

**A LOOK AT REVISED  
ARTICLES 3 AND 4 OF THE  
UNIFORM COMMERCIAL CODE**

*Gary J. Valeriano  
Anderson McPharlin & Connors  
1 Wilshire Bldg. 19th Floor  
624 Grand Avenue  
Los Angeles, CA 90017*

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GARY J. VALERIANO is a partner in the Los Angeles law firm of Anderson, McPharlin & Connors, and has specialized for several years in fidelity and related commercial–financial institution litigation. He has coauthored several papers on fidelity insurance, and served as an Adjunct Professor of Law at Loyola University School of Law from 1985 to 1987.

Mr. Valeriano is a graduate of California State University, Northridge and Loyola University School of Law. He is admitted to practice in California.

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## I. INTRODUCTION

In 1990, revisions to Articles 3 and 4 of the Uniform Commercial Code were introduced. Various states have taken their own time in adopting or implementing the UCC revisions but as of the preparation of this article, 36 out of the 50 states had passed laws implementing the changes.<sup>1</sup> The point of this article will be to examine the impact of the UCC changes on the respective rights and liabilities of the parties in the negotiation of instruments. This has particular significance for fidelity insurers in that it may have a direct impact upon coverage issues (in the case of financial institution bonds) or it could have an indirect impact by way of subrogation rights or rights of recovery against third parties (in the case of standard commercial fidelity bonds). The changes incorporate a few twists and turns but the theory behind the changes is essentially the same as under the original code. That is, the drafters of the new provisions have tried to allocate the consequences of the loss to those parties in the best position to avoid such loss.<sup>2</sup> Significantly, employers have been allocated a greater share of the blame in certain cases. However, the code has also adopted an approach which attempts to more evenly distribute the losses. The code moves away from the “winner take all” approach previously employed, to a “comparative” negligence standard.

This article contains two sections. The first section will briefly discuss and describe changes between old Articles 3 and 4 and the revised versions. The second section will set forth a series of hypotheticals and will describe how those hypotheticals would be resolved under the new code.<sup>3</sup>

## II. BACKGROUND

The revisions center upon the respective rights and liabilities of the various parties in the check negotiation process. This has an impact on the fidelity insurer in a number of ways, but most significantly, in terms of its rights of subrogation upon payment of a claim and its right of recovery against third parties who may be liable.

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1. The following states have adopted revised Articles 3 and 4 as of January 1, 1995: Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Dakota, Utah, Vermont, Virginia, Washington, West Virginia and Wyoming.

2. Rapson, Donald J., *Loss Allocation in Forgery & Fraud Cases: Significant Changes Under Revised Articles 3 and 4*, 42:2 Ala.L.R. 435, ft. 1.

3. For purposes of this article, former UCC provisions will be cited in the following way: UCC § \_\_\_\_\_. The new provisions will be designated: RUCC § \_\_\_\_\_.

Any number of situations triggering Articles 3 & 4 may give rise to claims under a commercial fidelity bond. Those claims will generally fall under the employee dishonesty coverage or the depositor's forgery coverage, however, it is conceivable that "premises" coverage and "transit" coverage may be affected as well. To the extent that the claim involves the negotiation or encashment of checks, whether received by the insured or issued by the insured, Articles 3 and 4 significantly affect the rights of the insured to recover its loss from financial institutions.

Since, in the normal subrogation situation, the insurer, upon payment, steps into the shoes of the insured, its rights are therefore concomitantly affected. In point of fact, in most cases it is usually harder for the fidelity insurer to recover against third party banks in many jurisdictions due to the imposition of the doctrine of superior equities.<sup>4</sup> That doctrine, of course, holds that while an insurer takes the rights of the insured as against third parties, if those third parties are not actual tortfeasors, but instead owe only a contractual obligation to the insured, the "equities" as between the insurer and the third party must weigh in on the side of the insurer for the insurer to recover. The UCC and its revisions have no impact upon that particular doctrine and this article will not discuss that issue which is also sometimes described as the "compensated surety" defense.<sup>5</sup> While that issue won't be discussed herein, it is a significant overlay to this entire area. It is important to keep in mind that while Articles 3 and 4 describe and determine the various rights of the parties in the check cashing chain, a fidelity insurer, is, theoretically, once removed. Therefore, while it is certainly arguable that the insurer is entitled to the same rights and defenses as its insured, many courts may impose an additional hurdle when fidelity insurers are involved.

The UCC revisions also obviously have an impact upon insurers of financial institutions. Under Insuring Agreement D (Forgery or Alteration), the institution has the right of passing along to its fidelity insurer certain losses resulting directly from the forgery or alteration of any negotiable instrument. Though this section is subject to certain exclusions, the bank's rights and liabilities under the UCC are a significant factor in the bank's decision on whether or not to pay on such claims. Prior to the revisions, it was generally perceived that any forged maker's signature was the responsibility of the maker's bank and that credit would be given immediately upon the submission of an affidavit of forgery. As will be seen, this may not necessarily be true under the new code. It is therefore conceivable that arguments by financial institutions that the maker now bears responsibility for forgeries on checks drawn on the maker's account will be more frequent.

