cmt. 4 (1990).

404. U.C.C. § 3-404(d) (1990)

405. 184 N.E.2d 358 (Mass. 1962).

has been reversed. Now, the customer may sue the payor bank, the depository bank, and any takers or collecting banks.

Depository banks may also be liable for a lack of ordinary care in opening an account for a dishonest employee of the drawer:

Suppose in Case # 5 that the check is not payable to an obscure "Supplier Co." but rather to a well-known national corporation. In addition, the check is for a very large amount of money. Before depositing the check, Employee opens an account in Depository Bank in the name of the corporation and states to the person conducting the transaction for the bank that Employee is manager of a new office being opened by the corporation. Depository Bank opens the account without requiring Employee to produce any resolutions of the corporation's board of directors or other evidence of authorization of Employee to act for the corporation. A few days later, the check is deposited, the account is credited, and the check is presented for payment. After Depository Bank receives payment, it allows Employee to withdraw the credit by a wire transfer to an account in a bank in a foreign country. The trier of fact could find that Depository Bank did not exercise ordinary care and that the failure to exercise ordinary care contributed to the loss suffered by the Employer. The trier of fact could allow recovery by Employer from Depository Bank for all or part of the loss suffered by Employer.⁴⁰⁶

The quoted Comment presents a worst-case movie scenario with enough lack of care to alert even the most naive or lethargic bank employee, but what if we modify one or more of the facts? Most embezzlements do not involve well-known corporations as payees. Many scams involve forged corporate resolutions or other paper authorizations to open checking accounts. Wire transfers to foreign countries seem rare in check scams.

Under the facts of Comment 4, how would six jurors (or, alas, twelve jurors) agree on the percentage of fault based upon each of the stated factors? It is likely that each juror would state his percentages for each party, and then the percentage would be averaged to arrive at the abhorred quotient verdict. On a more cynical note, how will the average jury arrive at comparative fault when the victim is the neighborhood hardware store or dress shop, and the drawee is the largest bank in the community? Finally, what effect will comparative fault have on the incidence and duration of litigation? The lawyers of defrauded customers may be encouraged to sue banks, since the prospects for recovery are improved, and the banks' lawyers may use the reality of increased risk to increase billable hours in defending cases: the trial bar may be rewarded at the expense of the public.

406. U.C.C. § 3-405 cmt. 4 (1990).

VIII. OTHER VOICES—WHAT OTHER COUNTRIES ARE DOING

Every time a check is presented for payment to a drawee bank the bank must worry whether the item is properly payable.⁴⁰⁷ The fictitious payee, the impostor rule, and the new entrustment rule all give shape to the “properly payable” concept. If one were writing on a clean slate, one might ask why the drawee bank and, for that matter, the depository and collecting banks, should become embroiled over the nature of the payee’s (or payees’) signatures in the conduct of their activities. In the vast majority of bank collections, the respective banks have no way of knowing why a particular check was drawn and issued by the drawer. Was this check issued to a payee whose name was falsely supplied by an employee of the *drawer*, or was his name falsely supplied by the employee of the *payee*? Was this payee impersonated? The questions are innumerable, yet the bank will not know of a fraud until someone files a claim.

When a debtor pays her creditor in cash, she knows that if something goes wrong in the payment process (such as fraud by the creditor), the initial and perhaps the final loss will fall on the debtor, and she will take precautions to protect herself. Once the debtor elects to use a check to pay the same creditor, she enlarges the scope of responsibility and may relax precautions, knowing the risk may be passed to someone else. The law in the United States has for so long encouraged this risk spreading approach, that it is now, perhaps, in the very nature of things.

Other countries and cultures have addressed these problems in ways the American legal system might learn from. For example, The Geneva Convention on Bills of Exchange of 1932 provides:

The possessor of a bill of exchange is deemed to be the lawful holder if he establishes his title to the bill through an uninterrupted series of endorsements, even if the last endorsement is in blank. In this connection, cancelled endorsements are deemed not to be written. When an endorsement in blank is followed by another endorsement, the person who signed this last endorsement is deemed to have acquired the bill by the endorsement in blank.

Where a person has been dispossessed of a bill of exchange, in any manner whatsoever, the holder who establishes his right thereto in the manner mentioned in the preceding paragraph is not bound to give up the bill unless he has acquired it in bad faith, or unless in acquiring it he has been guilty of gross negligence.⁴⁰⁸

It might be thought that the foregoing convention is an old civil law

407. See U.C.C. § 4-401 (1990); U.C.C. § 4-401 (1989).

408. Convention Providing a Uniform Law for Bills of Exchange and Promissory Notes, June 7, 1930, 143 L.N.T.S. 259 (1933-34).

aberration to be discounted in the United States. However, the Draft Convention on International Bills of Exchange and International Promissory Notes, which has been signed, but not ratified by the United States, states:

- (1) A person is a holder if he is:
 - (a) . . .
 - (b) In possession of an instrument which has been endorsed to him, or on which the last endorsement is in blank, and on which there appears an uninterrupted series of endorsements, even if any endorsement was forged or was signed by an agent without authority.⁴⁰⁹

This proposed Convention does not apply to checks, but it does represent the current civilian thinking advanced by American drafters.

