

# CHECK FRAUD AND THE FIDELITY INSURER

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## ***I. Introduction***

Dishonest employees frequently perpetrate fraud by abusing their employer's checking accounts or intercepting checks made payable to their employers. Thus, fidelity insurers are often presented with claim scenarios involving check fraud. The presence of check fraud also presents the opportunity, in many instances, for the fidelity insurer, by way of subrogation or assignment, to seek recovery from the financial institutions which handled the fraudulent checks.

This article will discuss the common fact patterns involving employee dishonesty and check fraud, the nature of the potential claims and defenses, and the applicable portions of the Uniform Commercial Code.<sup>1</sup> This article will not discuss coverage issues relevant to employee dishonesty claims involving check fraud, but will assume generally that the fidelity insurer has paid the insured/employer's claim and has acquired the employer's rights and claims against all involved financial institutions handling the fraudulent items.

## ***II. Check Fraud***

There are four basic types of check fraud involved in employee dishonesty claims: forgery of the drawer's signature, forgery of an endorsement, alteration, and counterfeiting:

- **Drawer's signature:** This type of fraud ordinarily occurs when the dishonest employee forges the employer's signature on a check drawn on the employer's account and then deposits the forged check into an account controlled by the employee. In this situation, the employer commonly will have valid claims against its own bank for charging

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<sup>1</sup>Because the authors of this article are from Texas, references to the Uniform Commercial Code [hereinafter UCC] will be in the form used in Texas. The primary distinction between the citation form in Texas and the uniform version is that the "-" is replaced with a ".". Thus, section 3-406 becomes section 3.406 in Texas. Of note, Texas adopted the 1990 revisions to the UCC effective January 1996. TEX. BUS & COM. CODE ANN. § 3.101 historical note (Vernon Supp. 2001).

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against its account an item that is not properly payable, subject, of course, to the bank's defenses.

- Forged endorsement: Endorsements are located on the back-side of the check. An endorsement is a signature generally made for the purpose of negotiating or restricting payment of an item. Employee dishonesty claims involving forged endorsements may involve items drawn by third parties payable to the employer or items drawn by the employer. For example, the employee might intercept a check payable to the employer, forge the endorsement, and deposit the check in a bank in which the employee has established an account (many times in a name similar to the employer) over a forged endorsement. In this situation, the employer's claims are usually against the depository bank, which, except for the fraud, has no relationship with the employer.

Another common fact pattern involving forged endorsements is when the employee tricks the employer into issuing a check, then intercepts the check and deposits it. In this scenario, the front side of the check may be legitimate (no forged drawer's signature and no alteration), but the check itself is bogus (for example, it is issued to a non-existent person) and usually will bear an unauthorized endorsement. Sometimes, a check has both front-side and back-side fraud – a forged drawer's signature and a forged endorsement.<sup>2</sup> Instances involving forged endorsements present possible claims against both the drawee and the depository bank.

- Alteration: This type of fraud generally will involve the dishonest employee altering an otherwise legitimate check by manipulating the name of the payee or the amount of the item and then obtaining the proceeds thereof. Like the forged drawer's signature, this is fraud on the front-side of the check and, usually, the employer will have valid claims against its own bank, subject to the relevant defenses.
- Counterfeit: Counterfeit checks are those which are cut from whole cloth. While the counterfeit check may imitate a real check with the proper account number and similar appearance, it is simply a check conceived in the mind of the dishonest employee. These checks will almost always bear a forged drawer's signature, but may also be have forged endorsements.

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<sup>2</sup>See section III.C. *infra*.

While there are many variations of check fraud, it is important to determine initially whether the claim involves front-side fraud (forged drawer's signature, alteration, or counterfeit) or back-side fraud (forged endorsement), or both. These distinctions, while initially appearing elementary, are critically important in evaluating potential claims and defenses.

### **III. Forged Drawer's Signature**

#### **A. INTRODUCTION**

This part of the article discusses issues commonly arising in connection with a dishonest employee forging the drawer's signature. As does this article throughout, this discussion assumes that the fidelity insurer owns the claims of the insured/employer, through subrogation or assignment, following payment of the claim. Thus, the analysis focuses on the employer's rights and claims, unless distinctions are noted. The discussion will include the theories of recovery and common defenses.

It should be noted further that the UCC does not treat the problem of check fraud in any single section or article, but sets forth its loss allocation scheme in several sections in Articles 3 and 4.<sup>3</sup> This loss allocation scheme, which generally establishes the rights and defenses of the parties, depends in a large part on the nature of the fraud.

#### **B. POTENTIAL PLAINTIFFS**

When the fidelity insurer pays an employer's claim involving a forged check, the obvious plaintiff is the employer whose account was charged with the forged check.<sup>4</sup> In most states, the fidelity insurer can sue in the name of the employer, but each state's law must be examined on this point.<sup>5</sup> The advantage to naming the employer as the plaintiff is to conceal from the jury the presence of insurance.

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<sup>3</sup>BARKLEY CLARK & BARBARA CLARK, *THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS* ¶ 10.01[1], at 10-1 (rev. ed. 2001) [hereinafter CLARK]. For an excellent article dealing with UCC Articles 3 and 4 in a fidelity bond context see Gary J. Valeriano, *Dealing with Articles 3 and 4 of the Uniform Commercial Code*, in *HANDLING FIDELITY BOND CLAIMS* (Keeley & Sukel eds. 1999).

<sup>4</sup>Thus, when a check with a forged signature has been charged against an employer's account by its bank, the employer is the potential Plaintiff. When the employer has fidelity insurance, and that insurance indemnifies the employer for the check fraud loss due to dishonesty, the fidelity insurer ordinarily will have the right to pursue the employer's rights. For an article discussing the fidelity insurer's subrogation rights see Michael R. Davison & Susan Koehler Sullivan, *Subrogation and Mitigation*, in *HANDLING FIDELITY BOND CLAIMS* (Keeley & Sukel eds. 1999).

<sup>5</sup>See *Franks v. Sematech, Inc.*, 936 S.W.2d 959, 960 (Tex. 1997).

In some instances, it may make sense to simply sue in the name of the fidelity insurer. Some jurisdictions may require the real party in interest, the insurer, to be named as the plaintiff. Sometimes the insured may request that the insurer not sue in the insured's name. This frequently occurs when the insured's own bank is the target defendant. The collateral source rule will ordinarily apply and will protect against arguments that the employer has no loss following payment by the insurer.<sup>6</sup> While most of these concepts are beyond the scope of this article, some of the issues unique to the subrogating fidelity insurer are discussed below.<sup>7</sup>

### C. DOUBLE FORGERY

As noted above, determining the type of check fraud is very important to analyzing the applicable claims and defenses. One particularly difficult type of check fraud is the double forgery check.

The double forgery check usually involves the dishonest employee obtaining access to the employer's blank check stock and then forging the drawer's signature (often by unauthorized use of a facsimile signature machine) and making checks payable to a non-existent entity. Thus, the endorsements may also be unauthorized, as the checks are entirely bogus.

The question presented in this type of situation is whether the checks should be analyzed as checks with front-side fraud or as checks with back-side fraud. This is a scenario affected significantly by the 1990 amendments to the UCC. Under the old UCC (which did not speak directly to the double forgery situation), the case law generally treated the checks as if they involved only forged drawer's signatures with the endorsements being effectuated by section 3.405 of the Code.<sup>8</sup> Under this rule, the loss generally fell on the drawee bank (which could not shift the loss to the depository bank through a breach of warranty claim because the endorsements were deemed effectuated).

The 1990 UCC effected a significant change to the case law. Under sections 3.404 and 3.405, a comparative negligence standard is adopted.<sup>9</sup> The loss is allocated to the drawee and depository banks based on the extent to which each contributed to

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<sup>6</sup>See *Mid-Century Ins. Co. v. Kidd*, 997 S.W.2d 265, 274 (Tex. 1999) ("The collateral source rule bars a wrongdoer from offsetting his liability by insurance benefits independently procured by the injured party.").

<sup>7</sup>See part VI *infra*.

<sup>8</sup>See, e.g., *NCUA v. Michigan Nat'l Bank*, 771 F.2d 154, 41 UCC Rep. 1573 (6<sup>th</sup> Cir. 1985); *Perini Corp. v. First Nat'l Bank*, 553 F.2d 398 (5<sup>th</sup> Cir. 1977); *Payroll Check Cashing v. New Palestine Bank*, 401 N.E.2d 752, 28 UCC Rep. 1421 (Ind. Ct. App. 1980); CLARK, *supra* note 3, ¶ 10.09, at 10-155.

<sup>9</sup>See detailed discussion of these section in part IV *infra*.

the loss.<sup>10</sup> Thus, under the revised code, the distinction of front-side versus back-side fraud in a double forgery situation is no longer relevant.

## D. POTENTIAL DEFENDANTS/THEORIES OF RECOVERY

### 1. Drawee Bank and Section 4.401

In a forged drawer's signature check fraud case involving employee dishonesty, the obvious defendant is the drawee bank. Thus, when dealing with front-side fraud (i.e., forged drawer's signature), the usual source of recovery will be the drawee bank (the employer's bank).

A bank may only charge to its customer's account items that are properly payable.<sup>11</sup> An item that bears an unauthorized drawer's signature is not properly payable.<sup>12</sup> A bank is presumed to know its depositor's signature.<sup>13</sup> Thus, as a general proposition, the employer is entitled to reimbursement of its account if the bank charges to the account an item that is not properly payable, subject to various defenses.<sup>14</sup>

It is also important to emphasize that, in the forged drawer's signature situation, the drawee bank ordinarily cannot shift the loss to the depository bank by a breach of warranty claim. Unlike the forged endorsement situation, discussed below, the loss in the forged signature case will fall on the drawee, except in very limited instances.<sup>15</sup> The 1990 UCC further reflects this loss allocation doctrine by providing that a presenting bank warrants only that it has no knowledge of the forged drawer's signature.<sup>16</sup>

Thus, for the fidelity insurer confronted with an employee dishonesty loss involving checks with forged drawer's signatures, the principal defendant is the drawee bank (the employer's bank), and the usual theory of recovery under the UCC is based on section 4.401(a) (although there may be other theories of recovery

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<sup>10</sup>See § 3.404(d) and § 3.405(b); CLARK, *supra* note 3, ¶ 10.09[2], at 10-168.

<sup>11</sup>§ 4.401(a).

<sup>12</sup>See § 4.401 cmt. 1 ("An item is properly payable from a customer's account if the customer has authorized the payment and the payment does not violate any agreement that may exist between the bank and its customer. . . . An item containing a forged drawer's signature or forged indorsement is not properly payable.")

<sup>13</sup>See *Frost Nat'l Bank v. Heafner*, 12 S.W.3d 104, 109 (Tex. App.—Houston [14<sup>th</sup> Dist.] 2000, *no writ*) ("A bank is presumed to know the signature of its depositor . . . .")

<sup>14</sup>*Id.* ("[A] bank may only charge against a customer's account an item properly payable from that account."); *Fidelity & Cas. Co. v. First City Bank*, 675 S.W.2d 316, 318 n.3 (Tex. App.—Dallas 1984, *writ ref'd n.r.e.*).

<sup>15</sup>See § 3.418 (which generally provides that payment by the drawee is final in favor of a holder in due course or a person who in good faith changes his position in reliance on payment).