Though the rights of a financial institution insurer to argue a failure to

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4. See, e.g., *Meyers v. Bank of America*, 11 Cal.2d. (1938).

5. Squires, *The Compensated Surety Defense Reconsidered*, 8 The Forum, 521 (1973).

mitigate on any claims submitted by its insured who has paid on a forgery without assertion of all available defenses under the revised UCC are of obvious import, this article will focus on the effect of the revisions on commercial fidelity insurers.

### III. HOW INSURERS ARE AFFECTED

A typical claim will arise in one of two circumstances. In the first instance, the insured may have a claim based upon the acts of one of its employees. For example, an employee may have forged the insured's name on the insured's own check, or an employee may have taken checks payable to the insured and forged the endorsement of its employer/insured. The second type of claim will involve an outsider who steals the insured's check. That check may be drawn on the insured's own account or, again, may be a check payable to the insured. In either case, the revisions to Articles 3 and 4 of the UCC have substantial impact on the rights of the financial institution, the employer/insured, and ultimately, the subrogated fidelity carrier.

### IV. SOME BASIC TERMS

Prior to a discussion of the revisions to Articles 3 and 4 of the UCC, it is important to clarify some of the terms that will be used. Both in this discussion and in the separate section following with hypotheticals, the term "drawer" will denote the party who is actually making the check. Therefore, if an employer is issuing a check on its own bank account, the employer is, in the UCC scheme, considered the "drawer" of the check.<sup>6</sup> The bank at which the employer banks, would be known as the "drawee bank."<sup>7</sup> This is the bank primarily responsible for handling the employer's account and would be charged, under normal circumstances, with the duty to review the employer's checks as they come in for collection to ascertain the correctness of those checks for payment. This review should, but may not, include a visual review of the check and the drawer's signature to make certain that it is a match with the signature of record. If there is any question as to the authenticity of the signature, it is perceived that the drawee bank would be in the best position to put a stop on the process.<sup>8</sup>

The "payee" is the party to whom the check is made payable.<sup>9</sup> The "payee bank" or the "depository bank" are virtually interchangeable and indicate the institution at which the check is presented for deposit or encashment.<sup>10</sup>

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6. RUCC § 3-103(a)(3). This term is interchangeable with the term "payor."

7. RUCC § 4-104(a)(8).

8. *See, Perini Corp. v. First National Bank*, 553 F.2d 398, 405 (5th Cir. 1977).

9. Ellis & Dow, "Banks and Their Customers Under the Revisions to Uniform Commercial Code Articles 3 and 4: Allocation of Losses Resulting from Forged Drawers Signatures," 25 Loy.L.A. L.R. 57, fn. 3.

10. UCC § 4-105(a) and (d). RUCC § 4-105(2).

While there are many other terms and definitions to be encountered in the revisions to the UCC, for purposes of this analysis, the foregoing will suffice.<sup>11</sup>

In a typical fidelity bond situation, the bonding company may be the insurer of the drawer, that is, the party issuing the check as a maker. For example, if XYZ Company has authorized John Smith, its treasurer, to sign checks, a forgery of John Smith's name on the check would constitute a forged drawer's signature. If the bonding company insured XYZ Company, a claim might be made on the basis of depositor's forgery or, if the facts warrant it, employee dishonesty.

The fidelity bonding company may also insure the payee in a forgery situation. Suppose XYZ Company is issued a check for its services by ABC Corp. Suppose further that XYZ Company's check is stolen from its offices, fraudulently endorsed, deposited at a bank, and eventually cashed out. XYZ may, in this case, have a claim based upon the forged endorsement of a check payable to it. Again, this claim may arise under depositor's forgery coverage or, depending on the facts, employee dishonesty. It is also conceivable that such a loss could trigger either the premises or transit coverage, depending upon at what point the check was converted.

On the other side of the equation, a financial institution bonding company may insure one of the two banks involved in the above scenario. Suppose John Smith's signature is forged on an XYZ Company check, is taken for deposit, and is cashed. XYZ Company's bank then debits XYZ Company's account. XYZ Company, in reviewing its statements, eventually determines that the cashed check bears a forgery. XYZ Company presents an affidavit of forgery and requests that its account be credited by its bank, the drawee bank. In this instance, the drawee bank may have a claim against its bonding company under the forgery coverage. Though this loss may be uncovered for a number of reasons, the "uncollected funds" exclusion is certainly triggered. There are, however, generally two exceptions to that exclusion: (1) when the payment or withdrawal is physically received by a depositor who is within the office of the insured at the time of the payment or withdrawal, or (2) when it involves employee dishonesty.

A financial institution bonding company may also insure the depository bank in the above hypothetical. If, for example, the forger takes XYZ Company's check and deposits it into an account he or she has opened at Big Bank, Big Bank may be liable to the drawee bank for breach of warranty, or it may be liable to the true payee for conversion.

In reality, when dealing with medium to large institutions, it is entirely possible that all four of the parties will be insured by a bonding company,

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11. Definitions are found, in the main, in RUCC §§ 1-201, 4-104, 4-105 and 5-103.

and it is possible that one bonding company may insure more than one of the parties involved. Therefore, depending obviously upon the deductible and other facts relating to coverage issues, the ultimate decision on who takes responsibility for the check is a decision very close to the hearts of the insurers.

