PAYMENT SYSTEMS
ELECTRONIC CASEBOOK

CHAPTER 3—CHECKS
SECTION 8

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SECTION 8. FORGERY, ALTERATION, AND OTHER FRAUD

Although forgery and alteration of negotiable instruments are far from common, they give rise to a surprisingly large number of litigated cases. The risk of loss due to forgery and alteration is not to be ignored by one who deals in negotiable paper. This is particularly true since the wrongdoer is often not caught until after having disposed of part or all of the gains, with the consequence that one of several innocent parties must be selected to bear the loss. What policies should govern the allocation of that loss? Which party should be selected? What remedies should be available to shift the loss to that party? The materials that follow are directed to answering these questions.

(A) THE BASIC RULES

R. Cooter & E. Rubin, A Theory of Loss Allocation for Consumer Payments

[A system of legal rules governing the] allocation of fraud, forgery, and error losses between consumers and financial institutions . . . can increase the efficiency of the payment system if those rules are properly designed. This Part identifies three major principles of economic efficiency for the design of such rules: loss spreading, loss reduction, and loss imposition.

A. The Loss Spreading Principle

A basic characteristic of economic actors is their attitude toward risk. Most people are risk averse: when facing a possible loss, they will pay more than the loss’s average value to eliminate the risk of it. In contrast, a risk neutral person places a value on risk equal to the loss’s average value. . . .

Two conditions affecting a party’s ability to achieve risk neutrality are the relative size of the loss and the party’s ability to spread it. Most decision makers are risk neutral toward losses that are small in proportion to their wealth, and risk averse toward losses that are relatively large. In addition, financial institutions, unlike consumers, can achieve complete risk neutrality by spreading the resulting losses across their entire group of customers. To be spread, the losses must be sufficiently small and occur frequently enough to be predictable. For example, a financial institution often cannot know whether specific payment instruments are forged, but because it engages in a large number of transactions, it can accurately predict the number of forgeries that will occur in a given year. Once the institution makes that prediction, it can pass on the cost to its customers as a charge for its service, just as it passes on the cost of paying tellers or encoding checks.

These considerations suggest the first principle of efficient payment law,
which is frequently called the loss spreading principle: assign liability for a loss to the party that can achieve risk neutrality at the lowest cost. In general, the party that can achieve risk neutrality at the lowest cost is the one that has greater economic resources and is in a position to spread the loss most effectively. This principle, therefore, suggests that liability for losses should fall on financial institutions rather than on individual consumers. The forgery or alteration of a single payment item, like a check, can involve a significant proportion of an individual’s wealth, but will typically constitute an insignificant loss for a financial institution. Moreover, the institution can predict the total volume of its losses and spread them over a large group of consumers, whereas consumers will generally end up bearing the entire loss themselves.

B. The Loss Reduction Principle

Independent of their ability to spread payment losses, consumers and financial institutions often have the ability to reduce these losses, and one of them can often do so at less cost than the other. Efficiency requires that the legal rules create incentives for such loss reduction. The standard means for creating legal incentives is the assignment of liability, which suggests the loss reduction principle: an efficient legal system assigns liability to the party that can reduce losses at the lowest cost.

Consumers and financial institutions often can reduce payment losses by taking the precautions that are presently available to them. Consumers can do so through ordinary prudence and care in making payments, and financial institutions can reduce losses through internal measures similar to quality control in manufacturing. Precautions, however, entail costs in money, time, and effort, which discourage consumers and financial institutions from undertaking them. Legal rules that impose liability on consumers or financial institutions force them to include this potential liability in their calculus of costs, and thus weigh it against the cost of precaution. In economic terms, the liable party internalizes the social value of the precaution. To achieve internalization at the most efficient level, payment rules must assign liability to the party who, on the basis of its position in the process, is able to take precaution against the loss at the lowest cost.

This conclusion, which is valid when means of precaution are presently available at relatively low cost, must be tempered by dynamic considerations. Recent technological innovations, such as automated check processing, have altered the cost of precaution and will continue to do so in the future. The imposition of liability can create an incentive for the development of innovations that reduce both the cost of precaution and the frequency of losses. Thus, the innovation element, which interacts with the precaution element in a dynamic context, suggests payment rules that assign liability to the party most likely to develop innovative methods of precaution over time.
Liability, however, is a useful incentive, whether for precaution or innovation, only to the extent that behavior responds to it; a particular assignment of liability that does not influence behavior has no economic justification. Moreover, if it influences behavior only to a limited extent, then its effectiveness must be discounted by that limitation.

C. The Loss Imposition Principle

The loss spreading and loss reduction principles indicate the party to which payment rules can most efficiently assign liability. The third principle in establishing an efficient payment law, the loss imposition principle, concerns the enforcement of this assigned liability. The enforcement process turns the law from a set of legal rules into a series of actual monetary transfers. Liability may be enforced through civil suits, criminal trials, or administrative proceedings, as well as through the many informal devices for settling disputes. One feature that all these mechanisms share is that they are costly; they represent a deadweight loss to the participants in the payment system. To achieve efficiency, therefore, the enforcement process should be as inexpensive as possible.

If reallocating the loss is required for increased efficiency, then the most desirable enforcement process is the one that will shift liability as cheaply as possible from the creditor to the party that should suffer the final loss. This goal can be achieved by fashioning simple, clear, and decisive liability rules. Such rules discourage people from bringing meritless lawsuits by decreasing the law’s level of ambiguity. In addition, they simplify court proceedings and lower litigation costs by decreasing the number of issues, the amount of relevant evidence, the number of required court appearances, and the amount of prelitigation legal counseling. The mechanisms that will generate simple, clear, and decisive liability rules, and thus achieve these advantages, are familiar: strict liability rather than fault-based liability, single factor standards rather than multiple factor standards, objective rather than subjective tests, and statutory liquidated damages rather than damages based on individualized determinations of loss.

Of course, structuring the enforcement process in this way may deprive it of the flexibility necessary for loss spreading and loss reduction, because it represents a fairly rough allocation of liability, rather than the precise allocation that these principles would recommend. The choice ultimately depends on the relative economic impact of all three principles of efficient loss allocation. In weighing the impact of these three principles, loss imposition factors will tend to be extremely significant, much more so than the precaution-oriented rules of the UCC would suggest. The cost of making even a single factual determination would quickly surpass all but the most catastrophic losses on a consumer account.
NOTE ON THE AVAILABILITY OF INSURANCE

Since nearly all of the bank’s share of loss due to forgery and alteration, as well as some of the rest, is covered by insurance, no contemporary discussion of the allocation of risk of loss is complete without reference to available insurance. Three principal types of coverage are available: fidelity bonds, depositors’ forgery bonds, and forgery insurance under bankers’ blanket bonds.

The fidelity bond protects an employer against losses sustained through forgeries by employees who are covered by the bond. Such bonds were originally written on an individual basis by a bonding company as surety, on behalf of a named employee as principal, and in favor of a named employer. When the number of employees in a single concern made this cumbersome, surety companies drafted schedule bonds to cover two or more employees, who may be designated by name in a name schedule bond or by position in a position schedule bond. In addition, blanket fidelity bonds are available, covering all officers and employees collectively. Nevertheless, many businesses eligible for fidelity coverage carry none at all.

The depositor’s forgery bond, which is available to all persons and commercial enterprises other than financial institutions, insures against loss due to forgery or alteration in connection with checks, drafts or notes made or purporting to have been made by the insured or its agent. In order to prevent litigation between the insured and its bank, the insured is permitted to include loss suffered by the depositary bank in its proof of loss. The bond covers only outgoing checks. An incoming check rider is also available to cover 75% of the insured’s interest in checks received in payment for services or property, other than property sold on credit. Coverage under the depositor’s forgery bond has not, however, become as popular as that under the fidelity bond.

Bankers’ blanket bonds have been issued by domestic underwriters since 1916 and are carried by all banks. They cover losses due to such hazards as robbery, burglary, larceny, misplacement, employee dishonesty. Although forgery insurance is optional for commercial banks under such a bond, most banks have clause D, which covers forgery and alteration. In the case of commercial banks, premiums on clause D are computed on the basis of a standard rate which takes into account the size of the bank, as indicated by total deposits, the number of accounts, and the limit of liability. The blanket bond premium may be substantially reduced on the basis of the experience under the bond during the preceding five years. Where the experience has been unsatisfactory, the underwriter may review the insured’s procedures, a deductible policy may be issued or a surcharge may be requested.

Is insurance available to the parties who must bear the risk of loss under the Code? To what extent do those parties in fact insure? Should the answers to these questions affect the allocation of the risk? For a discussion of these questions, see Farnsworth, Insurance Against Check Forgery, 60
Problem 3.8.1. Terry stole the Empire check from the mail, forged Quaker's indorsement, and deposited the check into an account at Merchant Bank that Terry had opened in the name of Quaker Manufacturing Co. The Bank of New York dishonored the check and returned it to Merchant Bank.

(a) What are Merchant Bank's rights against its customer, the thief? See UCC 4–214(a); UCC 3–416(a); UCC 4–207(b); UCC 3–415; UCC 3–403(a); Section 5, supra.

(b) What are Merchant Bank's rights against Empire? See UCC 3–414; UCC 3–301.

(c) What are Merchant Bank's rights against Quaker? See UCC 3–403(a).

Problem 3.8.2. Suppose that, under the facts of the preceding Problem, The Bank of New York paid the check bearing Quaker's forged indorsement.

(a) May The Bank of New York charge Empire's account? See UCC 4–401(a) & Comment 1.


Problem 3.8.3. Terry stole one of Empire's blank checks, drew a check payable to Kerry, who deposited it in Kerry's account at PNC Bank. The Bank of New York dishonored the check and returned it to PNC. What are PNC's rights against Kerry, Terry, and Empire?

Problem 3.8.4. Suppose that, under the facts of the preceding Problem, The Bank of New York paid the check bearing Empire's forged signature.

(a) May The Bank of New York charge Empire's account? See UCC 4–401(a) & Comment 1.


(c) May The Bank of New York recover from Kerry?

Problem 3.8.5. Empire drew a $1,000 check to Terry's order. Terry raised the amount to $10,000 and deposited the check into Terry's account at Merchant Bank. The Bank of New York dishonored the check and returned it to Merchant Bank.

(a) What are Merchant Bank's rights against its customer, the thief?

(b) What are Merchant Bank's rights against Empire?

Problem 3.8.6. Suppose that, under the facts of the preceding Problem, The Bank of New York paid the check.

(a) May The Bank of New York charge Empire's account? See UCC 3–407(c); UCC 4–401(a) & Comment 4.

(b) May The Bank of New York recover from Merchant Bank?

(c) May The Bank of New York recover from Terry?
NOTES ON FORGERY

(1) The Basic Situations. Consider, at the outset, three basic situations. Suppose that an innocent party has purchased: (1) a check on which the drawer’s signature has been forged (a “forged check”); (2) a check on which a necessary indorsement has been forged; (3) a check that has been altered by raising the amount. If the check is not paid, what recourse does that party have against prior parties? If the check is paid by mistake, what recourse does the payor bank have, against either its depositor or the person whom it paid? (We shall assume, realistically, that recourse against the forger is not a practicable solution.)

Forged checks. If a forged check is not paid, the innocent purchaser can turn to a prior party, if there is one other than the forger, for recourse. See UCC 3–416(a)(2); UCC 4–207(a)(2). If it is paid by mistake, the bank that pays it has no recourse against either its depositor or the person whom it paid. That it has no recourse against its depositor is clear from UCC 3–403(a) and UCC 4–401(a). That it has no recourse against the person whom it paid follows from the provision on finality of payment in UCC 3–418 coupled with the absence of any right to recover for breach of warranty under UCC 3–417(a)(3) and UCC 4–208(a)(3) as long as the person whom it paid had “no knowledge” of the forgery. (Recall that “knowledge” means “actual knowledge.” UCC 1–202(b).)

This rule denying the bank recovery against the person paid is popularly known as “rule of Price v. Neal,” after the great case of that name. Lord Mansfield there reasoned that “If there was no neglect in the [drawee], yet there is no reason to throw off the loss from one innocent man upon another innocent man; but in this case, if there was any fault or negligence in any one, it certainly was in the [drawee] and not in the [person paid].” Price v. Neal, 3 Burr. 1354, 97 Eng. Rep. 871 (K.B.1762).

Forged indorsements. If a check on which a necessary indorsement has been forged is not paid, the innocent purchaser can also turn to a prior party, if there is one other than the forger, for recourse. See UCC 3–416(a)(1), 4–207(a)(1). Furthermore, as in the case of the forged check, if the payor bank pays a check by mistake over a forged indorsement, it has no recourse against its depositor. See UCC 3–403(a); UCC 4–401(a). (Remember that the drawer’s order is to pay only to “the order of” the payee.) In contrast to the case of the forged check, however, the bank that pays a check by mistake on a forged indorsement can recover from the person paid, including a collecting bank, on the warranties of UCC 3–417(a)(1) and UCC 4–208(a)(1). In an early leading case, the court justified recovery on the “reason that the parties were equally innocent,” and said, by way of disposing of the rule of Price v. Neal, that “it is sufficient to distinguish the case, that it goes on the superior negligence of the party paying.” Canal Bank v. Bank of Albany, 1 Hill 287 (N.Y.1841).
Altered checks. If a raised check is not paid, an innocent purchaser can enforce the instrument for its original amount even against the drawer. See UCC 3–407(c). In addition, the purchaser can turn to a prior party, if there is one other than the forger, for recourse in the raised amount. See UCC 3–416(a)(3); UCC 4–207(a)(3). The bank that pays a raised check by mistake can charge its depositor’s account for the original amount only. See UCC 4–401(d)(1). The balance it can recover from the person paid, on the warranties of UCC 3–417(a)(2) and UCC 4–208(a)(2).

(2) Rationale of the Rule of Price v. Neal. Consider the pattern that emerges from the six Problems above. In the case of forged indorsements and alterations, regardless of whether the check is paid, the risk of loss (or, more accurately, the risk of having to pursue the malefactor) falls on the depositary bank or other person who dealt with the malefactor. Suppose that a merchant cashes for the forger a check bearing a forged drawer’s signature. If the payor bank detects the forgery and refuses to pay the check, who bears the loss? If the payor bank fails to detect the forgery and pays the check, who bears the loss? Why the difference in result? Although nearly all states recognized the rule of Price v. Neal under the Negotiable Instruments Law, there was no uniformity of reasoning. Is any of the following statements convincing?

(a) The justification for the distinction between forgery of the signature of the drawer and forgery of an indorsement is that the drawee is in a position to verify the drawer’s signature by comparison with one in his hands, but has ordinarily no opportunity to verify an indorsement.

Comment 3 to F3–417. But note that the rule of Price v. Neal does not depend on the payor bank’s negligence.

(b) The traditional justification for the result is that the drawee is in a superior position to detect a forgery because he has the maker’s [sic] signature and is expected to know and compare it; a less fictional rationalization is that it is highly desirable to end the transaction of an instrument when it is paid rather than reopen and upset a series of commercial transactions at a later date when the forgery is discovered.

Comment 1 to F3–418.

(c) The rule stated in this Section [that of Price v. Neal] is in accord with mercantile convenience, supporting the finality of transactions with mercantile instruments in situations where ordinarily it is reasonably possible for the payor to ascertain the fraud. Furthermore, the payee has surrendered the instrument.

Restatement, Restitution § 30, Comment a (1937).