<sup>16</sup>See § 4.208; CLARK, *supra* note 3, ¶ 10.03[2], at 10-41.

available in some states). The employer will be entitled to have its account reimbursed by the drawee bank in connection with each check bearing a forged drawer's signature, subject only to the relevant defenses. The subrogating fidelity insurer, therefore, most often will be asserting the employer's section 4.401 claim.

## 2. Common Law Theories of Recovery

As noted above, the UCC provides in its risk allocation scheme a statutory theory of recovery in favor of the drawer against the drawee bank, subject to certain defenses and limitations set forth below. When those defenses prove to be an impediment to recovery, the fidelity insurer will be tempted to look outside the UCC for common law theories of recovery. Obvious theories may be negligence, breach of contract, breach of fiduciary duty and comparative fault.

The principal question presented to courts considering whether any common law theories are available is whether those theories of recovery are consistent with the UCC risk allocation scheme. While this issue usually arises more often in forged endorsement cases, it presents itself whenever the plaintiff is concerned that the UCC risk allocation scheme may be unfavorable to the plaintiff's position. The courts have not been entirely consistent in determining whether non-UCC theories of recovery are available.<sup>17</sup> Some courts apply UCC defenses to protect banks sued under common law theories of recovery.<sup>18</sup>

The analysis by the courts usually is whether the UCC has displaced common law theories of recovery. As one commentator observes:

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<sup>17</sup>Several courts have concluded that, in a forged endorsement scenario, the UCC has displaced any common law negligence theory of recovery. *See, e.g.*, *Equitable Life Assur. Soc'y v. Okey*, 812 F.2d 906, 909 (4<sup>th</sup> Cir. 1987); *Stefano v. First Union Nat'l Bank*, 981 F. Supp. 417, 420 (E.D. Va. 1997); *Berthot v. Sec. Pac. Bank*, 823 P.2d 1326 (Ct. App. Ariz. 1992); *Ohio Cas. Ins. Co. v. Bank One*, No.95 C 6613, 1996 WL 507292 (N.D. Ill. September 4, 1996) (suit brought by a fidelity insurer after payment under a public officials bond). On the other hand, some courts have held that the UCC has not displaced a common theory of money had and received, particularly for purposes of determining the applicable limitations period, so long as the UCC defenses remain available concerning any claims brought under the common law theory. *See, e.g.*, *Peerless Ins. Co. v. Texas Commerce Bank*, 791 F.2d 1177, 1180 (5<sup>th</sup> Cir. 1986) (finding that subrogating fidelity insurer could rely on common law money had and received theory of recovery, with a four-year limitations period, so long as UCC defenses remained applicable); *Hecht v. New York Life Ins. Co.*, 385 N.E.2d 551, 554 (N.Y. 1978) (holding that UCC does not displace an action for money had and received.); *cf. Fid. & Cas. Co. v. First City Bank*, 675 S.W.2d 316 (Tex. App. – Dallas 1984, *writ ref'd n.r.e.*) (holding that fidelity insurer could not assert any common law theories of recovery, including claims for negligence or money had and received, in a no interest payee case when the final payment rule is applicable.).

<sup>18</sup>*See, e.g.*, *G.F.D. Enters., Inc. v. Nye*, 525 N.E.2d 10 (Ohio 1988) (defense of section 3.406 applied to tort claim against a bank for negligence in taking forged checks in exchange for money orders and cash).

Determining whether a particular rule is “displaced” by the UCC or may “supplement” it is an art, not an exact science. But in the general area of check fraud, articles 3 and 4 of the UCC occupy a very large field indeed, and the courts should not easily allow a litigant to press “common law” claims or defenses.<sup>19</sup>

It is beyond the scope of this article to analyze fully all jurisdictions to determine whether they will permit a subrogating fidelity insurer the right to pursue common law theories of recovery. Those theories should not be overlooked, even though many courts have limited their use in UCC fraudulent check cases. An examination of the applicable state’s law will provide the necessary guidance.

## E. DEFENSES

There are two principal defenses available to a drawee bank when it is sued for having paid a check with a forged drawer’s signature, both defenses being predicated on the negligence of the customer (which, in the case of the subrogating insurer, will be the negligence of the insured employer).

One defense relates to the customer’s duty to inspect its account statements and discover forgeries and alterations on the checks charged against its account. This defense is set forth in section 4.406 of the UCC. The other principal defense, under section 3.406, is broader and creates a possible defense if any negligence of the customer substantially contributes to the making of the forgery or alteration.

### 1. Section 4.406 – Customer’s duty to examine statements

Section 4.406 describes the customer’s duty to discover and report unauthorized signatures and alterations. The customer’s duty arises when the bank sends or makes available to the customer a statement of account showing the payment of items, accompanied with the items or with sufficient information to allow the customer reasonably to identify the items paid.<sup>20</sup> If the bank provides such a statement of account with the relevant information, 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 an unauthorized signature.<sup>21</sup>

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<sup>19</sup>CLARK, *supra* note 3, ¶ 1.02[2], at 1-19.

<sup>20</sup>§ 4.406(a) (“A bank that sends or makes available to a customer a statement of account showing payment of items for the account shall either return or make available to the customer the items paid or provide information in the statement of account sufficient to allow the customer reasonably to identify the items paid.”). *See* La Sara Grain Co. v. First Nat’l Bank, 673 S.W.2d 558, 561-62 (Tex. 1984); McDowell v. Dallas Teachers Credit Union, 772 S.W.2d 183, 188 (Tex. App. – Dallas 1989, *no writ*).

<sup>21</sup>§ 4.406(c); *see also* § 4.406(c) cmt. 1 (“The duty stated in subsection (c) becomes operative only if the ‘bank sends or makes available a statement of account or items pursuant to subsection (a).’ A bank is not under a duty to send a statement of account or the paid items to the customer; but,

If, from the items or statement provided, the customer reasonably should have discovered the unauthorized payment, the customer must notify the bank promptly of the relevant facts.<sup>22</sup>

The obligations of section 4.406(c) are “duties” of the customer.<sup>23</sup> Failure by the customer to discover and report unauthorized conduct affects the customer’s ability to recover from the bank in connection with the unauthorized transaction.<sup>24</sup>

There are two principal defenses under section 4.406 predicated on the customer’s duty to give notice.<sup>25</sup> Each is in the form of a preclusion – that is, the customer’s failure to give the requisite notice may preclude the customer from obtaining reimbursement to his account in regard to the unauthorized transaction. The first defense can be referred to as the Repeater Rule.<sup>26</sup> The second defense is referred to as the Absolute Notice Requirement.<sup>27</sup> Although some courts and commentators confuse these defenses, they are distinct. In some situations, both defenses may be applicable.

*a. The Repeater Rule.* The defense of the Repeater Rule is applicable when there are repetitive unauthorized transactions by the same wrongdoer.<sup>28</sup> A typical situation giving rise to the Repeater Rule involves an employee who, over several months, forges the customer/employer’s signature on a series of checks. The Repeater Rule creates a defense in favor of the bank concerning the unauthorized transactions when the customer fails to discover and report the unauthorized activity within thirty days after the customer has first been provided with an account statement reflecting the unauthorized activity.<sup>29</sup>

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if it does not do so, the customer does not have any duties under subsection (e).”).

<sup>22</sup>§ 4.406(c); *see, e.g.*, Hatcher Cleaning Co. v. Comerica Bank – Texas, 995 S.W.2d 933, 937-38 (Tex. App. – Fort Worth 1999, *no writ*) (holding that the “report” under § 4.406 by the customer need not be written but should make known the specific item on which the unauthorized signature appears).

<sup>23</sup>*See* § 4.406 cmt. 1 (“Under subsection (c), the customer has a duty to exercise reasonable promptness in examining the statement or the returned item to discover any unauthorized signature of the customer or any alteration and to promptly notify the bank if the customer should reasonably have discovered the unauthorized signature or alteration.”).

<sup>24</sup>*See* §§ 4.406(d) & (f).

<sup>25</sup>*Id.*; *Heafner*, 995 S.W.2d at 937; *La Sara*, 673 S.W.2d at 561-62.

<sup>26</sup>*See* § 4.406(d).

<sup>27</sup>*See* § 4.406(f).

<sup>28</sup>*See* § 4.406(d) (“If the bank proves that the customer failed, with respect to an item, to comply with the duties imposed on the customer by Subsection (c), the customer is precluded from asserting against the bank: . . . (2) the customer’s unauthorized signature or alteration by the same wrongdoer on any other item paid in good faith by the bank if the payment was made before the bank received notice from the customer of the unauthorized signature or alteration and after the customer had been afforded a reasonable period of time, not exceeding 30 days, in which to examine the item or statement of account and notify the bank.”).

<sup>29</sup>§ 4.406(d)(2).

The time within which to give notice under the Repeater Rule is thirty days. This thirty-day notice requirement is expressly provided within the statute itself, reflecting a legislative intent that, under some circumstances relevant to the relationship between banks and their customers, a thirty day notice provision is appropriate. In the pre-1996 version of section 4.406, the Repeater Rule contained a fourteen day notice provision. Thus, the post-1996 version of section 4.406 reflects an intent that thirty days, not fourteen days, be viewed as more appropriate.<sup>30</sup> This legislative intent to recognize the validity of a notice provision as short as thirty days is relevant to the consideration of the enforceability of shortened notice requirements under the Absolute Notice Requirement of section 4.406(d), which is discussed below.<sup>31</sup>

The Repeater Rule focuses on the beginning of the period of the unauthorized activity and creates a duty on the customer to discover the unauthorized activity at the first possible opportunity – when the first account statement reflecting the fraud is made available to the customer. The customer’s failure to discover and notify the bank creates a preclusion in favor of the bank. The customer’s failure to discover and report precludes the customer from asserting against the bank any subsequent unauthorized transactions by the same wrongdoer.<sup>32</sup>

The policy of the Repeater Rule reflects the notion that the customer is in the best position to discover the wrongdoing. Following the customer’s opportunity to discover the wrongdoing by review of the first account statement reflecting the wrongdoing, the loss of later transactions by the same wrongdoer should fall on the customer and not the bank.<sup>33</sup> This is because the customer’s failure to discover the wrongdoing usually provides the wrongdoer the opportunity to continue stealing.<sup>34</sup>

The preclusion of the Repeater Rule, unlike the preclusion of the Absolute Notice Requirement, is not absolute. If the customer proves that the bank failed to

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<sup>30</sup>See § 4.406(d) cmt. 2 (“Subsection (d)(2) changes former subsection (2)(b) by adopting a 30-day period in place of a 14-day period. Although the 14-day period may have been sufficient when the original version of Article 4 was drafted in the 1950’s, given the much greater volume of checks at the time of the revision, a longer period was viewed as more appropriate.”).

<sup>31</sup>See *infra* part III.E.1.c.

<sup>32</sup>§ 4.406(d)(2).

<sup>33</sup>See § 4.406(d) cmt. 2 (“Subsection (d) states the consequences of a failure by the customer to perform its duty under subsection (c) to report an alteration or the customer’s unauthorized signature. . . . Subsection (d)(2) applies to cases in which the customer fails to report an unauthorized signature or alteration with respect to an item in breach of the subsection (c) duty (See Comment 1) and the bank subsequently pays other items of the customer and the same wrongdoer is involved.”).