Should the insured who ultimately takes the loss make a claim on its bonding company, the ability of its bonding company to assert rights against other parties in the check cashing chain is then very much dependent upon the Uniform Commercial Code provisions. Those provisions will be the ultimate arbiter on how the risk is spread.

## V. THE REVISIONS

### *Reason for The Revisions*

It appears that the reason behind the recent revisions to Articles 3 and 4 of the UCC was dissatisfaction with the way in which loss allocation had been dealt with in the past.<sup>12</sup> Some commentators have viewed the old rules as essentially a “winner take all” approach.<sup>13</sup> That is, once it was determined which of the parties would ultimately bear responsibility, that party bore sole responsibility. There was a lack of comparative negligence and, even though another party may have been somewhat responsible for the ultimate loss, if that party managed to carry its burden of proof, that party could escape without damage. The purpose behind the new allocation system is to spread the blame in a more equitable fashion. That is, if more than one party is responsible for the loss, then the new provisions allow each of the parties to share in the loss to the extent of their comparable responsibility.

Some commentators have suggested that this approach was adopted so as to discourage litigation between financial institutions and customers/clients.<sup>14</sup> It is believed that if the parties will ultimately share the responsibility for the loss, they may be more reasonable in approaching the litigation process and may be more inclined to settle. Under the old system, one of the parties was going to escape without any liability whatsoever, and, therefore, they might be willing to take a chance on litigation. Under the old rules, no one wanted to lose the “fault” argument because losing that argument meant taking on the entire loss. Under the revisions, since ultimately the loss will be spread among the various parties, the parties may be less willing to fight since they know they can’t escape liability in total.

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12. See, e.g. RUCC § 3-405, Comment 1 (1992).

13. John J.A. Burke, *Loss Allocation Rules of the Check Payment System with Respect to Forged Drawer Signatures and Forged Endorsements: An Explanation of the Present and Revised UCC Articles 3 and 4*, 25 UCC Law J. 318, 321 (1993).

14. Rapson, *supra* at p. 461.

Another apparent reason for the revisions to Articles 3 and 4 is the belief that employers should bear more responsibility for the acts of their dishonest employees.<sup>15</sup> Though the allocation of loss has been made comparative rather than all or nothing, a new section to the code specifically deals with situations where an employee of a payee manages to corrupt the system and achieve personal benefit.<sup>16</sup> Under the old system, it was possible to foist some of the responsibility for this loss (if not entire responsibility) on the banks involved. Under the new code, it appears that employers will be taking on much more responsibility and therefore more liability with respect to the dishonesty and fraud of their own employees. Here we have a value judgment being made.

Under the old code, a forged drawer signature is viewed to be the responsibility of the drawee bank since the drawee bank was in the best position to avoid the loss by simply checking the signature of its client prior to issuing credit. This was true even if the forged signature was the product of the drawer's employee. Under the new code, the view is that the employer is in the best position to avoid this loss by adequately hiring, supervising and policing its own personnel procedures. Where you fall on this side of the equation obviously depends upon who your bond may be backing. If nothing else, this new attitude certainly recognizes and to some degree validates the realities of modern day commercial transactions. Many financial institutions no longer undertake a sight examination of signatures, as to do so would simply be too time consuming and impractical. While this calls into question the necessity of a signature and the sanctity of a correct signature, it is a simple commercial reality.

### *Significant Changes*

In this section we will examine the significant changes regarding loss allocation and the payment of negotiable instruments. For purposes of organization, we will discuss both the old rules and the new rules and how they impact upon certain significant loss events.

### *Forged Drawer Signature*

Assume that an XYZ Company blank check is stolen from its offices and its treasurer's signature is forged. The check is filled in, taken by the thief to the thief's bank and is cashed. XYZ Company's bank gives credit for the check which XYZ later determines is a forgery. Under the old rules, this situation would be controlled by the theory first enunciated in the 18th Century English case of *Price v. Neil*.<sup>17</sup> That case held that the drawee bank was

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15. See, e.g., RUCC § 3-405, Comment 1 (1992).

16. UCC § 3-405.

17. 97 Eng.Rep. 871, 3 Burr. 1354 (1762).

obligated to check the signature of its customer, the drawer, and not pay any instrument which was not properly signed. Therefore, the drawee bank, being in the best position to avoid this loss (by checking signatures) bears the responsibility.

That rationale had been adopted by the code which allowed for a bank to charge against a client's account any item "which is otherwise properly payable."<sup>18</sup> An item would not have been properly payable absent a "signature."<sup>19</sup> An unauthorized signature was "wholly inoperative," for purposes of the bank's obligations and was the equivalent of no signature at all with respect to the bank's client.<sup>20</sup> The code specifically defined an "unauthorized signature" as "one made with actual, implied or apparent authority and includes a forgery."<sup>21</sup> On this basis, under the old code, the drawee bank would be the party bearing the loss for this instrument. The bank would be obligated to recredit its customer's account and to pursue its rights against either the depository bank or the thief. As against the depository bank, the drawee bank's rights are nonexistent if the payee bank is a holder in due course.<sup>22</sup> That is, absent good faith on the part of the depository bank, a rare circumstance, the drawee bank is going to lose. Therefore, the drawee bank's only recourse is against the thief, who is probably long gone.