(d) Of the variety of justifications that have been advanced over the years, [two] are most convincing. The first is that the rule has a healthy cautionary effect on banks by encouraging care in the comparison of the signatures on ‘on us’ items against those on the signature cards that
they have on file. Prompt detection of the forgery and return of the dishonored check will often prevent loss, especially where the check has been taken from the forger for collection only, and although a detailed examination of every check may not be practicable for a bank that may pay as many as several hundred thousand checks a day, the rule of Price v. Neal ensures that the bank has a lively interest not only in the rapid processing of checks but also in the detection of forgery and the reduction of forgery losses. Although this risk is covered by Clause D of the bankers blanket bond, experience rating retains the cautionary effect of the rule. The second justification is that this very opportunity of the drawee to insure and to distribute the cost among its customers who use checks makes the drawee an ideal party to spread the risk through insurance. This argument, to be sure, is junior to the rule, since forgery insurance is a century and a half younger than Price v. Neal. Nevertheless, there is no question today that forgery bonds are adequate to cover loss due to the mistaken payment of forged checks.

Farnsworth, Insurance Against Check Forgery, 60 Colum. L. Rev. 284, 302–03 (1960).

(e) The traditional reason given for this differential treatment of forged drawers' signatures and forged indorsements is essentially a precaution rationale. The drawee bank is assigned the loss from a forged drawer’s signature because it has the consumer’s signature on file and can determine whether the signature on the instrument is genuine. . . . Price v. Neal has been criticized as outmoded in the modern era because financial institutions do not visually examine each signature on the forty billion or so checks that they process annually. This criticism, however, ignores the innovation element of loss reduction. If the financial institution is subject to liability, it will be motivated to develop new technology, such as signature reading machines. Whether such devices prove to be economically feasible is a decision that financial institutions must make, but it is precisely this ability to balance the cost of new technology against its benefits that makes them the most efficient bearers of the loss. From an efficiency perspective, however, the problem of allocating forgery losses among the various parties is less significant than its long history suggests. Neither checks nor other payment instruments now pass from one person to another the way they did in eighteenth century mercantile practice. . . . The result is that the first taker of a check with a forged indorsement is almost always a merchant or a bank, and with increasing frequency it is a bank. Between the merchant, the depositary bank, and the drawee bank, the allocation of liability can be left to the market, at least on a presumptive basis, because no market failure exists. . . . The rule of Price v. Neal need only be retained as a presumptive allocation among merchants and financial institutions.

(3) A Contrary View. In a major departure from present law, the ill-fated Uniform New Payments Code provided: “Each customer, transmitting account institution or transferor of an unauthorized draw order is liable to all parties to whom the draw order is subsequently transmitted and who pay, accept or give value in exchange for the order in good faith, if it has transmitted an unauthorized order. . . .” UNPC 204. The commentary gave the following explanation:

[This provision] marks the death knell for Lord Mansfield’s famous opinion in Price v. Neal . . . , which held that no warranty of the genuineness of a forged drawer’s signature is given to the payor bank by a person transmitting a check for collection. . . .

The rationale for the rule is not convincing. First, the traditional justification that the drawee is in a superior position to detect the forgery seems dubious today. Given the computerized payment of checks, necessitated by the high volume of items submitted for payment, it is uneconomical for an account institution to check the validity of all signatures. This is reflected by the reality that banks do not check signatures under a certain dollar amount even though they will be liable. It is cheaper to bear the liability than to avoid it. . . .

The second rationale for the rule is finality—the need for repose on transactions. . . . It must be recognized, however, that there is no such repose in cases of forged endorsements where warranties are now given to the payor bank. . . .

Not only is the rationale for the rule questionable, but the rule can be thought of as not giving adequate incentives to payees to check on the bona fides of people drawing checks to them. Under existing law, a merchant cashing a check need not be concerned with whether a person paying by check is actually the owner of the account on which the check is drawn. If Price v. Neal is abolished such incentives would exist. Check cashing outside the banking system is much less computerized thus allowing better opportunities for verifying the identity of a check cashier. . . . Absent Price v. Neal . . . , loss would ultimately lie with the payee, the taker from the thief. . . . Account institutions should generally support abolishing Price v. Neal because risks now borne by them could be shifted to their customers.

In addition, application of Price v. Neal makes no sense in cases of check truncation, where the drawer’s signature is not available for inspection by the payor account institution—assuming technology could not capture the signature at a reasonable cost. Since, on balance, the rule has no convincing justification and some significant costs in today’s high speed check processing environment, it is abolished. The Code rejects the possibility of allowing the collector of a check to avoid
liability by showing that the payor account institution was negligent, e.g., failed to detect an obvious forgery on a $1 million check. While such a rule might be justified in theory, importing the issue of negligence into liabilities among account institutions would probably cause more confusion for operations personnel and litigation than it is worth. . . .

(4) Retention of the Rule. Comment 3 to UCC 3–417 says only that “subsection (a)(3) retains the rule in Price v. Neal . . . that the drawee takes the risk that the drawer's signature is unauthorized unless the person presenting the draft has knowledge that the drawer's signature is unauthorized.” No rationale for the rule is offered.

What is the position under the UCC of a holder who takes a check in due course and then discovers that the drawer's signature has been forged? If the holder says nothing and is paid by the payor bank, can the payor bank recover the payment? Which answer accords with the reason behind the rule of Price v. Neal? Comment 4 to F3–417 explained that the warranty of no knowledge of a forged drawer's signature “is pertinent in the case of a holder in due course only in the relatively few cases where he acquires knowledge of the forgery after the taking but before the presentment. In this situation the holder in due course must continue to act in good faith to be exempted from the basic warranty.” How is it possible for the holder to act in good faith with knowledge of the forgery?

(5) The Federal Reserve Board Steps In. The rule of Price v. Neal was put to the test with “remotely created checks,” otherwise known as “telechecks” and “preauthorized drafts.” As the Federal Reserve Board explained:

“Remotely created checks” typically are created when the holder of a checking account authorizes a payee to draw a check on that account but does not actually sign the check. In place of the signature of the account-holder, the remotely created check generally bears a statement that the customer authorized the check or bears the customer's printed or typed name. Remotely created checks can be useful payment devices. For example, a debtor can authorize a credit card company to create a remotely created check by telephone, which may enable the debtor to pay his credit card bill in a timely manner and avoid late charges. Similarly, a person who does not have a credit card or debit card can purchase an item from a telemarketer by authorizing the seller to create a remotely created check.

70 CFR 71218 (Nov. 28, 2005).

Remotely created checks do not bear the drawer's signature or other readily verifiable indication of authorization and so may be particularly vulnerable to fraud. In response to significant consumer and bank complaints identifying cases of alleged fraud using remotely created checks, the Board promulgated amendments to Reg CC that have the effect of reversing the rule of Price v. Neal with respect to “remotely created checks”
as defined in Reg CC 229.2(fff). A bank that transfers or presents a remotely created check and receives a settlement or other consideration “warrants that the person on whose account the remotely created check is drawn authorized the issuance of the check in the amount stated on the check and to the payee stated on the check.” Reg CC 229.34(d).

Although the Board limited its action to remotely created checks, it “would welcome a public dialogue on broader check law issues, such as the utility of and possible alternatives to the Price v. Neal rule in the modern check processing environment.” 70 CFR at 71224.

(B) RIGHTS OF PAYEE WHOSE INDOREMENT HAS BEEN FORGED

Problem 3.8.7. Under the facts of Problems 3.8.1 and 3.8.2., where the check is stolen from the mail, Empire has received goods without paying for them.

(a) May Quaker recover from Empire? If so, on what theory?


Problem 3.8.8. Kim Kaller, Empire’s treasurer, received a telephone call from Quaker’s accounts-receivable clerk. Quaker’s clerk told Kaller that the Empire check, which Quaker had received, somehow “went missing” and that Empire should send a replacement.

(a) What courses of action are available to Empire? Which should Empire pursue? See UCC 3–310 & Comment 4; Maine Family Federal Credit Union v. Sun Life Assurance Co., supra.

(b) Kaller tells Quaker, “Sorry, it’s not our problem.” What should Quaker do?

Problem 3.8.9. After the Empire check was delivered to Quaker, Terry stole it, forged Quaker’s indorsement, and deposited the check into an account at Merchant Bank that Terry had opened in the name of Quaker Manufacturing Co. The Bank of New York paid the check.

(a) What rights, if any, does Quaker enjoy against Merchant Bank and The Bank of New York? See UCC 3–420. Would your answer be affected by the fact that Terry made several withdrawals after having made the deposit?

(b) What rights, if any, does Quaker enjoy against Empire?

(C) EFFECT OF PREPAYMENT NEGLIGENCE

Under the usual rules seen thus far the drawer is free from the risk of loss due to forged and altered checks and checks bearing forged indorsements. A purchaser cannot shift the loss to the drawer in the event that the check is dishonored, and the payor bank cannot shift the loss to the
drawer in the event that the check is paid by mistake. The usual rules, however, are subject to exceptions. The UCC contains two rules designed to shift the loss of a forgery or alteration to negligent parties. We consider the effect of prepayment negligence here. We consider postpayment negligence below in Section 8(E).

**Problem 3.8.10.** Instead of sending the $22,178.50 check to Quaker Manufacturing Co., Empire’s accounts payable clerk mistakenly sends the check to Quaker City Manufacturing Corp., another of Empire’s suppliers. Quaker City deposits the check, and The Bank of New York pays it. Who bears the loss? See UCC 3–406, Comment 3; Thompson Maple Products v. Citizens National Bank, infra; The Bank/First Citizens Bank v. Citizens and Associates, infra; Notes on Prepayment Negligence, infra.

**Problem 3.8.11.** Quaker’s accounts-receivable clerk indorses incoming checks with a rubber stamp that says, “Pay to PNC Bank. Quaker Manufacturing Co.” The rubber stamp is stored in an unlocked drawer of the clerk’s desk. During the clerk’s lunch break, the janitor took the day’s incoming checks (including the Empire check) from the clerk’s desk, stamped the back of each with a rubber stamp, and deposited them in the janitor’s personal account at Commerce Bank. The Bank of New York paid the Empire check. What rights, if any, does Quaker enjoy against Commerce Bank or The Bank of New York? See UCC 3–420; UCC 3–406.

**Thompson Maple Products v. Citizens National Bank of Corry**

Pennsylvania Superior Court, 1967.

■ **HOFFMAN, J.** In this assumpsit action, the plaintiff, Thompson Maple Products, Inc., seeks to recover more than $100,000 paid out on a series of its checks by defendant bank, as drawee. The payee’s signature on each of the checks was forged by one Emery Albers, who then cashed the checks or deposited them to his account with the defendant.

The case was tried to the court below sitting without a jury. That court entered judgment in favor of the plaintiff in the amount of $1258.51, the face amount of three checks which the defendant had paid without any endorsement whatever. It dismissed the remainder of the claim, and this appeal followed.

The plaintiff is a small, closely-held corporation, principally engaged in the manufacture of bowling pin “blanks” from maple logs. Some knowledge of its operations from 1959 to 1962 is essential to an understanding of this litigation.

The plaintiff purchased logs from timber owners in the vicinity of its

* [The court’s citations are to the applicable pre–1990 version of the UCC.]
mill. Since these timber owners rarely had facilities for hauling logs, such transportation was furnished by a few local truckers, including Emery Albers.

At the mill site, newly delivered logs were “scaled” by mill personnel, to determine their quantity and grade. The employee on duty noted this information, together with the name of the owner of the logs, as furnished by the hauler, on duplicate “scaling slips.”

In theory, the copy of the scaling slip was to be given to the hauler, and the original was to be retained by the mill employee until transmitted by him directly to the company’s bookkeeper. This ideal procedure, however, was rarely followed. Instead, in a great many instances, the mill employee simply gave both slips to the hauler for delivery to the company office. Office personnel then prepared checks in payment for the logs, naming as payee the owner indicated on the scaling slips. Blank sets of slips were readily accessible on the company premises.

Sometime prior to February, 1959, Emery Albers conceived the scheme which led to the forgeries at issue here. Albers was an independent log hauler who for many years had transported logs to the company mill. For a brief period in 1952, he had been employed by the plaintiff, and he was a trusted friend of the Thompson family. After procuring blank sets of scaling slips, Albers filled them in to show substantial, wholly fictitious deliveries of logs, together with the names of local timber owners as suppliers. He then delivered the slips to the company bookkeeper, who prepared checks payable to the purported owners. Finally, he volunteered to deliver the checks to the owners. The bookkeeper customarily entrusted the checks to him for that purpose.

Albers then forged the payee’s signature and either cashed the checks or deposited them to his account at the defendant bank, where he was well known. Although he pursued this scheme for an undetermined period of time, only checks paid out over a three-year period prior to this litigation are here in controversy. See Uniform Commercial Code, Act of April 6, 1953, PL 3, as amended, § 4–406, 12A PS § 4–406.

In 1963, when the forgeries were uncovered, Albers confessed and was imprisoned. The plaintiff then instituted this suit against the drawee bank, asserting that the bank had breached its contract of deposit by paying the checks over forged endorsements.

The trial court determined that the plaintiff’s own negligent activities had materially contributed to the unauthorized endorsements, and it therefore dismissed the substantial part of plaintiff’s claim. We affirm the action of the trial court.

Both parties agree that, as between the payor bank and its customer, ordinarily the bank must bear the loss occasioned by the forgery of a payee’s endorsement. Philadelphia Title Insurance Company v.
The trial court concluded, however, that the plaintiff-drawer, by virtue of its conduct, could not avail itself of that rule, citing § 3–406 of the Code: “Any person who by his negligence substantially contributes to . . . the making of an unauthorized signature is precluded from asserting the . . . lack of authority against . . . a drawee or other payor who pays the instrument in good faith and in accordance with the reasonable commercial standards of the drawee’s or payor’s business.” 12A PS § 3–406.

Before this court, the plaintiff Company argues strenuously that this language is a mere restatement of pre-Code law in Pennsylvania. Under those earlier cases, it is argued, the term “precluded” is equivalent to “estopped,” and negligence which will work an estoppel is only such as “directly and proximately affects the conduct of the bank in passing the forgery . . . .” See, e.g., Coffin v. Fidelity–Philadelphia Trust Company, 374 Pa. 378, 393, 97 A.2d 857, 39 A.L.R.2d 625 (1953); Land Title Bank and Trust Company v. Cheltenham National Bank, 362 Pa. 30, 66 A.2d 768 (1949). The plaintiff further asserts that those decisions hold that “negligence in the conduct of the drawer’s business,” such as appears on this record, cannot serve to work an estoppel.

Even if that was the law in this Commonwealth prior to the passage of the Commercial Code, it is not the law today. The language of the new Act is determinative in all cases arising after its passage. This controversy must be decided, therefore, by construction of the statute and application of the negligence doctrine as it appears in § 3–406 of the Code. Philadelphia Title Insurance Company v. Fidelity–Philadelphia Trust Company, supra, 419 Pa. at 84, 212 A.2d 222.

Had the legislature intended simply to continue the strict estoppel doctrine of the pre-Code cases, it could have employed the term “precluded,” without qualification, as in § 23 of the old Negotiable Instruments Law, 56 P.S. § 28 (repealed). However, it chose to modify that doctrine in § 3–406, by specifying that negligence which “substantially contributes to . . . the making of an unauthorized signature . . . .” will preclude the drawer from asserting a forgery [emphasis supplied]. The Code has thus abandoned the language of the older cases (negligence which “directly and proximately affects the bank in passing the forgery”) and shortened the chain of causation which the defendant bank must establish. “[N]o attempt is made,” according to the Official Comment to § 3–406, “to specify what is negligence, and the question is one for the court or jury on the facts of the particular case.”

In the instant case, the trial court could readily have concluded that

3. [Former] Section 3–404 of the Code provides: “Any unauthorized signature is wholly inoperative as that of the person whose name is signed unless he ratifies it or is precluded from denying it **.” [Cf. UCC 3–403(a).]
plaintiff’s business affairs were conducted in so negligent a fashion as to have “substantially contributed” to the Albers forgeries, within the meaning of § 3–406.

