

CHECK FRAUD IN THE COURTS AFTER THE REVISIONS TO U.C.C. ARTICLES 3 AND 4

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INTRODUCTION

A substantial amount of litigation on the issue of how to allocate the losses due to check fraud has occurred since 1990. In that year, the National Conference of Commissioners on Uniform State Laws (the NCCUSL) and the American Law Institute (the ALI) approved their revisions to Articles 3 and 4 of the Uniform Commercial Code (the U.C.C. or the Code).¹ Forty-eight state legislatures have enacted the 1990 versions of Articles 3 and 4.² They were again modestly revised in 2002.³ A sufficient amount of time has now passed to allow a substantial body of case law to develop from which one can examine the successes and failures of the revision project. This Article provides a comprehensive review of that case law and argues that the keystone of the revisions, a shift to a comparative negligence approach for allocating the losses that occur because of check fraud, has had only limited success in the courts.

The transition from the original Articles 3 and 4 to the revised Articles brought much controversy.⁴ Objections were raised not only about the process that led to the final revisions but the substance of the revisions as well.⁵ The criticisms for the most part focused on the portions of the revisions that dealt with allocation of losses after check fraud.⁶ In spite of any perceived shortcomings, the eventual success of the revisions in the state legislatures means that the new Articles 3 and 4 are here to stay for some time. In some areas of check fraud, the basic rules remain the same. As a general rule,

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1. U.C.C. art. 3, Prefatory Note (1990).

2. See U.C.C. art. 3 (1990); U.C.C. art. 4 (1990).

3. See U.C.C., *2002 Amendments to Articles 3 and 4*, in *SELECTED COMMERCIAL STATUTES: 2004 EDITION* app. s, at 1429 (2004). The minor changes in 2002 did not address the loss-allocation structure put into place in 1990. For a list of topics addressed by the 2002 Amendments, see *id.* The 2002 project focused on concerns where “there is a general consensus that the need for reform is plain and the opportunity for justifiable controversy small.” *Id.* Because of their controversial nature, as this Article makes clear, the check fraud rules hardly fall within this focus.

4. See generally U.C.C. art. 3, Prefatory Note (1990).

5. See *infra* text accompanying notes 28-30 (detailing the controversy).

6. See *infra* text accompanying notes 28-30 (detailing the controversy).

under the old and new schemes, banks initially bear the losses for unauthorized or altered checks.⁷ Application of a series of negligence-based defenses can upset this general scheme where negligence is involved. Under pre-revision law, the ultimate allocation system worked upon a principle of contributory negligence, where only a bank that had exercised ordinary care could allege the negligence of another party, usually its customer.⁸ If the bank's defense was successful, that other party would bear 100% of the losses for fraud. In many jurisdictions, a bank's failure to examine a check could be deemed as a per se lack of ordinary care.⁹ The result of the ordinary care requirement was often to prevent banks that had not examined checks presented for payment from raising their customer's negligence.¹⁰ Because many banks did not examine checks, another result was to keep most of the losses for check fraud in the banking system.¹¹

The revisions significantly altered this approach by replacing the original contributory negligence principle with one of comparative negligence.¹² The revisions contemplate allocating losses for check fraud on a pro rata basis, based on the percentage of respective fault of each party in contributing to the loss. In addition, the revisions expand the number of defenses that banks potentially can raise in attempting to shift losses to another party.¹³ Finally, the revisions make it clear that a bank's failure to examine an instrument does not in itself constitute a failure to exercise ordinary care,¹⁴ resolving the litigation that had arisen under the original U.C.C. decidedly in the favor of financial institutions.¹⁵ The changes not only allow even negligent banks to raise all possible defenses, but they also limit the ability of other parties to argue that the bank's failure to conduct a sight examination constituted negligence. This argument, if successful, could have shifted at least some losses back to financial institutions.

Critics of the project predicted that the effect of the revisions would be to place most of the significant losses due to check fraud on customers, rather than financial institutions,¹⁶ and in many respects, case law is showing that these concerns are valid. Having won many victories in the U.C.C.

7. See *infra* text accompanying notes 49-117 (describing, step-by-step, the basic loss allocation scheme and its underlying policy).

8. See *infra* text accompanying notes 120-128 (detailing the contributory negligence system).

9. See *infra* text accompanying notes 124-128.

10. *Id.*

11. See *infra* text accompanying note 128.

12. For a discussion of comparative negligence under the 1990 versions of Articles 3 and 4, see *infra* Part II.B.

13. For a discussion regarding loss-shifting defenses, see discussion *infra* p. 371.

14. See *infra* text p. 372.

15. See *id.*

16. See Julianna J. Zekan, *Comparative Negligence Under the Code: Protecting Negligent Banks Against Negligent Customers*, 26 U. MICH. J.L. REFORM 125, 160-76 (1992); see also Nan S. Ellis & Steven B. Dow, *Banks and Their Customers Under the Revisions to Uniform Commercial Code Articles 3 and 4: Allocation of Losses Resulting from Forged Drawer's Signatures*, 25 LOY. L.A. L. REV. 57, 58-59 (1991); Gail K. Hillebrand, *Revised Articles 3 and 4 of the Uniform Commercial Code: A Consumer Perspective*, 42 ALA. L. REV. 679, 697-98 (1991).

revision process, financial institutions have been able to expand upon those gains through the court system. As this Article discusses, judging at least from the first decade or so of litigation, it appears that many losses due to check fraud are being shifted onto the backs of bank customers, usually companies who have been victimized by an embezzling employee, rather than being borne by the bank. However, in the usual case, this is not being accomplished through application of the comparative negligence provisions: customers are not necessarily 100% at fault. Rather, a significant amount of the loss-shifting is accomplished both through case law that rejects the ability of customers to raise non-Code claims and through a widespread judicial acceptance of contractual modifications of the U.C.C. Form, in other words, is prevailing over the comparative negligence substance of the revisions in recent litigation.

Parts I and II of this Article discuss in detail the changes that were made in 1990 to Articles 3 and 4 that address check fraud.¹⁷ These changes substituted a new comparative negligence system for allocating losses in the place of the original contributory negligence system.¹⁸ Part III examines the conflicts that have arisen in the case law that has followed from the revisions. As will be discussed, a significant number of fraud cases are now being decided on technical defenses rather than through substantive application of the new comparative negligence scheme.

Part III also addresses the implications of this judicial trend. With some exceptions, the case law reflects a “winner takes all” approach to allocation of losses, with the winners in the usual case being the banks (and the loser being the defrauded customer). Although this result is limited to situations where the customer is negligent, the trend sharply conflicts with the underlying policy of the revisions to avoid such a winner takes all approach. In order to advance the policy of proportionate loss-sharing that was carefully implemented in the revisions, Part IV argues in favor of two positions that are now minority positions in the courts. First, while the skepticism with which many courts view common law claims is generally proper, common law claims by customers against depositary banks should be permitted in a narrow number of circumstances and should not be viewed as displaced by the U.C.C.¹⁹ Second, the Article takes the position that the current judicial liberality in enforcing agreements that limit customers’ rights under the bank statement defense found in section 4-406 of the Code is misguided and contrary to the basic policy of the Code that supports proportionate loss sharing.²⁰ The use of freedom of contract principles to justify the enforcement of such agreements ignores the adhesionary nature of the bank/depositor contract. Rather, courts should find agreements that purport

17. See *infra* text accompanying notes 21-245.

18. For a discussion of comparative negligence under the 1990 and 2002 versions of Articles 3 and 4, see *infra* Part II.B, at p. 371.

19. See *infra* Part III.A.

20. See *infra* Part III.B.

to modify section 4-406 of the U.C.C. to be unconscionable and unenforceable under the U.C.C.

I. ALLOCATING LOSSES FOR CHECK FRAUD: THE BASIC STRUCTURE

The 1990 revisions to Articles 3 and 4 were among the first in a sweeping U.C.C. revision project that only just concluded in 2003 with the approval of the revisions to Article 7 (Documents of Title) by the ALI and the NCCUSL.²¹ As this section will discuss, the revisions to Articles 3 and 4 of the U.C.C. were accompanied by substantial controversy.

A. *The Article 3/4 Revision Project, Generally*

The original versions of Articles 3 and 4 were promulgated by the NCCUSL and the ALI in 1952.²² The revision efforts attempted to address significant changes in United States payment systems that had occurred since the original enactment.²³ While the original U.C.C. contemplated a paper-based system with a largely manual collection system, over the years, check volume had exploded, processing had become highly mechanized, and the federal government had begun to regulate some area of bank collections alongside the state-based U.C.C. regulatory scheme.²⁴ In addition, new practices and types of financial instruments had emerged which were not easily accommodated within the existing structure of Article 3, which governs “negotiable instruments.”²⁵ After an unsuccessful effort to replace Articles 3 and 4 with a comprehensive “New Payments Code,”²⁶ the NCCUSL announced a more modest project to revise Articles 3 and 4 in 1985.²⁷

21. Press Release, Nat’l Conference of Comm’rs on Unif. State Laws, Revision of Uniform Commercial Code Article 7 Approved (Aug. 6, 2003), <http://www.nccusl.org/Update/DesktopModules/NewsDisplay.aspx?ItemID=62>. The last major hurdle in the project was the revisions to Article 2 (Sales) which were approved by the NCCUSL at its 2002 Annual Meeting. See Press Release, Nat’l Conference of Comm’rs on Unif. State Laws, Revisions to Key Articles of Uniform Commercial Code Completed (Aug. 5, 2002), <http://www.nccusl.org/Update/DesktopModules/NewsDisplay.aspx?ItemID=81>. ALI approval followed in 2003. Press Release, Nat’l Conference of Comm’rs on Unif. State Laws, ABA Approves Six NCCUSL Acts (Feb. 9, 2004), <http://www.nccusl.org/Update/DesktopModules/NewsDisplay.aspx?ItemID=86>. Those revisions are now being proposed for enactment by the state legislatures. *Id.* The recent amendments to Revised Article 1, which contains general provisions for the entire U.C.C., were completed in 2001. Press Release, Nat’l Conference of Comm’rs on Unif. State Laws, ABA Approves Seven NCCUSL Acts (Feb. 6, 2002), <http://www.nccusl.org/Update/DesktopModules/NewsDisplay.aspx?ItemID=70>. At the time of this Article, the Article 1 revisions have been approved by a number of states. Information regarding the adoptions of revisions to any of the articles is available through the NCCUSL’s website at <http://www.nccusl.org/Update/DesktopDefault.aspx?tabindex=3&tabid=60> (follow “Select An Act” link). The references to Article 1 herein are to the Revised (2001) version of Article 1.

22. U.C.C. art. 3, Prefatory Note (Revised 2002).

23. See U.C.C. art. 3, Prefatory Note (1990).

24. *Id.*

25. *Id.*

26. Steven B. Dow & Nan S. Ellis, *The Proposed Uniform New Payments Code: Allocation of Losses Resulting from Forged Drawer’s Signatures*, 22 HARV. J. ON LEGIS. 399, 400 n.5 (1985). For a discussion of the New Payments Code, see *id.* and Edward L. Rubin, *Thinking Like a Lawyer, Acting Like a Lobbyist: Some Notes on the Process of Revising U.C.C. Articles 3 and 4*, 26 LOY. L.A. L. REV.

The revisions were approved in 1990 by the NCCUSL and the ALI,²⁸ but that approval was accompanied by substantial criticism of the process. Some participants and commentators argued that the process had been dominated by special interest groups representing the financial institutions and that the process neglected consumer interests.²⁹ The result of this extreme bias was a proposed statute that largely favored the interests of financial institutions over consumers. Some consumer lobbyists encouraged states not to enact the revisions or pressed for the adoption of non-uniform amendments to the U.C.C. by the state legislatures considering enacting the revisions.³⁰ In spite of these criticisms, the revisions have been, for the most part, successfully adopted by state legislatures. Forty-eight states have enacted the revisions,³¹ with the states of New York and South Carolina as the only hold-outs.³²

On the substantive side, the revisions sought both to make uniform areas of the law that had been subject to different interpretations by the state courts, and to update the U.C.C. to address new technology, changes in banking practices, federal preemption issues, and newer forms of payment devices which had been inadequately accommodated by the original versions of Articles 3 and 4.³³ Some revisions were small, others quite significant.³⁴ Because Article 3 covers a number of kinds of negotiable instruments, a significant portion of the revisions dealt with non-check issues. For example, the definition of "negotiable instrument," a definition that determines whether Article 3 of the U.C.C. applies to the payment obligation at hand,³⁵ was amended, largely to address concerns with the negotiability of variable rate notes. These types of notes, in some jurisdictions, had been considered non-negotiable because their interest rate could not be determined by reference to the instrument alone. The revisions resolved this debate in favor of negotiability.³⁶ Other revisions directly addressed concerns

743, 745-46 (1993).

27. U.C.C. art. 3, Prefatory Note (1990).

28. *Id.*

29. See, e.g., Kathleen Patchel, *Interest Group Politics, Federalism, and the Uniform Laws Process: Some Lessons from the Uniform Commercial Code*, 78 MINN. L. REV. 83, 106-10 (1993); Rubin, *supra* note 26, at 748-67.

30. See Rubin, *supra* note 26, at 781-84 (recounting early efforts of consumer lobbyists to influence state legislatures considering the revisions).

31. U.C.C. art. 3 (1990); U.C.C. art. 4 (1990).

32. Thomas C. Baxter, Jr. et al., *Revised Articles 3 and 4 of the UCC: Will New York Say Nix?*, 114 BANKING L.J. 219, 221 (1997) (describing New York's objections to four aspects of the revisions: payment information, loss allocation, post-dated checks, and check truncation).

33. U.C.C. art. 3, Prefatory Note (1990).

34. For an extensive treatment of the principal changes to Articles 3 and 4, see generally Alvin C. Harrell & Fred H. Miller, *The New UCC Articles 3 and 4: Impact on Banking Operations*, 47 CONSUMER FIN. L.Q. REP. 283 (1993).