Under the old code, however, the drawee bank had the right to assert what came to be known as a "preclusion defense."<sup>23</sup> Under section 3-406, a bank could "preclude" its customer from asserting the forgery if the customer, through negligence, substantially contributed to that forgery. Under the old law, banks scrambled frantically for ways in which to ascribe some negligence in the creation of the forgery. The question of how a drawer "substantially contributes" to the making of a forgery was a question which received much attention from the courts. Many courts equated the substantial contribution standard with the substantial factor test present in negligence common law.<sup>24</sup> For example, a bank might argue that the checks were left unguarded or unprotected. If the checks had been lost, the bank could assert that as negligence on the part of the drawer. Generally, banks took the position that if a check somehow found its way into the hands of a thief, the drawer must have been negligent in some respect.

If the forgery was created by an employee of the drawer, the banks usu-

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18. UCC § 4-401(1).

19. UCC § 3-401.

20. UCC § 3-404(1).

21. UCC § 1-201(43).

22. UCC § 3-302.

23. Burke, *supra*, at p.338.

24. See *Thompson Maple Prod. v. Citizens Nat. Bank of Corry*, 234 A.2d 32 (Pa. S.Ct. 1967).

ally struck pay dirt. The banks would then argue that the employer/drawer was in the best position to hire and supervise its employees, and that their failure to take reasonable steps to do so, led to the ultimate forgery. In that case, the employer/drawer would then be left trying to rationalize and explain its behavior and how nothing it could have done would have prevented this particular employee from creating this particular forgery. It was an imprecise science at best and one which was hotly contested since the ultimate loser would bear full responsibility for the loss on the instrument. If the bank was successful in demonstrating that the drawer substantially contributed to the making of the forgery, the drawer would bear the full loss on that instrument. If the bank failed to do so, the bank would bear the full loss.

But it didn't end there. Under section 3-406, even if the bank was successful in demonstrating that the drawer had substantially contributed to the forgery, the drawer could avoid liability if it could demonstrate that the bank failed to act "in good faith and in accordance with reasonable commercial standards. . . ." This came to be known as the "last clear chance" doctrine as the negligence of the drawer would be excused because of the negligence of the drawee bank.<sup>25</sup> This also encouraged much finger-pointing and, in the case of litigation, extensive discovery. Generally it was viewed by the drawers that if the bank had failed to compare, by sight, the signature of the drawer on the check with the signature card on file at the drawee bank, the drawee bank had acted unreasonably and had failed to abide by "reasonable commercial standards." Of course, over time, drawee banks came to argue that "reasonable commercial standards" would not require a sight review of signatures on all checks. While this may have been true, many courts were reluctant to adopt this position. Therefore, generally, the loss fell to the banks. The only solace the bank could take in that instance would be an argument that the forgery was extremely "good" and that even a sight review would have failed to catch it. This encouraged much in the way of expert fees, as both sides scrambled to retain handwriting experts.

Under the new rules, the initial analysis will be much the same. The bank may charge against the account of the client any items which are "properly payable." The new provision states that "an item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and the bank."<sup>26</sup> A customer is not liable unless the customer has signed the instrument.<sup>27</sup> The new section 3-410 does, however, provide that a party is liable if the instrument is signed "by an agent or representative." An unauthorized signature is no longer "wholly inopera-

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25. Burke, *supra*, at pp.341-42.

26. RUCC § 4-401(a).

27. UCC § 3-401(a).

tive” but is instead “ineffective.”<sup>28</sup> While the language is different, the intent seems to be the same. This is born out by the fact that the definition of “unauthorized signature” is virtually unchanged.<sup>29</sup> To this point, therefore, the result under the new rules should be the same as under the old. At this point, the bank, having taken an instrument which bears an unauthorized signature, would be responsible for the loss.

Under the new rules, the bank may still avail itself of the defense under section 3-406, though that has changed to some degree. The “substantially contributes” test of former section 3-406 is continued in the new rule. As the notes to the new rule state:

“The ‘substantially contributes’ test is meant to be less stringent than a ‘direct and proximate cause’ test. Under the less stringent test, the preclusion should be easier to establish. Conduct ‘substantially contributes’ to a material alteration or forged signature if it is a contributing cause of the alteration or signature and a substantial factor in bringing it about.”<sup>30</sup>

The example given in the code Comments is instructive. In the hypothetical, the employer is ultimately deemed responsible for the loss on the instrument because it had kept a rubber stamp of the employer’s signature, along with the employer’s personalized blank check forms in an unlocked desk drawer.<sup>31</sup> Therefore, the employer’s simple negligence “substantially contributes” to the making of the forged check and the employer is deemed to be the loser. Under the new rules, therefore, it seems easier for the bank to thrust liability back to its customer as the code itself states that under the substantial contribution test, “the preclusion should be easier to establish.”