Thus, the record shows that pads of plaintiff’s blank logging slips were left in areas near the mill which were readily accessible to any of the haulers. Moreover, on at least two occasions, Albers was given whole pads of these blank logging slips to use as he chose. Mrs. Vinora Curtis, an employee of the plaintiff, testified:

“Q. Did you ever give any of these logging slips to Mr. Albers or any pads of these slips to Mr. Albers?
“A. Yes . . .

“Q. What was the reason for giving [a pad of the slips] to him, Mrs. Curtis?
“A. Well, he came up and said he needed it for [scaling] the logs, so I gave it to him.”

Mrs. Amy Thompson, who also served as a bookkeeper for the plaintiff, testified:

“Q. As a matter of fact, you gave Mr. Albers the pack of your logging slips, did you not?
“A. Yes, I did once.

“Q. Do you remember what you gave them to him for?
“A. I don’t right offhand, but it seems to me he said he was going out to look for some logs or timber or something and he needed them to mark some figures on . . . .

“Q. Well, if he was going to use them for scratch pads, why didn’t you give him a scratch pad that you had in the office?
“A. That’s what I should have done.”

In addition, the plaintiff’s printed scaling slips were not consecutively numbered. Unauthorized use of the slips, therefore, could easily go undetected. Thus, Mr. Nelson Thompson testified:

“Q. Mr. Thompson, were your slips you gave these haulers numbered?
“A. No, they were not.

“Q. They are now, aren’t they?
“A. Yes.

“Q. Had you used numbered logging slips, this would have prevented anybody getting logging slips out of the ordinary channel of business and using it to defraud you?
“A. Yes.”

Moreover, in 1960, when the company became concerned about the possible unauthorized use of its scaling slips, it required its own personnel to initial the slips when a new shipment of logs was scaled. However, this
protective measure was largely ignored in practice. Mrs. Amy Thompson testified:

“Q. And later on in the course of your business, if you remember Mr. Thompson said he wanted the logging slips initialed by one of the so-called authorized people?

“A. Yes.

“Q. [D]idn’t you really not pay too much attention to them at all?

“A. Well, I know we didn’t send them back to be sure they were initialed. We might have noticed it but we didn’t send them back to the mill.

“Q. In other words, if they came to you uninitialed, you might have noticed it but didn’t do anything about it.

“A. Didn’t do anything about it.”

The principal default of the plaintiff, however, was its failure to use reasonable diligence in insuring honesty from its log haulers, including Emery Albers. For many years, the haulers were permitted to deliver both the original and the duplicate of the scaling slip to the company office, and the company tolerated this practice. These slips supplied the bookkeeper with the payees’ names for the checks she was to draw in payment for log deliveries. Only by having the company at all times retain possession of the original slip could the plaintiff have assured that no disbursements were made except for logs received, and that the proper amounts were paid to the proper persons. The practice tolerated by the plaintiff effectively removed the only immediate safeguard in the entire procedure against dishonesty on the part of the haulers.

Finally, of course, the company regularly entrusted the completed checks to the haulers for delivery to the named payees, without any explicit authorization from the latter to do so.

While none of these practices, in isolation, might be sufficient to charge the plaintiff with negligence within the meaning of § 3–406, the company’s course of conduct, viewed in its entirety, is surely sufficient to support the trial judge’s determination that it substantially contributed to the making of the unauthorized signatures. In his words, that conduct was “no different than had the plaintiff simply given Albers a series of checks signed in blank for his unlimited, unrestricted use.” Cf. Gresham State Bank v. O & K Construction Company, 231 Ore. 106, 370 P.2d 726, 372 P.2d 187, 100 A.L.R.2d 54 (1962); Park State Bank v. Arena Auto Auctions, Inc., 59 Ill.App.2d 235, 207 N.E.2d 158 (1965).

Finally, the plaintiff argues that the defendant bank cannot rely on §

6. In this connection, the trial court also noted that the plaintiff at all times prior to the commencement of this litigation failed to keep an accurate inventory account. It could not therefore verify, at any given point in time, that it actually possessed the logs which it had paid for.
3–406 because it did not pay the checks in accordance with “reasonable commercial standards” as required by that section. All the checks were regular on their face and bore the purported endorsement of the named payee. It is asserted, however, that the defendant bank was required, as a matter of law, to obtain the second endorsement of Albers before accepting the checks for deposit to his account.

The short answer to that contention is that the trial court did not find, nor does the record show, that obtaining such a second endorsement is a reasonable, or even a general, commercial practice, where the depositor is well-known to the bank and where his identity can later be ascertained from code markings on the check itself.

Furthermore, under the Code, the bank did not have an unqualified right to a second endorsement. A check endorsed in blank is bearer paper. It is negotiable by delivery alone, without further endorsement. See UCC § 3–201, 3–204, 12A PS §§ 3–201, 3–204.

To the extent that banks do obtain such endorsements, they apparently do so for their own protection, over and above that provided by the warranties arising on presentment and transfer. Cf. UCC § 3–414, 12A PS § 3–414 (Contract of Indorser), with UCC § 3–417, 12A PS § 3–417 (Warranties). In short, the practice is not designed for the protection of the drawer.7 We are reluctant to hold that the plaintiff may shift the loss to the defendant bank, in this case, merely because the bank failed to exercise an excess of caution on its own behalf.

Judgment affirmed.

The Bank/First Citizens Bank v. Citizens and Associates
Supreme Court of Tennessee, 2002.
82 S.W.3d 259.

WILLIAM M. BARKER, J.

This case involves the application of Tennessee Code Annotated section 47–3–406 to determine who bears the loss of a bank’s acceptance of forged instruments. The drawer issued three checks payable to a mortgage company and delivered these checks to a branch manager of that company for transfer to the main office. The manager, however, forged the endorsement of the company and deposited these checks into her personal bank account. In a suit to recover the funds, the trial court applied section 47–3–406 and found that both the drawer and the depository bank failed to exercise ordinary care. It then allocated the loss between the parties as

7. In any event, a second endorsement could not have protected this drawer, since the record shows that it was not plaintiff’s practice to examine the backs of its checks when they were returned by the bank.
eighty percent to the drawer and twenty percent to the bank. A majority of the Court of Appeals affirmed. On appeal to this Court, we hold that the bank may not assert that the drawer is precluded from asserting the forgery against it under section 47–3–406, because it did not show that any failure by the drawer to exercise ordinary care substantially contributed to the making of the forged endorsements. The judgment of the Court of Appeals is reversed.

FACTUAL BACKGROUND

In January 1997, Allied Mortgage Capital Company (“Allied Mortgage”) opened a branch office in Cleveland, Tennessee, and shortly thereafter, it hired Ms. Frieda Gray as its branch manager for this office. In this capacity, Ms. Gray possessed the authority to conduct the day-to-day operations of the branch and to make loans. Ms. Gray was also authorized to receive, hold, and forward monies and documents to Allied Mortgage at its principal place of business in Texas.

The next month, Ms. Gray, representing herself as a branch manager of Allied Mortgage, contacted a land-development partnership, Citizens and Associates, about opening a branch office of Allied Mortgage in upper-east Tennessee. Ms. Gray hosted a seminar in Knoxville for about fifteen or twenty people to show how profitable investing in Allied Mortgage could be. Following this seminar, Citizens and Associates agreed to invest in the mortgage company in order to compliment its other land development interests. Ms. Gray stated that she would handle the transaction, and she obtained information from Citizens and Associates which she said was necessary for the main office to approve the investment.

Over the next thirty days, Citizens and Associates issued three checks to Allied Mortgage, in the total amount of $50,000.02, and it gave these checks to Ms. Gray for delivery to Allied Mortgage’s main office in Texas. However, Ms. Gray did not forward the checks to the main office. Instead, she endorsed each in the name of the corporation and deposited the instruments in her personal account at The Bank/First Citizens Bank (“First Citizens Bank”) in Cleveland. First Citizens Bank, as the depository bank, presented these checks to the drawee bank in Knoxville, which paid the checks and deducted the amounts paid from Citizens and Associates’ account.

Citizens and Associates soon discovered that a fraud had taken place. It contacted Allied Mortgage’s main office and confirmed that Allied Mortgage does not license franchises and that Ms. Gray was not authorized to negotiate franchise agreements. Citizens and Associates then contacted First Citizens Bank and demanded repayment of the face amounts of the checks, but First Citizens Bank denied any liability on the instruments. The bank then filed suit in the Bradley County Circuit Court, seeking a declaration that it possessed no liability on the three checks. Citizens and Associates filed a counterclaim against First Citizens Bank alleging that the
bank failed to exercise ordinary care in taking the instruments.

Following a bench trial, the court applied Tennessee Code Annotated section 47–3–406 and found that First Citizens Bank failed to exercise ordinary care in taking the checks. More specifically, the court concluded that the bank was negligent in permitting the deposit of checks made payable to a corporation into a personal account, especially when the corporation itself did not have an account with the bank. The court also found that Citizens and Associates was negligent in delivering the instruments to Ms. Gray without first confirming the transaction with Allied Mortgage. It then allocated the loss of the instruments, as required by section 47–3–406(c), as eighty percent to Citizens and Associates and twenty percent to First Citizens Bank. A final order confirming this ruling was entered on July 11, 2000.

Citizens and Associates appealed to the Court of Appeals, and a majority of that court affirmed the judgment of the trial court. The intermediate court found that the evidence supported the trial court’s findings regarding the failure of both parties to exercise ordinary care. The majority also affirmed the trial court’s allocation of the loss as supported by the evidence. However, in dissent, Judge Susano concluded that First Citizens Bank should be responsible for the entire loss. He found that because Ms. Gray was “without question an employee of Allied [Mortgage] and was authorized to receive documents and checks for her employer,” Citizens and Associates did not fail to exercise the ordinary care contemplated by section 47–3–406(a).

We granted permission to appeal to Citizens and Associates to resolve the proper application of Tennessee Code Annotated section 47–3–406 in this case. We now hold that First Citizens Bank may not assert the defense provided by section 47–3–406. Although we conclude that the record supports a finding that First Citizens Bank took the instruments in good faith, the bank did not show that the failure of Citizens and Associates to exercise ordinary care substantially contributed to the actual making of the forged endorsements. The judgment of the Court of Appeals is reversed.

THE NEGLIGENT DRAWER DEFENSE OF TENNESSEE CODE ANNOTATED SECTION 47–3–406

Neither party before this Court disputes that First Citizens Bank may be held liable, under the proper circumstances, for taking an instrument on a forged endorsement. However, under the Tennessee Uniform Commercial Code (“TUCC”), First Citizens Bank has available several defenses that it may assert against Citizens and Associates to avoid or minimize such losses. In this case, the trial court applied the defense contained in section 47–3–406—often referred to as the negligent drawer defense—and while
both parties agree that this section constitutes the applicable law, they disagree as to who should bear the loss of the forged instruments under this provision.

[V]iewing the statute in terms of this case, First Citizens Bank may assert that Citizens and Associates is precluded from asserting the forgery against the bank by showing (1) that it took the instruments in good faith; (2) that Citizens and Associates failed to exercise ordinary care; and (3) that this failure by Citizens and Associates “substantially contributed” to making of Ms. Gray’s forged signatures. Tenn.Code Ann. § 47–3–406(a). However, even if Citizens and Associates is found to be precluded from asserting the entire loss against First Citizens Bank, it may nevertheless seek to shift the burden of the loss to the bank by showing (1) that First Citizens Bank failed to exercise ordinary care in taking the instrument; and (2) that this failure substantially contributed to the loss. SeeTenn.Code Ann. § 47–3–406(b). The court may then apportion the loss to the extent “that the failure of each to exercise ordinary care contributed to the loss.” Tenn.Code Ann. § 47–3–406(c).

“Each of these steps in section [47–3–406] presents a question of fact, ordinarily to be resolved by the fact finder.” San Tan Irrigation Dist. v. Wells Fargo Bank, 197 Ariz. 193, 3 P.3d 1113, 1118 (2000). Importantly, however, if First Citizens Bank cannot meet its initial burden of showing that Citizens and Associates is precluded from asserting the forgery against it, then the entire loss must be borne by the bank itself. We examine each of these elements in turn.

**FIRST CITIZENS BANK’S GOOD FAITH PAYMENT OF THE INSTRUMENTS**

The first issue is whether First Citizens Bank took the instruments in good faith. Citing the general code definition of “good faith” in Tennessee Code Annotated section 47–1–201(19), First Citizens Bank asserts that it has met this standard because it acted with “honesty in fact” in taking the checks. A majority of the Court of Appeals agreed, noting that the record contains no evidence that “there was any dishonesty or collusion involved in the transaction.” However, although the Court of Appeals ultimately appears to have applied the correct definition of “good faith” in this context, it did not specifically examine the proper definition of this term as it applies to TUCC Article 3. Consequently, to clarify the law in this area, we

3. Importantly, section 47–3–406 provides a defense only against forged signatures and not against all unauthorized signatures. While Ms. Gray’s endorsement of the checks in the name of Allied Mortgage was certainly unauthorized in her capacity as an agent of Allied Mortgage, the endorsement also constituted a forgery. SeeMcConnico v. Third Nat’l Bank, 499 S.W.2d 874, 884 (Tenn.1973) (defining forgery under the UCC with reference to state criminal statutes as being the making of any writing with the intent to defraud). Because Ms. Gray’s intent to defraud is undisputed, we agree with the parties that section 47–3–406 applies in this case.
undertake a more detailed analysis of this issue.

In 1990, the American Law Institute and the National Conference of Commissioners on Uniform State Laws revised Articles 3 and 4 of the Uniform Commercial Code dealing with negotiable instruments, bank deposits, and collections. Prior to these revisions, the term “good faith” was defined in these articles by the general subjective standard of “honesty in fact.” However, one of the more significant revisions to Article 3 was to redefine the term “good faith” to require a party to show that it acted with “honesty in fact” in the transaction and that it adhered to “reasonable commercial standards of fair dealing.” See UCC § 3–103(a)(4).

In 1995, the Tennessee General Assembly substantially adopted Revised Articles 3 and 4, although, interestingly, it did not include the definition of “good faith” contained in UCC section 3–103(a)(4). Admittedly, there is some evidence that the legislature omitted the definition of this term inadvertently. . . .

Nevertheless, “[t]his court does not lightly assume drafting error by the Legislature.” See People v. Robles, 23 Cal.4th 1106, 99 Cal.Rptr.2d 120, 5 P.3d 176, 182 (2000). To the contrary, we presume that where the legislature departs from the language of a model act, it usually does so to express an intention different from the model act. . . . [W]e must conclude that the General Assembly intentionally omitted the UCC definition of “good faith” as it applies in Chapters 3 and 4 of Title 47, and we construe this term in accord with the general code definition to mean “honesty in fact in the conduct or transaction involved.” See Tenn.Code Ann. § 47–1–201(19).

Applying the general code definitions in this context, we agree with the lower court that the record supports a finding that First Citizens Bank took the instruments in good faith. This Court has defined the “honesty in fact” standard to mean an absence of a “knowing or reckless disregard of a customer’s rights.” Glazer v. First Am. Nat’l Bank, 930 S.W.2d 546, 549 (Tenn.1996) (defining “good faith” in section 47–1–102(19)). Our review of the record reveals that while First Citizens Bank was certainly negligent in permitting the deposit of a check made payable to a corporation into an individual account, no evidence shows that it knowingly disregarded the rights of anyone. Nor does a preponderance of the evidence support a finding that the bank acted recklessly in this regard. Therefore, we conclude that the record supports the conclusions of the lower courts that First Citizens Bank took the instruments in good faith.