35. U.C.C. § 3-104 cmt. 1 (1990).

36. For example, see *id.* § 3-112(b), which now provides in part:

Interest may be stated in an instrument as a fixed or variable amount of money or it may be expressed as a fixed or variable rate or rates. The amount or rate of interest may be stated or described in the instrument in any manner and may require reference to information not contained in the instrument.

relating to checks that had emerged since enactment of the original U.C.C. For example, new sections were added to address the use of instruments to attempt an accord and satisfaction,³⁷ obtaining holder in due course status in circumstances where there has been a breach of fiduciary duty,³⁸ and authorizing electronic presentment of items under Article 4.³⁹

Another major general change was to amend the definition of “good faith” to encompass not only a standard of “honesty in fact” but also one of “observance of reasonable commercial standards of fair dealing,”⁴⁰ an objective standard. The earlier standard of “honesty in fact,” standing by itself, could be interpreted as involving a purely subjective inquiry into the bank’s state of mind. The movement to an objective standard for good faith was a significant victory for bank customers by allowing the fairness of a bank’s conduct, judged in light of reasonable commercial standards, to be relevant to the determination of the exercise of good faith.

One of the most sweeping areas for reform in Articles 3 and 4 regarded the fraud loss provisions. In these areas, the revisions completely overhauled the law in many important respects. The next section addresses those changes in depth.

B. Allocating Fraud Losses

It is an inevitable reality in any payment system, including the checking system, that losses due to fraud will be incurred. A key issue in devising a regulatory scheme for the system is to establish a legal structure for allocating those losses.⁴¹ Because the check system is a paper-based payment system, losses in the check-based system most often occur due to forged or

Id. The effect of this language is to authorize variable rates, however calculated. *See id.*

37. *Id.* § 3-311.

38. *Id.* § 3-307.

39. U.C.C. § 4-110 (1990).

40. U.C.C. § 3-103(a)(6).

41. In the United States, there are different regulatory schemes for each principal type of payment system, and both state and federal governments are involved. Through Articles 3 and 4, checks are regulated primarily at the state level. However, substantial regulation of the check collection system occurs through federal regulations. *See* 12 C.F.R. pt. 210 (2005) [hereinafter Regulation J]; 12 C.F.R. pt. 229 [hereinafter Regulation CC]. Wire Transfers and Letters of Credit also are addressed through state law, by Articles 4A and 5, respectively. Letters of Credit are governed by largely private rules if the agreement incorporates the Uniform Customs and Practice for Documentary Credits, published by the International Chamber of Commerce. *See* U.C.C. § 5-115(c) (1995) (allowing letters of credit to be governed by U.C.P.). Credit Cards and Debit Cards are covered under federal law. *See* Truth-in-Lending Act, 15 U.S.C.A. §§ 1601 et seq. (Supp. 2005) (credit cards) [hereinafter TILA]; Electronic Funds Transfers Act, 15 U.S.C. §§ 1693 et seq. (Supp. 2001) (debit cards) [hereinafter EFTA]. The loss allocation rules in the case of fraud differ from system to system, depending upon the applicable loss. *See, e.g.*, TILA § 1643. In the case of credit cards, for example, a customer’s liability for unauthorized use is capped at a fifty dollar maximum. *See id.* Liability for unauthorized use of debit cards is tiered into three levels. EFTA § 1693g; 12 C.F.R. § 205.6. The customer is liable for fifty dollars in losses provided that notice of the loss of the card is given to the customer’s financial institution within two business days after learning of the loss. EFTA § 1693g; 12 C.F.R. § 205.6. Where notice is not given, customer liability for unauthorized transfers is capped at \$500. EFTA § 1693g; 12 C.F.R. § 205.6. The customer also might bear the loss for all unauthorized transfers occurring after a statement reporting an unauthorized transfer has been made available to the customer for sixty days. EFTA § 1693g; 12 C.F.R. § 205.6.

unauthorized signatures—either drawer’s signatures⁴² or indorsements⁴³—or due to alterations of the instruments.⁴⁴ The following examples provide typical fraud situations involving the use of checks to effectuate a typical corporate embezzlement plan:

Example #1 (Forged Drawer’s Signature): Bookkeeper at a corporation forges Corporation treasurer’s signature on a series of checks. She makes each of these checks payable to herself, and after indorsing them, deposits them into her personal account at Depository Bank. Depository Bank sends the checks for collection and the checks are paid by Payor Bank. Payor Bank debits Corporation’s account in the amount of the checks.

Example #2 (Forged Indorsement): Bookkeeper at Corporation is responsible for handling the company’s accounts receivable. On incoming checks made payable to Corporation, she forges the corporation’s indorsement on a number of checks. She then deposits the checks into her personal account at Depository Bank, which sends the deposited checks for collection to Payor Bank. Payor Bank pays the checks and debits the drawer’s account.

Example #3 (Alteration): Bookkeeper at Corporation alters a corporate check originally payable to her for \$100 so that it is payable for \$100,000, and deposits the check into her personal account at Depository Bank. Payor Bank pays the check in the amount as altered (\$100,000) and debits Corporation’s account for the full \$100,000.

In some embezzlement or theft cases, however, a forged signature might not appear on the check. Bookkeeper, from the earlier examples, could perhaps fraudulently induce her employer to issue the check to her order. Alternatively, she could obtain legitimately signed checks made payable to the order of the Depository Bank, yet deposit those checks into her personal account. In neither of these cases do any forged or unauthorized signatures appear on the check.

In any event, if Bookkeeper withdraws the funds deposited in these examples,⁴⁵ the issue addressed by the Code’s loss allocation scheme is who,

42. The “drawer” of a check is the “person who signs or is identified in a draft as a person ordering payment.” U.C.C. § 3-103(a)(5).

43. In the theft context, an “indorsement” is “a signature, other than that of a signer as maker, drawer, or acceptor, that alone or accompanied by other words is made on an instrument for the purpose of . . . negotiating the instrument.” *Id.* § 3-204(a).

44. “‘Alteration’ means (i) an unauthorized change in an instrument that purports to modify in any respect the obligation of a party, or (ii) an unauthorized addition of words or numbers or other change to an incomplete instrument relating to the obligation of a party.” *Id.* § 3-407(a).

45. Until the funds are withdrawn by Bookkeeper, there is no real, actual loss in the case. Prior to final payment by the payor bank, the funds are simply a series of credits that can be reversed. *See* U.C.C. § 4-214 (1990) (describing collecting banks’ charge-back rights); *id.* § 4-301 (detailing payor banks’

among all the parties who dealt with the instrument, ought to bear the loss. The faithless Bookkeeper is an obvious choice as a loss-bearer, but thieves (typical of their lot) often are insolvent or simply cannot be found. After the thief absconds with the funds, the remaining parties can find themselves locked in litigation over the issue of who should bear the loss. The cases can be complicated by claims of negligent conduct by one of more parties. For example, Corporation's failure to adequately supervise its employees could be claimed to evidence negligence; the Depository Bank's⁴⁶ role in allowing the deposit of the checks and the withdrawal of funds by Bookkeeper could constitute negligence; the Payor Bank's (Drawee)⁴⁷ role in paying the checks over the forgery or alteration might also be viewed as negligence.

The allocation of losses between the remaining parties is accomplished through application of a series of U.C.C. causes of action and defenses. As this Part I.B will discuss, the basic loss allocation scheme places the losses for check fraud in the banking system.⁴⁸ However, a series of defenses based upon negligence permits banks to avoid those losses and shift them to non-bank parties. Part II will discuss those defenses.

1. The Basic Loss Allocation Scheme: The Underlying Policy

It is possible, in any given instance of check fraud, that no negligence exists, or can be proved. Absent a showing of negligence, losses under the U.C.C. were and are placed,⁴⁹ in the usual case, upon one of the banks involved in the collection process. In the case of forged drawer's signatures, the loss is placed on the payor bank⁵⁰ (the bank that paid the check and the bank where the drawer opened the checking account).⁵¹ In the case of forged indorsements and alterations, the loss is placed on the first party who dealt with the thief.⁵² While it is possible for the first party to be a non-

right to revoke settlement). After final payment, the thief's account balance can be used to compensate for the amounts paid. *See, e.g.*, U.C.C. § 3-418 (allowing payor bank the right of restitution where value has not been given).

46. A "depository bank" is "the first bank to take an item" and can be a payor bank. U.C.C. § 4-105(2).

47. The "payor bank" is "a bank that is the drawee of a draft." *Id.* § 4-105(3). The equivalent term in Article 3 is "drawee," which is "a person ordered in a draft to make payment." U.C.C. § 3-103(a)(4). In the text, the terms "payor bank" and "drawee" are used interchangeably.

48. A number of articles that discuss various aspects of the new loss allocation scheme have appeared following the approval of the revisions. *See, e.g.*, Steven B. Dow, *The Impostor Rule and the Nature of Forgery Under the Revised Uniform Commercial Code: A Doctrinal Analysis and Some Suggestions for the Drafting Committee*, 39 AM. BUS. L.J. 25 (2001); Ellis & Dow, *supra* note 16; Timothy S. Fisher, *Check Fraud Litigation in Connecticut After the 1990 Revisions to the U.C.C.*, 68 CONN. B.J. 393 (1994); Donald J. Rapson, *Loss Allocation in Forgery and Fraud Cases: Significant Changes Under Revised Articles 3 and 4*, 42 ALA. L. REV. 435 (1991); Edward Rubin, *Efficiency, Equity and the Proposed Revision of Articles 3 and 4*, 42 ALA. L. REV. 551 (1991); Zekan, *supra* note 16.

49. There was little change in the basic loss allocation principles between the original U.C.C. and the revised version.

50. *Price v. Neal*, 97 Eng. Rep. 871 (K.B. 1762).

51. *See* U.C.C. § 4-105(3).

52. For a general understanding of how liability is transferred back from party to party, see the transfer and presentment warranties and comments in sections 3-416 and 3-417. Liability will generally

bank—for example where the thief cashed the check at a store or check cashing outlet—usually the party is the depository bank where the check was deposited and then sent for collection. Thus, absent proof of negligence,⁵³ losses are for the most part absorbed by the banking system: either payor banks (forged drawer's signatures) or depository banks (forged indorsements or alterations).

The rule that drawees bear the loss for unauthorized drawer's signatures stems back to the English common law and the celebrated case of *Price v. Neal*,⁵⁴ which involved two forged instruments and held that “[i]t was incumbent upon the [drawee], to be satisfied ‘that the bill drawn upon him was the drawer’s hand,’ before he accepted or paid it”⁵⁵ As the statement suggests, it is generally said that loss allocation rules traditionally rest on the principle that the losses due to the fraud ought to be placed on the party best able to avoid the loss.⁵⁶ In the case of a forged drawer's signature, that party arguably is the payor bank, which is in possession of a signature card of the drawer or other evidence of the customer's true signature. When a check is presented for payment, the rule of *Price v. Neal* suggests that the payor bank could have compared the forged signature on the check with that on the signature card, thus justifying placing the loss for forged drawer's signatures on the payor. In the case of forged indorsements and alterations, presumably the party who dealt with the thief was in the best position to evaluate the validity of the indorsement or determine if the instrument had been altered. In a substantial number of cases, this party is the depository bank, who is considered to be “in the best position to discover forged or omitted [i]ndorsements because of their face-to-face dealings with the [i]ndorser or holder presenting the check.”⁵⁷

Although tort concepts and the “best party to protect” rationale⁵⁸ provide the most traditional explanations for the development of the Code's basic loss allocation rules, the underpinnings of this rationale have eroded substantially in recent years. The check collection system has changed from one that once relied upon individual handling of paper checks to one that

rest with the person who dealt with the thief because she is liable under these warranties and because the thief, though liable, is likely insolvent.

53. U.C.C. § 3-406 (1990).

54. For a comprehensive discussion on the doctrine of *Price v. Neal*, see Steven B. Dow, *The Doctrine of Price v. Neal in English and American Forgery Law: A Comparative Analysis*, 6 TUL. J. INT'L & COMP. L. 113, 116-17 (1998); see also Christopher M. Grengs & Edward S. Adams, *Contracting Around Finality: Transforming Price v. Neal from Dictate to Default*, 89 MINN. L. REV. 163, 168-72 (2004) (relying upon Dow and arguing that rule of *Price v. Neal* should be a default rule rather than a mandatory rule).

55. *Price*, 97 Eng. Rep. at 872.

56. See, e.g., Rapson, *supra* note 48, at 435 (stating that a “guiding principle” of the loss allocation rules of the original U.C.C. “was said to be that loss should be imposed upon the party best able or in the best position to avoid the loss”).

57. *Sw. Bank v. Info. Support Concepts, Inc.*, 85 S.W.3d 462, 465 (Tex. Ct. App. 2002); see also *Kuhn v. Tumminelli*, 841 A.2d 496, 504 (N.J. Super. Ct. 2004), *cert denied*, 851 A.2d 648 (N.J. 2004) (unpublished table decision) (“[T]he depository bank is in the best position of any other bank in the negotiation chain to guard against forged or unauthorized [i]ndorsements.”).

58. See generally *Kuhn*, 841 A.2d at 504.

now predominantly relies on mechanized and automated systems for collection.⁵⁹ Checks are now usually processed in bulk and are guided not by human hands but rather by the magnetic ink character recognition (MICR) encoding found along the bottom of checks.⁶⁰ After the check is deposited at the depository bank and MICR-encoded with the remaining information necessary for collection, the MICR-encoding generally guides checks from depository bank to payors.⁶¹ Payor banks rarely examine every check, or even a significant number of checks, presented for payment on any given day. This assumes also that the physical paper check is transferred through the collection system and then presented to the payor bank for payment. In fact, check truncation, where the physical check is destroyed at some point during the collection process, is increasing.⁶² Electronic transmissions of the instruction represented by the physical check or the transfer of a digitized image of the check are emerging as typical routes for the modern check.

The transition to automated processing suggests that the rule of *Price v. Neal* is now a quaint historical relic with little practical force in modern banking law. In an automated era, the notion that payor banks in fact do, or should, individually compare the drawer's signature(s) on file with that on

59. *IBP, Inc. v. Mercantile Bank of Topeka*, 6 F. Supp. 2d 1258, 1265-66 (D. Kan. 1998).