Again, however, as under the former section, the new section allows the drawer/customer to assert the last clear chance doctrine in an attempt to push liability back to the drawee bank. However, there are two substantial differences on the implementation of the new code in this regard. First of all, under the new code, the failure of the drawee bank to exercise ordinary care in the paying or taking of the instrument does not establish sole liability on the drawee bank. Under the new code, that liability is now proportional and “loss the allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss.”<sup>32</sup> Therefore, if the drawer/customer is successful in demonstrating that the bank has failed to exercise ordinary care, that is not total absolution for the drawer/customer. Instead,

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28. RUCC § 3-403(a).

29. RUCC § 1-201(43).

30. RUCC § 3-406, Comment 2 (1992).

31. RUCC § 3-406, Comment 3 (1992).

32. UCC § 3-406(b).

the trier of fact must determine the percentages attributable to each party's negligence.

Another significant change in the new code is the definition of "ordinary care."<sup>33</sup> Ordinary care is defined as the "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." However, the definition does not end there. In unmistakably clear language, the drafters of the new Articles 3 and 4, state as follows:

"In the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general banking usage not disapproved by this division or Division 4. . . ."

Therefore, under the new rules, if the bank has failed to sight review checks, and that failure neither violates the bank's policies nor the policies of the banks in that area, the bank has acted with "ordinary care." Therefore, Section 3-406(b) would not apply and the loss on the check would fall squarely on the side of the drawer/customer. As one commentator has noted:

"Inasmuch as failure to examine items for forgery is virtually the only way in which a payor bank can be negligent in this context, the negligent customer will bear the loss much more frequently under the RUCC than under the code. As a result, it is more likely under the RUCC than under the code that both negligent and non-negligent customers will choose to bear the loss rather than to litigate the question of negligence, even in the case of large items."<sup>34</sup>

Therefore, the bottom line on the new code in a forged drawer situation seems to be a shifting of the loss from the drawee bank to the drawer. Under the new rules, the only way the drawee bank would be fully responsible for the loss of the check would be if the drawer/customer is absolutely free of negligence.

One final note of comparison rests with the requirement of review by a customer of its bank statements. Under old section 4-406, a customer was barred from asserting a forgery against its bank if multiple forgeries by the same party were not discovered within 14 calendar days after the items and statements were made available to the customer. Under the new code, the customer is given 30 days. Under both the new and old section, the customer is absolutely barred from raising the defense of an unauthorized sig-

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33. UCC § 3-103(7).

34. Ellis & Dow, *supra*, at 68.

nature if the customer fails to report it within one year of the receipt of their monthly statement.

Again, in this regard the new definition of “ordinary care” will have a substantial impact. Under the old code, the bank could not assert the 14-day bar if the customer demonstrated that the bank acted with a “lack of ordinary care” in paying the item. Again, this would often mean simply proving that the bank had failed to sight review the checks in question. If that were the case, then the bank again bore the entire loss.

Under the new code, if the customer establishes a lack of ordinary care on the part of the bank, “the loss is allocated between the customer precluded and the bank asserting the preclusion according to the extent to which the failure of the customer . . . and the failure of the bank . . . contributed to the loss.”<sup>35</sup> Therefore, comparative negligence is called into play and the loss is allocated between the parties. However, it is important to keep in mind that, again, the definition of “ordinary care” seems to absolve the bank from the necessity of a sight review of checks. Therefore, a lack of ordinary care has become harder to prove and, as a result, customers may end up bearing the loss more often than not.

#### *Forged Endorsements*

Suppose a check payable to XYZ Company is stolen. The thief has opened an account at the depository bank in the name of XYZ Company (or something very close to it), endorses the check, deposits it and receives credit for same.

Under the old code, the depository bank would typically bear the loss on the forged endorsement.<sup>36</sup> This is logical since the depository bank, being the party who actually dealt with the forger, was in the best position to avoid that loss by requiring sufficient proof of identification or by not allowing the deposit of corporate checks into a personal account. The depository bank was also deemed responsible for having adequate safeguards and restrictions on the opening of a corporate account. As in the case of a forged drawer’s signature, the endorsement in this situation was “wholly inoperative.”<sup>37</sup> Since it was an unauthorized signature under section 1201(43), it meant that the signature requirement had not been fulfilled.<sup>38</sup> Therefore, the instrument was not “properly payable” and the depository bank was stuck.<sup>39</sup>

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35. RUCC § 4-406(e).

36. Unless the check was made to a fictitious payee or an “imposter.” UCC § 3-405.

37. UCC § 3-404.

38. UCC § 3-401.

39. UCC § 4-401.

This was true even though the depositary bank had passed the check along to the drawee bank which had paid on the instrument. The depositary bank remained liable because it had breached the “warranty of good title,” which, in essence, held that the depositary bank vouched for the authenticity of the signature of the endorser.<sup>40</sup> Therefore, under the old rules, a drawer could request that the drawee bank recredit its account. The drawee bank would usually do so and assert liability on the part of the depositary bank for breach of warranty. Therefore, in most cases involving a forged endorsement under the old code, the depositary bank would bear the loss.