CITIZENS AND ASSOCIATES’ FAILURE TO EXERCISE ORDINARY CARE AND ITS SUBSTANTIAL CONTRIBUTION TO THE FORGERY

Although the record supports a finding that First Citizens Bank took the instruments in good faith, section 47–3–406 also requires the bank to show that the drawer’s failure to exercise ordinary care substantially contributed to the forgery of the instrument. Although the Court of Appeals reached a
contrary conclusion, we cannot conclude that the bank has met its burden in this regard.

No reported case in this state has discussed the requirements of “ordinary care” or “substantial contribution” as they relate to the conduct of the drawer. However, the official comments shed some light on what was intended by these standards. For instance, Comment 2 to section 47–3–406 states that conduct is a substantial contribution to a forged signature if the conduct is a “contributing cause” of the signature and is “a substantial factor in bringing it about.” The comment also notes that the “substantial contribution” standard “is meant to be less stringent than a ‘direct and proximate cause’ test” that prevailed prior to the UCC’s adoption, thereby making the preclusion generally easier to establish.

Relying upon this comment, the Court of Appeals held that a drawer can be precluded under this section if the drawer negligently issues an instrument to a third party for delivery to the payee. Though the intermediate court’s analysis is not without some support, several other courts have held that “only negligence which proximately relates or contributes to the forgery, and not merely to the issuance of the checks, would relieve a collecting bank of liability for improper payment of a fraudulently endorsed check.” See, e.g., Vectra Bank v. Bank W., 890 P.2d 259, 263 (Colo.Ct.App.1995) (emphasis added). Indeed, at least one court has held, as a matter of law, that the drawer’s negligence in issuing the instrument, without more, cannot substantially contribute to the forgery within the contemplation of UCC section 3–406. See Guaranty Bank & Trust Co. v. Federal Reserve Bank, 454 F.Supp. 488, 490–91 (W.D.Okla.1977) (addressing factual scenario in which a loan was negotiated and an instrument was delivered to a party not named as the payee).

5. See, e.g., Winkie, Inc. v. Heritage Bank, 99 Wis.2d 616, 299 N.W.2d 829, 833 (1981) (“It is sufficient to point out in passing that this first preclusion of a drawer’s claim would arise from negligence of the drawer in the process by which the check was issued, that is, prior to the presentment and payment of the checks.”). The comments to section 47–3–406 also give one example of when the issuing of an instrument can constitute a substantial contribution to the making of a forged signature: when the drawer negligently issues a check to a person with the same name as the payee. We note, however, that this example does not stand as authority for the larger holding made by the Court of Appeals. Under the circumstances presented in the comment, the actual signature of the person taking the check would always constitute a forgery under the UCC, and as such, the drawer’s negligence is clearly a substantial contribution to the forgery. A much different case is presented when, as here, a check payable to a corporation is delivered to an agent of that corporation not bearing the same name.

6. See also . . . Twellman v. Lindell Trust Co., 534 S.W.2d 83, 90–91 (Mo.Ct.App.1976) (“The U.C.C. seems to foresee a more direct type of contribution to a forgery. . . . We do not think that plaintiff’s actions in trusting Londe and giving Londe a check which plaintiff had made payable to International Harvester could be said to have substantially contributed to Londe’s forgery.”). . . .
This latter position certainly comports more closely with the plain language of section 47–3–406, which speaks only of the drawer’s negligence being a substantial contribution “to the making of a forged signature.” (emphasis added). Consequently, we agree with those cases holding that a drawer’s negligence leading to the unwarranted issuance of checks will not generally suffice to establish a defense under section 47–3–406. Rather, the party asserting the preclusion must show some causal relationship between the lack of ordinary care and the actual making of the forged signature, such that the drawer’s negligence can be said to have substantially contributed to the ability of the unauthorized person to forge the payee’s name and to pose as the intended payee.

Whatever negligence Citizens and Associates may have been guilty of in issuing the three checks payable to Allied Mortgage, we cannot say that it increased the possibility that Ms. Gray would forge the endorsement of Allied Mortgage and pose as the payee of the instruments to her bank. Citizens and Associates, for example, did not leave blank the name of the payees in the various checks or make the checks payable to Ms. Gray as an agent of Allied Mortgage. Rather, Citizens and Associates only delivered these checks to an acknowledged agent of the payee that, according to testimony by an employee of Allied Mortgage, possessed the actual authority to receive checks on behalf of the payee. Without something more, this conduct alone simply cannot be said to have substantially contributed to the making of the forged endorsements.

Consequently, while the record supports the trial court’s conclusion that Citizens and Associates was negligent in issuing the checks payable to Allied Mortgage, the record does not show that this negligence substantially contributed to the ability of Ms. Gray to forge the endorsements and pose as the actual payee. Accordingly, we hold that even if First Citizens Bank took the instruments in good faith, the bank cannot assert the negligent drawer defense of section 47–3–406 because it has not shown that any failure by Citizens and Associates to exercise ordinary care substantially contributed to the making of the forged endorsements.

[Reversed.]

NOTES ON PREPAYMENT NEGLIGENCE

(1) Background of UCC 3–406. Negligent drawers have been with us a long time. Their treatment in UCC 3–406 derives directly from the seminal case of Young v. Grote, 4 Bing. 253, 130 Eng.Rep. 764 (1827).

In that case, Young, a depositor, contested the right of Grote, his banker, to charge a check to his account in the amount of £350.2s. During his absence, Young left five signed blank checks with his wife, who was not conversant with business. She gave one to Worcester, Young’s clerk, who filled it up for £50.2s. and showed it to her. The word “fifty,” as written,
began in the middle of the line, and Worcester later added before it the words “Three hundred and,” inserted the digit 3, and obtained payment for £350.2s. from Grote.

The court held that Young must bear the loss. Best, C.J., first stated the general rule that “a bank who pays a forged check, is in general bound to pay the amount again to his customer, because, in the first instance, he pays without authority.” He went on to say that, “In the present case, was it not the fault of Young that Grote and Co. paid 350l. instead of 50l.? . . . It is urged, indeed, that the business of merchants requires them to sign checks in blank, and leave them to be filled up by agents. If that be so, the person selected for the care of such a check ought at least to be a person conversant with business as well as trustworthy. . . . [Such a person] would have guarded against fraud in the mode of filling it up; he would have placed the word fifty at the beginning of the second line; and would have commenced it with a capital letter, so that it could not have had the appearance of following properly after a preceding word; he would also have placed the figure 5 so near to the printed £ as to prevent the possibility of interpolation. It was by the neglect of these ordinary precautions that Grote and Co. were induced to pay.”

(2) The Influence of Young v. Grote and Thompson Maple Products. Comment 1 to UCC 3–406 explains that subsection (a) “is based on former Section 3–406” and “adopts the doctrine of Young v. Grote”: “By issuing the instrument and ‘setting it afloat upon a sea of strangers’ the maker or drawer voluntarily enters into a relation with later holders which justifies imposition of a duty of care.”

Comment 2 notes that the less stringent “‘substantially contributes’ test of former Section 3–406 is continued . . . in preference to a ‘direct and proximate cause’ test. . . . Conduct ‘substantially contributes’ to a material alteration or a forged signature if it is a contributing cause of the alteration or signature and a substantial factor in bringing it about. The analysis of ‘substantially contributes’ in former Section 3–406 by the court in Thompson Maple Products v. Citizens National Bank of Corry . . . states what is intended by the use of the same words in revised Section 3–406(b).”

The court in The Bank/First Citizens Bank quotes Comment 2’s explanation of the “substantially contributes” test, but the opinion makes no reference to Thompson Maple Products. Are the two cases consistent?

(3) Drawer’s Cause of Action. In The Bank/First Citizens Bank, First Citizens Bank sought a declaration that it possessed no liability on the three checks. It filed the suit in response to Citizens and Associates’ demand that the bank “repay[ ] the face amounts of the checks.” What might have been the legal basis for Citizens and Associates’ demand? Consider three possibilities: conversion, warranty, and negligence.

Conversion. The last sentence of UCC 3–420(a) makes clear that the
drawer of a check has no claim for conversion of the check. As Comment 1 explains, “There is no reason why a drawer should have an action in conversion. The check represents an obligation of the drawer rather than property of the drawer. The drawer has an adequate remedy against the payor bank for recredit of the drawer’s account for unauthorized payment of the check.”

Did Citizens and Associates sue the drawee? Perhaps. A footnote explains that, to present a clearer picture of the issues between the parties, the court omitted much of the “somewhat complex” procedural history of the case, which ultimately involved “six parties with a number of cross-claims, counterclaims, counter suits, and motions to intervene.”

Warranty. First Citizens Bank breached the presentment warranty in UCC 4–208(a)(1). Because Ms. Gray was not authorized to enforce or indorse checks payable to her employer, First Citizens Bank was neither a person entitled to enforce the check nor authorized to obtain payment on behalf of a PETETI. The presentment warranties in UCC 4–208(a), however, are made to drawees who pay drafts, not to drawers. (A drawer who pays a dishonored draft receives the benefit of the warranty, see UCC 4–208(d), but the checks in The Bank/First Citizens Bank were paid by the bank and not dishonored.)

Negligence. The court indicates that “Citizens and Associates filed a counterclaim against First Citizens Bank alleging that the bank failed to exercise ordinary care in taking the instruments.” What is the basis of this claim? Read UCC 3–406(a) and (b) carefully. Which, if either, of these provides an affirmative claim against a negligent party? Does either apply to the facts of Citizens and Associates counterclaim? See Halifax Corp. v. Wachovia Bank, 268 Va. 641, 604 S.E.2d 403 (2004) (UCC 3–406 does not create an affirmative cause of action).

Even if UCC 3–406 does not create an affirmative cause of action for negligence, would Citizens and Associates be able to bring a common-law cause of action against First Citizens Bank for negligence? The answer to this depends first, on whether First Citizens Bank owes a duty of care to non-customers and, second, on whether UCC Article 3’s forgery rules displace a common-law cause of action for negligence. See Software Design & Application, Ltd. v. Hoeff & Arnett, Inc., 49 Cal. App. 4th 472, 56 Cal. Rptr. 2d 756 (1996) (“absent extraordinary and specific facts, a bank does not owe a duty of care to a non-customer”); UCC 1–103(b).

(D) SPECIAL LOSS-SHIFTING RULES

As we have seen, the UCC’s loss-allocation rules generally impose forgery losses upon those who deal with the forger. UCC 3–406 overrides these rules to impose the loss on those persons whose negligence substantially contributed to the making of the forgery. UCC 3–406 does so
by precluding the negligent person from asserting the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection. A negligent person who raises the preclusion will share in the loss to the extent its negligence substantially contributed to it.

We turn now to three other rules that override the basic loss-allocation rules. These rules, two of which appear in UCC 3–404 and one in UCC 3–405, are similar to UCC 3–406. They allow a person who, in good faith, pays the instrument or takes it for value or for collection to shift the loss to a person outside the banking system, except to the extent that the former’s negligence substantially contributed to the loss. These special rules differ from UCC 3–406 in three significant ways:

- They impose losses on persons outside the banking system even when those persons are not negligent.
- Rather than preclude the assertion of a forgery, they expressly make otherwise ineffective indorsements effective.
- Rather than providing that the “loss is allocated between the person precluded and the person asserting the preclusion,” they expressly allow a person upon whom the loss is imposed to “recover from” a negligent person.

**Problem 3.8.12.** Kim Kaller, Empire’s treasurer, drew a $25,000 check to the order of Quaker for a nonexistent delivery of goods. Kaller indorsed the check in Quaker’s name and deposited it in an account Kaller had opened in Quaker’s name in Metro Bank. The Bank of New York paid the check and charged it to Empire’s account. Kaller has absconded with the proceeds. Does Empire have a claim against The Bank of New York or Metro Bank? See UCC 3–404(b) and Comment 2, Case #2; Notes on UCC 3–405 and UCC 3–404(b), infra.

**Problem 3.8.13.** Meredith Hussler, one of Empire’s clerks, furnished Kim Kaller with a forged invoice from Quaker for a nonexistent delivery of goods. Kaller drew a $25,000 check to Quaker in payment of the invoice. Hussler stole the check before it was mailed to Quaker, indorsed it in Quaker’s name, and deposited it in an account Hussler had opened in Quaker’s name in Metro Bank. The Bank of New York paid the check and charged it to Empire’s account. Hussler has absconded with the proceeds.

(a) Does Empire have a claim against The Bank of New York or Metro Bank? See UCC 3–405 and Comment 2, Case #7; Continental Casualty Company v. Fifth/Third Bank, infra.

(b) Would it make a difference if Quaker actually delivered the goods and the invoice was genuine?

(c) What result if Hussler, after indorsing the check in Quaker’s name, had deposited it in Hussler’s own account in Metro Bank? What if Hussler’s indorsement in Quaker’s name included “for deposit”?

(d) What result if Hussler deposited the check without indorsing it?
(e) What result if the forged invoice was from Quark Manufacturing Co.,
which does not exist?

**Problem 3.8.14.** Quaker’s outside auditors recently discovered that
Quaker’s treasurer, Sandy Rocks, has been stealing from the company and
falsifying the books to cover up the thefts. Rocks’s primary technique has
been to take incoming checks payable to Quaker, write on the back “Pay to
Sandy Rocks, Empire Enterprises,” deposit them in Rocks’s account at
Metro Bank, and withdraw the proceeds.

(a) Is Quaker entitled to replacement checks from the drawers?
(b) What other sources of recovery does Quaker have? See UCC 3–406;
UCC 3–405; Continental Casualty Company v. Fifth/Third Bank, infra.
(c) What result if the fraud had been accomplished by Sandy’s brother,
Cleveland, who stole the check from Quaker’s mail room, where he works?

**Continental Casualty Company v. Fifth/Third Bank**
United States District Court for the Northern District of Ohio.

■ CARR, Chief Judge.

This is a subrogation claim by an insurance company, which paid a loss
resulting from the defalcation of an agent, Samuel Balber, of Brooks
Insurance Company, a Toledo, Ohio, insurance agency. Jurisdiction exists

Balber deposited more than $500,000 worth of premium payment checks
into his personal account at defendant Fifth/Third Bank (5/3). The checks
should have been deposited into the company’s account. Brooks had a
half-million dollar insurance policy with Continental Casualty Company
(Continental) for employee dishonesty and fraud. After Balber’s misconduct
came to light, Continental paid Brooks on the policy, and Brooks assigned
its rights against 5/3 to Continental.

Continental seeks to recover from 5/3 the $500,000 it paid Brooks.
Fifth/Third defends by asserting, *inter alia*, statutory Uniform Commercial
Code (UCC) defenses that place the liability for fraudulent checks not on the
depository bank but on either 1) an employer who places a dishonest
employee in a position of responsibility with regards to checks; or 2) a
person whose negligence substantially contributes to the making of the
forgeries. UCC §§ 3–405 (employee dishonesty); 3–406 (negligence
substantially contributing to the making of a forgery).

Pending are cross motions for summary judgment and a motion by
Continental to strike the deposition testimony of Dennis Johnson, Chief
Executive Officer of Brooks. For the following reasons, Continental’s motion
for summary judgment is granted in regards to ten checks with missing or
illegible endorsements and 127 checks with restrictive endorsements.
Otherwise, the motions are denied.
Background

Brooks is a Toledo-area insurance agency. Samuel Balber was a sales agent for Brooks. Brooks maintained its depository accounts at 5/3. Balber had an account at 5/3 in the name of “Samuel Balber Insurance.”