<sup>34</sup>See § 4.406(d) cmt. 2 (“One of the most serious consequences of failure of the customer to comply with the requirements of subsection (c) is the opportunity presented to the wrongdoer to repeat the misdeeds. Conversely, one of the best ways to keep down losses in this type of situation is for the customer to promptly examine the statement and notify the bank of an unauthorized signature or alteration so that the bank will be alerted to stop paying further items.”).

exercise ordinary care<sup>35</sup> in paying the item or items in question, and that this failure contributed to the loss, the loss is allocated between the customer and the bank based upon their respective degrees of fault.<sup>36</sup> The bank has the burden of proving the customer's negligence, and the customer has the burden of proving the bank's negligence.<sup>37</sup> The potential negligence of the drawee bank usually is determined by an analysis of how the bank paid the checks in question and whether the bank actually verified the signature on the checks.<sup>38</sup> Also, if the customer proves the bank did not pay the item in good faith,<sup>39</sup> the preclusion against the customer is inapplicable.<sup>40</sup>

The loss to the bank of the Repeater Rule defense due to its failure to exercise ordinary care is in stark contrast to the defense of the Absolute Notice Requirement, which applies in favor of the bank without regard to care.<sup>41</sup> This distinction is important and carefully written into section 4.406.

*b. The Absolute Notice Requirement.* The Absolute Notice Requirement creates an absolute preclusion against the customer who fails his duties under section

<sup>35</sup>Ordinary care as used in section 4.406 is defined in section 3.103(7) which provides in relevant part: 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 chapter or Chapter 4.

<sup>36</sup>See § 4.406(e) ("If subsection(d) applies and the customer proves that the bank failed to exercise ordinary care in paying the item and that failure contributed to loss, 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 to comply with Subsection (c) and the failure of the bank to exercise ordinary care contributed to the loss.").

<sup>37</sup>Section 4.406(d) states, "If the bank proves that the customer failed, with respect to an item, to comply with the duties imposed on the customer . . ." and § 4.406(e) states, "If Subsection (d) applies and the customer proves that the bank failed to exercise ordinary care in paying the item and that failure contributed to the loss . . ."

<sup>38</sup>See discussion of this issue *infra* notes 67 – 75.

<sup>39</sup>Section 4.104(c) incorporates in Article 4 the definition of good faith set forth in § 3.103(4), which provides that good faith means: ". . . honesty in fact and the observation of commercial standards of fair dealing." This was a definitional change made in the post-1996 Code. Under the pre-1996 version, good faith required only "honesty in fact." See *La Sara*, 673 S.W.2d at 563 ("Good faith is defined as 'honesty in fact in the conduct or transaction concerned.'"). The test for good faith under the pre-1996 version of the Code is the actual belief of the party in question, not the reasonableness of that belief. The new definition does not, however, require the exercise of ordinary care, but requires fairness. See § 3.103 cmt. 4 ("Although fair dealing is a broad term that must be defined in context, it is clear that it is concerned with the fairness of the conduct rather than the care with which the an act is performed. Failure to exercise ordinary care in conducting a transaction is an entirely different concept than failure to deal fairly in conducting the transaction."); § 4.406 cmt. 4 ("The connotation of this standard is fairness and not absence of negligence.").

<sup>40</sup>See § 4.406(e) ("If the customer proves that the bank did not pay the item in good faith, the preclusion under Subsection (d) does not apply.").

<sup>41</sup>See § 4.406(f) (Which begins with the phrase: "Without regard to care or lack of care of either the customer or the bank . . .").

4.406.<sup>42</sup> This reflects a policy consideration of establishing an absolute time limit on the responsibility of banks for unauthorized transactions.<sup>43</sup> If the customer does not discover and report his or her unauthorized signature or any alteration on an item within one year after receipt of the account statement or item reflecting the unauthorized activity, the customer is precluded from asserting a claim against the bank arising from the unauthorized signature or alteration.<sup>44</sup>

The preclusion of the Absolute Notice Requirement applies to the customer notwithstanding the failure of the bank to exercise ordinary care.<sup>48</sup> Even if the bank fails to exercise ordinary care in paying the item, the customer must timely discover and report the unauthorized transaction or be precluded from asserting the unauthorized activity against the bank and thereby become entitled to reimbursement.<sup>49</sup> As noted, this is in direct contrast to the Repeater Rule defense. Under the Repeater Rule, if the bank is negligent, the loss is apportioned according to the respective fault of the bank and the customer. Under the Absolute Notice Requirement, the negligence of the bank is irrelevant inasmuch as the customer is precluded from recovery if he or she fails to discover and report the conduct in a timely manner.

Also, it should be noted that, while the Repeater Rule is lost as a defense to the bank by the express provisions of § 4.406(e) if the bank does not pay in good faith, the Absolute Notice Requirement of section 4.406(f) does not contain similar language.<sup>50</sup> This difference in language raises the question of whether the absence of good faith deprives the bank of the Absolute Notice Requirement defense.<sup>51</sup>

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<sup>42</sup>§ 4.406(f) (“Without regard to care or lack of care of either the customer or the bank, a customer who does not within one year after the statement or items are made available to the customer (Subsection (a)) discover and report the customer’s unauthorized signature on or any alteration of the item is precluded from asserting against the bank the unauthorized signature or alteration.”).

<sup>43</sup>See § 4.406 cmt. 5 (pre-1996 version) (§ 4.406 “. . . places an *absolute time limit* on the right of the customer to make claim for payment of altered or forged paper . . . . The forty existing statutes on the subject as well as Section 4-406 evidence a public policy in favor of imposing on customers the duty of prompt examination of their bank statements and the notification of banks of forgeries and alterations and in favor of reasonable time limitations on the responsibility of banks for payment of forged or altered items.”) (emphasis added).

<sup>44</sup>§ 4.406(f).

<sup>48</sup>*Id.*

<sup>49</sup>See *La Sara*, 673 S.W.2d at 561.

<sup>50</sup>§ 4.406(f).

<sup>51</sup>In a case under the pre-1996 version of § 4.406, however, the Supreme Court of Texas held that absence of good faith resulted in a loss of the Absolute Notice Requirement defense. See *La Sara*, 673 S.W.2d at 563 (Tex. 1984). Also, in *American Airlines Federal Credit Union v. Martin*, the court noted under section 4.406: “To assert a claim against the bank based on an unauthorized signature (*absent any allegation that the bank did not act in good faith*), a customer must comply with the duty to discover and report within one year.” 29 S.W.3d 86, 95 (Tex. 2000) (emphasis added).

*c. Can the One Year Absolute Notice Requirement Be Shortened by Agreement?* The Absolute Notice Requirement of section 4.406(f) provides for a one year notice requirement. Whether this one year notice requirement can be shortened by agreement is an issue that generally has been resolved in favor of allowing shortened notice provisions.

1. Section 4.103 – Variation by Agreement. A proper analysis of whether shortened notice provisions are enforceable begins with reference to the general provisions of Article 4 and, in particular, section 4.103(a). All provisions of Article 4 are subject to variation under the “blanket power”<sup>52</sup> conferred by section 4.103(a), subject to certain limitations.<sup>53</sup> The “agreement”<sup>54</sup> may be with respect to a single item or it may be a general agreement between the depository bank and the customer at the time the deposit account is opened.<sup>55</sup> The parties’ agreement may be proven by various types of evidence.<sup>56</sup>

Agreements varying terms of Article 4 are enforceable under section 4.103(a) so long as the provisions: (a) do not disclaim the bank’s responsibility for its lack of good faith; (b) do not limit the measure of damages; and (c) do not state a manifestly unreasonable provision.<sup>57</sup>

2. Cases Considering Shortening the One Year Absolute Notice Requirement. Recently, the Supreme Court of Texas considered the issue of whether the one year absolute notice requirement could be shortened to sixty days by

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<sup>52</sup>See § 4.103(a) cmt. 2 (“Subsection (a) confers blanket power to vary all provisions of the Article by agreements of the ordinary kind.”).

<sup>53</sup>§ 4.103(a) (“The effect of the provisions of this chapter [Article 4] may be varied by agreement, but the parties to the agreement cannot disclaim a bank’s responsibility for its own lack of good faith or failure to exercise ordinary care or limit the measure of damages for the lack or failure.”).

<sup>54</sup>As used in section 4.103(a), the term “agreement” has the meaning given to it by § 1.201(3) which provides: “‘Agreement’ means the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance as provided in this title (Sections 1.205 and 2.208) . . . .”

<sup>55</sup>See § 4.103 cmt. 2 (The agreement may be “. . . a general agreement between the depository bank and the customer at the time the a deposit account is opened.”).

<sup>56</sup>See § 4.103 cmt. 2 (“Legends on deposit tickets, collection letters and acknowledgments of items, coupled with action by the affected party constituting acceptance, adoption, ratification, estoppel or the like, are agreements if they meet the test of the definition of ‘agreement.’”).

<sup>57</sup>§ 4.103(a); see also *Parent Teacher Ass’n, Public School 72 v. Mfrs. Hanover Trust Co.*, 524 N.Y.S. 2d 336, 338 (N.Y. Civ. Ct. 1988) (“These [UCC] provisions are not exclusive. Given the Code’s effort to harmonize the law with its view of commercial reality, and in accord with traditional common law notions of freedom of contract, the Code permits parties to a contract of deposit to agree between themselves as to their duties, and the legal consequences to flow from breach, provided that the agreement does not disclaim the bank’s responsibility for its own lack of good faith or failure to exercise ordinary care. [citations omitted]. Thus, the contract of deposit may include conditions precedent or the equivalent of a shortened statute of limitations [citations omitted] as long as they are not unconscionable or manifestly unreasonable, or the product of overreaching.”).

agreement between the bank and the customer.<sup>58</sup> It concluded that such agreements are enforceable.<sup>59</sup> This holding was consistent with prior Texas cases.<sup>60</sup>

Courts of other jurisdictions have also recognized and enforced shortened absolute notice requirements.<sup>61</sup> These courts analyze the notice requirement as a duty and recognize that the time allowed for compliance of that duty can be established by agreement.

The leading UCC commentators also recognize the absolute notice requirement of section 4.406 as a customer's duty and further recognize that a bank and its customer may shorten the one year notice requirement by agreement.<sup>62</sup>

These shortened notice provisions may be the greatest potential impediment to the subrogating fidelity insurer. It is the obligation of the customer/insured to give notice to its bank concerning checks with forged drawer's signatures. The fidelity

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<sup>58</sup>See *Am. Airlines Employees Fed. Credit Union v. Martin*, 29 S.W.3d 86 (Tex. 2000). For a discussion of the *Martin* case, see Stephen L. Baskind, *Deposit Agreements Between Banks and Their Customers – The Texas Supreme Court Settles the Shortened Notice Provision Question*, 32 TEX. TECH L. REV. 191 (2001).

<sup>59</sup>See *Martin*, 29 S.W.2d. at 89.

<sup>60</sup>See, e.g., *Basse Truck Line, Inc. v. First State Bank*, 949 S.W.2d 17, 21-22 (Tex. App. – San Antonio 1997, writ denied); *Tumlinson v. First Victoria Nat'l Bank*, 865 S.W.2d 176, 177 (Tex. App. – Corpus Christi 1993, no writ).