60. The following case excerpt provides an excellent description of the typical check collection process when the physical check is transferred:

Once the depository bank cashes the check, the bank initiates payment of the instrument by adding the amount of the check to the MICR encoding line in electronically-recognized characters. This act completes the MICR encoding line. From that point forward, all processing of the check through various banking channels is effectuated through automatic electronic equipment. Thus, under the MICR encoding scheme, the depository bank is the only situs at which the check is inspected by an individual sight examination unless the drawer requests "exception item processing." Assuming . . . the depository bank is not also the payor bank, the depository bank sends the MICR-encoded check to an automated bank clearinghouse (presumably a branch of the Federal Reserve System) which routes the check via high-speed processing machinery to the payor bank for payment. The automated collection and payment procedures that [the payor bank] utilizes rely upon the MICR encoding information to process checks. Accordingly, while acting as a non-depository payor bank . . . [the payor bank] does not examine checks manually.

Id. (footnotes omitted). Because MICR encoding is the principal means for guiding a check along a collection route, MICR fraud is a common tool of thieves. Fraudulent MICR symbols can slow down the collection process (and detection of the theft). The thief can use the added time to abscond with the funds prior to discovery of the fraudulent check. See *Firststar Bank v. Wells Fargo Bank*, No. 02 C 186, 2004 WL 1323942, at *3-*4 (N.D. Ill. June 14, 2004) (ruling on a case involving the deposit of a check with fraudulent MICR encoding that significantly delayed collection and detection of the fraud).

61. See *IBP*, 6 F. Supp. 2d at 1266 (stating that banks rely on MICR encoding information).

62. In October 2003, Congress passed the Check Clearing for the 21st Century Act, Pub. L. No. 108-100, 117 Stat. 1177 (2003) (codified at 12 U.S.C.A. §§ 5001-5018 (Supp. 2005)), also known as "Check 21." Check 21 facilitates check truncation by authorizing "substitute checks," made from electronic images of the original check. The Act allows financial institutions to create a paper substitute for the actual check, when needed, while facilitating electronic imaging and transmission early in the collection process. Substitute checks have legal status as a check, but Check 21 does not require any bank to accept electronic checks.

Check 21 became effective in October 2004. The Federal Reserve Board's final rule amending Regulation CC, 12 C.F.R. pt. 229 (2005), to accommodate Check 21 is available at Press Release, FED. RESERVE BD. (July 26, 2004), <http://www.federalreserve.gov/boarddocs/press/bcreg/2004/20040726/default.htm>. The Federal Reserve Board anticipates that Check 21, once fully implemented, will increase the incidence of truncation. *Id.* If this is the case, Check 21 closes the era of returning physical checks to customers in their monthly statements.

the paper checks presented for payment is quite tenuous. In some cases of more sophisticated forgery, such as where the forged signature is a perfect replica of the authorized signature or where the check bears a facsimile or stamped signature, even sight examination would not have prevented the payment. Because of the tenuous hold that negligence rationales have on the loss allocation rules in light of modern check collection, it is hard to claim today that placing losses initially on the payor bank for forged drawer's signatures should be based upon the tort concept that the payor bank is in the best position to protect against forged checks.

As the U.C.C. itself has long recognized, principles of finality provide better support for allocating losses to the payor banks, even in the absence of negligence.⁶³ Yet, even finality provides a dubious rationale for placing losses on the payor, since finality is not an absolute value in and of itself. A more coherent explanation for the modern loss allocation rules, however, might be one of simply placing the risk in the banking system—a position taken by other payment systems.⁶⁴ As a matter of policy, this approach has several commendable attributes. Placing fraud losses on the financial institutions provides the banking industry with strong incentives to adopt practices and develop technology designed to reduce the losses due to check fraud.⁶⁵ Thus, there are sound reasons for simply keeping check fraud losses within the financial system as the basic loss allocation rules provide. As will be discussed later in Part II,⁶⁶ however, the revisions take a different approach, allowing banks to shift these losses back to their customers by raising defenses based upon negligence. While as a matter of abstract policy the placing of losses in the banking system is sound, in the rules established by the U.C.C., the policy has been substantially diluted through the application of the negligence defenses.

2. *The Basic Loss Allocation: Statutory Scheme*

As just stated, the general stance of Articles 3 and 4 is to place losses for forged drawer's signatures initially on the payor bank and for forged indorsements or alterations on the first party to take the instrument after the theft. The U.C.C. accomplishes this allocation through a rather complicated

63. Even the original version of Article 3 recognized the unreality of the traditional rationale for imposing losses on payor banks for forged drawer's signatures, suggesting finality as a "less fictional rationalization" and stating that "it is highly desirable to end the transaction on an instrument when it is paid rather than reopen and upset a series of commercial transactions at a later date when the forgery is discovered." U.C.C. § 3-418 cmt. 1 (1952).

64. See James Steven Rogers, *The Basic Principle of Loss Allocation for Unauthorized Checks*, 39 WAKE FOREST L. REV. 453, 463-67 (2004) (arguing that unavoidable losses due to check fraud ought to be borne by the payment system provider). For example, customer liability in the case of debit cards and credit cards is extremely limited. See *supra* note 41 (describing the state and federal regulatory schemes for payment systems).

65. See Grengs & Adams, *supra* note 54, at 180, 184-86 (stating that the holding in *Price v. Neal* creates an incentive for payors to implement procedures and to adopt technologies that detect and deter fraud).

66. See *infra* discussion beginning on p. 369.

series of causes of action. These actions are founded upon contract-based, warranty-based, and property-based provisions scattered throughout the Code.

a. Contract

The drawer's claim after a forgery or alteration is based upon the underlying contract between the drawer and the payor bank, entered into when the customer/drawer opened the account at the payor bank. The bank's basic contractual obligation is found at section 4-401 of the Code, which establishes that a bank can pay only those items which are "properly payable."⁶⁷ Items that are properly payable are defined as those items that are authorized by the customer and are in accordance with any agreement between the customer and bank.⁶⁸ If the drawer is the plaintiff, the drawer can assert that an item paid over a forged indorsement or forged drawer's signature was a breach of the bank/depositor agreement because such items are not considered "properly payable."⁶⁹ In the case of an alteration, a bank that makes payment in good faith to a holder may charge the customer's account only according to the original terms of the altered items.⁷⁰ In any case, if the bank cannot raise a valid defense, the payor bank is required to recredit the drawer's account.⁷¹ If this occurs, at this point the loss effectively is shifted to the payor bank, which must use warranty or restitution theories to shift the loss to parties from which it received the instrument.

b. Warranty and Restitution

If it is required to recredit its customer's account, the payor bank can assert a breach of presentment warranty action against the parties that transferred the instrument to it.⁷² When parties transfer checks, they make a set of warranties to the payor bank (known as the presentment warranties) and to subsequent transferees other than the payor bank (known as the transfer warranties).⁷³ In the theft context, these warranties substantively cover (1)

67. U.C.C. § 4-401(a) (1990) provides:

A bank may charge against the account of a customer an item that is properly payable from the account even though the charge creates an overdraft. An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and bank.

68. *Id.*

69. An official comment in the revisions makes it plain that "[a]n item containing a forged drawer's signature or forged indorsement is not properly payable." *Id.* § 4-401 cmt. 1.

70. *Id.* § 4-401(d)(1). If the amount of a check was changed from \$250 to \$250,000, the original amount is considered properly payable and can be charged to the customer's account for that amount. *Cf.* HSBC Bank USA v. F&M Bank No. Va., 246 F.3d 335, 335 (4th Cir. 2001) (cashier's check case). The excess amount in this example, \$249,750, would be recredited to the customer's account. *Id.* at 338.

71. *See id.* at 339.

72. *See* U.C.C. § 3-417 (1990).

73. The presentment warranties, which are made by transferors to the payor or drawee, are found at U.C.C. section 3-417 and section 4-208. The transfer warranties, which are made by transferors to transferees other than the drawee or payor, are found in section 3-416 and section 4-207. Because Article 3

whether the transferor is entitled to enforce the instrument, (2) whether the signature of the drawer is genuine, and (3) whether there are alterations of the instrument. A successful warranty action would mean that the payor bank could effectively shift any loss it had to the parties who transferred the instrument to it.⁷⁴

In the case of the presentment warranty made to the payor bank regarding the authenticity of the drawer's signature, the warranty provides only that the transferor "has no knowledge that the signature of the . . . drawer . . . is unauthorized"⁷⁵ Because of the qualification that knowledge must be shown to successfully establish a breach of the warranty, the payor bank's presentment warranty action against its transferor would usually be unsuccessful in the case of forged drawer's signatures.⁷⁶ Rarely can a payor bank establish the actual knowledge⁷⁷ necessary to establish a breach of the drawer's signature warranty by a prior transferor. Thus, in the case of forged drawer's signatures, where no defenses are available to the bank, the losses most often rest on the payor bank.⁷⁸ This is because it has no theory or action⁷⁹ which it can employ to establish the liability of another party. Yet, under the bank/depositor agreement it is obliged to recredit its customer's account.⁸⁰ The end result is that the payor bank bears the loss.

Unlike the presentment warranty regarding the drawer's signature, the presentment warranties regarding the transferor's entitlement to enforce the instrument and regarding alterations are absolute, in that they are not qualified by a requirement that the transferor have knowledge of the defect. Each previous transferor warrants to the drawee which pays a draft both that the transferor, at the time of transfer, was entitled to enforce the instrument⁸¹ and that there were no alterations on the instrument.⁸² In cases where an

covers negotiable instruments, the Article 3 warranties extend to any transfer of a negotiable instrument, which includes checks. Article 4 warranties only apply to "items," which are defined as "an instrument or a promise or order to pay money handled by a bank for collection or payment." § 4-104(a)(9). Thus, the Article 4 warranties only extend to transfers handled by a bank, which usually begins at the time a customer deposits a check at the depository bank. For ease of reference, subsequent citations will refer only to the Article 4 sections establishing the transfer and presentment warranties.

74. See *id.* §§ 4-207 to -08 & cmts.

75. Section 4-208(a)(3) provides that a transferor, at the time of transfer, warrants to the drawee that pays the draft on good faith that "the warrantor has no knowledge that the signature of the purported drawer of the draft is unauthorized"

76. Knowledge is an actual knowledge standard under the Code. See U.C.C. § 1-202(b) (Revised 2001) ("Knowledge" means actual knowledge."). It is a much stricter standard than a "notice" standard, which includes a "reason to know" test. See *id.* § 1-202(a)(3).

77. *Id.*

78. See U.C.C. § 3-418(c) (1990).

79. An action in restitution against transferors is possible. See *id.* § 3-418 (allowing for an action when a drawee pays a draft on the mistaken belief that the drawer's signature is genuine). But under the revised U.C.C., persons who give value in good faith or those who in good faith change their position in reliance on payment have a complete defense to the action. See *id.* § 3-418(c). Most prior transferors will be able to meet this test and will have a defense against any restitution action brought by the payor bank.

80. See, e.g., *HSBC Bank USA v. F&M Bank No. Va.*, 246 F.3d 335, 337-38 (4th Cir. 2001).

81. This warranty is established in section 4-208(a)(1): "[T]he warrantor is, or was, at the time the warrantor transferred the draft, a person entitled to enforce the draft or authorized to obtain payment or acceptance of the draft on behalf of a person entitled to enforce the draft"

82. This warranty is established in section 4-208(a)(2): "the draft has not been altered." To have an

indorsement is forged, no transferor after that forgery will be a person entitled to enforce the instrument and this warranty will be breached.⁸³ In cases where the instrument has been altered, the warranty as to alterations will be breached. Therefore, in the case of forged indorsements and alterations, the payor bank, in the usual case, can easily establish a breach of the presentment warranty by its prior transferors and shift the loss to its transferors.⁸⁴

In addition to the presentment warranties made by transferors to the drawee/payor bank, a second set of warranties, known as transfer warranties, is made among transferees other than drawee. In substance similar to the presentment warranties,⁸⁵ the transfer warranties allow transferors, liable to the payor bank for breach of presentment warranty, to claim a breach of transfer warranty by their transferor. In the case of forged indorsements and alterations, the party liable to the payor bank could then shift the loss to its

“alteration,” defined *supra* note 44, that breaches this warranty, there must be a pre-existing instrument that was changed or completed. *See Bank of Am. v. Amarillo Nat’l Bank*, 156 S.W.3d 108 (Tex. Ct. App. 2004) (finding that the presentment of check which was a copy of the original did not breach the alteration warranty).

83. The conclusion is reached through the following series of steps through Code sections: A “[p]erson entitled to enforce” means, generally, a “holder” of the instrument, or at least someone who has the rights of a holder. U.C.C. § 3-301. After the initial issue of the instrument, holder status requires a transferee to acquire the instrument through a “negotiation.” *Id.* § 3-201(a) (“‘Negotiation’ means a transfer of possession, whether voluntary or involuntary, of an instrument by a person other than the issuer to a person who thereby becomes its holder.”). Where an instrument is payable to an identified person (say, “John Smith”), it can only be negotiated as a transfer of possession and indorsement by *the holder* (in this example John Smith). *Id.* § 3-201(b). Thus, if John Smith’s indorsement is forged by a thief, the transfer is not a negotiation because the thief was not the holder. Because no subsequent parties in possession of the instrument are holders or people entitled to enforce, transfers by those parties also do not qualify as negotiations. *See* U.C.C. § 3-201 & cmts. After a forgery of an indorsement, no subsequent party can become a holder (since no negotiation can occur), and therefore, the warranty that the transferor is entitled to enforce is always breached. Instruments payable to bearer, by contrast, can be negotiated by transfer of possession alone. *See id.* § 3-201(b) & cmt. 1.

The concept of “holder” in the Code makes no certain statement about the *bona fides* of the party in possession of an instrument. Subsequent parties who act innocently and in complete good faith, such as the transferees in the example just discussed, can be non-holders after a forged indorsement. *See id.* § 3-201 cmt. 1. If an instrument is payable to bearer, the thief can be a holder even if that possession is wrongful. *Id.* Where the thief forges the drawer’s signature on the check, the thief and subsequent parties in possession of the instrument can be holders. *Id.* § 3-301. This is because at the time of issue, holder status (and the status of a person entitled to enforce) is determined by the definition at section 1-201(b)(21)(A), which provides that a holder is “the person in possession of a negotiable instrument that is payable either to bearer or to an identified person that is the person in possession.” If the thief in the above example forges John Smith’s name as drawer and issues a check to the thief, the thief is in possession of the instrument and is therefore both a holder and a person entitled to enforce the instrument. The thief also can create holder status in subsequent transferees by indorsing and transferring the instrument. *See id.* § 3-205. The warranty as to entitlement to enforce is therefore not breached in the instance of a forged drawer’s signature.