Balber defrauded Brooks by taking 279 checks for insurance premiums, endorsing them, and depositing the funds into his 5/3 account. His misdeeds were discovered and he ultimately pleaded guilty to criminal charges of bank fraud on November 1, 2002. The U.S. District Court for the Northern District of Ohio sentenced Balber to a thirty-four month term of imprisonment. Balber was ordered to pay Brooks $698,115.52 in restitution, but has, thus far, not done so.

Balber endorsed 127 checks, totaling $215,301.19, “for deposit only.” He endorsed 142 checks, totaling $320,682.96, with a “Brooks Insurance Agency” ink stamp and signed with the name of a deceased former Brooks employee, Rose Bodner. Ten checks, totaling $17,758.68, had missing or illegible endorsements.

This series of defalcations was not the first time Balber had taken customer payments and deposited them into his own account. In 1990, Balber’s accounts included such a large number of receivables that Brooks’s attorney contacted Balber about the problem. A Brooks employee eventually was assigned the task of scrutinizing Balber’s accounts in the future.

Around the time Brooks discovered the problems with Balber’s accounts in 1990, Balber informed Brooks’s Chief Executive Officer, Dennis Johnson, that he (Balber) had a substance abuse problem. In 1990, Balber paid Brooks $186,729.50 to resolve a receivable for one of his clients. Balber paid this amount with a check drawn on his own bank account, rather than with a check drawn on the client’s bank account. As a result of that incident, Brooks officials told Balber he could not deposit premiums into his own account.

After Brooks learned around 1990 about Balber’s substance abuse problem and high receivables, Balber ceased being a shareholder and officer with the agency.

Brooks’s knowledge of prior misdeeds by Balber, 5/3 argues, shows Brooks negligently failed to take preventative measures to stop Balber from misappropriating funds again. Continental, on the other hand, argues that 5/3 exaggerates the significance of Balber’s substance abuse problem and the severity of the earlier account irregularities.

This is a conversion claim, but both sides accuse each other of conduct that constitutes negligence or bad faith. Continental maintains that 5/3 grossly failed to follow reasonable banking practices by allowing Balber to deposit checks made out to Brooks into Balber’s own account. Fifth/Third, on the contrary, insists Brooks negligently failed to monitor both Balber and its own accounts, thereby substantially contributing to the fraud.
The dispositive issue is which party should bear the loss from Balber’s improprieties.

**Discussion**

...  

**III. Defenses to Continental’s Conversion Claim**

Continental is suing 5/3 for conversion of the 279 checks which 5/3 permitted Balber to deposit in his own account. Under Ohio law, a bank is liable to a payee in conversion if the bank takes a check for deposit that does not bear the authorized endorsement of the named payee or deposits a check in violation of a restrictive endorsement. (UCC §§ 3–420, 3–206). Continental is not suing under common law negligence. The defenses to a conversion claim are set forth in UCC § 3–405 (fraudulent endorsement by employee with responsibility for checks) and § 3–406 (negligence contributing to forged signatures).

**A. Section 3–405—Employee Fraud**

Section 3–405 covers situations involving a dishonest employee who forges his employer’s signature. If triggered, § 3–405 puts the liability for the employee’s forgeries on the employer, and not the bank that deposited the fraudulent instruments. The facts of the case must satisfy all of § 3–405’s elements for this provision to provide a defense to the bank.

To prevail under § 3–405 [i.e., to have the checks, even if fraudulently endorsed by Balber, treated as if they had been endorsed properly for Brooks’s account], 5/3 must show: 1) it deposited the checks into Balber’s account in good faith; and 2) Brooks entrusted Balber, its employee, with responsibility with respect to premium checks received by him.

If 5/3 makes this showing, the burden under § 3–405 shifts to Continental to prove that the bank failed to exercise ordinary care and that its failure substantially contributed to the loss.

**1. Bank Took Checks in Good faith**

Fifth/Third cannot invoke the defenses of § 3–405 (fraudulent endorsement by an employee with responsibility for the instrument) or § 3–406 (negligence that contributed to a forged signature) unless it took the checks from Balber “in good faith.” UCC §§ 3–405(a), 3–406(b).

A finding of bad faith is warranted if a bank for an extended period of time and despite bank policies dictating otherwise permits a person to deposit stolen checks to an account that does not belong to the payee. According to Continental, courts find bad faith as a matter of law in such situations because corporations do not allow agents to deposit checks payable to the company into the agent’s account.

Continental also points to 5/3’s own policy, which states that “[a]ny checks written to any form of a business entity should be deposited into an account with that business’ name.” Fifth/Third argues that it did not violate
its policy because it did not deposit the checks into Balber's personal account, but into his business account.

Fifth/Third contends that the endorsements on the checks were such that tellers acted properly in depositing the money into the account for “Samuel Balber Insurance.” The majority of checks bore endorsements invoking both Brooks’s and Balber’s authority.

I agree with Continental that the 5/3 policy language does not evidence the distinction 5/3 tries to make: namely, that depositing the checks into Balber’s account was in accordance with bank policy and reasonable commercial standards because it was a business account. That 5/3 may have violated its own policies does not, however, end the matter.

Indeed, even if 5/3 acted negligently in depositing the checks into Balber's account, it does not automatically follow that 5/3 acted in bad faith. “[M]ere failure to follow commercially reasonable banking procedures or to comply with its own policies” does not per se equal bad faith. [Pavex, Inc. v. York Fed. Sav. & Loan Assoc., 716 A.2d 640, 645 (Pa.Super.1998).]

Bad faith is “a bank's conscious and deliberate decision to remain ignorant of the existence of a fraudulent scheme despite irregularities on the face of the transactions.” Id. Additionally, “bad faith may properly be found where there has been either a gross violation of bank policies over an extended period and/or involving large sums, or a conscious and deliberate decision to ignore the existence of a fraudulent scheme.” Id. at 646.

Fifth/Third’s acts in this case occurred over a protracted period of time and involved numerous transactions for large sums. Ultimately, however, the evidence does not show that 5/3’s failure to follow its own policies and banking procedures was great enough to constitute a gross violation. No evidence, furthermore, indicates that the bank’s behavior resulted from deliberate decisions to ignore obvious fraud. Thus, 5/3 took the checks from Balber in good faith.

2. Entrusted With Responsibility for the Instruments

The next issue is whether Balber was an employee who was entrusted with responsibility for the instruments.

The term “responsibility” is defined by § 3–405.

(3) “Responsibility” with respect to instruments means authority to do any of the following:

(a) To sign or indorse instruments on behalf of an employer;
(b) To process instruments received by the employer for bookkeeping purposes, for deposit to any account, or for other disposition;
(c) To prepare or process instruments for issue in the name of the employer;
(d) To supply information determining the names or addresses of payees of instruments to be issued in the name of the employer;
(e) To control the disposition of instruments to be issued in the name of the employer;

(f) To act otherwise with respect to instruments in a responsible capacity.

“Responsibility” with respect to instruments does not include the 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.

UCC § 3–405.

Continental maintains that Balber’s job duties did not include “responsibility” for checks. According to Continental, Balber had no responsibility for processing, endorsing or depositing payments, which was handled exclusively by Brooks’s accounting department. Checks from customers for premiums were to be made payable to Brooks and deposited in Brooks’s checking account. Customers were to mail checks to Brooks, although sales agents could pick checks up from customers and then give those checks to the accounting department for processing. In short, Continental argues Balber had none of the responsibilities outlined in subparagraphs (a) through (e) under § 3–405(a)(3).

Fifth/Third counters by arguing that Brooks turned a “blind-eye to violations of” the policy that its accounting department had exclusive responsibility to deposit checks made payable to the company. Fifth/Third contends Brooks entrusted Balber with responsibility for the checks because it failed to monitor receivables, invoice forms, and agents’ banking and collection practices. The general theory of 5/3’s argument is that while Brooks’s written policies required customers to mail payments to Brooks, Balber’s actual practices—as known and implicitly approved of by Brooks—included his receipt of premium payments and depositing them in the bank.

For the sake of argument, I shall assume the facts are as 5/3 alleges them. The question, then, is whether the fact that Brooks failed to monitor Balbler and implicitly approved of his practices (or implicitly granted him authority to deposit checks by allowing him to do so regularly) constitutes “responsibility” under § 3–405(3).

Fifth/Third supports its view of “responsibility” with an unpublished Third Circuit case, Schrier Bros. v. Golub, 123 Fed.Appx. 484, 2005 WL 280733 (3d Cir.2005). The facts of that case are similar to those here. In Schrier Brothers, a sales agent for a janitorial supply company regularly received payment checks from customers. The sales agent was to put checks from customers in a company lockbox. Customers had the option of mailing checks to the company. Id. The Third Circuit held that the sales agent was an employee with responsibility for the checks.

Likewise, in Halla v. Norwest Bank Minnesota, 601 N.W.2d 449, 452–53
 Forgery

(Minn.App.1999), a real estate manager responsible for collecting rent on the employer’s behalf was found to be an employee who was entrusted with responsibility for checks.

Continental correctly notes that I am not bound by the unpublished Third Circuit opinion. But Third Circuit opinions, even unpublished ones, are persuasive authority. The Minnesota decision in Halla also is persuasive authority.

In any event, Continental counters Schrier Brothers by arguing that the Third Circuit focused on the “‘regularity’ of the agent’s practice of accepting checks from customers and his responsibility for sending the checks to the company’s lockbox for deposit.”

Continental asserts that no evidence shows that Balber had continuing and regular access to either customer checks or check records. Continental insists that Balber was permitted to handle checks only when customers did not mail them to Brooks. Balber’s authority, Continental argues, was limited to delivering checks to the accounting department.

In this case, a rational trier of fact could, however, find that Balber regularly accepted checks from customers. After all, he was able to get his hands on and negotiate 297 checks that should have gone into Brooks’s account, rather than his. Even absent direct evidence of how Balber came to acquire the checks, a fair inference can be drawn that many, if not most or all of the 297 checks came directly to him, rather than passing through Brooks’s normal channels.

The evidence shows, moreover, that Brooks permitted Balber (and other agents) to accept checks from customers, even if it did not regularly expect him to do so. The consequences of allowing such practice are not overcome by an internal policy stating that employees are not supposed to accept or handle checks. If an employer’s practices regularly disregard it written policy, the practice trumps the written policy. Actions, a jury could find, spoke louder than words.

I conclude, accordingly, that whether Balber regularly accepted checks and whether such acceptance, under all the circumstances, caused him to have “responsibility” for the checks is a question for the jury to resolve.

3. Balber Made Forged Endorsements on Almost All Checks

The next element of § 3–405 requires that the employee make a fraudulent endorsement of the instrument. UCC § 3–405(b). The bank seeking to invoke § 3–405 has the burden of proving the checks were endorsed in the name of the person to whom it is payable. UCC § 3–405(b). “Fraudulent endorsement” is defined by U.C.C. § 3–405 as “in the case of an instrument payable to the employer, a forged endorsement purporting to be that of the employer.”

Checks are deemed forged if they bore an endorsement in the name of the payee or a name substantially similar to that name. John Hancock Fin.
Services, Inc. v. Old Kent Bank, 346 F.3d 727, 731 (6th Cir.2003).

Both § 3–405 and § 3–406 are not available defenses for 5/3, therefore, against Continental’s conversion claim for the ten checks with missing or illegible endorsements. Hartford Fire Ins. Co. v. Maryland Nat’l Bank, 341 Md. 408, 671 A.2d 22, 31 (1996). A missing or illegible endorsement is neither in the name of the payee nor substantially similar to the name of the payee, and therefore not forged.

The other endorsements purported to invoke the name of “Brooks Insurance Agency.” Some were endorsed, in addition to the Brooks Insurance Agency endorsement, “Samuel Balber Insurance.” Additionally, some checks purported to be authorized by “Rose Bodner,” Balber’s deceased former secretary. Many of the checks signed in Bodner’s name also bore an ink stamp that read, “Brooks Insurance Agency By” (with Bodner’s name handwritten after the word, “by”).

Continental claims the 142 checks endorsed by Bodner were not forged because 1) the ink stamp used was not the stamp officially used to endorse checks, and 2) Bodner, even when alive, was not authorized to endorse checks for Brooks. In short, Continental maintains that, for an endorsement to be forged, it must contain the actual signature of an authorized agent of Brooks.

Continental is incorrect. The proper test is whether the signature was in the name of the payee or substantially similar to that name. The payee here is the business entity, Brooks Insurance Agency. I find the 142 signatures endorsed by Bodner and invoking Brooks’s name were substantially similar to the name of the payee.

In this case, the 142 checks signed by Bodner were accompanied by a Brooks Insurance Agency ink stamp. The law does not require a perfect match, only substantial similarity.

The ink stamp used by Balber need not have been the same as that used by Brooks employees and the signatures need not have been in the name of an authorized Brooks agent. This is so because the payee here is not an individual, but a business entity. Such entity may, at any given moment, have multiple individuals authorized to endorse checks on its behalf. In such instances, the actual name of the person whose signature seeks to invoke the business entity’s authority is less critical than the use of the entity’s name to the determination that an endorsement was substantially similar to the name of the payee.

Thus the 142 checks purportedly signed by Bodner on behalf of Brooks were forged.

4. The Restrictive Endorsements on 127 Checks Bar a § 3–405 Defense

The fourth element of § 3–405 requires that “the endorsement [be]
effective as the endorsement of the person to whom the instrument is payable.” (UCC § 3–405(b)). This requirement does not excuse a bank from complying with restrictive endorsements on checks; a depository bank that pays a check inconsistently with a restrictive endorsement is liable to the payee in conversion. Soc. Nat’l Bank v. Security Fed. Sav. & Loan, 71 Ohio St.3d 321, 324, 643 N.E.2d 1090 (1994); O.R.C. § 1303.26 (UCC § 3–206); see also State of Qatar v. First Am. Bank of Virginia, 880 F.Supp. 463, 471 (E.D.Va.1995) (stating § 3–405 does permit bank to disregard restrictive endorsements).

Continental argues 5/3 violated the restrictive endorsements on 127 checks that were endorsed:

For deposit only
Brooks Ins. Agency
Samuel Balber Insurance

The phrase “for deposit only” in an endorsement requires a bank to deposit the money into an account in the name of the person or entity listed immediately below those words.

Thus, the location of the phrase “for deposit only”—directly above “Brooks Ins. Agency”—required 5/3 to deposit the money into an account in the name of Brooks Insurance Agency. This reasoning is supported by a leading Uniform Commercial Code treatise. 2 White & Summers, Uniform Commercial Code § 16–7 (4th ed.).

The example given by White and Summers in this section is illustrative. In it, a business endorses a check with the inscription “for deposit only” followed by the name of the business. A postal worker steals the check and endorses it in his name below both the phrase “for deposit only” and the endorsement in the name of the business. A depository bank places the check in postal worker’s account. Under such circumstances, the business has a valid claim for conversion against depository bank for violating restrictive endorsement. The bank, therefore, should have deposited the funds into account in name of business entity whose name immediately followed the restrictive endorsement “for deposit only.”

A bank has a duty to examine a restrictive endorsement, follow its directions, and therefore refuse to deposit funds into a particular account—or at least investigate the matter—if the restrictive endorsement so requires.

Ohio law, additionally, considers the phrase “for deposit only” to be a restrictive endorsement requiring deposit to the payee’s account, regardless of whether an account number is designated.

Here, Brooks was the entity named immediately below the restrictive endorsement “for deposit only.” There is no evidence that 5/3 investigated the situation. The law required 5/3 to obey the restrictive endorsement and deposit the funds from the checks into Brooks’s account. Summary judgment
is warranted for Continental, therefore, with regard to the 127 checks that bore restrictive endorsements because § 3–405 does not protect a bank that violates such endorsements.