<sup>61</sup>See, e.g., *Fundacion Museo de Arte Contemporaneo Caracas v. CBI -TDB Union Bancaire Privee*, 996 F. Supp. 277, 280-81, 291 (S.D.N.Y. 1998), *aff'd*, 160 F.3d 147 (2d Cir. 1998) (upholding deposit agreement provision with thirty day notice provision); *Coinc. v. Mfrs. Hanover Trust Co.*, 16 U.C.C. Rptr. Serv. 184 (N.Y. Sup. 1975) (fourteen day notice provision approved); *Jamison v. First Georgia Bank*, 387 S.E. 2d 375 (Ga. App. 1989) (sixty day notice provision approved); *Stowell v. Cloquet Co-Op Credit Union*, 557 N.W.2d 567 (Minn. 1997) (fourteen day notice provision approved); *Borowski v. Firststar Bank Milwaukee*, 579 N.W.2d 247 (Wis. Ct. App. 1998) (fourteen day notice provision approved as being “not manifestly unreasonable”); *Parent Teacher Ass'n, Public School 72 v. Mfrs. Hanover Trust Co.*, 524 N.Y.S.2d 336 (N.Y. Civ. Ct. 1988) (fourteen day notice provision approved).

<sup>62</sup>THOMAS D. CRANDALL, MICHAEL J. HERBERT & LARY LAWRENCE, UNIFORM COMMERCIAL CODE § 17.13.4, at 17:199 (1996) (“ . . . [T]he bank and the customer can shorten the time the customer has to report unauthorized signatures by agreement.”); CLARK, *supra* note 3, ¶ 3.01[3][c][ii], at 3-30 - 3-33 & ¶ 10.05[1][c][i], at 10-56.2 - 10-66.1 (rev. ed. 1999) (“Can a drawee bank bind its customer to a provision in the deposit agreement that requires the reporting of forgeries within a shorter time than allowed by § 4-406(4), such as thirty (30) days from the mailing of the statement and canceled checks? Such a contractual provision would appear to be authorized by § 4-103(1), because it is not an attempt by the bank to disclaim its own negligence.”); 6B RONALD A. ANDERSON, UNIFORM COMMERCIAL CODE § 4-103:70 *et. seq.*, at 589-594 (3<sup>rd</sup> ed. 1998) (“In accord with the general principle of permitting parties freedom to make their own transactions, and providing a flexibility allowing particular variations in particular and general changes, Code § 4-103 expressly authorizes the parties to vary by agreement the provisions of Article 4 of the Code.”); 5 WILLIAM D. HAWKLAND, J. FAIRFAX LEARY & RICHARD M. ALDERMAN, UNIFORM COMMERCIAL CODE SERIES § 4-103:2, at 4-143-4 (1999) (summarizing the time frames fixed by the UCC, as well as the potential bank agreements attempting to shorten the time frames).

insurer may find that insured did not do so, and such failure may bar the insurer's subrogation claim. This is particularly true when the insured has agreed to a shortened notice provision in the deposit agreement with its bank. It is important to note that a new notice period begins with each account statement that reflects a forgery. Thus, each time a statement is delivered a new notice period begins to run. Further, the insured may not be very interested in pursuing claims against its own bank, particularly when it has fidelity insurance. Thus, the fidelity claims handler must be extremely careful to consider the necessity of notice immediately upon receipt of notice of the claim. Of course, failure of the insured to preserve subrogation rights may be a defense to a claim, but the safe course of practice is to make sure notice is given or to give notice directly to the bank and attempt to preserve all possible claims against the bank.

## **2. Section 3.406 – Negligence Contributing to a Forgery**

Section 3.406, like section 4.406, creates a defense to banks in forged signature and alteration cases. Whereas section 4.406 focuses on the customer's duty to inspect account statements, section 3.406 considers a broader range of customer activity and possible negligence. Section 3.406 provides that, if a customer's failure to exercise ordinary care substantially contributes to the making of a forged signature or alteration, the customer is precluded from asserting the forgery or alteration against a bank which pays the item in good faith.<sup>63</sup> Thus, in a situation involving a forgery of the drawer's signature, section 3.406 provides a possible defense to the drawee bank if the customer's negligence substantially contributes to the making of the forgery.

It is important to observe that section 3.406 applies only to "forged" signatures and not merely "unauthorized" signatures.<sup>64</sup> This is a change from the old UCC, which applied the defense in both circumstances. Apparently, the draftsmen of the UCC believe agency law will handle adequately the unauthorized signature situation.<sup>65</sup> From the perspective of the subrogating fidelity insurer, this distinction is important if the items in question are merely unauthorized, and not forged, because the claim against the drawee bank may not be defended under section 3.406.

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<sup>63</sup>Section 3.406(a) states:

A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the being of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection.

<sup>64</sup>See § 3.406 cmt. 2 ("Section 3-406 refers to 'forged signature' rather than 'unauthorized signature' that appeared in the former Section 3-406 because it more accurately describes the scope of the provision.").

<sup>65</sup>§ 3.406 cmt. 2 ("Unauthorized signature is a broader concept that includes not only forgery but also the signature of an agent which does not bind the principal under the law of agency. The agency cases are resolved independently under agency law. Section 3-406 is not necessary in those cases.").

Of note, section 3.406 does not create liability, but instead creates a preclusion against recovery by the negligent party.<sup>66</sup> The type of negligent conduct of the customer which can form the basis of the defense is not defined in section 3.406.<sup>67</sup> One commentator has noted:

The drafters contemplate a shortened chain of causation that rejects the idea that intervening causes – such as criminal activity – can break the chain. This language would clearly include negligence in its most traditional forms – careless hiring, careless monitoring of employees, and failure to safeguard checkbooks, rubber stamps, or facsimile machines.<sup>68</sup>

Thus, the subrogating insurer evaluating possible claims against its insured's bank in instances of forged drawer's signatures will also be analyzing the negligence of the insured in supervising the employee and reviewing how the dishonest employee accessed blank check stock and the like.

Under the earlier version of the UCC, in order to rely on the defense of section 3.406, a bank itself had to be free of negligence. Specifically, it had to establish that it had paid the item in question in accordance with reasonable commercial standards. Under the new UCC, this requirement for reliance on the defense by a bank is deleted. In its place, the draftsmen create a system of comparative fault.<sup>69</sup> The burden to prove the negligence is on the party asserting the negligence; the bank must prove the customer's negligence and the customer must prove the bank's negligence.<sup>70</sup>

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<sup>66</sup>§ 3.406 cmt. 1 (“Section 3-406 does not make the negligent party liable in tort for damages resulting from the alteration [or forgery].”).

<sup>67</sup>Section 3.406 cmt. 1 provides:

No attempt is made to define particular conduct that will constitute ‘failure to exercise ordinary care [that] substantially contributes to an alteration.’ Rather, ‘ordinary care’ is defined in Section 3-307(a)(7) in general terms. The question is to the court and jury for decision in the light of the circumstances in the particular case including reasonable commercial standards that may apply.

<sup>68</sup>CLARK, *supra* note 3, ¶ 10.42[2] at 10-50.

<sup>69</sup>Section 3.406(b) provides:

Under subsection (a), if the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure contributes to loss, the loss is 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.

Section 3.406 cmt. 4 observes: “If the person precluded under subsection (a) proves that the person asserting the preclusion failed to exercise ordinary care and that failure substantially contributed to the loss, the loss is allocated between the two parties on a comparative negligence basis.”

<sup>70</sup>Section 3.406(c) provides: “Under subsection (a), the burden of proving failure to exercise ordinary care is on the person asserting the preclusion. Under subsection (b), the burden of proving failure to exercise ordinary care is on the person precluded.”

As noted above, in the typical case, the negligence of the drawer/insured can be found in a variety of types of conduct from the manner of supervision of the dishonest employee to the policies and practices in issuing checks and protecting check stock and facsimile signature devices. Concerning the negligence of the drawee bank, the general focus is the manner in which the item was paid and, in particular, whether the bank actually verified the customer's signature before paying the check or merely paid the check through a means of automated processing which does not include manual inspections. Under the old UCC, there was a large body of case law which addressed the issues of whether a bank had to manually verify signatures and whether failure to do so amounted to negligence as a matter of law.<sup>71</sup>

The new UCC changes this issue by its adoption of a definition of ordinary care which expressly does not require manual inspection of items if (1) the failure to examine manually does not violate the bank's prescribed procedures, and (2) the automated procedures do not vary unreasonably from general banking usage.<sup>72</sup> Thus, the mere failure by the drawee bank to inspect checks manually for forgeries will not, in and of itself, result in a finding of negligence as a matter of law.<sup>73</sup> The propriety of the verification process used by the bank will be an issue for the trier of fact.<sup>74</sup>

Usually, banks adopt a procedure of manually inspecting only large items of a certain dollar amount (in smaller banks it may be \$5,000 to \$10,000 and in larger banks it may be as high as \$50,000). The bank's automated processing equipment will segregate these large items for review by a human being. The new UCC permits this type of practice so long as it is reasonable. As one commentator observes: "If the bank has a prescribed procedure and sticks to it, and if that procedure does not depart unreasonably from the signature verification procedure used by other banks similarly

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<sup>71</sup>See *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 552 N.E.2d 783 (Ill. 1990) (holding that the issue of a bank's negligence in using automated check processing which did not include a manual inspection of signatures was a question for the trier of fact); *Medford Irrigation Dist. v. W. Bank*, 676 P.2d 329 (Ore. Ct. App. 1984) (holding that a bank was negligent as a matter of law for failing to manually verify signatures).

<sup>72</sup>See § 4.406 cmt. 4. Section 3.103(7) provides in particular concerning payment of checks by banks:

"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 chapter or Chapter 4.

This definition of ordinary care most likely would cause a different result in cases like *Medford Irrigation Dist. v. W. Bank*, 676 P.2d 329 (Ore. Ct. App. 1984) and *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 188 (Tex. App. - Dallas 1989, *no writ*), which held that automated processing of checks amounted to a lack of ordinary care as a matter of law.

<sup>73</sup>§ 4.406 cmt. 4 ("The definition of 'ordinary care' in Section 3-103 rejects those authorities that hold, in effect, that failure to use sight examination is negligence as a matter of law.")

<sup>74</sup>See § 3.307.

situated, the bank should not be guilty of negligence in paying the forged items.”<sup>75</sup> Nevertheless, the subrogating insurer should not assume the bank will always prevail on this issue. Care should be taken to determine the bank’s policies, whether those policies were actually followed and whether those policies vary from banks located in the same area. Fact finders may be surprised that checks are processed without any human review and may be reluctant to approve such processes, particularly when evidence can be developed to establish that use of such automated processes is primarily designed to save the bank money.

The defense of section 3.406 may also arise in the forged endorsement context, which is discussed below.<sup>76</sup>

### 3. Limitations

The old UCC contained no particular limitations period for suits by customers against drawee banks based on forged drawers’ signatures. The new UCC in section 4.111 provides: “An action to enforce an obligation, duty, or right arising under this chapter must be commenced within three years after the cause of action accrues.”

While this section may clear up some limitations issues, there remain areas of concern. Care should be taken not to confuse the three year limitations period with the notice provision under section 4.406. These are separate issues. While a customer may be able to wait three years to bring suit, failure to give notice within one year under section 4.406 (or an agreed shorter time) may bar the claim.