Under the Geneva Convention of 1932, followed in the domestic law of much of the civilian world, a thief can steal a check, indorse the payee's name, and pass it on to a good faith holder who will acquire good title absent gross negligence.⁴¹⁰ This holder can, in turn, deposit the check in a depository bank and collect from the drawee-payor bank, both of which are protected by the depositor's "holder in due course" status. The payee loses title, and any attendant cause of action, in the same way a bona fide taker from the finder of lost cash would acquire good title to the money in the United States. The losing payee is merely left under this rule with a suit against the thief, the bad faith taker, or the taker guilty of gross negligence.

Perhaps the civilian approach is too heretical for contemplation by citizens of the United States, who may find the English system more palatable. The English Stamp Act of 1853 stated:

Provided always, that any draft or order drawn upon a banker for a sum of money payable to order on demand, which shall, when presented for payment, purport to be endorsed by the person to whom the same shall be drawn payable, shall be a sufficient authority to such banker to pay the amount of such draft or order to the bearer thereof; and it shall not be incumbent on such banker to prove that such endorsement, or any subsequent endorsement, was made by or under the direction or authority of the person to whom the said draft or order was or is made payable either by the drawer or any endorser thereof.⁴¹¹

It would appear that this section of the Act is still in force in Eng-

409. John A. Spanogle, *United Nations: Convention on International Bills of Exchange and International Promissory Notes*, 28 I.L.M. 170, 183 (1989).

410. *Convention Providing a Uniform Law for Bills of Exchange and Promissory Notes*, June 7, 1930, 143 L.N.T.S. 259 (1933-34).

411. *Stamp Act, 1853*, 16 & 17 Vict., ch. 59, § 19 (Eng.).

land. In any event, much of this old act was incorporated into the Bills of Exchange Act of 1882:

When a bill payable to order on demand is drawn on a banker, and the banker on whom it is drawn pays the bill in good faith and in the ordinary course of business, it is not incumbent on the banker to show that the indorsement of the payee or any subsequent indorsement was made by or under the authority of the person whose indorsement it purports to be, and the banker is deemed to have paid the bill in due course, although such indorsement has been forged or made without authority.⁴¹²

It is notable that the drawee banker is protected only when he pays the bill in good faith and in the ordinary course of business. These same two terms are found throughout articles 3 and 4 of the UCC.

Under both of the above English statutes, the drawee bank is not responsible for forgery of the payee's signature as it would be in the United States. In addition to this protection of the drawee bank, the Cheques Act of 1957 provides:

Where a banker in good faith and in the ordinary course of business pays a cheque drawn on him which is not indorsed or is irregularly indorsed, he does not, in doing so, incur any liability by reason only of the absence of, or irregularity in, indorsement and he is deemed to have paid it in due course.⁴¹³

Again, the drawee bank is protected even when the check has not been indorsed by the payee. The Cheques Act, not content to immunize merely the drawee-payor bank, proceeds to protect the depository collecting bank as well:

- (1) Where a banker, in good faith and without negligence,-
 - (a) receives payment for a customer of an instrument to which this section applies; or
 - (b) having credited a customer's account with the amount of such an instrument, receives payment thereof for himself; and the customer has no title, or a defective title, to the instrument, the banker does not incur any liability to the true owner of the instrument by reason only of having received payment thereof.
- (2) This section applies to the following instruments, namely,-
 - (a) cheques;
 - . . .
- (3) A banker is not to be treated for the purposes of this section as having been negligent by reason only of his failure to concern himself with

412. Bills of Exchange Act 1882, 45 & 46 Vict., ch. 61, § 60 (Eng.).

413. The Cheques Act, 1957, 5 & 6 Eliz. 2, ch. 36, § 1 (Eng.).

absence of, or irregularity in, indorsement of an instrument.⁴¹⁴

Inasmuch as both the drawee-payor bank and the depositary bank are protected against suit by the true owner of a check, the only recourse of the defrauded party would be against the forger, or one who took from the forger. Section 24 of the Bills of Exchange Act of 1882, states in part:

[w]here a signature on a bill is forged or placed thereon without the authority of the person whose signature it purports to be, the forged or unauthorized signature is wholly inoperative, and no right to retain the bill or to give a discharge therefor or to enforce payment thereof against any party thereto can be acquired through or under that signature, unless the party against whom it is sought to retain or enforce payment of the bill is precluded from setting up the forgery or want of authority.⁴¹⁵