5. Whether 5/3 Failed to Exercise Ordinary Care

The fifth element of § 3–405 concerns whether the person paying or taking the instrument for value exercised ordinary care in so doing. UCC § 3–405(b). If the person who took the instrument for value did not exercise ordinary care, then comparative fault principles apply. (UCC § 3–405(b)).

The UCC defines “ordinary care” as “observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged.” UCC § 3–103(7).

A bank fails to exercise ordinary care if it does not comply with reasonable commercial standards. A bank’s acceptance of corporate checks for deposit into an agent’s account is commercially unreasonable. Continental Casualty, 263 Ill.Dec. 592, 768 N.E.2d at 367; see also Martin Glennon v. First Fidelity, 279 N.J.Super. 48, 652 A.2d 199, 203–04 (1995) (bank violates reasonable commercial standards where it accepts a corporate check for deposit into an agent’s account); Govoni & Sons Const., Inc., 742 N.E.2d at 1103 (same).

While normally the issue of negligence is for the trier of fact, courts have found certain egregious practices by banks to violate reasonable commercial standards as a matter of law. Examples of practices involving “clearly unreasonable conduct on the part of [a] bank” include: “payment of checks with missing endorsements, failure to respect restrictive endorsements, failure to inquire into the authority to sign of one purporting to be an agent, and allowing deposit of a check indorsed by a corporate payee into a personal account’ “ Govoni & Sons Const. Co., Inc., 742 N.E.2d at 1103.

i. Failure to Exercise Ordinary Care

Whether 5/3 exercised ordinary care here depends on how the checks were endorsed.

First, 5/3 failed to exercise ordinary care as a matter of law with regards to the checks bearing missing or illegible endorsements. See Govoni & Sons Const. Co., Inc., 742 N.E.2d at 1103 (taking check with missing endorsement is failure to exercise ordinary care as a matter of law). Depositing the ten checks lacking endorsements or bearing illegible endorsements into Balber’s account, or any account for that matter, violated reasonable commercial practices.

Second, 5/3 failed to exercise ordinary care as a matter of law by violating the restrictive endorsements on 127 checks.4 See id.(ignoring a

4. Not only is disregarding a restrictive endorsement commercially unreasonable, it also is a distinct grounds for liability. (UCC § 3–206).
restrictive endorsement equals failure to exercise ordinary care as a matter of law).

Third, the trier of fact will determine whether 5/3 failed to exercise reasonable care in taking the 142 checks with the endorsement of both Brooks (through Bodner) and Samuel Balber Insurance. These checks, importantly, did not have restrictive endorsements. This was also not a situation where Balber took checks made out to Brooks and signed only his own name on the back. Instead, the checks bore an endorsement purporting to invoke Brooks’s authority. That fact is significant. A teller could have concluded that Brooks, through Bodner, negotiated the checks to Balber. A teller might also be faulted, however, for failing to enquire into the propriety of Balber’s deposit of premium payment checks into his own account or Bodner’s authority to negotiate checks (using the ink stamp) to Balber.

ii. Comparative Fault

For the 142 checks without restrictive, missing, or illegible endorsements, the trier of fact must determine how the loss should be allocated under comparative fault principles. UCC § 3–405.

Section 3–405(b) states “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.” UCC § 3–405(b). A trier of fact could conclude that Brooks, by negligently failing to monitor Balber and its own accounts, should be allocated some of the fault for the forgeries.

Comparative fault does not apply to the checks with restrictive, missing, or illegible endorsements. Section 3–206, which states that a person paying or taking for value an instrument in violation of a restrictive endorsement is liable for conversion, does not contain comparative fault principles. Comparative fault is likewise not an issue for the ten checks with missing or illegible endorsements because, as mentioned earlier, § 3–405 and § 3–406 only apply to forged endorsements. A missing or illegible endorsement is not a forgery.

B. Section 3–406–Negligence Contributing to the Forgery

... I decline to grant summary judgment for 5/3 on this issue and leave it to the trier of fact to determine both if Brooks was negligent and, if so, whether that negligence substantially contributed to the making of the forged instruments.

The record contains enough evidence for the trier of fact to reach both conclusions. Balber made his previous substance abuse problem known to Johnson. Brooks likewise was aware of Balber’s prior misdeeds. Balber was able to pilfer almost 300 checks worth more than $500,000 over a three–year period without detection. It will be up to the jury to determine the legal consequences of his actions and Brooks’s apparent inaction.

In general, Continental insists that “[n]egligence of the payee is not a
defense to a conversion claim against a depository bank taking checks for collection bearing a forged instrument.” *John Hancock Fin. Serv., Inc.*, 346 F.3d at 732–33. True, negligence of the payee is not a complete defense, but § 3–405(b) and § 3–406 contain comparative negligence principles. The facts here are, moreover, distinguishable on several grounds from *John Hancock*, which dealt with issues of Michigan law and an attempted § 3–406 defense.

First, § 3–406 only applies to forged endorsements. In *John Hancock*, the Sixth Circuit agreed with the district court that the endorsements at issue were not forged, thus making the rest of § 3–406—which contains comparative fault language—inapplicable. *Id.* at 730–31. The endorsements at issue in this case, however, were forged.

Elsewhere in the *John Hancock* decision, the Sixth Circuit stated the comparative fault principles of the Michigan Tort Reform Act did not apply to a UCC–based conversion claim. That holding does not apply here because there is no comparable tort reform act at issue.

Comparative fault, therefore, operates here to the extent § 3–405 and § 3–406 are triggered, which the trier of fact will decide.

**IV. Summary: Final Analysis of Sections 3–405 and 3–406**

Fifth/Third cannot invoke a § 3–405 (or § 3–406) defense with regards to the 127 checks with restrictive endorsements or ten checks with missing or illegible endorsements. Summary judgment in favor of Continental, therefore, is warranted for those 137 checks.

With regards to the 142 checks without restrictive endorsements, issues of regularity and responsibility, negligence, and comparative negligence issues are disputed, and for the trier of fact to resolve.

. . .

**NOTES ON UCC 3–405 AND UCC 3–404(b)**

(1) “Inside jobs.” Many forgeries arise when an employee embezzles from the employer. For example, a payee’s employee may take incoming checks, forge the payee’s indorsement, and obtain payment. Likewise an employee of the drawer may steal an outgoing check issued by the employer-drawer, forge the payee’s indorsement, and obtain payment. Or an employee (say, a corporation’s treasurer) may draw a check payable to a payee to whom the drawer owes no money, with a view towards obtaining payment of the check. UCC 3–405 and UCC 3–404(b) contain special rules for these “inside jobs.” These rules are designed to impose upon an employer many forgery losses arising from wrongdoing by its employee.

*Responsible Employees.* Like the negligence rules in UCC 3–406, the rules in 3–405 protect those who, in good faith, pay an instrument or take it for value or for collection. But unlike UCC 3–406, which applies a rule of preclusion, UCC 3–405 operates to make certain forged indorsements
effectively—generally, forged indorsements made by employees and independent contractors retained by the payee or drawer and whom the payee or drawer entrusted with “responsibility” with respect to the instrument. UCC 3–405(a)(3) defines “responsibility” very broadly. However, the term “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.” As with UCC 3–406, a negligent taker or payor bears part of the loss. See UCC 3–405(b).

**Drawers with bad intent; fictitious payees.** UCC 3–404(b) contains a similar rule, which makes an indorsement in the name of the payee effective if the person signing the check on behalf of the drawer does not intend the payee to have an interest in the check. Suppose, for example, that Kim Kaller, Empire’s treasurer, decides to embezzle from Empire. As part of this scheme, Kaller signs Empire checks payable to Empire’s creditors, deposits the checks in Kaller’s bank account, and uses the proceeds to take a trip around the world. Under the general rules, The Bank of New York would have no right to charge Empire’s account for any of these checks. Each check instructed The Bank of New York to pay the named payee or someone who took the check from the payees. Instead, the Bank of New York paid a third party. The Bank of New York would have a claim against the presenting bank and all previous transferors for breach of the warranty in UCC 4–208(a)(1). However, under UCC 3–404(b), Kaller is a holder of each of these checks, and Kaller’s indorsement in the name of the payee is effective in favor of a person who, in good faith, pays the instrument or takes it for value or for collection. See UCC 3–404, Comment 1, Case #2. This means that The Bank of New York may charge Empire’s account and has no claim for breach of a presentment warranty. Thus, like the rule in UCC 3–405, the primary function of the rule in UCC 3–404(b) is to shift the risk of employee dishonesty from the payor bank to the employer, which can guard against that risk by obtaining a fidelity bond.

Suppose that, in the previous example, Kaller made a check payable to Quark Manufacturing Co., a firm that does not exist. UCC 3–404(b) covers this case, that of a “fictitious payee,” as well. An indorsement by Kaller (or any other person) in the name of Quark Manufacturing Co. is effective a Quark’s indorsement in favor of a person who, in good faith, pay an instrument or take it for value or for collection. See UCC 3–404, Comment 1, Case #1.

**2) Other Applications of UCC 3–404(b).** The rule in UCC 3–405 applies only to indorsements forged by employees entrusted with responsibility with respect to instruments or by persons acting in concert with such an employee. In contrast, the rule in UCC 3–404(b) is not limited to “inside jobs.” Rather, it applies to every case which “a person whose intent determines to whom an instrument is payable . . . does not intend the
person identified as payee to have any interest in the instrument,” including some cases where an outsider forges the drawer’s signature. See UCC 3–404, Comment 2, Case #4 and #5.

(3) **Double Forgeries.** Sometimes, a malefactor forges both the drawer’s signature and the payee’s indorsement. Consider the facts of Gina Chin & Associates v. First Union Bank, 256 Va. 59, 500 S.E.2d 516 (1998):

Chin, a food wholesaler, maintained checking accounts at Signet Bank and Citizens Bank of Washington, D.C. (the drawee banks). During 1994 and 1995, an employee of Chin, Amie Cheryl Lehman, forged the signature of one of Chin’s officers on a number of checks that were payable to Chin’s suppliers. Lehman then forged the payees’ indorsements and, with the assistance of a First Union teller, deposited the checks in an account which she held at First Union. The drawee banks then paid the checks and debited a total amount of $270,488.72 from Chin’s accounts.

Because the checks involve a forged drawer’s signature, one might argue that, under the rule of Price v. Neal, the drawee banks should bear these losses. But one might also argue that, inasmuch as the checks bear forged indorsements, the loss should fall on First Union. Although the answer was not clear under former Article 3, the reported “double forgery” cases generally imposed the loss on the payor bank. Current Article 3 adopts this view. Perhaps surprisingly, it uses reaches UCC 3–404(b) or UCC 3–405 to reach the desired result.

In *Gina Chin*, Lehman was the “person whose intent determines to whom [each check] is payable.” See UCC 3–110(a). She did “not intend the person identified as payee to have any interest in the instrument.” UCC 3–404(b). Accordingly, Lehman was the first holder of each check, and her indorsement in the name of the payee was effective as the payee’s indorsement in favor of the drawee banks and First Union (assuming they acted in good faith). See id. As a holder, Lehman was a person entitled to enforce the check, and so First Union did not breach the presentment warranty in UCC 4–208(a)(1). Although the checks were paid to a PETETETI, they were not properly payable from Chin’s account because the drawer’s signature was unauthorized. Thus, the drawee banks bear the loss unless they can shift it to Chin (perhaps under UCC 3–406) or to First Union (under UCC 3–404(d)).

Note that if Chin had entrusted Lehman with responsibility with respect to instruments, then Lehman’s indorsement would have been effective as that of the named payee under UCC 3–405.

(4) **Effect of Negligence.** In the first instance, both UCC 3–405 and UCC 3–404 make indorsements effective and impose losses without regard to negligence. Each, however, allows the person bearing the loss to recover from a person who fails to exercise ordinary care in paying the instrument or in taking it for value or for collection, if the latter’s failure substantially
contributes to the loss. Any recovery is “to the extent the failure to exercise ordinary care contributed to the loss.” UCC 3–405(b); UCC 3–404(d).

**Problem 3.8.15.** C.C. Conn approached Kim Kaller, Empire’s treasurer, impersonating J.J. Sterling, a reputable merchant. Kaller drew a $5,000 check payable to Sterling as an advance payment for goods that Conn, as Sterling, promised to furnish to Empire. Conn indorsed it in Sterling’s name, and The Bank of New York paid it and charged it to Empire’s account. Conn absconded with the proceeds.

(a) Does Empire have a claim against The Bank of New York? See UCC 3–404(a).

(b) Would it make a difference if Kaller had drawn the check payable to “Sterling Industries, Inc.” rather than to Sterling? What if Conn had not impersonated Sterling but had claimed to be the new president of “Sterling Industries, Inc.” to which Kaller had made the check payable? See Advocate Health and Hospitals Corp. v. Bank One, N.A., infra; Note on Impostors, infra.

**Advocate Health and Hospitals Corp. v. Bank One, N.A.**

■ Justice McBRIDE delivered the opinion of the court:

The issues on appeal are whether the imposter defense contained in section 3–404(a) of the Illinois version of the Uniform Commercial Code, Negotiable Instruments may be properly asserted in a section 2-615 motion to dismiss a complaint for failure to state a claim and whether the defense is factually applicable to the present dispute.

As detailed in this court’s earlier opinion, *Blutcher v. EHS Trinity Hospital*, 321 Ill.App.3d 131, 254 Ill.Dec. 106, 746 N.E.2d 863 (2001), one of the defendants in that action, a hospital, issued a $200,000 check in settlement of a patient’s medical malpractice claim, after the patient’s attorney falsely represented that he was authorized to settle the claim and tendered a notarized covenant not to sue bearing his client’s forged signature. The client only learned of the settlement a year later, when he questioned why the hospital was no longer named as a defendant in an amended version of the complaint. The circuit court granted the client’s subsequent petition to vacate the falsified settlement agreement, vacate the order dismissing the hospital as a defendant, and reinstate the medical malpractice claim as to the hospital, and was affirmed on appeal.

The present suit is the hospital’s attempt to recoup the $200,000 debited to its checking account by its bank, defendant First National Bank of Chicago, n/k/a Bank One, N.A. (First National). The hospital alleged in a second amended complaint that the attorney forged his client’s endorsement
on the check, endorsed the check himself, deposited it into an account the attorney maintained with nonparty American National Bank of Chicago (American National), and kept the proceeds. The hospital claimed that First National’s payment of the check bearing the client’s forged endorsement was a breach of section 4-401 of the UCC. Section 4-401 indicates a bank may charge an item against a customer’s account only if the item is “properly payable,” and the official comment to that section indicates an item bearing a forged endorsement is not considered properly payable. The hospital gave no indication in its second amended complaint as to why it had issued the check to the attorney.

Those circumstances, however, were disclosed to the trial judge by First National, after it obtained a copy of a legal memorandum which the hospital had filed in the Blutcher proceedings in an effort to enforce the forged settlement agreement. First National relied on the facts disclosed in the hospital’s Blutcher memorandum, in a successful section 2-615 motion to dismiss the hospital’s UCC claim with prejudice. First National’s argument was that since the forged covenant not to sue had induced the hospital to issue the check to the dishonest attorney, the UCC’s imposter defense precluded the hospital from shifting its $200,000 loss to First National. Under the imposter defense, an endorsement in the name of the payee is “effective” if an imposter “by use of the mails or otherwise” has induced the drawer to issue the check to the imposter in the name of the payee. [UCC 3–404(a).] Title to the check passes as though the forged endorsement is genuine, and liability on the check lies with the drawer, rather than a depositary bank, such as American National in this instance, or a payor or drawee bank, such as First National in this instance, as long as there is no lack of good faith by the banks involved. The rationale for the imposter defense is that “[t]he drawer is in the best position to avoid the fraud and thus should take the loss.” [UCC 3–404(a), Comment 3.] Furthermore, “because the drawer * * * has increased the chance of forgery by dealing with a person who intends to commit a forgery, and has even permitted the forger to choose the name that he will forge, the drawer’s * * * culpability is deemed to outweigh that of subsequent purchasers.” 4 Hawkland, Uniform Commercial Code Series § 3–405 (2002) (section 3–405 has been renumbered as section 3–404). Aside from the imposter defense, due to the client’s forged signature on the check, the bank that accepted it, American National, would be liable for warranting to the subsequent bank, First National, that “all signatures on the item are authentic and authorized.” [UCC 4–207(a)(2).]