84. *See* U.C.C. § 4-207.

85. The transfer warranties are found in section 3-416 and section 4-207. Three of the six transfer warranties relate to circumstances involving check fraud and address alterations, indorsements, and forged drawer’s signatures:

A customer or collecting bank that transfers an item and receives a settlement or other consideration warrants to the transferee and to any subsequent collecting bank that: (1) the warrantor is a person entitled to enforce the item; (2) all signatures on the item are authentic and authorized; (3) the item has not been altered . . .

§ 4-207(a). The remaining transfer warranties address situations not usually important where there is theft.

prior transferors, and so on, leaving the first party who dealt with the thief bearing the loss.⁸⁶

The recent case of *Clean World Engineering, Ltd. v. MidAmerica Bank*,⁸⁷ nicely illustrates the application of the sections just laid out. In *Clean World*, Clean World Engineering had a total of \$137,445.02 in checks and other transfers diverted from their account at MidAmerica.⁸⁸ The theft demonstrates the sophistication with which check fraud can occur today, and therefore, the facts merit some attention. The thief, Nicholas Fredich, placed an ad in the local newspaper seeking applicants for a bookkeeping position.⁸⁹ He stole the identity of one of these applicants, "Robert C. Landrum," from the resumes sent and applied for a bookkeeping position at Clean World using that identity.⁹⁰ Clean World did the usual reference checking of Landrum and hired Fredich, thinking he was Landrum, based on positive reports.⁹¹ Fredich started work at Clean World on September 2, 1997.⁹² On September 17th, he claimed an emergency and took several days off, and then he failed to report back for work.⁹³ A suspicious employee then discovered that many checks were missing from the cabinet where they were kept, and further investigation showed that those checks had been forged by Fredich.⁹⁴ Some of the checks were deposited in an account at TCF Bank Illinois opened by Fredich and were paid by MidAmerica.⁹⁵ MidAmerica reimbursed Clean World for some of the checks, but it refused to do so for some others.⁹⁶ The lawsuit followed, and the trial court found in favor of Clean World, ordering full reimbursement.⁹⁷

On appeal, MidAmerica did not contest the fact that it paid items over forged signatures, but it asserted that the trial court erred in finding that Clean World exercised ordinary care, arguing instead that the court should have ruled that the employer's failure to exercise ordinary care contributed to the forged signature.⁹⁸ In support of this claim, MidAmerica pointed to the thief's testimony at trial that "he was given full and complete access" to company checks and to the accounting programs used for printing checks.⁹⁹ Discounting this testimony from a convicted felon, the appellate court up-

86. *See id.*

87. 793 N.E.2d 110 (Ill. App. Ct. 2003).

88. *Id.* at 113. Besides forging checks, the thief also executed a wire transfer of over \$20,000. *Id.*

89. *Id.* at 112.

90. *Id.*

91. Fredich's application, which was scrutinized by Clean World, contained Landrum's personal information. *Id.* Clean World also obtained a credit report (under Landrum's social security number) and called a prior employer, who gave a positive reference for Landrum. *Id.*

92. *Id.*

93. *Id.*

94. *Id.* at 113.

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.* at 114.

99. *Id.* Fredich pled guilty to forgery in the criminal charges brought against him after he was caught.

held the trial court's finding that there was no negligence on the part of Clean World.¹⁰⁰ MidAmerica also argued that TCF, the depository bank, breached its presentment warranties and that the transferor's "knowledge of the forgery is irrelevant to a finding of a breach of presentment [] warranties."¹⁰¹ The court rejected this argument and correctly held that a payor bank is required to show that the transferor had knowledge of the unauthorized signature to establish a breach of the presentment warranty regarding the authenticity of the drawer's signature.¹⁰² Because MidAmerica could not show any such knowledge on TCF's part, the warranty claim failed and MidAmerica, the payor bank, was left bearing the entire loss.¹⁰³

c. Conversion

Sometimes the party victimized by check fraud is not the drawer or customer of the payor bank but rather the owner of an issued instrument who had the instrument stolen and their indorsement forged. Example #2 (Forged Indorsement) from above, where Bookkeeper forges the Corporation's indorsement on checks made payable to the Corporation, provides such a case. In these circumstances the cause of action of the owner is based on conversion rather than on paying an item that was not properly payable (which is the drawer's claim against the payor bank). After the forgery of an indorsement on an issued check, the harm is against the owner's property rights in the instrument rather than a breach of any underlying agreement.¹⁰⁴ The owner's right to raise a conversion claim after a forged indorsement is secured by U.C.C. section 3-420(a), which provides:

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.¹⁰⁵

As stated above, where there has been a forgery of an indorsement, there can never be a "negotiation" of the instrument or a "[p]erson entitled

100. *Id.* at 115-16.

101. *Id.* at 118. MidAmerica based its argument on another Illinois case, *First Nat'l Bank of Chi. v. MidAm. Fed. Sav. Bank*, 707 N.E.2d 673 (Ill. App. Ct. 1999), which dealt with presentment warranties in the case of forged indorsements rather than forged drawer's signatures. *Clean World Engineering, Ltd.*, 793 N.E.2d at 118. As stated in the text, the warranties regarding the authenticity of the indorsements on the instrument are not qualified by a knowledge requirement, as is the case for forged drawer's signatures. *Id.* at 118-19.

102. *Clean World Engineering, Ltd.*, 793 N.E.2d at 118.

103. *Id.* at 118-19.

104. *See* U.C.C. § 3-420 (1990).

105. *Id.* § 3-420(a).

to enforce' an instrument."¹⁰⁶ Any person who subsequently takes a stolen instrument that has a forged indorsement will "take[] by transfer, other than a negotiation, from a person not entitled to enforce the instrument"¹⁰⁷ and thus, will have converted the instrument under the language of the second sentence of the subsection.

A goal of the revisions was to streamline the litigation that inevitably follows in the wake of check fraud. Therefore, the section addressing conversion attempts to resolve a significant amount of litigation that occurred under the original U.C.C. regarding which parties are properly the defendants in a conversion action and which parties are properly the plaintiffs. Under the original U.C.C., a debate arose over whether a depository bank could be a defendant in a conversion action.¹⁰⁸ The revisions now expressly allow direct action against the depository bank.¹⁰⁹ Another area of litigation prior to the revisions concerned whether a drawer of a check or a payee who had not received delivery of the instrument could raise a claim based on conversion.¹¹⁰ The revisions now expressly cut-off the ability of these par-

106. *Id.* § 3-301; *see also supra* note 83.

107. U.C.C. § 3-420(a).

108. This debate is discussed in comment 3 to section 3-420. When an instrument has a forged indorsement, the warranty as to entitlement to enforce is *ipso facto* breached by all transferors of the instrument. If an owner sues the payor bank for conversion, the payor bank would then bring its transferors into the action, asserting a breach of the presentment warranty regarding the transferor's entitlement to enforce the instrument. Often the depository bank (the party in direct contact with the thief) ultimately would bear the loss. In cases in which the thief forged indorsements on checks drawn at a number of payor banks, an action would need to be brought against those payor banks, only to have the liability ultimately rest on the one depository bank. While efficiency and avoidance of circuitous actions would suggest allowing a direct action against the depository bank, some courts, nonetheless, required that the conversion claim be only brought against the payor bank. *See, e.g., Knesz v. Cent. Jersey Bank & Trust Co.*, 477 A.2d 806 (N.J. 1984). This position is perhaps better supported by the literal language of the U.C.C.'s original section on conversion.

The addition of a direct action for conversion against the depository bank created an interesting transitional issue in jurisdictions that did not recognize the action prior to the revision. Minnesota, for example, was one of those states. *See Denn v. First State Bank of Spring Lake Park*, 316 N.W.2d 532, 536-37 (Minn. 1982). In *Geldert v. American National Bank*, 506 N.W.2d 22 (Minn. Ct. App. 1993), the court faced a case governed by the original U.C.C. that asserted an action in conversion against the depository bank. The court nonetheless denied the conversion claim directly against the depository bank given that the revisions to section 3-420 were not the applicable law. *See id.* at 28.

While the revisions clearly establish that a depository bank is properly a defendant in a conversion action, the drawees are also viable defendants. *See King v. White*, 962 P.2d 475, 483-84 (Kan. 1998) (rejecting the argument that revisions removed conversion liability of drawees).

109. The right to pursue a depository bank directly is accomplished through subsection (c) of section 3-420, which provides in full:

A representative, *other than a depository bank*, who has in good faith dealt with an instrument or its proceeds on behalf of one who was not the person entitled to enforce the instrument is not liable in conversion to that person beyond the amount of any proceeds that it has not paid out.

§ 3-420(c) (emphasis added). To paraphrase, "representatives," other than depository banks, *are not* liable in conversion. *Cf. id.* Therefore, depository banks *are* liable in conversion. *Cf. id.* Collecting banks are considered "representatives" because they act in an agency capacity. *See* U.C.C. § 4-201 (1990) (collecting banks as agents or subagents of the owner of instruments); U.C.C. § 1-201(b)(33) (2001) ("representative" includes agents). Thus, all other collecting banks other than depository banks are not proper defendants in a conversion action.

110. *See* U.C.C. § 3-420 cmt. 1. The seminal case in this area under the original Code is *Stone & Webster Engineering Corp. v. First National Bank & Trust Co.*, 184 N.E.2d 358 (Mass. 1962). In *Stone*

ties to bring conversion actions.¹¹¹ The bar on a drawer's action in conversion does not mean that drawers and payees on unissued instruments lack a remedy. Rather, the drawer's action is properly against the payor bank, based upon the bank/depositor agreement, for paying an item that was not properly payable. The payee of an undelivered instrument has the right to pursue the drawer on the underlying obligation, which is not discharged in cases where there has been no delivery.¹¹²

The revisions also attempt to narrow the number of claims that might be raised in lawsuits through their response to the famous California case of *Sun 'n Sand, Inc. v. United California Bank*.¹¹³ *Sun 'n Sand* involved an employee who altered the amounts on checks signed by her employer. Upon discovering the fraud, Sun 'n Sand sued the depository bank for breach of warranty and also for negligence. The court allowed both actions and found that the drawer was a recipient of the warranties made in the collection process¹¹⁴ and held that a common law negligence action was permitted under the U.C.C.¹¹⁵ If the drawer could show "circumstances sufficiently suspicious that [the depository bank] should have been alerted to the risk that [the] Sun 'n Sand's employee was perpetrating a fraud,"¹¹⁶ then liability in negligence could be established. The revisions to the U.C.C. clearly reject the first holding of *Sun 'n Sand* regarding the ability of drawers to raise a warranty action.¹¹⁷ The revisions are less clear as to the impact of the revisions on the viability of negligence actions, which are generally outside of the Code. As will be discussed later on,¹¹⁸ this omission has led to a substantial amount of litigation over the continuing vitality of common law claims apart from or in addition to the U.C.C. causes of action discussed here.

Actions for conversion, actions based on the bank/depositor agreement, and presentment and transfer warranty actions taken together lead to the

& *Webster Engineering Corp.*, the court held that the drawer had no action in conversion. *Id.* at 364.

111. The last sentence of U.C.C. section 3-420(a) provides that:

An action for conversion of an instrument may not be brought by (i) the issuer or acceptor of the instrument or (ii) a payee or indorsee who did not receive delivery of the instrument either directly or through delivery to an agent or a co-payee.

The drawer, as issuer of the instrument, is now prevented from bringing a conversion action. While this rule generally is accepted by the courts, *see, e.g., Mid-Continent Specialists, Inc. v. Capital Homes, L.C.*, 106 P.3d 483 (Kan. 2005) (discussing in detail the bar on drawer's action in conversion), as will be discussed in Part III.A., a minority of courts are interpreting section 3-420 in a manner that does permit drawers to raise conversion actions. *See infra* discussion in Part III.A.

112. U.C.C. § 3-420 cmt. 1.

113. 582 P.2d 920 (Cal. 1978).

114. *Id.* at 927-29. *Sun 'n Sand* represents just one of a number of cases decided under the original Code that allowed a drawer to bring an action based upon a breach of warranty. *See, e.g., Allied Concord Fin. Corp. v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 80 Cal. Rptr. 622, 624 (Cal. Ct. App. 1969); *Ins. Co. of N. Am. v. Atlas Supply Co.*, 172 S.E.2d 632, 635-36 (Ga. Ct. App. 1970).

115. *Sun n' Sand*, 582 P.2d at 935-37.

116. *Id.* at 936.

117. U.C.C. § 3-417 cmt. 2 ("The result in [*Sun 'n Sand*] is rejected."); *see also In re Ostrom-Martin, Inc.*, 188 B.R. 245, 257 (Bankr. C.D. Ill. 1995) (using language in comment 2 to deny drawer standing to enforce presentment warranties).

118. *See infra* Part III.A.

results suggested by the general loss allocation schemes mentioned earlier. If the payor bank is a defendant, it will be successful in shifting the loss to its transferors through a presentment warranty theory in the case of forged indorsements or alterations. In the case of forged drawer's signatures, the payor bank will ultimately bear the loss. If a depository bank is a defendant in an action for conversion, it will be ultimately liable unless, given the circumstances of the transaction, it received the check from a prior transferor who breached its transfer warranty to the depository bank.

II. THE TRANSITION TO COMPARATIVE NEGLIGENCE

As the discussion thus far shows, the initial loss allocation structure places losses in the banking system, either on the depository bank (for forged indorsements and alterations where the depository bank receives the check from the thief) or the payor bank (for forged drawer's signatures). Although the initial structure is best said to be based on strict liability rather than negligence,¹¹⁹ the revisions, consistent with the original U.C.C., allow this initial allocation to be changed where negligence can be established in a particular case. The original U.C.C. allowed banks to shift losses back to negligent parties under certain circumstances. The revisions expand on the negligence defenses and made them more widely available to banks. Because some of the most significant changes in policy in the revised Code lie in this area of payment law, each approach will be discussed in turn.