Of course, both the depositary bank and the drawee bank had available to it the preclusion defense available under old Section 3-406. However, in the case of a forged endorsement it was usually harder to establish that either the party who made the check or the party to whom the check was payable had been negligent in handling the instrument, unless an employee was involved. Generally, however, the depositary bank would bear the loss mainly because that bank had usually allowed a third party to deposit a check made payable to another party or because of its failure to abide by procedures regarding the opening of a corporate account (i.e., the failure to get corporate resolutions and/or articles of incorporation, a corporate stamped signature card, etc.) That being the case, the depositary bank usually had a difficult time proving that it had acted reasonably and therefore, if not under the initial analysis, at least under the doctrine of “last clear chance,” the depositary bank would be the ultimate loser.

The new code does not seem to alter that situation very much. In most situations involving a forged endorsement, the depositary bank will still be liable. The biggest change arises in cases where the endorsement is of a fictitious payee or was caused by an employee of the party asserting the forgery.

*Endorsement Where Thief is an Employee of the Payee*

Under the old code, a forged endorsement by one who is an employee of the payee was usually treated no differently than a forged endorsement on a check stolen by a nonemployee.

Under the old code, the defense available to the depositary bank when a claim was asserted by the true payee, would be under section 3-406. Thereunder it would be incumbent upon the depositary bank to demonstrate that the payee’s negligence “substantially contributed” to the making of the unauthorized signature and that the payee was precluded from asserting the forgery as against the depositary bank which was the holder in due course. This would start the whole procedure in motion and it would then be neces-

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40. UCC § 4-207.

sary for the payee to demonstrate that the depository bank failed to act in accordance with the reasonable commercial standards, thereby shifting the loss back to the depository bank.

The new code, however, has a section specifically dealing with this factual scenario.

Under the new code:

For the purpose of determining the rights and liabilities of a person who, in good faith, pays an instrument or takes it for value or for collection, if an employer entrusted an employee with responsibility with respect to the instrument and the employer or person acting in concert with the employee makes a fraudulent endorsement of the instrument, the endorsement is effective as the endorsement of the person to whom the instrument is payable if it is made in the name of that person.<sup>41</sup>

Therefore, under the new code, if an employee with “responsibility” for checks forges the endorsement (or it is done by a coconspirator), the endorsement is good and the employer bears the loss.

Under the new code, “responsibility” is defined as follows:

Responsibility with respect to instrument means authority (A) to sign or endorse instruments on behalf of the employer, (B) to process instruments received by the employer for bookkeeping purposes, for deposit to an 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, or (F) to act otherwise with respect to instruments in a responsible capacity. ‘Responsibility’ 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.<sup>42</sup>

Under this section, if, for example, a janitor were to come upon a check payable to his employer, take that check and deposit it, the defense would not be triggered as the janitor was not a person who has been “entrusted” with responsibility with respect to the instrument. Section 3-406 may still come into play, but the stricter liability under section 3-405 is not applicable.

Section 3-405 does, however, contain an out if the employer can establish that the depository bank failed to “exercise ordinary care in paying or taking the instrument and that failure contributes to loss resulting from the

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41. RUCC § 3-405(b).

42. RUCC § 3-405(a)(3).

fraud. . . .”<sup>43</sup> In that case, the employer and the depository bank share the loss on a comparative negligence basis.

*Forged Endorsements by Impostors, and Fictitious Payees*

Suppose that a nonemployee induces XYZ Company to issue a check to ABC Corp. on the mistaken belief that XYZ Company owes an obligation on an outstanding debt to ABC Corp. In this situation, under the old code any issuance of a check to an imposter, a fictitious payee or an actual payee who never receives the check and is owed no obligation, is effective under old section 3-405 and must be paid. Under the old code the loss falls squarely on the drawer of the check.

“Section 3-405 reflects the policy that the loss should fall on the employer, because the employer is in the best position to prevent the loss by the careful selection and supervision of employees.”<sup>44</sup>

Under the new code, revised section 3-404 replaces section 3-405. While the analysis is the same, the new provision actually introduces concepts of comparative negligence into the equation. Under the new code, if the drawer of the check can demonstrate that the depository bank failed to “exercise ordinary care in paying or taking the instrument and that failure contributes to loss resulting from payment of the instrument,” then the bank must share in the loss to the extent its actions contributed to such loss.<sup>45</sup> Therefore, under the new code, the fictitious payee rule has actually been liberalized to allow for possible sharing of loss by depository banks which have failed to exercise ordinary care in the acceptance and encashment of instruments bearing forged endorsements.

## VI. HYPOTHETICALS

In this section we deal with 12 different hypotheticals which illustrate how losses would be handled under the new rules. To the extent that this analysis is different from how the situation would be handled under the old rules, it will be noted.

### **1. An employee of XYZ Company forges the treasurer’s signature on a check payable to the employee.**

Since the check bears a forgery, it is an unauthorized signature and therefore ineffective as an obligation of the drawer.<sup>46</sup> Therefore the check is not “properly payable,” and the drawee bank would have to recredit the XYZ

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43. RUCC § 3-405(b).