[T]he questions are what type of conduct constitutes an imposter and whether the bank proved an imposter induced the hospital to issue the $200,000 check at issue.

The current, revised version of UCC Article 3, which is the article pertaining to negotiable instruments, does not include a definition of the
term “imposter,” and the prior, or original version of Article 3 included only a brief official comment, indicating, “‘Impostor’ refers to impersonation, and does not extend to a false representation that the party is the authorized agent of the payee. The maker or drawer who takes the precaution of making the instrument payable to the principal is entitled to have his indorsement.” [F3–405(1)(a), Comment.]

Because the old official comment made it clear that the imposter defense “does not extend to a false representation that the party is the authorized agent of the payee,” courts have consistently indicated that misrepresentation of a person’s authority as an agent is not enough to trigger the imposter defense. When a person honestly identifies himself or herself, but falsely purports to be an agent of another, the person is simply misrepresenting his or her status, rather than misrepresenting his or her identity. An impersonation, or misrepresentation of identity, is always required before the imposter rule can be invoked, whether the imposter pretends to be the principal or his agent. This principle is illustrated by [Title Insurance Co. of Minnesota v. Comerica Bank-California, 27 Cal. App.4th 800, 32 Cal. Rptr. 2d 735 (1994), in which a bank customer’s son obtained home equity loans in her name by falsely representing that he was authorized to act on her behalf. The son arranged for checks to be issued totaling about $167,000, without assuming his mother’s identity or forging her signature on the loan documents. He always correctly identified himself as her son. Although his conduct was fraudulent, it was not an impersonation of his mother, and thus was not enough to invoke the imposter defense. Similarly, here, we find the mere fact that the dishonest attorney orally misrepresented his authority to settle his client’s pending medical malpractice suit against the hospital was not enough to trigger the imposter defense. The question is whether the attorney’s additional conduct of using the forged covenant not to sue amounted to an assumption of his client’s identity.

Courts have disagreed over whether an impersonation occurs when, as in this case, a forged document is tendered in order to obtain a negotiable instrument. The disagreement has resulted in two lines of authority.

There is only one post-UCC Illinois case addressing the imposter defense, but the topic was apparently only a minor issue, and thus provoked little discussion by the court. Because of this, and the need for uniformity in the interpretation of the UCC (see 1 Hawkland Uniform Commercial Code Series, 1–102 (2002)), we consider it appropriate to consider the non-Illinois authority cited by the defendant bank and plaintiff hospital.

The bank relies upon the minority line of cases, which has applied the imposter defense when a forged document has been used to obtain a negotiable instrument. The leading opinion is Minster State Bank v. BayBank Middlesex, 414 Mass. 831, 611 N.E.2d 200 (1993), in which the court construed a promissory note bearing a husband’s signature and his
wife’s forged signature as the husband’s “implicit[ ]” impersonation of his spouse. The court was of the opinion that although the husband had not impersonated his wife “in the literal ‘in person’ “sense, he had held himself out as her, in writing, inducing the bank to issue a loan check. . . .

We are not persuaded by Minster’s reasoning. We regard an imposter as “[o]ne who pretends to be someone else to deceive others” (Black’s Law Dictionary 760 (7th ed.1999)), or “a person who practices deception under an assumed character, identity or name” (Random House Webster’s Unabridged Dictionary 962 (1998)), rather than someone who correctly identifies himself or herself but suggests through forged documents or signatures that another person is involved in their financial or business transaction. A dissenting justice in Minster considered it crucial that the husband had never represented that he was anyone other than himself. The dissent pointed out that if the husband had forged the wife’s signature and returned the promissory note to the bank without a cover letter or with a cover letter purportedly from her, then clearly an imposture “by use of the mails or otherwise” [UCC 3–404(a)] as stated in the UCC would have occurred. Impersonation would have occurred in those circumstances because the mailing would have falsely represented that the wife, not the husband, was the correspondent. However, the facts showed that the husband had only lied about his wife’s participation in the loan transaction and never expressly or implicitly told anyone that he was her. The dissent believed the court had too lightly dismissed the “sound logic” of the other developing line of authority which would have construed the husband’s conduct as a misrepresentation coupled with a forged document.

. . . [This line of cases] includes a case we consider the most factually similar to the present dispute, Clients’ Security Fund v. Allstate Insurance Co., 219 N.J.Super. 325, 530 A.2d 357 (1987). In that New Jersey case, an attorney tendered forged client releases in order to obtain settlement checks. The checks were made payable to the attorney and his clients, but the attorney forged the clients’ endorsements, deposited the funds into his own account at another bank, and then kept the proceeds. The New Jersey court was satisfied that under these facts, the imposter defense was not applicable. It emphasized that the attorney never pretended to be anyone other than himself. He always represented the true fact that he was the claimants’ attorney, and never claimed to be the clients themselves. In the court’s opinion, rather than impersonating someone, the attorney misrepresented that his clients intended to settle, and then strengthened his misrepresentation with a forged document. The court also indicated that if it deemed the attorney to be an impersonator, it would effectively negate the UCC’s general rule that a forged endorsement is ineffective to pass title. “Virtually every forger would be an ‘impersonator’ Every forged instrument would thus be rendered effective, thereby immunizing the depositary bank from liability.” Clients’ Security, 219 N.J.Super. at 333, 530 A.2d at 361. . . .
We are persuaded that this line of cases is the proper interpretation of the UCC imposter defense. We point out, however, that although we consider Clients’ Security to be the most analogous, none of the previous cases appears to have involved a forged signature that was notarized.

We now consider the bank’s basis for seeking dismissal of the hospital’s pleading. The bank relied on three documents.

These documents, however, do not establish the imposter defense was applicable. They do not prove that anyone assumed the client’s identity, nor do they prove that the assumption of identity is what induced the hospital to issue the settlement check. The statements clearly indicate that the attorney misrepresented his authority to settle, yet misrepresentation of authority is not an imposter and has never been enough to trigger the defense. The statements also clearly establish that the client’s signature was notarized, yet they do not indicate that an actual assumption of the client’s identity was necessary to gain the notary’s endorsement. These statements leave open several possible ways of obtaining the notarization, and not all of them involve an imposter. We do not know what actually occurred and what discovery might reveal about the circumstances leading up to the issuance of the settlement check. [A] question of fact exists as to whether an imposter, or assumption of identity . . . occurred, and that the moving party failed to meet its burden of proving imposture as a matter of law. We also point out that the documents clearly disclose that the attorney tendered the covenant not to sue bearing the client’s forged signature and that the hospital tendered its check, but they do not establish that the notarized document in particular is what induced the hospital to issue the check. Even assuming that an actual imposture was required to gain the notary’s endorsement, a question of fact remains as to whether that imposture induced issuance of the check.

At this point in time, material questions of fact remain as to what transpired before the $200,000 settlement check was issued. It cannot be said that there is no set of facts which would entitle the hospital to recover against the bank. Accordingly, the bank was not entitled to judgment as a matter of law and the dismissal of the bank’s complaint was erroneous. The judgment of the circuit court is reversed, and this cause is remanded for further proceedings consistent with this opinion.

Reversed and remanded.

QUESTION

In The Bank/First Citizens Bank, supra, page 202, First Citizens Bank filed a motion for summary judgment, claiming that it was entitled to judgment as a matter of law under UCC 3–404(a). The trial court refused to allow the bank to invoke the imposter defense and denied the motion. Was
the motion decided correctly?

NOTE ON IMPOSTORS

Since the inception of the UCC, the “impostor” rule has appeared in form as a Siamese twin of the fictitious payee rule, the two rules inseparably connected in the same section, now UCC 3–404. Yet in function the two rules have little in common, except to put the risk of a forged indorsement on the drawer.

As we have seen, the primary function of the fictitious payee rule today is to shift the risk of employee dishonesty from the payor bank to the employer, who can guard against that risk by obtaining a fidelity bond. The primary function of the impostor rule is to shift the risk of confidence games practiced on the drawer from the payor bank to the gullible drawer, who has no available means of insuring against this risk.

We saw in Chapter 1, Section 1, that, under a similar impostor rule in UCC 2–403(1)(a), an owner of goods who was “conned” out of them by an impostor bears the loss as against a good faith purchaser who took the goods from the impostor. Is the impostor rule of UCC 3–404(a) as well founded? Is it significant that even a gullible drawer of a check expects to have the genuine indorsement of the payee, an expectation that has no counterpart in the sale of goods? Does the impostor rule adequately take into account the fact that an impostor often must work an imposture not only against the drawer but also against the depositary bank? See UCC 3–404(d).

(E) EFFECT OF POSTPAYMENT NEGLIGENCE

UCC 4–406 imposes on two duties on a customer to whom a bank sends or makes available the items paid for the customer’s account (or a statement of account showing payment of the items). First, the customer must exercise reasonable care and promptness in examining the items or the statement to determine whether any payment was unauthorized because of an alteration or an unauthorized drawer’s signature. Second, if the customer should reasonably have discovered the unauthorized payment, the customer must promptly notify the bank of the relevant facts. Like UCC 3–406, which deals with prepayment negligence, the UCC’s treatment of postpayment negligence derives from the common law.

Critten employed a clerk named Davis, whose duty it was to fill out checks for Critten’s signature and give them, together with the relevant bills, to Critten, who signed them, put them in envelopes, and placed them in the mailing drawer. Over a two-year period, Davis took twenty-four checks from the drawer, obliterated with acid the names of the payee and the amount, and made them payable to cash in a raised amount. He paid the bills himself and kept the excess. Since Davis was also entrusted with the verification of the bank balance, his speculations went unnoticed, although
he usually failed to alter the check stubs to conceal them, until another clerk verified the balance when Davis was absent from work. Critten then sued the drawee for the excess it had paid on the checks. The court concluded that:

the depositor owes his bank the duty of a reasonable verification of the returned checks. . . . The practice of taking checks from check books and entering on the stubs left in the book the date, amount and name of the payee of the check issued has become general, not only with large commercial houses but with almost all classes of depositors in banks. The skill of the criminal has kept pace with the advance in honest arts and a forgery may be made so skillfully as to deceive not only the bank, but the drawer of the check as to the genuineness of his own signature. But when a depositor has in his possession a record of the checks he has given, with dates, payees, and amounts, a comparison of the returned checks with that record will necessarily expose forgeries or alterations. It is true that it will give no information as to the genuine character of the indorsements, and because the depositor has no greater knowledge on that subject than the bank, it owes the bank no duty in regard thereto. . . . It is also true that verification of the returned checks would not prevent a loss by the bank in the case of the payment of a single forged check, and probably not in many cases enable the bank to obtain a restitution of its lost money. It would, however, prevent the successful commission of continuous frauds by exposing the first forgeries. . . . While we hold that this duty rests upon the depositor, we are not disposed to accept the doctrine asserted in some of the cases that by negligence in its discharge or by failure to discover and notify the bank, the depositor either adopts the checks as genuine and ratifies their payment or estops himself from asserting that they are forgeries. . . . If the depositor has by his negligence in failing to detect forgeries in his checks and give notice thereof caused loss to his bank, either by enabling the forger to repeat his fraud or by depriving the bank of an opportunity to obtain restitution, he should be responsible for the damage caused by his default, but beyond this his liability should not extend.

Therefore, although a comparison of returned checks with unaltered stubs would have thwarted subsequent alterations, Critten was not precluded from recovering for the first and second checks, which were returned together; comparison would have come too late to have prevented their payment. But comparison of the first and second checks with the stubs would have prevented payment of the third, fourth and fifth checks, and Critten was accountable for these. The sixth check, however, had been so mutilated by Davis that the bank was itself negligent in paying it, and the bank was therefore liable for that and subsequent checks. Furthermore,
Davis had presented one of the checks for which Critten would have been accountable through a collecting bank, rather than directly to the payor bank. As to that check, the payor bank had recourse against the collecting bank and could not hold Critten. Critten v. Chemical National Bank, 171 N.Y. 219, 63 N.E. 969 (1902). In 1904, shortly after this decision, New York enacted a statute precluding a drawer from contesting payment of a forged or altered check, regardless of the drawer’s exercise of reasonable care, unless the drawer had notified the payor bank within one year after return of the cancelled check.

Observe how closely UCC 4–406 tracks the Critten case and subsequent legislation. Subsections (c) and (d) deal with the duty of the depositor “to examine the statement or the items.” Subsection (e) deals with the effect of the bank’s lack of care. Subsection (f) contains the counterpart of the statutory period. As to alterations, resolution of the controversy between payor bank and collecting bank is found in UCC 3–417(c) and UCC 4–208(c).

**Problem 3.8.16.** Empire asks whether there is a specific period of time within which it must examine The Bank of New York’s statement and its returned checks. If there is, Empire would like to know the consequences of any delay. Empire would also like to know, since it is a small company, if it runs any risk by having the same employee prepare checks for signature, enter them in the checkbook, and reconcile the statements and returned checks with the checkbook. Advise Empire. See UCC 4–406.

**Problem 3.8.17.** Using three of Empire’s blank checks, Terry drew a series of checks payable to Kerry. Kerry deposited each check in Kerry’s account at PNC Bank, and The Bank of New York paid all three. The Bank of New York sends a statement of account to Empire on the tenth day of each month. Empire’s July statement showed that the first check had been paid; however, it never arrived at Empire’s offices. Empire’s August statement showed payment of the second check, and its September statement showed payment of the last check. Empire called the bank to report the forgeries on September 24. Which of the checks, if any, must The Bank of New York recredit to Empire’s account?

**Problem 3.8.18.** The Bank of New York’s policy, like that of many large New York banks, is to examine all checks presented for payment in the amount of $2,500 or more and a random one percent of other checks. Under the facts of the preceding Problem, Empire would like to shift the losses arising from Terry’s wrongdoing in to The Bank of New York. To what extent, if any, can it do so under the following circumstances:

(a) Each check was in the amount of $2,000, the forgery was obvious, but The Bank of New York did not examine the checks. See UCC 4–406; UCC 3–103(a)(9); Notes on Postpayment Negligence, infra.

(b) Each check was in the amount of $5,000, the forgery was obvious, but
The Bank of New York did not examine the checks.

(c) Each check was in the amount of $5,000, The Bank of New York examined the checks, but each signature was a “perfect forgery.”

**National Title Insurance Corporation Agency v. First Union National Bank**

Supreme Court of Virginia., 2002.
263 Va. 355, 559 S.E.2d 668.

Opinion by Justice CYNTHIA D. KINSER.

Pursuant to the provisions of Code § 8.4-406(f), a bank’s customer is precluded from asserting against the bank an unauthorized signature or alteration on an item if the customer fails to report such fact to the bank within one year after a statement of account showing payment of the item is made available to the customer. The dispositive issue in this appeal is whether a bank and its customer may, by contractual agreement, shorten the one-year period provided in Code § 8.4-406(f). Because we conclude that Code § 8.4-103(a) permits the parties to vary that time period, we will affirm the judgment of the circuit court holding that an agreement reducing the period to 60 days is binding on the parties.