A. 1962 Contributory Negligence System

The original versions of Article 3 and Article 4 worked upon principles of contributory negligence. They recognized three negligence defenses that a defendant, usually the payor bank, might raise to avoid the loss. The first was based on general negligence, occurring before the theft, which contributed to the loss.¹²⁰ If a party substantially contributed to an alteration or unauthorized signature, they were precluded from asserting the fraud as a defense. The second defense was based on a party's failure to examine their bank statements. If a customer did not "exercise reasonable care and promptness to examine the statement"¹²¹ they could be precluded from asserting their unauthorized signature or alterations as a defense.¹²² Finally, in

119. See *supra* text accompanying notes 63-64.

120. Original section 3-406 provided as follows:

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

U.C.C. § 3-406 (1952).

121. U.C.C. § 4-406(1) (1952).

122. If the bank could prove that the customer failed to exercise the required care in examining the statement,

cases of indorsements the defendant could assert section 3-405, which covered situations involving imposters and so-called “fictitious payees.” Where applicable, this defense rendered irregular indorsements effective.¹²³

At least in the case of the first two defenses, only a party that had exercised ordinary care could assert the defense.¹²⁴ Thus, the scheme envisioned a contributory negligence standard where only a non-negligent party could assert the negligence of another. However, the original U.C.C. provided no standards for determining ordinary care and lacked a definition for that term. With the matter of what constituted “ordinary care” left to the courts, it was not surprising that conflicting case law arose defining a bank’s duties in this area. For the most part, these cases centered on the payor bank’s duty to examine instruments presented to it for payment. In the case of *Medford Irrigation District v. Western Bank*,¹²⁵ decided under the original U.C.C., the court found that a payor bank’s failure to examine checks presented for payment was negligence as a matter of law.¹²⁶ This was the case even though the bank argued that its practice of limited sight review was consistent with current industry standards and was commercially reasonable.¹²⁷ By contrast, other courts found limited sight review to comport with the bank’s duty of ordinary care.¹²⁸ Since a payor bank’s ability to raise defenses, and thus shift the loss to its customer, hinged on this issue, the stakes on win-

the customer [was] precluded from asserting against the bank (a) his unauthorized signature or any alteration on the item if the bank also establishes that it suffered a loss by reason of such failure; and (b) an unauthorized signature or alteration by the same wrongdoer on any other item paid in good faith by the bank after the first item and statement was available to the customer for a reasonable period not exceeding fourteen calendar days and before the bank receives notification from the customer of any such unauthorized signature or alteration.

Id. § 4-406(2).

123. The original fictitious payee rule was as follows:

An indorsement by any person in the name of a named payee is effective if (a) an imposter by use of the mails or otherwise has induced the maker or drawer to issue the instrument to him or his confederate in the name of the payee; or (b) a person signing as or on behalf of a maker or drawer intends the payee to have no interest in the instrument; or (c) an agent or employee of the maker or drawer has supplied him with the name of the payee intending the latter to have no such interest.

U.C.C. § 3-405(1)(a)-(c).

124. Under the last clause of original section 3-406, *see supra* note 120, the drawee must “pay[] the instrument in good faith and in accordance with the reasonable commercial standards of the drawee’s or payor’s business” in order to raise the defense. *Id.* § 3-406. Original section 4-406 provided that the preclusion in “subsection (2) does not apply if the customer establishes lack of ordinary care on the part of the bank in paying the item(s).” U.C.C. § 4-406(3). Original section 3-405, however, lacked a similar provision. *See* U.C.C. § 3-405. Thus, a debate arose in the courts and scholarly literature regarding whether a bank’s negligence was at all relevant under this section. *See* JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* § 16.4, at 707-08 (3d ed. 1988) (discussing this debate and siding in favor of making the drawee’s care or lack of it relevant); *Pavex, Inc. v. York Fed. Sav. & Loan Ass’n*, 716 A.2d 640, 644-46 (Pa. Super. Ct. 1998) (applying old fictitious payee rule and finding that a bank must act in good faith to assert the defense).

125. 676 P.2d 329 (Or. Ct. App. 1984).

126. *Id.* at 332-33.

127. *Id.* at 332. The bank in *Medford* did not review checks in amounts under \$5,000, but rather automatically paid them.

128. *See, e.g., R.I. Hosp. Trust Nat’l Bank v. Zapata Corp.*, 848 F.2d 291, 294-95 (1st Cir. 1988) (involving the practice of reviewing checks over \$1,000).

ning this point in the revision process were high for both banks and customers.

As this suggests, the original U.C.C., consistent with all contributory negligence approaches, was an “all or nothing” loss allocation system. Either the bank or the negligent customer would bear the whole loss. Furthermore, unless the bank paid or took the instrument in accordance with reasonable commercial standards, it could not successfully assert the negligence of another party. If unable to raise a defense, the bank would bear the entire loss under the initial loss allocation rules discussed earlier.

B. 1990 Comparative Negligence System

The revisions to Articles 3 and 4 brought a substantial overhaul to the contributory negligence system of the original Code. The current Code for the most part retains the same causes of action and initial loss allocation scheme,¹²⁹ but substantially revises and expands the defenses available to defendants. Most significantly, a new definition of “ordinary care” has been added to the Code.¹³⁰ The revisions also replace the contributory negligence structure of the original U.C.C. with one of comparative negligence. This is accomplished by adding a new action that parties against whom defenses apply can raise against negligent banks. When these changes are fully utilized, the entire framework of the revisions affords banks greater ease in shifting losses away from themselves and onto their customers.

1. Defenses

The U.C.C. now has four defenses to replace the three original defenses. Regarding the customer’s general duty of care, section 3-406 remains in most respects the same as the original version:

A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making 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.¹³¹

Continuing with tests established under the original U.C.C., the “substantial contribution” test in this section has been construed to mean “that there must be some causal connection or relationship between the negligence of the plaintiff and the [forgery].”¹³² However, the requirement that a

129. See *supra* note 49 and accompanying text.

130. See U.C.C. § 3-103(a)(9) (1990).

131. *Id.* § 3-406(a). For a discussion of current case law that addresses how courts apply this section, see *infra* text accompanying notes 216-229.

132. *Vectra Bank of Englewood v. Bank W.*, 890 P.2d 259, 263 (Colo. Ct. App. 1995); see also *Travelers Indem. Co. v. Good*, 737 A.2d 690, 694 (N.J. Super. Ct. App. Div. 1999) (quoting *Gast v. Am.*

drawee must have acted in accordance with reasonable commercial standards¹³³ to raise this defense has been deleted. This is a significant change from the prior U.C.C. because it allows even a negligent party to raise the defense, subject to the comparative negligence causes of action to be discussed later.¹³⁴

The revised bank statement defense also omits the earlier requirement that a bank exercise ordinary care to raise the defense.¹³⁵ However, the defense is only applicable where “[a] bank [] sends or makes available to a customer a statement of account showing payment of items for the account.”¹³⁶ While a bank is not legally required to send its customer a state-

Cas. Co. of Reading Pa., 240 A.2d 682, 685 (N.J. Super. Ct. App. Div. 1968)) (The “substantially contributes” test “‘indicates [a] causal relationship and is the equivalent of the ‘substantial factor’ test applied in the law of negligence generally.’”); U.C.C. § 3-406 cmt. 3 (explaining that revisions are intended to continue analysis established under prior case law for “substantial contribution”). The causation element in this section “is meant to be less stringent than a ‘direct and proximate cause’ test.” *Id.* § 3-406 cmt. 2. Nonetheless, the negligence must proximately relate to *the forgery* and not merely to the issuance of checks that subsequently were forged. *See, e.g., Bank/First Citizens Bank v. Citizens & Assocs.*, 82 S.W.3d 259, 265-67 (Tenn. 2002) (collecting similar cases and holding that mere negligent issuance of checks was insufficient to assert section 3-406).

There must also be a “forged signature” in order for section 3-406 to apply. If an instrument is missing an indorsement, section 3-406 does not apply because of the absence of a forged signature. *See Chow v. Enter. Bank & Trust Co.*, No. 024762BL52, 2003 WL 22481372, at *3 (Mass. Super. Ct. Sept. 11, 2003). Where a signature is present in the usual case the requirement of a forged signature will be met; in other cases the “forgery” at issue is less clear. For example, in *John Hancock Fin. Serv. v. Old Kent Bank*, 185 F. Supp. 2d 771 (E.D. Mich. 2002), *aff’d*, 346 F.3d 727 (6th Cir. 2003), a John Hancock representative embezzled nearly \$800,000. *Id.* at 774. The representative, Sherman, instructed a client to write checks payable to John Hancock, but the checks were delivered to Sherman. *Id.* at 773-74. Sherman then indorsed these checks “Sherman and Associates Financial Services” and deposited them into an account in that name at Old Kent Bank. *Id.* at 773-74. According to Sherman’s testimony, Old Kent never questioned the difference between the named payee and the indorsement on the check, and Sherman did not lie or provide an explanation as to why he was depositing John Hancock checks. *Id.* at 774.

Upon discovering the theft, John Hancock reimbursed its clients and then brought an action for conversion against Old Kent, the depository bank. *Id.* at 775. As a defense, Old Kent argued that, under section 3-406, John Hancock’s negligent supervision of Sherman contributed to the loss. *Id.* John Hancock claimed that section 3-406 was inapplicable in the case because section 3-406 only referred to negligence that contributed to a forged signature on an instrument. *Id.* at 778. Thus, under John Hancock’s argument, the section was inapplicable because the indorsement “Sherman and Associates Financial Services” was not a forgery of the payee’s name. *Id.* Rather, a forged indorsement, as meant by section 3-406, was a signature “that replicates the name of the authorized person and is made with an intent to deceive.” *Id.* Old Kent, on the other hand, argued that a “forged signature” within the meaning of section 3-406 included any signature of a person other than the intended payee, and thus, Sherman’s indorsement fell within section 3-406. *Id.* at 775. Old Kent argued that allowing it to raise John Hancock’s negligence would be consistent with the new loss allocation rules established under the revisions. *Id.* at 778. The court accepted John Hancock’s interpretation. *Id.* at 779. Only when the signature attempted to be the payee’s genuine signature could an agent’s signature be considered the forgery of the payee’s signature. *Id.* Thus, Sherman’s indorsement was not a “forged indorsement,” and Old Kent was not permitted to raise John Hancock’s own negligence under section 3-406. *Id.*

Old Kent’s argument that section 3-406 should apply is not without merit. Under the court’s interpretation, Old Kent was left bearing 100% of the loss, a result contrary to the basic loss-sharing principles established by the Code. *See supra* note 57 and accompanying text. Had Sherman simply forged John Hancock’s signature, Old Kent obviously could have raised Hancock’s negligence, yet because Sherman used his own name, Old Kent was prevented from doing so.

133. *See supra* note 124.

134. *See infra* text accompanying notes 172-230.

135. *See supra* note 124.

136. *See* U.C.C. § 4-406(a) (1990). A bank is not required to send the original checks back with the

ment of account or the actual items, if it fails to do so it forfeits its ability to raise the bank statement defense. If it does send the statement or items, the customer has a duty of reasonable promptness to examine the statement and notify the bank of an unauthorized payment.¹³⁷ Where the customer fails in this regard, he is precluded from asserting a claim against the bank:

(1) the customer's unauthorized signature or any alteration on the item, if the bank also proves that it suffered a loss by reason of the failure; and (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.¹³⁸

Regardless of the exercise of care or lack of it, by either the customer or the bank, a customer must discover and report the customer's unauthorized signature or alteration within one year after the statement or items have been made available.¹³⁹ If the customer does not do so, it is precluded from asserting the unauthorized signature or alteration.

The bank statement defense established in section 4-406 is a powerful one for financial institutions. The case of *Peak v. Tuscaloosa Commerce Bank*¹⁴⁰ shows the impact of the defense. Thelma Peak's grandson forged her signature on over \$17,000 in checks, which were paid by the bank. The grandson, who lived with Ms. Peak, was allowed to pick up her mail. He would intercept the bank statements, remove the cancelled forged checks, and alter the statements and the statement balance so that the statement bore no evidence of his forgery.¹⁴¹ Ms. Peak testified that she reviewed her statements, but only to check if the balances on the statement matched with

statement, a practice known as truncation, which is discussed *supra* note 62 and accompanying text. Rather, the statutory requirement is that a bank "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." *Id.* § 4-405(a). Describing an item by item number, amount, and date of payment is sufficient to meet this test. *Id.* Where items are not returned, a bank has a duty nonetheless either to retain the items or to maintain the capacity to furnish legible copies of the items for seven years. *Id.* § 4-406(b).

137. *Id.* § 4-406(c). That section provides in full:

If a bank sends or makes available a statement of account or items pursuant to subsection (a), the customer must exercise reasonable promptness in examining the statement or the items to determine whether any payment was not authorized because of an alteration of an item or because a purported signature by or on behalf of the customer was not authorized. If, based on the statement or items provided, the customer should reasonably have discovered the unauthorized payment, the customer must promptly notify the bank of the relevant facts.

Id.

138. *Id.* § 4-406(d)(1)-(2).

139. *Id.* § 4-406(f).

140. 707 So. 2d 59 (La. Ct. App. 1997).

141. *Id.* at 60.

her records.¹⁴² She did not, in other words, do an item-by-item examination that might have revealed the forgeries.¹⁴³ She discovered the forgeries about eight months after they started, when a bank representative informed her that her account was overdrawn.¹⁴⁴ She sought to recover from the bank.¹⁴⁵ The court granted summary judgment for the bank, and the appellate court affirmed.¹⁴⁶ The court found that the evidence established that Ms. Peak's failure to review her bank statements and to promptly notify the bank constituted a valid defense.¹⁴⁷ Ms. Peak therefore was responsible for the full amount of the loss.¹⁴⁸

Section 3-404 of the revisions addresses imposters and fictitious payees. The effectiveness of indorsements under the imposter rule¹⁴⁹ has been expanded to encompass situations where the imposter impersonates an agent of the principal to whom the issuer makes the instrument payable.¹⁵⁰ Under the original U.C.C., if an instrument was made payable to a principal (for

142. *Id.* at 61.