The limitations period begins after the cause of action “accrues.” Accrual probably occurs when the check bearing the forgery is charged to the customer’s account. This would mean that a separate limitations period may apply to each check. At least one court, however, has held that the cause of action did not accrue until the bank refused the customer’s demand to reimburse the account.<sup>77</sup> Thus, reference to law of the relevant state may be required to analyze fully the applicable limitations periods.

A review of the applicable deposit agreement should also be made to determine whether the three year limitations period has been modified by agreement (as well as whether the section 4.406 absolute notice requirement has been shortened by agreement, as discussed above).

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<sup>75</sup>CLARK, *supra* note 3, ¶ 10.06[2], at 10-141.

<sup>76</sup>See *infra* part IV.E.3.

<sup>77</sup>See Walker & Walker, Inc. v. Liberty Nat’l Bank & Trust Co. 20 UCC Rep. 2d 1291 (Okla. 1993); see also CLARK, *supra* note 3, ¶ 10.07.

#### **4. Common law defenses**

As noted above, there may be common law theories of recovery available to the subrogating insurer in a check fraud case. Usually those theories of recovery are affected by common law defenses. It is beyond the scope of this article to review all states to determine the availability of common law theories, but the wise subrogating insurer and its attorney will determine which common law theories and defenses, if any, are applicable.

#### **F. SUMMARY**

As set forth above, there are various theories of recovery and defenses applicable in the forged drawer's check scenario. When a forged check is charged to the customer's account, the bank generally must reimburse the account. If the customer is negligent concerning the issuance of the check or in reviewing its account statements, the bank may avoid liability unless it, too, was negligent. Questions of the bank's negligence usually revolve around issues of check verification. If both parties are negligent, the UCC generally applies a comparative fault system to allocate the loss. This comparative fault system is "pure" in the sense that it does not prevent recovery, or shifting a portion of the loss, by a party which is more than fifty percent negligent.<sup>78</sup>

From the perspective of the subrogating insurer anticipating assertion of its insured's rights against the insured's bank, special care must be taken to give notice to the bank at the earliest time possible, in order to preserve claims fully. Insureds cannot be counted on always to give notice timely, particularly when their focus is on recovering from their fidelity insurer. The insured may, and often does, overlook or discount claims against its bank, especially if the loss is mostly insured under an employee dishonesty policy. The careful fidelity insurer, however, can preserve claims against the bank and often may recover significant amounts from the bank under the applicable UCC loss allocation scheme.

### ***IV. Forged Endorsements***

#### **A. INTRODUCTION**

This portion of the article will discuss issues relevant to the fidelity insurer concerning an employee dishonesty claim involving checks with back-side fraud involving forged endorsements. The article assumes that the fidelity insurer owns the claims of the insured/employer, through subrogation or assignment, following payment

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<sup>78</sup>See CLARK, *supra* note 3, ¶ 10.06[2], at 10-140.

of the claim. Thus, the analysis focuses on the employer's rights and claims unless distinctions are noted.

## **B. POTENTIAL PLAINTIFFS**

When the fidelity insurer pays the employer concerning a claim involving forged endorsements, the obvious plaintiff is, as with the forged drawer's signature situation, the employer. In the forged endorsement scenario, the employer may be in the position of payee of the checks or the drawer thereof. One common fact situation is when the employee intercepts checks payable to the employer, forges the endorsement and obtains the proceeds of the checks. In this situation, the fidelity insurer (which has paid the employer under a fidelity policy) will be asserting the rights of the employer in its capacity as the intended payee of the check.

Another common fact pattern involving forged endorsements involves the employer as the drawer of the checks. In this fact pattern, the employee causes the employer to issue an otherwise valid check to a person or entity not entitled to payment. The employee then intercepts the check issued by the employer, negotiates it by endorsing in the name of the payee (which is typically a fictitious payee or payee not entitled to the proceeds) and acquires the proceeds. In this situation, the fidelity insurer, which has paid the employer under a fidelity policy, will be asserting the rights of the employer in its capacity as drawer of the check; however the fraud – unlike the forged drawer's signature situation – is in the endorsement of the check.

Thus, in the forged endorsement situation, care must be taken to determine whether the employer/insured was the payee of the check or the issuer of the check. This distinction will have a significant impact on the nature of the available remedies.

## **C. STANDING TO SUE IN A FORGED ENDORSEMENT CASE**

As noted above, one of the principal issues in a forged endorsement case is determining precisely the type of fraud. This determination will go a long way in determining the applicable theories of recovery and potential defendants.

### **1. Delivery**

The concept of delivery of the check in question plays a large part in determining rights and obligations of checks with forged endorsements. As noted, one of the most common forms of check fraud involving employee dishonesty arises from the interception of otherwise valid checks by dishonest employees. *When* the dishonest employee steals the check is very relevant. For example, if the employee of the payee steals the check from the payee after the check has been delivered by the drawer to the payee, the rights in the check are generally in the payee. If the employee steals the check after it is issued by the drawer, but before delivery to the payee, then

the rights in the check (and to recover in regard to the check) generally remain with the drawer or issuer of the check.

These rules are generally described in section 3.420 of the UCC and its comments. Section 3.420 states the basic rules of conversion: the law applicable to conversion of personal property applies and an instrument is converted if it is taken for transfer from a person not entitled to enforce payment or a bank makes or obtains payment for a person not entitled to enforce the instrument.<sup>79</sup> An action for conversion may *not* be brought by the issuer or drawer of a check or by a payee who did not receive delivery of the check.<sup>80</sup> The basic rules concerning how delivery affects the rights and obligations of the parties to a check are as follows:

- a. A payee has no right to sue for conversion of a check if he *did not receive delivery* of the check. So if the dishonest employee steals the check from his or her employer before it is delivered to the payee, the payee has no right in the check, but can enforce the obligation underlying the check – because that obligation has never been discharged if the check was never delivered. In such case, the payee can obtain a second check from the drawer by enforcing the underlying obligation. The drawer has rights against its bank (the drawee) under section 4.401 for having paid an item which is not properly payable (*i.e.*, one bearing a forged endorsement). The drawee then has rights against the depository bank for breach of warranty under section 4.208(a)(1) based on the depository bank's collection of a check with a forged endorsement.<sup>81</sup> Generally, the drawer has no direct cause of action against the depository bank for conversion under section 4.320, but if the depository bank relies on the defenses of sections 4.304 and 4.405 and is negligent, the drawer may be entitled to recover directly from the depository bank.<sup>82</sup>
  
- b. On the other hand, if the dishonest employee steals the check *after it is delivered* to the payee, then the underlying obligation owed by the drawer to the payee is satisfied.<sup>83</sup> The payee's rights are restricted to the

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<sup>79</sup>Section 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.

<sup>80</sup>Section 3.420 provides: “ An action for conversion of an instrument may not be brought by: (a) the issuer or acceptor of the instrument; or (b) a payee or indorsee who did not receive delivery of the instrument either directly or through delivery to an agent or a co-payee.”

<sup>81</sup>See § 3.420 cmt. 1.

<sup>82</sup>See discussion of this issue *infra* notes 90 – 95.

<sup>83</sup>See § 3.310.

instrument and the payee has a cause of action in conversion against either the depository bank or the drawee.<sup>84</sup>

In sum, care must be taken to determine exactly what type of fraud has occurred and exactly where the employer/insured stands in relation to the fact pattern. If the employer/insured is the drawer whose dishonest employee steals a check before delivery, its rights and obligations are different from the employer/insured who stands in the position of a payee who has received delivery before the check is stolen.

## 2. Issues Relating to Co-payees

Sometimes, checks involved in fraud are made payable to more than one payee. If a check is made payable to two payees (such as “Payee A and Payee B”), it must be endorsed by both payees to be negotiated properly.<sup>85</sup> If it is payable in the alternative (such as “Payee A or Payee B”), it can be endorsed properly by either payee.<sup>86</sup> If there is ambiguity as to the payees (such as “Payee A and/or Payee B”), the check is treated as if it is payable in the alternative (“Payee A or Payee B”) and either payee can effectively endorse.<sup>87</sup>

Particularly relevant to check fraud cases is the issue of delivery, which, as discussed above, defines to some extent the nature of the available remedies. When a check is made payable to “Payee A and Payee B,” delivery to one is deemed delivery to both.<sup>88</sup> Thus, when check fraud – usually a forged endorsement – occurs after delivery to one of two co-payees, the payee who did not receive delivery is entitled to sue for conversion (against either the drawee or the depository bank) under section 3.420.<sup>89</sup>

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<sup>84</sup>See § 3.420 cmt. 1.

<sup>85</sup>§ 3.110(d) and § 3.110 cmt. 4 (“If an instrument is payable to X and Y, neither X nor Y acting alone is the person to whom the instrument is payable. Neither person, acting alone, can be the holder of the instrument.”); *see also* §§ 3.109(b) and 1.210(20).

<sup>86</sup>See § 3.110 cmt. 4 (“If an instrument is payable to X or Y, either is the payee and if either is in possession that person is the holder and the person entitled to enforce the instrument.”).

<sup>87</sup>*Id.* (“In the case of ambiguity persons dealing with the instrument should be able to rely on the indorsement of a single payee.”).

<sup>88</sup>Section 3.420(a) provides that a conversion action is *not* available to a co-payee who did not receive delivery through a co-payee. *See* § 3.420 cmt. 1 (“If a check is payable to more than one payee, delivery to one of the payees is deemed to be delivery to all of the payees.”).

<sup>89</sup>*Id.*; *see also* § 3.420(a) cmt. 1 (“[3.420] also covers cases in which an instrument is payable to two persons and the two persons are not alternative payees, e.g., a check payable to John and Jane Doe. Under Section 3-110(d) the check can be negotiated or enforced only by both persons acting jointly. Thus, neither payee acting without the consent of the other, is a person entitled to enforce the instrument. If John endorses the check and Jane does not, the indorsement is not effective to allow negotiation of the check. If Depository Bank takes the check for deposit to John’s account, Depository Bank is liable to Jane for conversion of the check if she did not consent to the transaction.”).

### **3. Direct Claim by Drawer Against Depository Bank**

As noted above, the general rules of delivery and section 3.420 suggest that, when a check is stolen from the drawer before delivery, the drawer still owes the intended payee on the underlying obligation and only has rights against its own bank, the drawee, under section 4.401 for having charged to the drawer's account an item not properly payable due to the forged endorsement. Because the drawee can then pass the loss on to the depository bank by a warranty claim, the obvious question is: "Why can't the drawee just sue the depository bank directly?"

The UCC seems to create an impediment to a direct action by the drawer of the check against the depository bank in section 3.420 when it expressly forbids a conversion action by a drawer.<sup>90</sup> The decisions under the old UCC were split. Some courts prohibited direct suits against depository banks by drawers in forged endorsement scenarios.<sup>91</sup> Some courts allowed direct suits.<sup>92</sup> The new UCC seems to prohibit such direct actions when it observes in comments: "There is no reason why a drawer should have an action in conversion. . . . The drawer has an adequate remedy against the payor bank for recredit of the drawer's account for unauthorized payment of the check."<sup>93</sup>

This UCC impediment to direct actions by drawers against depositories causes attorneys and courts to look for other theories of recovery under common law, such as negligence or other tort based theories. The desire to sue the depository bank -- and not the drawee -- in forged endorsement cases arises in many instances because the drawer/insured does not want to sue its own bank. While some jurisdictions may recognize these non-UCC, common law theories, in most instances there is another solution under the UCC.