44. Burke, *supra*, at p.375.

45. RUCC § 3-404(d).

46. RUCC § 3-403(a).

Company account.<sup>47</sup> However, the drawee bank can assert Section 3-406 if it can establish that XYZ Company's failure to exercise ordinary care substantially contributed to the making of the forgery. For example, if it demonstrates that the employee managed to steal blank checks from an unlocked desk drawer, the bank may, if the trier of fact believed that this action substantially contributes to the making of the forgery, shift liability back to the employer/drawer.

In that event, it would be incumbent upon the employer/drawer to show that the bank itself failed to exercise ordinary care, keeping in mind that term is now defined in the code itself.<sup>48</sup> If the employer/drawer can demonstrate a failure to exercise ordinary care on the part of the bank, then they would share the loss on a proportional basis.<sup>49</sup>

## **2. Employee forges treasurer's signature on a check to an imposter.**

This situation opens up potential liability to the employer/drawer from two sources: the depository bank and the drawee bank. The analysis against the drawee bank would be under section 3-406. If the employer/drawer can show it is free of negligence, the drawee bank will bear the loss. If the drawee bank can show a lack of ordinary care on the part of the employer/drawer, the employer/drawer will bear responsibility for the loss. If both the drawee bank and the employer/drawer are negligent, they will share a responsibility for the loss.

The depository bank in this instance would be absolved under section 3-404 since the check was issued to an imposter.

## **3. An employee forges the treasurer's signature on a check to a legitimate supplier but to whom no money is owed.**

The result should be the same as in Hypothetical 2, above. As to the depository bank, under RUCC § 3-404, it doesn't matter if the payee is fictitious or real. The endorsement by the thief is good and the depository bank takes as a holder in due course.

## **4. A nonemployee forges a treasurer's signature on a check to a nonemployee.**

This would be the same result as hypothetical No. 1 above. Initially, the drawee bank would bear the liability for this check since it is not entitled to credit the employer's account on the unauthorized signature. However, to the extent that the drawee bank can demonstrate that the employer failed to exercise ordinary care, the loss is transferred back to the employer. Should

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47. RUCC § 3-401.

48. RUCC § 3-103(7).

49. RUCC § 3-406(b).

the employer demonstrate that the bank failed to exercise ordinary care, then the loss would be distributed on a proportional basis.<sup>50</sup>

In this case, it would not appear that the depository bank is liable at all since the endorsement may not have been forged.

**5. A nonemployee forges a treasurer's signature on a check to an imposter.**

This would call for the same result as in number 2 above. The fact that it is a nonemployee is of no consequence to the analysis of whether or not the employer was negligent and that negligence substantially contributed to the making of the forgery. If that is the case, then the employer will bear the loss. If the employer was not negligent, then the drawee bank will bear the loss. If both bank and employer were negligent, they will share the loss on a proportional basis under RUCC § 3-406(b).

In this situation the depository bank would be off the hook since endorsement by anyone in the name of an imposter serves as a good and effective endorsement.<sup>51</sup>

**6. A nonemployee forges the treasurer's signature on a check to a supplier who is owed nothing.**

This example is Case No. 5 in the 1992 Comments to the RUCC § 3-404. As the code describes, the depository bank takes as a holder in due course and, because the endorsement is effective, there is no breach of warranty under Section 3-417(e)(1) or Section 4-208(a)(1) because the depository bank was the person entitled to enforce the check when it was forwarded for payment. However, because the check is forged, the drawee bank is not entitled to charge the employer's account and the drawee bank would therefore bear the loss.

The drawee bank does, however, have the right to assert its defenses under Section 3-406 or Section 4-406 if the assertion of the forgery was untimely.

**7. An employee steals a check payable to an actual supplier.**

This requires an analysis under section 3-405. If the employee who stole the check is an employee entrusted with "responsibility" with respect to checks, then that person's endorsement on the instrument is effective and the employer would bear the loss.

The employer is given the right to demonstrate that the bank paying on the check failed to exercise ordinary care, which has the effect of requiring

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50. RUCC § 3-406(a) and (b).

51. RUCC 3-404(b)(2).

that the drawer/employer and the drawee bank share proportionally on the loss.

The more likely target for the employer/drawer in this case would be the depository bank, however, an analysis under 3-405 is still required. The employer would bear initial liability and it would be incumbent upon the employer to show that the depository bank failed to exercise ordinary care in the handling of the check. It might be able to do this if, for example, the depository bank allowed the employee to open an account in the name of IBM Corp. without appropriate authorization or resolutions.<sup>52</sup> If that is the case, then the depository bank and the employer will share in the loss.

**8. The treasurer issues a check to an imposter and later steals that check.**

Since the treasurer is authorized to sign on behalf of the company, there is no forged maker's signature. This therefore triggers Section 3-404 and, under 3-404(b), since the "person whose intent determines to whom the instrument is payable" did not intend the payee to have any interest in the instrument, the depository bank would take as a holder and the endorsement would be effective. On that basis, the employer would bear the loss.<sup>53</sup>

However, under 3-404(b), the employer has the right to demonstrate that the depository bank itself acted without "ordinary care" and, to the extent the depository bank did so act, the loss will be shared.