143. *Id.* at 65.

144. *Id.* at 60.

145. *Id.*

146. *Id.* at 65.

147. *Id.* at 64.

148. Ms. Peak did not present any evidence that the bank also failed to exercise ordinary care, thus creating no genuine issue of fact that warranted a trial. *See id.*

149. Indorsements made in circumstances where an imposter are involved are governed by subsection (a):

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

§ 3-404(a) (1990). For the imposter defense to be successful, the imposter must induce the issuer to issue the instrument to *the imposter* (or a person acting in concert with the imposter). This showing may sometimes be difficult. In a recent Illinois case interpreting this section, the nephew of an out-of-town uncle forged his uncle's signature on a maturity notice form for a certificate of deposit owned by the uncle, requesting that the CD be closed and the proceeds mailed to the uncle's address. *First Nat'l Bank of Chi. v. MidAm. Fed. Sav. Bank*, 707 N.E.2d 673, 675-76 (Ill. App. Ct. 1999). After verifying the signature under its procedures, the bank, First National, sent a cashier's check made payable to the uncle for \$157,611.30, the amount of the CD, to the address. *Id.* The nephew forged the uncle's indorsement and deposited the check into his account at MidAmerica, the depository bank. *Id.*

The theft was discovered when the uncle returned and discovered that the CD had been closed. *Id.* Since the uncle's indorsement had been forged, a replacement check was issued by First National, who then asserted that MidAmerica breached its presentment warranty, because of the forged indorsement. *Id.* MidAmerica raised the imposter rule as a defense. *Id.* at 677. The court found that section 3-404(a) was not applicable because there was no evidence that the nephew impersonated the uncle, and because the nephew did not induce First National to issue the instrument to the nephew. *Id.* at 677-78. Rather, the check had been issued in the uncle's name and sent to the uncle's address. *Id.* at 678.

150. Case law following the revisions has established that there must be an *impersonation* of an actual agent, rather than a mere misrepresentation of agency status, for this section to apply. *See Lewis v. Tel. Employees Credit Union*, 87 F.3d 1537, 1550 (9th Cir. 1996); *King v. White*, 962 P.2d 475, 481 (Kan. 1998). Where a forged document is used to obtain a negotiable instrument which is then indorsed, courts are divided on whether an "impersonation" has occurred. *Compare Minster State Bank v. Bay-Bank Middlesex*, 611 N.E.2d 200, 202 (Mass. 1993) (finding that a forged document creates viable imposter defense), *with Advocate Health & Hosps. Corp. v. Bank One*, 810 N.E.2d 500, 506-08 (Ill. App. Ct. 2004) (finding that a forged document is insufficient for "impersonation," and discussing relevant case law, *appeal denied*, 823 N.E.2d 962 (Ill. 2004) (unpublished table decision)).

example, “Pay to the order of UNICEF”), and the imposter merely made a representation that he was an agent of that principal (“I am vice-chair of UNICEF”), the indorsement in the name of the principal was considered ineffective in passing title. The issuer would then have a claim that the check was not properly payable because the principal did not indorse the instrument. Under the 1990 U.C.C., such indorsements are considered effective and the issuer has no basis for claiming improper payment.¹⁵¹

Instruments that involve fictitious payees are covered in subsection (b) of section 3-404.¹⁵² That subsection applies to circumstances where “a person whose intent determines to whom an instrument is payable . . . does not intend the person identified as payee to have any interest in the instrument” and to circumstances where the payee “is a fictitious person.”¹⁵³ If this is the case, any person in possession of the instrument is a holder,¹⁵⁴ and “[a]n indorsement by any person in the name of the payee stated in the instrument is effective . . . in favor of a person who, in good faith, pays the instrument or takes it for value or for collection.”¹⁵⁵

The revisions brought an entirely new defense for employee fraud, which was once handled only by the fictitious payee rule in the original U.C.C. Under new section 3-405, where an employer entrusts an employee¹⁵⁶ with responsibility with respect to an instrument and the employee makes a fraudulent indorsement, the indorsement is effective against a person who in good faith paid the instrument or took it for value or collection.¹⁵⁷ *Responsibility* with respect to instruments is very broadly defined to cover most acts in a responsible capacity regarding instruments, but it must be more than allowing mere access to instruments though the handling of the mail and the like.¹⁵⁸ As a new defense, it is an open issue as to how broadly courts might interpret this definition. The limited case law discussing the specific issue of “responsibility” suggests, however, that courts are giving the term the expansive meaning intended.¹⁵⁹

151. This change in the law is discussed in the second paragraph of section 3-404, cmt. 1.

152. *Id.* § 3-404.

153. *Id.* § 3-404(b)(i)-(ii). For a discussion of the term “holder,” see *supra* note 83.

154. § 3-404(b)(1).

155. *Id.* § 3-404(b)(2).

156. An “employee” is defined to “include[] an independent contractor and employee of an independent contractor retained by the employer.” *Id.* § 3-405(a)(1).

157. *Id.* § 3-405(b).

158. As defined by the U.C.C.,

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

Id. § 3-405(a)(3).

159. See *Schrier Bros. v. Golub*, 123 F. App’x 484, 487-89 (3d Cir. 2005) (finding that salesperson

A *fraudulent indorsement* under the new employee fraud defense includes either (1) the employer's indorsement on a third party check, or (2) the payee's indorsement on the employer's check.¹⁶⁰ Thus, if a bookkeeper forges the employer's indorsement of a check made payable to "Employer Corp.," the indorsement would be a "fraudulent indorsement" rendered effective under this defense. If the bookkeeper forges an indorsement on a check issued to a third party, that also is a "fraudulent indorsement" which is considered effective under the defense. If the remaining requirements of the employee fraud defense are met, the indorsement would be effective in either case and the plaintiff would bear the loss.

Sections 3-405 and 3-404 each include provisions which are intended to address the problem of a thief's failure to indorse the instrument in the exact name of the payee or failure to indorse the instrument prior to depositing the check.¹⁶¹ Where the name is not the "mirror image" of the payee's name, or where the instrument is not indorsed, the issuer or owner could try to seize upon this defect as a basis for asserting bank liability. The revisions now effectively cut off these arguments by providing that indorsements that are "substantially similar" to the name of the named payee fall within the defenses.¹⁶² Thus, if a check is made payable to Texas Insurance Agency, Inc. and the thief indorses it "Texas Insurance,"¹⁶³ the irregularity in the indorsement is not a cause for complaint. However, checks made payable to

authorized to accept payments had "authority"); *Smith v. AmSouth Bank, Inc.*, 892 So. 2d 905, 911 (Ala. 2004) (finding that employee had responsibility under section 3-405 and that factors in section 3-405(a)(3) are disjunctive rather than conjunctive); *Med Data Serv. Bureau, L.L.C. v. Bank of La. in New Orleans*, 898 So. 2d 482, 490 (La. Ct. App. 2004) (finding that mere access to instruments, without more, is insufficient to establish responsibility); *Cable Cast Magazine v. Premier Bank Nat'l Ass'n*, 729 So. 2d 1165, 1167 (La. Ct. App. 1999) (finding that employee had responsibility); *Halla v. Norwest Bank Minn.*, 601 N.W.2d 449, 452-53 (Minn. Ct. App. 1999) (finding that an employee of real estate company responsible for collecting rent and damage deposits had responsibility over the instruments). However, as stated in the last sentence to section 3-405(a)(3), simple access that employees might have to the employer's checks is insufficient to establish "responsibility." *Duong & Assocs. v. Bank One*, 169 S.W.3d 246 (Tex. App. 2005) (reversing summary judgment in favor of bank due to lack of evidence on "responsibility"), *reh'g en banc denied*, 2005 Tex. App. Lexis 4939 (Tex. Ct. App. June 23, 2005).

160. U.C.C. § 3-405(a)(2).

161. *Id.* §§ 3-404(c), 3-405(c).

162. Section 3-405(c) addresses this situation:

[A]n indorsement is made in the name of the person to whom an instrument is payable if (i) it is made in a name substantially similar to the name of that person or (ii) the instrument, whether or not indorsed, is deposited in a depository bank to an account in a name substantially similar to the name of that person.

Section 3-404 has an identical provision. *Id.* § 3-404(c).

163. *See Basse Truck Line, Inc. v. First State Bank, Bandera, Tex.*, 949 S.W.2d 17, 19 (Tex. App. 1997). In *Basse Truck Line*, the court addressed a case governed by the original U.C.C. but decided after the revisions to Articles 3 and 4 had been enacted by the Texas legislature. *Id.* at 20. The plaintiff, whose indorsement was forged, argued, among other things, for a mirror image rule for indorsements—an argument that the court rejected. *Id.* at 19-20. Yet, the court determined that the U.C.C. revisions adopted by the Texas legislature would make the mirror image rule "immediately obsolete." *Id.* at 20; *see also Knight Publ'n Co. v. Chase Manhattan Bank*, 479 S.E.2d 478, 483-84 (N.C. Ct. App. 1997) (applying Revised Article 3's "substantially similar" test although the original article controlled when the incident occurred).

“McMullen Oil Co.” deposited into an account in the name of McMullen Oil Co. Pension Plan would not meet the substantially similar test.¹⁶⁴

Beyond the expansion of defenses in the bank’s favor through the addition of the new employee fraud defense, a change in the requirement that only a bank exercising ordinary care could assert a defense adds to the overall pro-bank slant of the revisions. A bank now must only establish that it paid or took the instrument in “good faith” to raise these defenses. Thus, the question of the bank’s good faith, or lack thereof, in taking or paying the instrument becomes relevant. It is not surprising, therefore, to observe that the issue before some courts after the revisions is an attempt to limit the effect of the defenses by establishing that the customer may avoid the defense with a showing that the bank failed to exercise ordinary care¹⁶⁵ or failed to pay the instrument in good faith.¹⁶⁶ In *San Tan Irrigation District v. Wells Fargo Bank*,¹⁶⁷ the plaintiff was a corporate payee whose employee had forged the company’s indorsement and deposited the checks in her personal account at Wells Fargo Bank.¹⁶⁸ The company sued for conversion.¹⁶⁹ The Arizona Court of Appeals found that Wells Fargo’s good faith was relevant to be considered at trial, and that good faith was to be determined by the new subjective and objective standards established by the revisions.¹⁷⁰ However, the court expressly made it clear that the definitions of “good faith” and “ordinary care” were not coextensive.¹⁷¹

To summarize, the revisions expand the negligence defenses available to banks. The new section 3-405, addressing employee fraud specifically, and the revisions to section 3-404 provide additional defenses for a defendant/bank’s arsenal. In addition, banks who themselves have failed to exer-

164. *In re McMullen Oil Co.*, 251 B.R. 558, 576 (Bankr. C.D. Ca. 2000).

165. *See* *Espresso Roma Corp. v. Bank of Am.*, 124 Cal. Rptr. 2d 549, 552-56 (Cal. Ct. App. 2002) (discussing and analyzing evidence of bank’s exercising ordinary care); *Daley Contr. Co. v. Petrucelli*, No. CV980358418, 2003 WL 553324, at *3 (Conn. Super. Ct. Feb. 5, 2003) (suggesting that a showing of lack of ordinary care may prevent the bank from using the preclusion of section 4-406(d)).

166. *See* *U.S. Fid. & Guar. Co. v. Bank of Bentonville*, 29 F. Supp. 2d 553 (W.D. Ark. 1998) (section 3-405 case); *Gerber & Gerber, P.C. v. Regions Bank*, 596 S.E.2d 174 (Ga. Ct. App. 2004); *Bank/First Citizens Bank v. Citizens & Assocs.*, 82 S.W.3d 259 (Tenn. 2002) (section 3-406 case); *San Tan Irrigation Dist. v. Wells Fargo Bank*, 3 P.3d 1113 (Ariz. Ct. App. 2000) (section 4-406 case); *Halla v. Norwest Bank Minn.*, 601 N.W.2d 449 (Minn. Ct. App. 1999).

167. *San Tan Irrigation Dist.*, 3 P.3d 1113.

168. *Id.* at 1114.

169. *Id.* at 1115.

170. *Id.* at 1116-17.

171. *Id.*; *see also* U.C.C. § 3-103 cmt. 4 (1990) (stating that good faith “is concerned with the fairness of conduct rather than the care with which an act is performed”). The standard for ordinary care is discussed *infra* in the text accompanying notes 177-182. Because good faith addresses the fairness of conduct rather than the degree of care exercised, arguably proving a lack of good faith in the usual case is more difficult than proving a failure to exercise ordinary care. Usually a bank involved in situations of fraud has failed to be careful rather than acted unfairly. *Cf.* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 16-3, at 574 (5th ed. 2000) (examining distinction between acting carelessly and acting unfairly). However, the inclusion of “reasonable commercial standards” in the definition of good faith (albeit that those standards are of “fair dealing”) opens the way for some courts to conflate duties of good faith and ordinary care. *See* *Buckeye Check Cashing, Inc. v. Camp*, 825 N.E.2d 644, 647 (Ohio Ct. App. 2005) (finding that the objective component of the good faith definition requires acting “in a responsible manner”).

cise ordinary care are permitted to raise defenses, a significant modification from the position taken under the original U.C.C. Even if a negligent bank successfully can employ a defense to shift the loss to the plaintiff, the bank may still be liable for the consequences of their negligent acts, at least under the revisions as drafted. The standard of care for banks in handling checks is addressed by new comparative negligence causes of action available to the party that raised the original claim, usually the customer or the owner of an instrument. The next section addresses these new actions and the standard of ordinary care for banks.

2. *Comparative Negligence "Causes of Action"*

If a defendant successfully raises one of the defenses just discussed, the party against whom that defense applies may have a claim based on the defendant's own negligence. For example, assume that a payor bank successfully asserts that the drawer's failure to exercise ordinary care substantially contributed to the making of a forged drawer's signature. Under the earlier contributory negligence scheme, the negligent drawer would bear the entire loss. However, under revised section 3-406, the drawer (which is "the person precluded" in the following language) has a claim against the bank (which is "asserting the preclusion" in the following language):

[I]f the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure substantially 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.¹⁷²

In other words, if a claimant against whom the defense applies can establish that the other party asserting the defense also failed to exercise ordinary care, the loss is allocated among the negligent parties according to their respective fault. Sections 4-406 (Bank Statements),¹⁷³ 3-404 (Imposters and Fictitious Payees),¹⁷⁴ and 3-405 (Employee Fraud)¹⁷⁵ contain similar provi-

172. U.C.C. § 3-406(b). The burden of proof in this case is on the party precluded, that is, the party against whom the defense is raised in the first instance. *Id.* § 3-406(c).