In almost all instances of endorsement fraud, the bank which takes the fraudulent checks will be asserting the defenses of section 3.404 and 3.405 (which are discussed below). The assertion of those defenses by a depository bank, oddly enough, will expose it to a direct action by a drawer in a forged endorsement case through the comparative risk allocation scheme adopted by the new UCC. Notwithstanding the apparent impediment to a direct conversion action by a drawer against a depository bank, the comment to section 3.404 expressly allows a direct suit by the drawer against the depository bank when sections 3.404 or 3.405 apply:

If a check payable to an imposter, fictitious payee, or payee not intended to have an interest in the check is paid, the effect [of section

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<sup>90</sup>See *supra* note 80.

<sup>91</sup>See, e.g., *Stone & Webster Eng. Corp. v. First Nat'l Bank*, 184 N.E.2d 358 (Mass. 1962).

<sup>92</sup>See, e.g., *Fid. & Dep. Co. of Maryland v. First Nat'l Bank*, 297 N.W.2d 46 (Wis. App. Ct. 1980).

<sup>93</sup>§ 3.420 cmt. 1.

3.404] is to place the loss on the drawer of the check . . . . The drawer is in the best position to avoid the fraud and thus should take the loss. . . . But in some cases the person taking the check might have detected the fraud and thus have prevented the loss by exercise of ordinary care. . . . *In each case the most likely defendant is the depository bank that took the check and failed to exercise ordinary care. In those cases, the drawer has a cause of action against the offending bank to recover a portion of the loss.*<sup>94</sup> (Emphasis added).

One leading commentator has observed that while the new UCC continues to forbid, in section 3.420, a direct conversion action by the drawer against the depository bank, it, at the same time, creates a direct “tort” action in favor of the drawer under sections 3.404 and 3.405:

This right of the drawer to sue the depository bank directly was not available under the old Code because the warranties run only to the drawee bank and conversion belongs only to the intended payee. The same barrier exists under the Revision. However, a direct negligence claim avoids these restrictions. In short, the Revision has created a brand new cause of action with tort colorings.<sup>95</sup>

Thus, reference to common law theories may not be necessary by a drawer seeking to sue the depository bank directly in a forged endorsement case. How this direct action plays out with the defenses of sections 3.404 and 3.405 is discussed below.

## D. POTENTIAL DEFENDANTS

### 1. UCC Theories of Recovery against Drawee and Depository Banks

As discussed above, the factor which determines what party has rights concerning a check with a forged endorsement case is delivery.<sup>96</sup> For example, if a check is stolen from the drawer and the endorsement is then forged, the rights in the check generally remain with the drawer, whose UCC claim will be against the drawee based on an allegation under section 4.401 that the drawee charged against the drawer’s account an item that is not properly payable.<sup>97</sup> The underlying obligation of the drawee to the payee will not have been discharged due to lack of delivery and the drawer will still owe the payee in that regard.<sup>98</sup> Recall that the UCC does not provide

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<sup>94</sup>§ 3.404 cmt. 3.

<sup>95</sup>CLARK, *supra* note 3, ¶ 12.07[3][b], at 12-200.

<sup>96</sup>*Id.* ¶ 12.01[2], at 12-2; *see also supra* part IV.C.1.

<sup>97</sup>§ 4.401.

<sup>98</sup>*Id.*; CLARK, *supra* note 3, ¶ 12.01[2], at 12-2.

a conversion cause of action by the drawer directly against the depository bank.<sup>99</sup> In some instances involving forged endorsements, the UCC will provide a direct cause of action by the drawer against the depository bank in order to advance the UCC's comparative negligence risk allocation scheme.<sup>100</sup>

If, however, the check is delivered to the payee and then stolen and negotiated over a forged endorsement, the intended payee will have rights in the check. The payee can sue either the drawee or the depository bank for conversion under section 3.420.<sup>101</sup>

## 2. Common Law Theories of Recovery

As discussed above, the UCC set out a loss allocation scheme for check fraud cases involving forged endorsements. Sometimes, potential plaintiffs in check fraud cases will not be happy with the result of the UCC scheme and will look to common law for other possible theories of recovery. As discussed above, different jurisdictions may allow common theories of recovery,<sup>102</sup> but such analysis is beyond the scope of this article. Nevertheless, care should be taken to analyze fully the law of the relevant jurisdiction to determine whether common law theories of recovery are available.

### E. DEFENSES

The principal defenses available to banks when sued in forged endorsement cases are based on the negligence of the plaintiff – usually regarding situations in which the plaintiff's employees' acts or omissions caused, or partially caused, the loss. Thus, in almost every forged endorsement case, the same defenses typically will be in question. These defenses are found in sections 3.404, 3.405 and 3.406 of the UCC.

As discussed above, the liability of the drawee bank to its customer in a forged endorsement case arises from its having charged to the customer's account an item that is not properly payable. The item is not properly payable because there is no authorized endorsement.<sup>103</sup>

Concerning an intended payee, drawee banks and depository banks are potentially liable for conversion under section 3.420 for having taken an item with a forged endorsement.<sup>104</sup>

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<sup>99</sup>*Id.*

<sup>100</sup>*Id.*

<sup>101</sup>*Id.*

<sup>102</sup>*See supra* part III.D.2.

<sup>103</sup>*See* § 4.401 cmt. 1 (“An item containing a forged drawer's signature or forged indorsement is not properly payable.”).

<sup>104</sup>Section 3.420 cmt. 1 (“[3.420(a)] covers cases in which a depository bank or payor bank takes an instrument bearing a forged endorsement.”).

The potential liability of banks in these cases is based on the presence of the forged endorsement. The old UCC recognized in section 3.405, however, that, in some instances, the negligence of the drawer was such that the loss should fall not on the bank taking the fraudulent check, but on the drawer who was deemed to have been in a better position to prevent the fraud and the loss.<sup>105</sup> In these situations, the old UCC simply effectuated otherwise forged endorsements. That is, it created a legal fiction of an authorized endorsement. The potential liability of the banks, which was predicated on the presence of a forged endorsement, was defeated by the effectuation of the endorsement, thereby leaving the loss to fall on the drawer. This risk allocation scheme applied to forged endorsements was preserved, albeit altered, in sections 3.404 and 3.405 of the new UCC. The fact patterns supporting application of these defenses involve imposters, fictitious (no-interest) payees, padded payrolls, and so-called “responsible employees.”

### 1. Section 3.404 – Impostors/Fictitious Payees

Section 3.404(a) describes the impostor defense. If an impostor induces the issuer of a check to issue the check to the impostor (or a person acting in concert with the impostor) by impersonating the payee, an endorsement in the name of the payee is effective in favor of banks, acting in good faith, which pay or collect the item.<sup>106</sup> This is similar to the older version, except the defense has been strengthened in regard to agent impersonations.<sup>107</sup> Under the new UCC, the defense is applicable even if the impostor impersonates an agent of a corporate payee.<sup>108</sup>

Section 3.404(b) describes the fictitious or no-interest payee defense. It actually deals with two separate fact scenarios. First, if a person, whose intent determines to whom a check is payable under section 3.110,<sup>109</sup> does not intend the person identified as payee to have any interest in a check, then an endorsement by any person in the name of the payee is effective in favor of banks, acting in good faith,

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<sup>105</sup>CLARK, *supra* note 3, ¶ 12.07[1].

<sup>106</sup>Section 3.404(a) provides:

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

<sup>107</sup>CLARK, *supra* note 3, ¶ 12.07[1].

<sup>108</sup>*See* § 3.404 cmt. 1.

<sup>109</sup>Section 3.110(a) provides that the person to whom a check is payable is determined by the intent of the person, whether or not authorized, signing as, or on behalf of, the issuer of a check. Section 3.110(b) generally provides that, if the signature of the issuer of check is made by automated means, the payee is determined by the intent of the person who supplied the name of the payee.

which pay or collect the check.<sup>110</sup> Second, if the person identified as payee of a check is a fictitious person, then an endorsement by any person in the name of the payee is effective in favor of banks, acting in good faith, which pay or collect the check.<sup>111</sup>

One additional change made by the new UCC deals with the form of the endorsement. As noted, the endorsement must be made in the name of the named payee. An endorsement is considered made in the name of a payee if (a) it is substantially similar to the name of the payee; or (b) the check, whether or not endorsed, is deposited in a depository bank to an account in a name substantially similar to the name of the payee.<sup>112</sup>

Under the old UCC, some courts required that the language of the endorsement precisely match the name of the payee.<sup>113</sup> This was known as the “mirror image” rule.<sup>114</sup> Under the new UCC, the endorsement need only be substantially similar to that of the payee.<sup>115</sup> The effect of this change is to make reliance on the defense easier for banks sued in forged endorsement cases. They will have to establish only that the endorsement is substantially similar to the name of the payee in order to rely properly on the defense, or that the check, whether or not endorsed, was deposited into an account with an account name substantially similar to the name of the payee.

The rationale for the effectuation of otherwise forged endorsement under section 3.404, which protects banks and places the loss on the drawer, is well stated in the comments:

If a check payable to an impostor, fictitious payee, or payee not intended to have an interest in the check is paid, the effect of subsection (a) and (b) is to place the loss on the drawer of the check rather than on the drawee or the Depository Bank that took the check for collection.

<sup>110</sup>See § 3.404(b). For an example of a no-interest payee case under the old UCC, see *Fidelity & Casualty Co. v. First City Bank*, 675 S.W.2d 316, 318-19 (Tex. App. – Dallas, 1984, writ ref'd n.r.e.).

<sup>111</sup>*Id.*

<sup>112</sup>Section 3.404(c) provides:

Under subsection (a) or (b), an endorsement is made in the name of the payee if:

(1) it is made in a name substantially similar to that of the payee; or  
(2) the instrument, whether or not indorsed, is deposited in a depository bank to an account in a name substantially similar to that of the payee.

<sup>113</sup>See *Knight Publishing Co. v. Chase Manhattan Bank, NA*, 479 S.E.2d 478 (N.C. Ct. App. 1997), review denied, 487 S.E.2d 548 (N.C. 1997); *Seattle-First Nat'l Bank v. Pac. Nat'l Bank*, 587 P.2d 617 (Wash. Ct. App. 1978); but see *Basse Truck Line, Inc. v. First State Bank*, 949 S.W.2d 17, 20-21 (Tex. App. – San Antonio 1997, writ denied) (“We therefore hold that an endorsement need only be substantially similar to the named payee in order to qualify under [the pre-1996 version of section 3.405].”).

<sup>114</sup>CLARK, *supra* note 3, ¶ 12.07[4][b].

<sup>115</sup>Section 3.405 cmt. 1 states in part: “Former section 3-405 was read by some courts to require that the indorsement be in the exact name of the named payee. Revised Article 3 rejects this result.”