**9. The treasurer signs a check payable to a supplier who is owed nothing. The treasurer later steals the check.**

This hypothetical could be governed by Section 3-404(b) or 3-405(b). This situation is dealt with in the Comments to RUCC § 3-404 as Case No. 2. As stated in those Comments, "If treasurer intended to steal the check when the check is drawn," then Section 3-404(b) applies. If, however, the treasurer did not decide to steal the check until *after* the check was drawn, the case is covered by Section 3-405. In either event, the results are the same. The employer bears the responsibility for loss except to the extent that it can demonstrate that the depository bank was negligent. To the extent that it can demonstrate that the depository bank was negligent, the loss is proportionately shared.

The drawee bank is not liable since the treasurer signed the check and it is authorized.

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52. RUCC § 3-405, Comment 4 (1992).

53. This hypothetical is dealt with in RUCC § 3-404, Comment 2, Case #1 (1992).

**10. An employee prepares a check payable to an imposter, the treasurer signs the check and the employee steals it.**

This is clearly a case governed by Section 3-405, the new section of the new code. Since the employee is apparently one who is entrusted with responsibility “with respect to the instrument,” that employee’s signature on the check is a valid endorsement.

Arguably, it is also covered by section 3-404(a), the “imposter” provision. In either event, the employee’s endorsement on that check is valid and operates as a defense to a depository bank. In this event, the loss will fall upon the employer. Again, however, under either section 3-404 or section 3-405, to the extent that the employer can demonstrate that the depository bank was negligent, the depository bank will share in that loss.

**11. An employee prepares a check to a supplier who is not owed money, the treasurer signs it and the employee later steals it.**

This would be governed solely by Section 3-405, and would render the employer/drawer responsible for the loss. Again, the employer/drawer can avail itself of Section 3-405(b) and attempt to demonstrate that the depository bank was negligent in its handling and payment of the check. To the extent that the employer/drawer can so demonstrate, the depository bank will share the loss.

**12. A nonemployee steals a check payable to a supplier, forges the endorsement and deposits the check.**

The result in this situation depends upon whether the check actually was received by the supplier or whether the theft took place before receipt. If the check was stolen before receipt, then the supplier had never actually received payment and the obligations from the drawer to the supplier still existed.<sup>54</sup> The loss would therefore fall upon the drawer, who would then assert its rights against the drawee bank, as the drawee bank would have paid on a check not “properly payable” because it contained an unauthorized signature.<sup>55</sup>

The drawee bank would then have to assert negligence of the drawer in order to avail itself of the defenses available under section 3-406. If, for example, the drawee bank could show that the drawer kept a huge stack of issued checks on a desk in plain view of anyone who happened to be passing by, the drawee bank may be able to establish negligence which substantially contributed to the making of the forgery. It would then be incumbent upon the drawer to demonstrate that the drawee bank, itself, failed to exercise ordinary care in the acceptance and encashment of the check. If it cannot do

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54. RUCC § 3-420, Comment 1 (1992).

55. RUCC § 4-401(1).

so, the drawer will bear responsibility for the check. To the extent that it can demonstrate that the drawee bank was responsible, the drawee bank and the drawer will share in the loss.

If, however, the check had reached the supplier and was stolen from the supplier's premises, then an action exists against the depositary bank. Since the payee did receive the check, the payee is entitled to bring a conversion action against the depositary bank under new Section 3-420.<sup>56</sup>

The depositary bank could then assert its rights under 3-406 and argue that, to the extent that the payee was negligent, the payee is precluded from claiming a forgery. If, for example, it can demonstrate that the payee received its checks and simply kept them at an open counter, available to any and all who might pass by, the depositary bank may be able to shift liability back to the payee.

It would then be the payee's responsibility to demonstrate that the depositary bank itself acted without ordinary care in accepting the deposit. For example, if the nonemployee went in and that same day opened an account in the name of the supplier, without a corporate resolution or without articles of incorporation, the deposit and crediting of a large check into such an account would no doubt require a finding of comparative negligence.

## VII. CONCLUSION

The recent revisions to Articles 3 and 4 of the Uniform Commercial Code have substantially shifted the rights and responsibilities of the various parties in the check cashing process. The emphasis seems to be on a more evenly distributed approach, substituting comparative negligence for what was before an all or nothing analysis.

Employers and the fidelity bonding companies of employers, should be very aware of these changes as they substantially affect the right of the employer to make claims against either the drawee bank or the depositary bank on forged endorsements and drawers' signatures. By and large, it seems that the changes operate to put more responsibility on the employers. Though this is the case, the employers are still entitled to some recompense if the banks are at all negligent in their discharge of duties. Under the old code, of course, if an employer was found to be liable, that employer received nothing from other parties.

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56. RUCC § 3-420(a) states:

The law applicable to conversion of personal property applies to instruments. An instrument is also converted if it is taken by transfer, other than a negotiation, from a person not entitled to enforce the instrument or a bank makes or obtains payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment. An action for conversion of an instrument may not be brought by (1) the issuer or acceptor of the instrument or (2) a payee or endorsee who did not receive delivery of the instrument either directly or through delivery to an agent or a co-payee.