173. Section 4-406(e) provides:

If subsection (d) applies and the customer proves that the bank failed to exercise ordinary care in paying the item and that the failure substantially contributed to loss, the loss is allocated between the customer precluded and the bank asserting the preclusion according to the extent 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. If the customer proves that the bank did not pay the item in good faith, the preclusion under subsection (d) does not apply.

174. 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 substantially contributes to loss resulting from pay-

sions permitting loss shifting where the defenses apply. The envisioned result anticipated is one based on comparative, rather than the contributory, negligence.

The comparative negligence cause of action may seem, at a superficial level, to provide (admittedly negligent) customers with ample leverage to shift at least part of the loss back to the negligent banks involved. However, the new definition of ordinary care in the revisions disarms this weapon significantly. As discussed earlier, substantial case law had arisen under the original U.C.C. regarding the duty of banks to examine checks sent for payment as part of their duty of ordinary care.¹⁷⁶ The revisions answer that question decidedly in favor of the banks through the new definition:

“Ordinary care” in the case of a person engaged in business means observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged. In the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank’s prescribed procedures and the bank’s procedures do not vary unreasonably from general banking usage not disapproved by this Article or Article 4.¹⁷⁷

As can be seen, the second sentence of this definition expressly releases banks from any general duty to examine checks where it takes the “instrument for processing for collection or payment by automated means,” as long as the failure to examine does not contravene an established procedure that itself does not vary unreasonably from general banking usage.¹⁷⁸ Because payor banks generally use such means in the payment process, this sentence relieves them from examining checks, as was required in some jurisdictions under the prior law.¹⁷⁹ The general standard of “ordinary care” in the first sentence of the definition also suggests that adherence to local business standards and practices can be equated with the exercise of ordinary care, even if those practices are not necessarily in the customer’s interest.¹⁸⁰ If

ment 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.

175. Section 3-405 provides:

If the person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss resulting from the fraud, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.

Id. § 3-405(b) (1990).

176. See *supra* text accompanying notes 124-128.

177. U.C.C. § 3-103(a)(9).

178. *Id.*

179. See *supra* text accompanying notes 125-128.

180. See Zekan, *supra* note 16, at 171.

this is the case, adhering to a standard of “whatever anyone else is doing” can be viewed as the exercise of ordinary care.¹⁸¹ For these reasons, the new definition was the focus of some criticism after the revisions, since the new definition can be perceived as a wholesale release of banks from any strong obligation of ordinary care, as ordinarily understood.¹⁸²

The litigation in the years following the revisions suggests that the new definition is having the impact anticipated by its critics. Because the new definition limits a party’s ability to argue that a payor bank’s failure to examine checks presented for payment constitutes a lack of ordinary care, which was the primary topic of debate in pre-revision cases, the focus of litigation has moved away from the question of the ordinary care of the payor bank. However, because the new definition provides a safe harbor only for payor banks that pay checks in accordance with their procedures, some room for debating the ordinary care of the payor bank still exists. Payor banks are not completely absolved of any responsibility for their acts even in light of the new definition. For example, the bank in *Travelers Indemnity Co. v. Good*,¹⁸³ had a policy of verifying any check in excess of \$5,000, which would have included the checks forged in that case.¹⁸⁴ The bank established that it trained employees and supervisors in the check clearing department in the verification process.¹⁸⁵ Although the trial court granted summary judgment for the bank on the issue of whether the bank exercised ordinary care, the New Jersey Appellate Division reversed the grant of summary judgment.¹⁸⁶ The bank had done little more than provide to the court evidence of its stated policy.¹⁸⁷ The appellate court found this evidence was insufficient to warrant summary judgment, and the plaintiff¹⁸⁸ was allowed to further explore the bank compliance with its stated policy in the case of the forged checks at issue and the adequacy of the training provided by the bank to its employees.¹⁸⁹

In spite of occasional cases such as *Traveler’s*, where the court finds room for assessing the payor bank’s conduct at trial, the new definition of “ordinary care” is having the definite impact of limiting possible negligence claims against the payor bank. The impact can be seen in *Expresso Roma*

181. The “commercial standards” adhered to must be reasonable, indicating that the prevailing local practice must still be reasonable, viewed objectively. The comments to the definition support this view and state that “[n]othing in Section 3-103(a)(9) is intended to prevent a customer from proving that the procedures followed by a bank are unreasonable, arbitrary, or unfair.” U.C.C. § 3-103 cmt. 5.

182. See, e.g., *Zekan*, *supra* note 16, at 166-76; see also *Hillebrand*, *supra* note 16, at 697-98 (suggesting that the new definition might insulate banks from liability).

183. 737 A.2d 690 (N.J. Super. Ct. App. Div. 1999).

184. *Id.* at 692.

185. *Id.*

186. *Id.* at 696.

187. *Id.*

188. The victim in the case was a law firm, whose bookkeeper had forged eight checks totaling \$76,975. *Id.* at 692. The plaintiff was Travelers, who paid out the losses under the firm’s insurance policy and was subrogated to the insured’s rights against one of the defendants, PNC Bank. *Id.*

189. *Id.*

Corp. v. Bank of America.¹⁹⁰ A bookkeeper at Expresso Roma forged over \$330,000 in company checks over a three-year period.¹⁹¹ After discovery of the theft, the company brought an action against the drawee bank.¹⁹² The court found that the record did not create an issue of fact regarding the bank's ordinary care.¹⁹³ Under the "bulk file bookkeeping" procedures adopted by Bank of America in California,¹⁹⁴ fraud filters were not designed to catch forged employee signatures.¹⁹⁵ In support of its motion for summary judgment, the bank submitted a declaration of its witness, an expert in bank collections, who asserted that the bank's processing procedures were consistent with other banks in California.¹⁹⁶ The court found this affidavit sufficient to warrant summary judgment, and rejected the customer's claim that practices of banks of other sizes, such as digital imaging or signature cards, should have been compared to Bank of America's process.¹⁹⁷ Rather, the standard for reasonable commercial standards was that set by *comparable* banks,¹⁹⁸ in this case large banks in California. Since the bank's expert provided uncontroverted evidence on that matter, there was no genuine issue of fact for trial.¹⁹⁹

While cases like *Expresso Roma* might cause business customers to consider moving their accounts to smaller or specialty banks that might provide a higher level of fraud protection, *Arney v. Glendale Federal Bank*,²⁰⁰ suggests that such a move might prove fruitless in an era of bank mergers. In *Arney*, the corporate customer had been victimized by the forgery of more than seventy corporate checks.²⁰¹ The business argued that it specifically had chosen the payor bank because smaller banks could provide more personal service, including knowing the business owner and recognizing his signature, which would lead to a lower probability of payment over fraudulent signatures.²⁰² On several occasions the bank manager had called the business owner to verify signatures on particular checks.²⁰³ After the bank merged with a larger bank, the bank apparently stopped making signature

190. 124 Cal. Rptr. 2d 549 (Cal. Ct. App. 2002).

191. *Id.* at 550.

192. *Id.*

193. *Id.* at 556. The issue of ordinary care was relevant because, under the court's analysis, a demonstration that the bank failed to exercise ordinary care would preserve the customer's claim even though it had failed promptly to notify the bank after receipt of its statements. *See id.* at 552; *infra* notes 371-379 and accompanying text (discussing this line of litigation).

194. *Express Roma Corp.*, 124 Cal. Rptr. 2d at 553.

195. *Id.* at 553-54.

196. *Id.*; *see also* *Spacemakers of Am., Inc. v. SunTrust Bank*, 609 S.E.2d 683 (Ga. Ct. App. 2005) (granting summary judgment to bank due to its offered evidence that industry standards had been met and a lack of evidence establishing its failure to exercise ordinary care).

197. *Expresso Roma Corp.*, 124 Cal. Rptr. 2d at 553-54.

198. *See* U.C.C. § 4-406 cmt. 4 (1990) (suggesting that comparable banks be the standard for ordinary care).

199. *Expresso Roma Corp.*, 124 Cal. Rptr. 2d at 554-55.

200. No. B138813, 2001 WL 1613811 (Cal. Ct. App. Dec. 18, 2001).

201. *Id.* at *1.

202. *Id.* at *2.

203. *Id.*

comparisons.²⁰⁴ The customer claimed he relied on the bank's representation that it would conduct sight review of his checks.²⁰⁵ The court dismissed the customer's estoppel claim, stating that the customer could not show justifiable reliance on the bank's earlier practices.²⁰⁶

It is somewhat easier to establish in litigation the lack of ordinary care on the part of depository banks than for payor banks. The Official Comments to the revisions suggest that a depository bank may be a likely target for a claim that a bank in the collection process failed to exercise ordinary care.²⁰⁷ In all respects depository banks receive far less shelter under the definition of ordinary care than that generously afforded to payor banks. This is in large part because, even if a depository bank uses automated systems to process checks,²⁰⁸ it still often engages in face-to-face contact with the embezzler.²⁰⁹ Although there is no general duty to question customers in transactions,²¹⁰ the surrounding facts and circumstances of the relations between the thief and the depository bank may support a claim that the depository bank failed to exercise ordinary care. Ordinary care issues related to the depository bank's actions may exist where the depository bank violates its own internal policies in handling a check²¹¹ or where it accepts a check

204. *Id.*

205. *Id.*

206. *Id.* at *5; *see also* Kiernan v. Union Bank, 55 Cal. App. 3d 111 (Cal. Ct. App. 1976) (establishing that no estoppel action exists in similar circumstances under the pre-revision U.C.C.); Weber, Leicht, Gohr & Assocs. v. Liberty Bank, 620 N.W.2d 472 (Wis. Ct. App. 2000) (denying a misrepresentation claim based on alleged statements that sight review would be conducted). These courts overlook the issue of whether the bank-depositor agreement, properly interpreted in light of the parties' course of performance, included a term requiring sight review. *See* U.C.C. § 1-201(b)(3) (Revised 2001) ("'Agreement', as distinguished from 'contract', means the bargain of the parties in fact, as found in their language or inferred from other circumstances, including course of performance, course of dealing, or usage of trade as provided in Section 1-303."); *Id.* § 1-303 (defining course of performance).

207. *See* U.C.C. § 3-405 cmt. 4 (1990) (discussing the ways in which depository banks may fail to exercise ordinary care), § 3-406 cmt. 4 (discussing the ways in which depository banks may fail to exercise ordinary care).

208. *See supra* notes 60-62 and accompanying text.

209. Daley Constr. Co. v. Petrucelli, No. CV9803578418, WL 553324, at *3 (Conn. Super. Ct. Feb. 5, 2003) (citing 2 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 19-3, at 251-52 (4th ed. 1995)). In some rarer cases, the depository bank might in fact use automated means for deposit. *See, e.g.,* Grand Rapids Auto Sales, Inc. v. MBNA Am. Bank, 227 F. Supp. 2d 721, 726 (W.D. Mich. 2002) (explaining system in which a credit card bank used wholly automated means to process checks sent for payment of credit card bills).

210. Meng v. Maywood Proviso State Bank, 702 N.E.2d 258, 265 (Ill. App. Ct. 1998) (finding no duty to question the depositor in cases involving cashier's checks).

211. Mahaffy & Assocs. v. Long, 52 U.C.C. Rep. Serv. 2d 477, 484 (Del. Super. Ct. 2003) (determining that allegations against Bank for failure to follow standard procedures were sufficient to raise questions of fact on bank's ordinary care); Hunter's Modern Appliance, Inc. v. Bank IV Okla., 949 P.2d 701, 703-04 (Okla. Civ. App. 1997) (holding that a question of fact existed regarding the bank's exercise of ordinary care because the bank violated its published internal operating procedures when it cashed checks made payable to the company but cashed by an employee). *But see* Smith v. AmSouth Bank, Inc., 892 So. 2d 905, 912 (Ala. 2004) (finding that a bank's failure to follow its established policy was insufficient evidence of failure to exercise ordinary care). The *Smith* case appears contrary to the U.C.C.'s implication, found in the definition of ordinary care, that the violation of a bank's prescribed procedures for examining checks is relevant to the issue of whether or not ordinary care was exercised in a particular case. *See* U.C.C. § 3-103(a)(9) (quoted in full *supra* text accompanying note 177). The language in the definition specifically addresses only situations where the violated procedures involve sight examination. But, the reflected principle is that a failure to abide by procedures is relevant to the issue of ordinary

without an indorsement.²¹² At least one court has found that negligence as a matter of law can be established if a bank does not require the thief to present identification when cashing checks.²¹³ Courts also are receptive to circumstances in which a depository bank could have been put on notice that a theft was occurring, such as where the thief cashes all checks at one teller's window²¹⁴ or where the size of checks written and deposited by a faithless bookkeeper indicated that embezzlement was occurring.²¹⁵

Most often, however, the negligence argument will be raised by the bank and be based upon the customer's (either drawer's or owner's) behavior, rather than the customer raising the issue against the bank. The case law indicates, not surprisingly, a wide variety of circumstances that may support the bank's argument. Where the victim is a corporation, abundant facts often may exist to establish such a defense, usually based on the lack of care demonstrated in supervising the affairs of the business. A failure to monitor a partner states a defense in negligence.²¹⁶ As seen in the argument raised by the bank in *Clean World Engineering, Ltd. v. MidAmerica Bank*,²¹⁷ discussed earlier,²¹⁸ an employer's alleged failure to screen its employees coupled with a failure to keep checks in a locked container might expose the employer to a bank's defense of negligence.²¹⁹

Although the vast majority of cases decided under the revisions involve corporate embezzlements and fraud, negligence can also be an issue in recent consumer cases. In the consumer context, the impact of the changes to the definition of ordinary care can be quite significant, most particularly where elderly or ill customers are involved. A recent case, *Mercantile Bank of Arkansas v. Vowell*,²²⁰ is a classic example of a bank's allegation of consumer negligence. The bank's customers allowed their daughter, whom they knew was involved in drugs and writing bad checks, to live with them.²²¹

care.