Cases governed by subsection (a) always involve fraud, and fraud is almost always involved in cases governed by subsection (b). The drawer is in the best position to avoid the fraud and thus should take the loss.<sup>116</sup>

As discussed in more detail below, however, even when the defense of § 3.404 is available, the drawer may still be able to recover from the involved banks if it can establish that the banks were negligent. Under the new UCC, a comparative fault system is adopted which was not present under the old UCC. These issues are discussed below.<sup>117</sup>

## 2. Section 3.405 – Responsible Employee (Padded payroll)

Under the old section 3.405, a third defense, in addition to the impostor and fictitious payee defenses, existed for forged endorsement cases. This defense is now found in the new section 3.405, which has been rewritten and broadened to include a variety of situations involving check fraud.

Under the old version of section 3.405, the focus was on outgoing checks – checks issued by the employer/drawer. As noted above, the UCC policy advanced by old section 3.405 (concerning fictitious payees, no-interest payees, and padded payrolls) was to place the loss on the drawer in situations in which its employees fraudulently caused the issuance of the check. New section 3.405 (along with section 3.404) not only continues those rules, but also incorporates the same concept with regard to incoming checks. Thus, new section 3.405 deals with employers who are both issuers of checks and intended payees of checks. Under the applicable parameters of section 3.405, forged endorsements are effectuated. The result is to place the loss on the employer by the effectuation of the bogus endorsements.<sup>118</sup> The policy of the new section 3.405 is stated in the comments:

Section 3.405 adopts the principle that the risk of loss for fraudulent indorsements by employees who are entrusted with responsibility with respect to checks should fall on the employer rather than the bank that takes the check or pays it, if the bank was not negligent in the transaction. Section 3-405 is based on the belief that the employer is in a far better position to avoid the loss by care in choosing employees, in supervising them, and in adopting other measures to prevent forged indorsements on instruments payable to the employer or fraud in the issuance of instruments in the name of the employer.<sup>119</sup>

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<sup>116</sup>§3.404 cmt. 3.

<sup>117</sup>See *infra* part IV.E.4.

<sup>118</sup>CLARK, *supra* note 3, ¶ 12.05[4][b].

<sup>119</sup>§ 3.405 cmt. 1.

Section 3.405 sets forth several definitions of terms which control its application. An “employee” includes independent contractors or their employees.<sup>120</sup> “Fraudulent endorsement” is defined to include two types of checks: incoming and outgoing.<sup>121</sup> On incoming checks, ones payable to the employer, a “fraudulent endorsement” is a forged endorsement of the employer.<sup>122</sup> For outgoing checks, ones on which the employer is the issuer, a “fraudulent endorsement” is a forged endorsement of the intended payee.<sup>123</sup>

Section 3.405(a)(3) uses the definition of “responsibility” with respect to instruments to define the types of employee activities within the scope of the defense. It states:

(3) “Responsibility” with respect to instruments means the authority (i) to sign or endorse instruments on behalf of the employer, (ii) to process instruments received by the employer for bookkeeping purposes, for deposit to an account, or for other disposition, (iii) to prepare or process instruments for issue in the name of the employer, (iv) to supply information determining the names or addresses of payees of instruments to be issued in the name of the employer, (v) to control the disposition of instruments to be issued in the name of the employer, or (vi) to act otherwise with respect to instruments in a responsible capacity. “Responsibility” 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.<sup>124</sup>

Like section 3.404, section 3.405 effectuates otherwise bogus endorsements, if the transaction fits within the scope of the various definitions. Thus, if an employer has entrusted an employee with “responsibility” with respect to a check, and the employee (or his co-conspirator) makes a “fraudulent endorsement” on the check, section 3.405 effectuates the endorsement in favor of banks which take or pay the check.<sup>125</sup> As with section 3.404, the endorsement must be substantially similar to the

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<sup>120</sup>Section 3.405(a)(1) provides: “‘Employee’ includes an independent contractor and employee of an independent contractor retained by the employer.”

<sup>121</sup>Section 3.405(a)(2) provides:

‘Fraudulent endorsement’ means:

(A) in the case of an instrument payable to the employer, a forged endorsement purporting to be that of the employer; or

(B) in the case of an instrument with respect to which the employer is the issuer, a forged endorsement purporting to be that of the person identified as payee.

<sup>122</sup>*Id.*

<sup>123</sup>*Id.*

<sup>124</sup>§ 3.405(a)(3).

<sup>125</sup>Section 3.405(b) provides in pertinent part:

For purposes of determining the rights and liabilities of a person who, in good faith, pays

name of the payee or deposited into an account with a substantially similar name.<sup>126</sup> If section 3.405 applies, banks generally will be protected in forged endorsement scenarios, subject to the comparative negligence scheme described below.

Section 3.405 is much broader in application than the old version of section 3.405 and will provide a defense to banks in a large variety of situations in which responsible employees forge endorsements on their employer's checks and checks made payable to their employers. It should be noted that, despite its breadth, section 3.405 will not apply to all employees but only to those employees who truly have direct responsibility for incoming checks and outgoing checks. For example, section 3.405 will not apply if the "janitor" steals and endorses an incoming check.<sup>127</sup> While section 3.405 might not create a defense in the "janitor" scenario, the bank might still have a similar argument under the defense of section 3.406 if it could convince a fact finder that the employer was negligent in permitting access to the check by the janitor.<sup>128</sup>

### 3. Section 3.406

As described above, section 3.406 creates a preclusion in favor of banks acting in good faith when the person suing the bank acted negligently and the negligence contributed to the loss. As one commentator notes, however, section 3.406 "has a lesser role to play in forged endorsement cases than in cases involving forged drawer's signatures and alterations."<sup>129</sup> It is more likely that a drawer's negligence will facilitate a forgery of its signature or an alteration of its check. Nevertheless, negligence in forged endorsement cases by drawers and by intended payees is certainly possible and may result in the invocation of the section 3.406 preclusion. For example, as noted above, there may be negligence in permitting lower level employees access to checks, such negligence not being within section 3.405, but possibly sufficient to satisfy section 3.406. As with sections 3.404 and 3.405, section 3.406 establishes a comparative fault scheme.<sup>130</sup>

### 4. Sections 3.404, 3.405 and 3.406 – Comparative Negligence

As discussed above, the defenses of sections 3.405, 3.405 and 3.406 are not absolute. If there is negligence by the banks involved in taking or paying the checks

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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 employee or a person acting in concert with the employee makes a fraudulent endorsement of the instrument, the indorsement is effective as the indorsement of the person to whom the instrument is payable it is made in the name of that person.

<sup>126</sup>§ 3.405(c).

<sup>127</sup>See § 3.405 cmt. 3, case #1.

<sup>128</sup>See § 3.405 cmt. 3, case #1.

<sup>129</sup>CLARK, *supra* note 3, ¶ 12.06.

<sup>130</sup>See § 3.406(b).

in question, the UCC adopts a pure<sup>131</sup> comparative fault scheme which allocates the loss based on the parties' relative negligence.<sup>132</sup> One commentator observes that the adoption of the comparative negligence scheme will "encourage settlements" but will make summary judgments in favor of banks in check fraud cases significantly more difficult to obtain.<sup>133</sup> Thus, the comparative negligence scheme should be viewed positively by subrogating fidelity insurers.

As regards forged endorsements, the UCC comments well illustrate some typical cases of depository bank negligence which will be very relevant to the fidelity insurer pursuing its insured's claims against banks.<sup>134</sup> These examples also illustrate that drawers, who otherwise seem precluded from suing depository banks directly in forged endorsement cases by section 3.420, should always consider reliance on the comparative negligence scheme as a basis to sue whatever negligent banks as are involved.<sup>135</sup> Depository bank negligence in forged endorsement cases may involve allowing an employee to open an account in an employer's name (or an account in similar but slightly different name) without authority; allowing corporate checks payable to the employer deposited into personal accounts of the employee (or purported d/b/a accounts created by the employee in similar names as the employer); failing to observe suspicious conduct and transactions in the account (like the deposit of very large corporate items immediately after the account is open or multiple large withdrawals in cash from an apparent corporate account); and violation of the bank's own policies in dealing with deposit items. The possibilities are myriad, so each case must be examined on its own merit.

The new comparative negligence scheme may be the single most important change in the UCC from the perspective of the subrogating insurer. Under the old UCC, the defenses of sections 3.404 and 3.405 generally were considered absolute and defeated claims against banks even if the banks were negligent.<sup>136</sup> Now, with the comparative negligence scheme, the loss is attributable based on fault. An example of this effect under section 3.404 is stated as follows by one commentator:

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<sup>131</sup>CLARK, *supra* note 3, ¶ 10.06[2]. ("The Revision [to the UCC] embraces a 'pure' form of comparative negligence, not a regime under which a plaintiff more than 50 percent negligent recovers nothing.")

<sup>132</sup>Section 3.404(d) provides:

With respect to an instrument to which Subsection (a) or (b) applies, if a person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure contributes to loss resulting from payment of the instrument, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.

Section 3.405(b) provides similarly.

<sup>133</sup>CLARK, *supra* note 3, ¶ 12.05[b][4].

<sup>134</sup>See § 3.404 cmt.4 and § 3.406 cmt. 4 (each dealing with depository bank negligence).

<sup>135</sup>See *supra* note 94 and accompanying text.

<sup>136</sup>See, e.g., *W. Cas. & Sur. Co. v. Citizens Bank of Las Cruces*, 676 F.2d 1344 (10<sup>th</sup> Cir. 1982).

The trier of fact will apportion liability on a comparative negligence basis. For example, in a padded payroll case the trier of fact might conclude that the drawer was 75 percent at fault for hiring the dishonest bookkeeper while the drawee bank was at zero percent fault because it owes no duties with respect to indorsements, and the depository bank was 25 percent at fault for the manner in which it allowed the bookkeeper to open up and maintain the account into which the checks were deposited.<sup>137</sup>

## 5. Limitations

The most common claim concerning forged endorsements is for conversion. Suits for conversion under the UCC must be brought within three years after the cause of action accrues.<sup>138</sup> Many courts hold that a cause of action for conversion of a check by a depository bank accrues when the check is deposited and that the discovery rule does not toll the running of limitations.<sup>139</sup> Thus, subrogating fidelity insurers must exercise care to determine when the checks in question bearing forged endorsements were deposited, so as to protect against the running of limitations. Each check will have its own limitations period, usually starting, as described above, on the date of deposit at the depository bank.

## F. WARRANTY CLAIMS

Although it is beyond the scope of this article, any discussion of forged checks would be incomplete without a mention of the warranties made by banks upon collection of checks. These warranties generally allow the drawee bank, which has exposure for a check bearing a forged endorsement, to sue the depository bank for breach of presentment warranties.<sup>140</sup> The same is not true for a check bearing a forged drawer's signature.<sup>141</sup> Thus, even if the subrogating fidelity insurer chooses to sue the drawee in a forged endorsement case, it is likely the drawee will join the depository as an additional defendant. Suing both parties from the outset may be beneficial. This is particularly true to the extent that the depository bank raises, as a defense to the drawer's warranty claims, the argument that the drawer can rely on

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<sup>137</sup>CLARK, *supra* note 3, ¶ 12.07[5][b]; for an excellent article discussing factors relevant to establishing bank negligence see Mark E. Wilson, *Banking Industry Standards Relevant to Coverage and Recoveries Under the Revised Uniform Commercial Code*, V FID. L.J. 79 (1999). The article provides many helpful sources of information which will aid a litigant attempting to establish bank negligence. See also COMPTROLLER OF THE CURRENCY, CHECK FRAUD: A GUIDE TO AVOIDING LOSSES (Feb. 1999).