**FACTS AND MATERIAL PROCEEDINGS**

National Title Insurance Corporation Agency (National Title) opened an escrow checking account with First Union National Bank (First Union) in April 1996. At that time, the parties entered into a “DEPOSIT AGREEMENT AND DISCLOSURES For Non-Personal Accounts” (Deposit Agreement) that defined and governed the relationship between them. The provisions of Paragraph 12 of that Deposit Agreement, which are at issue in this appeal, absolve First Union of any liability for paying an item containing an unauthorized signature, an unauthorized indorsement, or a material alteration if National Title does not report such fact to First Union within 60 days of the mailing of the account statement describing the questioned item. In pertinent part, Paragraph 12 states:

You should carefully examine the statement and canceled checks when you receive them. If you feel there is an error on the statement, or that some unauthorized person has withdrawn funds from the account, notify us immediately. The statement is considered correct unless you notify us promptly after any error is discovered. Moreover, because you are in the best position to discover an unauthorized signature, an unauthorized [i]ndorsement or a material alteration, you agree that we will not be liable for paying such items if . . . (b) you have not reported an unauthorized signature, an unauthorized [i]ndorsement or material alterations to us within 60 days of the mailing date of the earliest statement describing these items. . . .
Subsequently, First Union paid two checks ostensibly drawn on National Title’s account, both of which were counterfeit checks and were not executed by an authorized signatory to the account. The first check, paid in November 1998, was described in an account statement mailed on December 5, 1998, and the second check, paid in December 1998, was described in National Title’s account statement mailed on January 5, 1999. National Title did not report either of the unauthorized signatures to First Union within 60 days of the mailing of the respective account statements describing the two checks.

After First Union refused to credit National Title’s account in the amounts paid on the two checks bearing unauthorized signatures, National Title filed a motion for judgment seeking to recover its losses from First Union. In its answer, First Union asserted, among other things, that National Title was precluded from making this claim because it had failed to report the unauthorized signatures within the 60-day time period specified in Paragraph 12 of the Deposit Agreement between the parties.

Ruling on the parties’ cross-motions for summary judgment, the trial court concluded that First Union and National Title could contractually reduce the one-year period for reporting unauthorized signatures set forth in Code § 8.4-406(f) and that the 60-day period agreed upon by the parties in this case is not “manifestly unreasonable” under the provisions of Code § 8.4-103. The court therefore denied National Title’s motion for summary judgment and granted First Union’s motion, entering judgment in favor of First Union. National Title now appeals from that final judgment.

ANALYSIS

Title 8.4 of Virginia’s Uniform Commercial Code (UCC) establishes the rights and duties between banks and their customers with regard to deposits and collections. A bank may charge against the account of its customer only those items that are properly payable from that account. See Code § 8.4-401(a). Items bearing unauthorized signatures, such as the checks in this case, are not properly payable. Id.

However, a customer has certain duties with regard to discovering and reporting an unauthorized signature or alteration on an item. If a bank sends or makes available to its customer a statement of account showing payment of items for the account, “the customer must exercise reasonable promptness in examining the statement or the items to determine whether any payment was not authorized because of an alteration of an item or because a purported signature by or on behalf of the customer was not authorized.” Code § 8.4-406(c). A customer must promptly report to the bank

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5. The term “item” means an instrument or a promise or order to pay money handled by a bank for collection or payment.” Code § 8.4-104(9). The term “customer” means a person having an account with a bank or for whom a bank has agreed to collect items . . . .” Code § 8.4-104(5).
any unauthorized payment that the customer “should reasonably have discovered” based on the statement or items provided. *Id.*

If a customer fails to comply with these duties, the customer is precluded from asserting against the bank the unauthorized signature or alteration on the item. Code § 8.4-406(d)(1). However, if a customer establishes that the bank “failed to exercise ordinary care in paying the item and that the failure substantially contributed to loss, the loss is allocated between the customer precluded and the bank asserting the preclusion according to the extent” that the failure of each party contributed to the loss. Code § 8.4-406(e).  

Finally, if a customer does not discover and report an unauthorized signature or alteration on an item within one year after the statement or items are made available to the customer, the customer is thereafter precluded from asserting against the bank the unauthorized signature or alteration. Code § 8.4-406(f). This preclusion applies irrespective of whether the bank paid the item containing the unauthorized signature or alteration in good faith. *Halifax Corp. v. First Union Nat’l Bank*, 262 Va. 91, 101, 546 S.E.2d 696, 703 (2001).

On appeal, National Title first argues that Code § 8.4-406(f) is a statute of repose, i.e., a rule of substantive law, and that the one-year period set forth in that section is, therefore, not subject to contractual modification by the parties. Next, National Title posits that Paragraph 12 of the Deposit Agreement imports the time bar established in Code § 8.4-406(f) into subsection (c), thereby rendering the preclusion in subsection (f) meaningless. National Title further asserts that Paragraph 12 impermissibly changes the comparative negligence provisions established in Code § 8.4-406(e) and reinstates the concept of contributory negligence into Code § 8.4-406(c). Finally, National Title contends that the 60-day time limit for reporting an unauthorized signature or alteration on an item is “manifestly unreasonable,” but that, if Paragraph 12 is enforceable, the 60-day limit should be construed as the parties’ definition of “reasonable promptness” in determining comparative negligence, rather than as an absolute bar to National Title’s claim against First Union. We do not agree with National Title.

The issue in this appeal is whether a bank may, through a contractual agreement with its customer, shorten the one-year period provided in Code § 8.4-406(f) to a period of 60 days. In *Halifax Corp.*, 262 Va. at 101, 546 S.E.2d at 703, we characterized that one-year period as a statutorily prescribed notice that operates as “a condition precedent to the customer’s right to file an action against the bank to recover losses caused by the unauthorized signature or alteration.” This condition precedent does not limit a customer’s claim against a bank but requires that the customer first

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6. If a bank does not pay an item in good faith, the preclusion under Code § 8.4-406(d) as to the customer does not apply. Code § 4.6-406(e).
perform the duty to discover and report any unauthorized signature or alteration on an item before bringing suit against the bank. However, that characterization of subsection (f) as a condition precedent is not, as National Title suggests, determinative of the question whether a customer and a bank can, by agreement, shorten the one-year period. The provisions of Code § 8.4-103(a) provide the analytical framework for resolving that question.

Code § 8.4-103(a) states that

[t]he effect of the provisions of this title may be varied by agreement but the parties to the agreement cannot disclaim a bank's responsibility for its lack of good faith or failure to exercise ordinary care or limit the measure of damages for the lack or failure. However, the parties may determine by agreement the standards by which the bank's responsibility is to be measured if those standards are not manifestly unreasonable.

According to Official Comment 2 regarding § 4-103 of the UCC, “[s]ubsection (a) confers blanket power to vary all provisions of the Article by agreements of the ordinary kind.” Thus, this statute allows a bank and its customer to vary by agreement the effect of the provisions of Title 8.4 as long as the agreement does not: (1) “disclaim a bank’s responsibility for its lack of good faith,” (2) “[disclaim a bank’s responsibility for its] failure to exercise ordinary care,” or (3) “limit the measure of damages for the lack or failure.” Code § 8.4-103(a).

The clause in Paragraph 12 of the Deposit Agreement reducing the one-year period in Code § 8.4-406(f) to a period of 60 days does not run afoul of these limitations on the authority to vary the effect of the provisions of Title 8.4. The Deposit Agreement does not absolve First Union of its duty to exercise ordinary care or good faith, nor does it limit the measure of damages. Instead, Paragraph 12 merely varies the effect of Code § 8.4-406(f) in that the period of time in which National Title must report an unauthorized signature or alteration on an item, without having its claim for losses precluded by the bar in subsection (f), is shortened from one year to 60 days. This reduction in the length of the statutory notice period is consistent with the concept embodied in Code § 8.4-406(f) that a bank can be held potentially liable for paying an item containing an unauthorized signature or alteration only for a limited period of time. Thus, we conclude that a bank and its customer may contractually shorten the one-year period contained in Code § 8.4-406(f) and that First Union and National Title did so in Paragraph 12 of the Deposit Agreement.

Notwithstanding this reduced time period, if National Title complies with its duty to exercise reasonable promptness in examining its account statement and reporting any unauthorized signature or altered item, First Union remains liable for paying an item bearing an unauthorized signature or alteration. Likewise, the comparative negligence provisions contained in Code § 8.4-406(e) remain in effect during the 60-day period after First Union
makes available to National Title a statement showing payment of items from National Title’s account. Thus, the provisions of Paragraph 12 at issue do not alter the scheme of liability between banks and their customers as set forth in Code § 8.4-406.

... Finally, National Title contends that the 60-day period for reporting unauthorized signatures or alterations is “manifestly unreasonable” under Code § 8.4-103(a). As used in subsection (a), this term is the test for determining the validity of an agreement that sets the standards by which a bank’s responsibility for its lack of good faith or failure to exercise ordinary care is to be measured. While it is not necessary for us to decide in this case whether the test of manifest unreasonableness also applies to a determination regarding the validity of a reduction in the time period contained in Code § 8.4-406(f), we will utilize that standard in this appeal since it is the one advanced by National Title. In doing so, we conclude that the 60-day time limitation set forth in Paragraph 12 of the Deposit Agreement is not “manifestly unreasonable.” Other jurisdictions have likewise upheld the validity of reductions in the one-year period provided in Code § 8.4-406(f) to periods similar to or shorter than 60 days.

A condition precedent such as the one set forth in Code § 8.4-406(f) recognizes that a customer is in a better position than a bank to know whether a signature is authorized or an item has been altered. A reduction in the one-year period allowed in subsection (f) to a period of 60 days encourages diligence by a customer and is “in accord with public policy by limiting disputes in a society where millions of bank transactions occur every day.” Basse Truck Line, Inc. v. First State Bank, 949 S.W.2d 17, 22 (Tex.App.1997) (quoting Parent Teacher Ass’n, 524 N.Y.S.2d at 340).

CONCLUSION
For these reasons, we will affirm the judgment of the circuit court.

QUESTIONS
1. Under the court’s holding, should a customer who discovers an alteration or forged signature after the 60-day deadline has passed notify the bank?

2. In a footnote, the court summarily rejected National Title’s argument that the 60-day limit should be construed as the parties’ definition of “reasonable promptness.” Do you agree with the court? Had the court accepted this construction, would the outcome of the case have changed?

3. Paragraph 12 of the Deposit Agreement extends beyond forged and altered checks to items bearing an unauthorized indorsement. Should the

4. We do not decide today whether a period shorter than 60 days would be “manifestly unreasonable.”
court’s holding concerning the parties’ freedom under UCC 4–103 be applied to validate this aspect of the Agreement? Consider UCC 4–406, Comment 5:

[T]he reference in former subsection (4) to unauthorized indorsements is deleted. Section 4-406 imposes no duties on the drawer to look for unauthorized indorsements. Section 4-111 sets out a statute of limitations allowing a customer a three-year period to seek a credit to an account improperly charged by payment of an item bearing an unauthorized indorsement.

NOTES ON POSTPAYMENT NEGLIGENCE

(1) Exercise of Ordinary Care in Paying an Item. Even though a payor bank generally bears the loss on forged checks that it pays, it may find it cheaper to use automated payment procedures and absorb that loss for relatively small checks than to verify the drawer’s signature on every check. At least this would be so if the loss were confined to the amount of the individual check. But if such a practice amounts to a failure to exercise ordinary care, the bank takes the much greater risk of bearing the loss on forged checks as to which the customer is precluded from asserting the forgery under UCC 4–406. How far can a payor bank go in declining to verify drawer’s signatures before it runs afoul of the standard of ordinary care?

In Medford Irrigation District v. Western Bank, 66 Or.App. 589, 676 P.2d 329 (1984), the court held that Western Bank had gone too far. The bank had concluded that “a small number of forgeries was detected by individual review of checks, while the cost of that review was approximately $200,000 per year. . . . Western utilizes a computer check payment system. Checks for a face amount under $5,000 are paid without human intervention or ‘sight review’ of the signatures. Checks are received for payment at Western’s data processing center in Portland, and unless there is a ‘hold’ or a ‘stop payment’ order for a check, it is paid automatically by computer. . . . The computer is programmed to ‘kick out’ checks with a face amount of $5,000 or more. Absent specific instructions from a customer, only checks of $5,000 or more are individually reviewed for authorized signatures or alterations.” As a matter of law, this was held not to be “ordinary care” under former UCC 4–406. “Although a procedure may be common throughout the banking industry, it is not, by that fact alone, a reasonable procedure.”

Subsequent decisions showed some tolerance of bankers’ reliance on automation. For example, in Rhode Island Hospital Trust National Bank v. Zapata Corp., 848 F.2d 291 (1st Cir.1988), the payor bank examined signatures on all checks for more than $1,000, and on checks between $100 and $1,000 if they were in a randomly selected one per cent or if the bank had reason to suspect a problem. This practice saved the bank about
$125,000 annually. The bank "established that most other banks in the nation follow this practice and that banking industry experts recommended it." Indeed, most banks used a limit of $2,000 rather than $1,000. Relying in part on Learned Hand’s “formula” in *United States v. Carroll Towing* (defining “duty” by calculating the probability of injury times the gravity of harm to determine the “burden of precaution” that is warranted), the court held that the bank had “made out a prima facie case of ‘ordinary care’” under F4–103(3), now UCC 4–103(c) (action or non-action consistent with general banking usage not disapproved by Article 4 is prima facie the exercise of ordinary care). While the customer “might still try to show that the entire industry’s practice is unreasonable,” it had not shown this. Such cases did not, however, entirely allay the banking industry’s fears.

To allay these fears, a new provision was added to revised Article 3, under which ordinary care does not require a payor bank that uses “automated means . . . 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 Articles 3 or 4. Although this provision applies primarily to UCC 4–406, it is tucked away in a new definition of “ordinary care” in UCC 3–103(a)(7) because it applies as well to UCC 3–406. See Comment 5 to UCC 3–103. Comment 4 to UCC 4–406 explains “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 definition of ‘ordinary care’ . . . rejects those authorities that hold, in effect, that failure to use sight examination is negligence as a matter of law. The effect . . . 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 . . . a bank should not have to share that loss solely because it has adopted an automated . . . payment procedure in order to deal with the great volume of items at a lower cost to all customers.” Might this provision affect the incentive of banks to develop automated means for verification of signatures?

UCC 3–103(a)(9) refers to reasonable commercial standards “prevailing in the area in which the person is located, with respect to the business in which the person is engaged.” Does this mean that certain practices may constitute the exercise of ordinary care if they are followed by a bank in New York City but not if they are followed by a bank in Hoopeston, Illinois?

Comment 4 to UCC 4–406 refers to procedures that are “commonly followed by other comparable banks in the area.” Does the reference to “comparable banks” mean that what constitutes ordinary care may differ depending on whether the payor is Bank of America or a community bank? The California Court of Appeals thinks so: “Size is a relevant factor in identifying comparable businesses because, in the banking context, a reasonable commercial standard for processing checks at a small bank with a relatively small volume of checks, and personal familiarity with its
customers, would be quite different than what is reasonable for a large bank that processes upwards of a million checks per day.” See Espresso Roma Corp. v. Bank of America, 100 Cal. App. 4th 525, 124 Cal. Rptr. 2d 549 (1st Dist. 2002). Does UCC 3–103(a)(9), which refers to reasonable commercial standards “prevailing in the area in which the person is located, with respect to the business in which the person is engaged,” support this reading? Does the statute require it?

(2) Missing Signatures. Is a signature of an organization “unauthorized” under UCC 4–406 if the signature of more than one person is required to constitute the organization’s authorized signature and one of the required signatures is missing? Authority was split under former UCC 4–406. The split is resolved by UCC 3–403(b) and 4–104(c). See Comment 4 to UCC 3–403.