It appears the deprived owner of a check could bring an action for conversion against the wrongdoer, or an action for money had and received for the proceeds of a collected check.⁴¹⁶ The net affect of the English legislation protecting banks is to leave litigation to the nonbanking parties.⁴¹⁷

414. The Cheques Act § 24.

415. Bills of Exchange Act § 24.

416. See MAURICE MEGHAH & FRANK R. RYDER, *BYLES ON BILLS OF EXCHANGE* 278-79 (25th ed. 1983).

417. If published press reports are any indication, the impersonation scams have been increasing both in raw numbers and in amount stolen. See generally Sharon H. Rosenberg, *Check Fraud Teams Targeting Banks, Business*, *MIAMI DAILY BUS. REV.*, Dec. 27, 1993 § 1 at 1; Hindi Diamond, *Banks Reacting to 'Epidemic' of Postal Thievery*, *S. FLA. BUS. J.*, Nov. 26, 1990, § 1 at 1. The typical scam will involve a residential tenant applying for a loan in the name of the real property owner. If the property has an existing mortgage, a forged satisfaction of mortgage will be recorded. At the closing, the "tenant owner" will present forged documents to prove his identity. The closing check is then deposited in an assumed name account, and the proceeds withdrawn.

A variation on this scheme is where a trespasser breaks into a vacant home, takes occupancy, and tells neighbors that he has rented the house. The mortgage scam then proceeds in the above manner. Of course, vacant lots can be fair game for loans as well. These mortgage scams are difficult to prevent because of the ease, for example, in obtaining false drivers' licenses, but could be decreased in number if lenders insisted upon the personal identification of the mortgage applicants by reliable persons who have known them a long time. From personal observations at numerous closings, the author can certify that most lawyers and notaries are naive in accepting paper documentation as proof of identity. The possibility of malpractice suits is limitless.

Another recent and successful check scam is where crooks present forged cashier's and certified checks to open checking and savings accounts. See Fred R. Bleakley, *How They Bounce! Bad Check Toll Rises As It Becomes Easier to Pull Off Such Fraud*, *WALL ST. J.*, Dec. 2, 1993, at 1. These checks will appear to be issued or certified by real or imagined banks in Puerto Rico, for example, or other distant sources. The "depositors" will then attempt a quick withdrawal to take advantage of the early clearing times provided in Federal Reserve Regulations J and CC. Federal Reserve System Regulation J, 12 C.F.R. § 210.11 (1994); Federal Reserve System Regulation CC, 12 C.F.R. § 229.10 (1994). One recent, unpublicized, case resulted in hundreds of thousands of

IX. CONCLUSION

At first reading, it would appear that the draftspersons of section 3-404 have adopted comparative fault and the entrustment principles in an attempt to level the playing field between banks and their customers in the paying and collecting of fictitious payee and impersonation checks. A second reading, however, reveals that the entrustment approach will probably swallow up most of the former fictitious payee and impersonation cases. For example, the intent of the crooked employee no longer has application under Revised section 3-404, but under Revised section 3-405, she has the power to indorse the payees' names on checks issued by her employer.

Under Old section 3-405, if the signer of the check (or the person who supplied the payee's name) did not acquire the intent to steal until the issuance of the check, then her intent would not control. Now, under Revised section 3-405, the intent of the crook controls no matter when she acquired the intent to steal. Under the fictitious payee and impersonation cases, only a limited area of payee names were fair game; now any payee's name is fair game to an entrusted employee.⁴¹⁸

dollars in losses for a large number of South Florida banks. The author has, for a long time, advised his students to make a contemporaneous inquiry of the issuing or certifying bank named on a check at closing. Telephone calls cost money, but counterfeit checks cost even more.

418. One final caveat must be made. A rash of bankruptcy cases illustrate a secondary scam carried out by crooked employees who have been caught stealing and induce the victimized employer to accept a promissory note for the stolen funds in exchange for a general release and a covenant not to sue. *See, e.g., In re West*, 22 F.3d 775 (7th Cir. 1994). The cases do not articulate why employers take these notes, but they are offered as a way of bargaining out of criminal prosecution. When employees promptly file for bankruptcy and a discharge of the promissory notes, the victimized employers must then argue against discharge because the debts were incurred as a result of the willful frauds.

Most of the courts have held that although a promissory note does not usually discharge an underlying debt, when the creditor-employer gives a general release and a covenant not to sue, the note will discharge the debt and substitute a new obligation dischargeable in bankruptcy. If the release reserves rights on the original obligation it would not be dischargeable, but it seems clear under this rationale, a careless employer can be cheated twice by the same crooked employee.