<sup>138</sup>§ 3.118(g).

<sup>139</sup>See, e.g., *Lycro Acquisition 1984 v. First Nat'l Bank*, 860 S.W.2d 117, 199 (Tex. App. – Amarillo 1993, writ denied).

<sup>140</sup>CLARK, *supra* note 3, ¶ 112.04[1][b]; § 4.208(a)(1).

<sup>141</sup>*Id.*

sections 3.404, 3.405 and 3.406.<sup>142</sup> If these defenses are raised by the depository bank, the UCC clearly suggests that the drawer (otherwise barred by a direct conversion action by section 3.420) can assert direct claims against the depository based on its negligence, under the comparative fault provisions of sections 3.404, 3.405 and 3.406.<sup>143</sup>

## ***V. Alterations***

### **A. INTRODUCTION**

This portion of the article will discuss issues relevant to the fidelity insurer concerning an employee dishonesty claim involving checks that have been altered.

The article assumes that the fidelity insurer owns the claims of the insured/employer, through subrogation or assignment, following payment of the claim. Thus, the analysis focuses on the employer's rights and claims, unless distinctions are noted.

### **B. DEFINITION OF AN ALTERATION**

Generally, an alteration is any change in the writing of a check without the authority of the drawer.<sup>144</sup> The old UCC defined a "material" alteration. The new UCC does not use the word "material."<sup>145</sup> Section 3.407 describes two forms of alteration: (a) "an unauthorized change in an instrument that purports to modify in any respect the obligation of a party"; and (b) "an unauthorized addition of words or numbers or other change to an incomplete instrument relating to the obligation of a party."<sup>146</sup>

There are various common types of alterations which include: (a) raising the amount of a check, (b) unauthorized completion of an incomplete check (such as completing a pre-signed check for an amount more than authorized), (c) changing the name of the payee, (d) changing a joint payee check by changing "and" to "or," (e) adding a new payee's name, (f) deleting words showing a fiduciary relationship, (g) changing the date, (h) changing the name of the drawee bank, (i) changing the MICR encoding, and (j) changing a restrictive endorsement.<sup>147</sup>

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<sup>142</sup>*Id.*

<sup>143</sup>*See supra* part IV.E.4.

<sup>144</sup>CLARK, *supra* note 3, ¶ 11.01.

<sup>145</sup>§ 3.407.

<sup>146</sup>*Id.*

<sup>147</sup>CLARK, *supra* note 3, ¶ 11.01.

### C. THEORIES OF RECOVERY/LIABILITIES OF BANKS

The liability of the drawee bank to the drawer in an alteration case is based on section 4.401. Under section 4.401, the drawee may only charge items that are properly payable, and an item is properly payable only if it is authorized.<sup>148</sup>

The most common form of alteration is the changing of the amount of the check by increasing the original amount.<sup>149</sup> If the change to the amount is unauthorized or fraudulent (such as by a dishonest employee on of his employer's checks), the check only may be charged against the drawer in the original amount.<sup>150</sup>

The drawee bank which has paid an altered item is not necessarily liable to its customer for the full amount of the altered check if the alteration is based on the amount. Both sections 3.407 and 4.401 set forth the same rules, which generally provide that the drawee can charge the account of the customer with: (a) the amount of the item as originally completed or, (b) concerning an incompleting item completed by the dishonest employee, according to the terms of the completed item even if the bank knows of the completion (unless it knows that the completion was improper).<sup>151</sup> Thus, if a check is originally made for \$1,000.00 and is altered to appear to be for \$10,000.00, the drawee can charge the customer's account for \$1,000.00. It would be required to reimburse the account for the other \$9,000.00.<sup>152</sup> On the other hand, if a check is signed in blank and left with instructions to the employee to complete it for \$1,000.00 and the employee completes it for \$10,000.00, the drawee can properly charge the account of the employer/issuer with the full \$10,000.00.<sup>153</sup> This scenario demonstrates why pre-signed checks are always a terrible idea.

If the alteration is of another form (*i.e.*, to the name of the payee), then the drawee's bank's liability to the drawer would be for the full amount of the check.<sup>154</sup> However, the loss in an alteration case likely will not stay with the drawee bank. Under the presentment warranties of section 4.208, the depository bank warrants to the drawee that the check "has not been altered."<sup>155</sup> Thus, in almost all situations of alterations, the drawee will be able to shift its loss to the depository bank through a breach of warranty claim.

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<sup>148</sup>Section 4.401(a) provides in pertinent part that "a bank may charge against the account of a customer an item that is properly payable" and "an item is properly payable if it is authorized."

<sup>149</sup>In regard to changing the amount, the written words of the check control the figures, if there is an inconsistency. *See* § 3.114.

<sup>150</sup>Section 3.407(b) provides in pertinent part that an "alteration fraudulently made discharges a party whose obligation is affected" but "the instrument may be enforced according to its original tenor."

<sup>151</sup>§ 3.407(c) and § 4.401(d).

<sup>152</sup>*See* CLARK, *supra* note 3, ¶ 11.01.

<sup>153</sup>*Id.*

<sup>154</sup>*Id.*

<sup>155</sup>§ 4.208(a)(2).

Even though the loss in an alteration case normally will fall on the depository bank due to the presentment warranties (subject to the negligence of the drawer discussed below), the UCC does not seem to allow the drawer to sue the depository bank directly as the warranties made by the depository bank run in favor only of the drawee bank and not in favor of the drawer.<sup>156</sup> The courts generally have not allowed direct causes of action by the drawer against the depository bank.<sup>157</sup>

Thus, as relevant to the fidelity insurer, alteration scenarios usually will arise when the insured/employer's employees have altered the employer's checks. Upon payment, the subrogating insurer will be looking primarily to assert claims against the drawee (the employer's) bank for recovery. Unfortunately, like other aspects of the check fraud, the bank is not without defenses.

#### **D. DEFENSES**

The principal defense available to a drawee is based on the drawers's negligence, as found in section 3.406 discussed above.<sup>158</sup> Section 3.406 sets up a preclusion in favor of the drawee bank providing that the drawer, whose negligence substantially contributes to the alteration, may not assert the alteration against the drawee.<sup>159</sup> As noted above, however, if the drawee itself is negligent, section 3.406 will allocate the loss based on the relative fault of the parties.<sup>160</sup> In regard to issues relevant to the bank's possible negligence, the subrogating insurer needs to recall that the new UCC has a favorable new definition of "ordinary care" for banks which generally allows payment of checks without manual inspection.<sup>161</sup> As in the forged drawer's signature cases, this new definition will present difficulties in proving bank negligence.<sup>162</sup> Under this revised definition allowing payment without manual inspection, a drawee will not be negligent even concerning the most obvious alterations because those alterations will never be caught by automated payment systems.<sup>163</sup>

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<sup>156</sup>*Id.*; CLARK, *supra* note 3, ¶ 11.01.

<sup>157</sup>*See* Kings Premium Serv. Corp. v. Mfrs. Hanover Trust Co., 496 N.Y.S.2d 524 (N.Y. Sup. Ct. 1985).

<sup>158</sup>*See supra* part IV.E.3.

<sup>159</sup>*Id.*; § 3.406(a).

<sup>160</sup>*Id.*; § 3.406(b).

<sup>161</sup>*See supra* note 71 and accompanying text.

<sup>162</sup>*Id.*; § 3.103(7).

<sup>163</sup>*See* CLARK, *supra* note 3, ¶ 11.04[2].

## VI. Issues Unique to Subrogating Insurers

### A. COMPENSATED SURETY/SUPERIOR EQUITIES DOCTRINE

Subrogation is an equitable concept which allows an insurer to stand in the position of the insured after payment with regard to the insured's claims against third parties who cause the loss.<sup>164</sup> Some courts have denied subrogation rights against banks to insurers on the theory that the insurer, which is compensated to bear the loss, should not be able to shift the loss to a third party unless the insurer has superior equities.<sup>165</sup> If the insured and the bank generally are innocent of wrongdoing when a dishonest employee causes a loss by check fraud, some courts refused to allow the insurer to recover against the insured's bank because the insurer was compensated by premiums to absorb the loss.<sup>166</sup> Although a full discussion of this topic is beyond the scope of this article, the fidelity insurer seeking to sue banks in check fraud cases needs to examine the law of the state in question to determine whether the compensated surety/superior equities doctrine is applicable. Taking an assignment of the insured's rights (which may be contractually required by the relevant fidelity policy) may protect against the assertion of the superior equities defense.<sup>167</sup>

### B. SUPERIOR EQUITIES V. UCC RISK ALLOCATION SCHEME

The compensated surety/superior equities doctrine creates a loss allocation scheme based, theoretically, on equitable concepts. The UCC, however, is a legislative risk allocation scheme which carefully allocates losses in check fraud cases. What happens when these two schemes clash? The better-reasoned decisions hold that the UCC allocation scheme should take priority.<sup>168</sup>

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<sup>164</sup>For articles and cases describing subrogation in fidelity context, see James A. Knox, Jr., *Salvage*, in FINANCIAL INSTITUTION BONDS (Duncan L. Clore 2d ed., 1998) [hereinafter Knox] and Stephen L. Baskind, *Recoveries (Policy Provisions, Rights Against Third Parties, Bankruptcy Issues)*, in FIDELITY BONDS (Gilbert J. Schroeder ed., 1991).

<sup>165</sup>*Am. Sur. Co. v. Bank of Cal.*, 482 F.2d 160 (9<sup>th</sup> Cir. 1943); *Fed. Ins. Co. v. Arthur Anderson & Co.*, 552 N.E.2d 870 (1990); see, Edward Gallagher, *Barriers to the Exercise of the Fidelity Insurer's Subrogation Rights*, 1 FID. L.J. 37 (1995).

<sup>166</sup>*Id.*; CLARK, *supra* note 3, ¶ 10.11.

<sup>167</sup>See Knox, *supra* note 164.

<sup>168</sup>See *Nat'l Union Fire Ins. Co. v. Riggs Nat'l Bank*, 93 F.3d 885 (D.C. Cir 1996); see also CLARK, *supra* note 3, ¶ 10.11 ("Now that the UCC is the universal law of the land, the common-law 'superior equities' doctrine or 'compensated surety' defense has outlived its usefulness. Courts should decide check-fraud cases on the basis of the rules of Articles 3 and 4, not on whether the plaintiff is an insurance company or whether the insurer has taken a formal assignment of the claim.").

### ***VII. Conclusion***

Fidelity insurers will continue to encounter employee dishonesty claims involving check fraud. These situations generally will present covered losses, payable by the insurer. These claims, however, will also present opportunities for insurers to recover from the banks handling the bogus checks by subrogation or assignment. The UCC rules allocating loss in check fraud cases ultimately will determine whether the insurer can recover and, if so, how much the insurer can recover. Knowledge of these rules is critical to the preservation and prosecution of the insurer's rights. The careful fidelity insurer, when presented with an employee dishonesty claim involving check fraud, will continually keep the UCC rules in mind – particularly those requiring notice to the involved banks. In the end, check fraud cases should always be viewed by fidelity insurers not only as potentially covered losses, but also as excellent recovery opportunities.