212. *Schmitz v. Firststar Bank Milwaukee*, 664 N.W.2d 594, 596 (Wis. 2003). *Contra Am. Parkinson Disease Assoc. v. First Nat'l Bank of Northfield*, 584 N.W.2d 437, 439 (Minn. Ct. App. 1998) (finding that it is not a commercially unreasonable practice to accept checks without payee's indorsement). While section 4-205 allows a depository bank to supply an indorsement, it only allows a bank to supply the missing indorsement of the customer. U.C.C. § 4-204 (1990). The *Schmitz* case refused to extend this section to situations in which the bank takes an unindorsed check from a thief. *Schmitz*, 664 N.W.2d at 596.

213. *Atl. Mut. Ins. Co. v. Provident Bank*, 669 N.E.2d 901, 904 (Ohio Mun. Ct. 1996).

214. *Daley Constr. Co.*, 34 Conn. L. Rptr. at 144.

215. *Johnson Dev. Co. v. First Nat'l Bank of St. Louis*, 999 S.W.2d 314 (Mo. Ct. App. 1999).

216. *DiMase v. Fleet Nat'l Bank*, 723 A.2d 765 (R.I. 1999) (restrictive indorsement case).

217. 793 N.E.2d 110 (Ill. App. Ct. 2003).

218. *Supra* text accompanying notes 87-102 (*Clean World* case).

219. The court rejected the argument that the employer's conduct in that case constituted negligence. 793 N.E.2d at 112; *see supra* text accompanying note 100. The bank in any case must show that the procedures implemented by the business or the duties given to the employee were not "commercially reasonable" considering similar businesses in the area. *See supra* text accompanying note 177 (defining "ordinary care"). For a case finding that a failure to supervise was negligence as a matter of law, *see Atlantic Mutual Insurance Co. v. Provident Bank*, 669 N.E.2d 901, 904 (Ohio Mun. Ct. 1996).

220. 117 S.W.3d 603 (Ark. Ct. App. 2003).

221. *Id.* at 605.

The daughter had forged her parents' signatures on checks in the past.²²² The parents took only nominal precautions against further thefts by hiding the wife's purse and checkbook under the kitchen sink.²²³ Although the wife was a diabetic and an alcoholic, the husband relied on the wife to review the monthly bank statements and to balance the checkbook.²²⁴ The daughter forged forty-two checks and made a number of unauthorized ATM withdrawals.²²⁵ The trial court found, affirmed by a majority of the appellate court, that the couple took proper precautions to safeguard their checks from their daughter.²²⁶

As *Vowell* suggests, elderly and infirm account holders can be particularly vulnerable targets for victimization by unscrupulous relatives and acquaintances who forge checks on the account.²²⁷ This may expose the account holder, or their executor or legal caregiver, to a claim of negligence by alleging that proper steps should have been taken to ensure proper handling of the financial affairs of the victim.²²⁸ While merely allowing family members access to checks has been found insufficient to establish a lack of ordinary care,²²⁹ additional facts, such as those seen in *Vowell*, might exist to support and strengthen a bank's argument that the consumer failed to exercise ordinary care. If successful, the defense will preclude the customer's claim against the bank. The revisions, therefore, pose a double threat for consumers, particularly elderly or disabled consumers. First, they are often unable to argue the bank's ordinary care duties, which are now circumscribed by the new definition. Second, they face significant exposure

222. *Id.*

223. *Id.*

224. *Id.*

225. *Id.* at 607.

226. *Id.* at 608. A concurring opinion disagreed strongly with the appellate court's finding that the trial court committed no error in these circumstances:

[T]here is ample evidence that appellee and his wife, as joint account holders, failed to exercise ordinary care and thus substantially contributed to the forgeries. In fact, the trial court found that appellee left the monitoring of all account activities to his very ill wife, that both he and his wife knew of the propensities of their daughter, and that their entire attempt to protect their check books consisted in hiding the purse and the books under the kitchen sink. . . .

It is quite understandable that loving parents will try to provide shelter to their prodigal children, even though the children remain unrehabilitated from propensities that are unsavory. Nevertheless, the decision to house a thieving relative does not absolve one of the duty to exercise common sense regarding family valuables.

Id. at 615 (Griffen, J., concurring).

227. *E.g.*, *Mac v. Bank of Am.*, 90 Cal. Rptr. 2d 476 (Cal. Ct. App. 1999); *Scott v. Mellon Bank*, No. 02-06-0003, 2003 WL 22931335 (Del. Ct. Com. Pl. Aug. 8, 2003), *aff'd sub nom.*, *Mellon Bank v. Scott*, No. Civ.A. 03A-09-002JTV, 2004 WL 2828055 (Del. Super. Ct. Apr. 29, 2004); *Henrichs v. Peoples Bank*, 992 P.2d 1241 (Kan. Ct. App. 1999); *Marx v. Whitney Nat'l Bank*, 713 So. 2d 1142 (La. 1998); *Peak v. Tuscaloosa Commerce Bank*, 707 So. 2d 59 (La. Ct. App. 1997); *Hancock Bank v. Ensenat*, 819 So. 2d 3, 13 (Miss. Ct. App. 2001); *Hollywood v. First Nat'l Bank of Palmerton*, 859 A.2d 472, 474-75 (Pa. Super. Ct. 2004), *appeal denied sub nom.*, *Estate of Hollywood v. First Nat'l Bank of Palmerton*, 876 A.2d 396 (Pa. 2005) (unpublished table decision). The *Peak* case is discussed *supra* text accompanying notes 140-148.

228. *See Hancock Bank*, 819 So. 2d at 13.

229. *See Marx*, 713 So. 2d at 1142; *see also Scott*, 2003 WL 22931335, at *3 (giving girlfriend access to checking account during disability is insufficient to establish a lack of ordinary care).

for their own failures to exercise ordinary care. Although the vast majority of decided cases involve businesses, the potential effect of the new definition in the consumer context should not be understated. Unlike businesses, ordinary consumers will not have insurance to cover such theft losses, and the consumers will be left absorbing the losses themselves. In addition, many consumers do not have the resources to litigate the issue of ordinary care effectively.²³⁰ While cases such as *Vowell* often are—quite appropriately—coming down on the consumer’s side, courts should be sensitive to consumer interests when evaluating matters of ordinary care.

C. Summarizing the Revisions

A brief summary of these rather intricate causes of action, defenses, and counteractions is in order. The process might best be envisioned as one involving three steps: (1) the initial cause of action, based on either section 4-401 or section 3-420,²³¹ (2) where available under the facts, the defendant’s defenses, based on sections 3-404,²³² 3-405,²³³ 3-406,²³⁴ and 4-405,²³⁵ and (3) where available under the facts, the original plaintiff’s comparative negligence cause of action claim. In spite of the formal elegance of these provisions, case law applying them to the point of actually allocating the losses among the parties is rare.²³⁶ *Atlantic Mutual Insurance Co. v. Provident Bank*²³⁷ is one of the few post-revision cases to arrive at a pro rata loss allocation among the parties involved. In *Atlantic Mutual*, an employee forged the signature of the employer on two checks made payable to a fictitious person.²³⁸ The thief indorsed the checks in the name of the payee and cashed them at The Provident Bank, apparently also the payor bank.²³⁹ The company’s insurance company sued the bank. Recognizing that the items were not properly payable, the court then turned to section 3-406 and examined

230. See Rubin, *supra* note 48, at 569 (“[C]onsumers can virtually never enforce their rights against a bank because it will simply be too expensive to do so.”).

231. U.C.C. § 4-401 (1990); U.C.C. § 3-420 (1990).

232. *Id.* § 3-404.

233. *Id.* § 3-405.

234. *Id.* § 3-406.

235. U.C.C. § 4-405.

236. While the Code envisions allocating losses among responsible parties other than the thief, a state proportionate fault statute might permit joinder of a party, such as the thief, to determine the parties’ percentage of responsibility. Or, the state’s comparative negligence laws, generally, might conflict with the principles of the Code. The question then arises whether the non-U.C.C. statute should apply to allocate losses under the Code, thus reducing a bank’s potential exposure in the usual case. Courts to date have rejected the incorporation of state comparative or proportionate fault rules when they conflict with the Code. See *Sw. Bank v. Info. Support Concepts, Inc.*, 149 S.W.3d 104 (Tex. 2004) (refusing to require joinder of the thief as a responsible third party and extensively discussing the case law in this area).

237. 669 N.E.2d 901 (Ohio Mun. Ct. 1996); see also *Rodrigue v. Olin Employees Credit Union*, 406 F.3d 434, 448-53 (7th Cir. 2005) (affirming district court’s allocation of 10% loss to drawer and 90% loss to credit union); *Bank/First Citizens Bank v. Citizens & Assocs.*, 82 S.W.3d 259, 260 (Tenn. 2002) (stating that lower courts allocate losses 80% to drawer and 20% to payor bank).

238. 669 N.E.2d at 902.

239. *Id.*

the parties' respective negligence in the case.²⁴⁰ The court found that the company was negligent as a matter of law for failing adequately to check the background of its employees and for not keeping its check paper in a locked place.²⁴¹ Thus, the company was precluded from raising the unauthorized signatures.²⁴² However, the court also found that the bank was negligent in failing to obtain identification from the thief prior to cashing the checks.²⁴³ Therefore, the bank also was negligent.²⁴⁴ The court concluded that "both [shall] wallow equally in the fruits of their failures" and allocated the loss equally between the company and the bank.²⁴⁵

When carried out to their full effect, as in *Atlantic Mutual*, the revisions represent a substantial shift from the position taken by the original U.C.C. For example, the ability of banks to raise defenses is no longer subject to a condition that they themselves have exercised ordinary care. Rather, the current standard for raising defenses is one of "good faith" in taking or paying the instrument. The number of possible defenses has been expanded to specifically address employee fraud and to place many of those types of losses on employers. Finally, there are new comparative negligence actions available to parties against whom the defenses apply, but there is also a new definition of ordinary care that insulates banks from claims that the bank failed to exercise ordinary care.

The revisions were undoubtedly a significant and controversial shift in the policy underlying the allocation of check fraud losses. As the discussion thus far has implied, in some cases courts have had relative ease in applying the new structure to actual instances of theft. However, in other areas, within a short period after enactment, substantial disagreement has risen in the case law. In these respects the changes are not functioning effectively in the courts. The next section studies the key areas of conflict in recent litigation.

III. KEY CONFLICTS IN THE CASE LAW AFTER THE REVISIONS

The drafters hoped that the revisions to Articles 3 and 4 in 1990 might result in a reduction in litigation, because a reworked and clarified statute might facilitate the resolution of check fraud cases out of court.²⁴⁶ Litigation

240. *Id.* at 903-04.

241. *Id.* at 904.

242. *Id.*

243. *Id.* The company argued that the bank was negligent not only for not obtaining identification, but also because the payroll checks cashed by the thief were in amounts significantly over amounts for legitimate payroll checks cashed by the bank for other employees. *Id.* at 902. One check was not computerized, while ordinary payroll checks were all computerized. *Id.* Although the bank did not ask for identification in this case, on prior occasions the bank contacted the company before cashing employee payroll checks. *Id.*

244. *Id.*

245. *Id.* at 904.

246. *See* U.C.C. art. 3, Prefatory Note (1990) ("By clarification of troublesome issues, and by the provisions of Sections 3-404 through 3-406 which reform rules for allocation of loss from forgeries and alterations, the Revision should significantly reduce litigation."); Rapson, *supra* note 48, at 474 ("The

following the enactment of the revisions suggests that the revisions may have fallen far short of this goal in the check fraud area, considering the sizable number of cases that have emerged in the decade or so following enactment of the statute by state legislatures. Moreover, the post-revision case law indicates that there has been, at best, limited significance to the move to comparative negligence. This is because, as was just noted, many courts simply do not get to the point of sharing losses in the manner anticipated by the Code.²⁴⁷ A number of cases, to be discussed in this section, are being decided in favor of the banks on formalities, such as the plaintiff's failure to plead a viable claim for recovery against financial institutions²⁴⁸ and failure to comply with notice periods established under the bank statement defense or under the bank/depositor agreement.²⁴⁹

In short, financial institutions have been able to leverage their gains in the revision process with a body of case law that favors their interests. A statute that was criticized for its pro-industry bias after its approval by the NCCUSL and the ALI is being interpreted by many courts to accentuate, rather than ameliorate, that bias. As will be discussed in this Part III, a broad shift has occurred from the earlier system that often left check fraud losses in the banking system, even where customers were negligent. The loss allocation system under the revisions, as applied by the courts, is now one that can extremely favor the banking industry by placing the losses on the banks' customers. This can be the case even where the bank involved in a fraud itself has been negligent. Contrary to the comparative negligence principles that underlie the revisions, the case law demonstrates that the loss allocation rules are moving closer to a "winner take all" approach. As predicted by some commentators when the revisions were approved, the "winner" in the usual case is the bank.²⁵⁰

It is important to emphasize that, in a case where there is no evidence of negligence by the customer or other victim of check fraud, the banking system will still bear the loss irrespective of the banks' exercise of due care or failure thereof. As discussed previously, the general loss allocation rules place those losses absolutely within the banking system.²⁵¹ Where a customer reviews the statement sent by the bank in a timely manner and reports an unauthorized signature, for example, the bank statement defense will not provide a mechanism for the financial institution to shift the loss to the customer.²⁵² In such cases, the customer may bring a claim against the payor bank, if necessary, for paying an item not properly payable. Absent a show-

result should be a far more understandable and workable statute that will enable affected persons to allocate losses in a more just and equitable manner and to resolve their disputes without the need for protracted litigation.").

247. See *supra* note 237 and accompanying text.

248. See *infra* Part III.A.1.

249. See *infra* Part III.B.1.

250. See Ellis & Dow, *supra* note 16, at 74 (practical effect of revisions will be to place losses on customers); Zekan, *supra* note 16, at 179 (result of revisions is to pass loss to customers).

251. See *supra* text accompanying notes 49-118.

252. U.C.C. § 4-406 cmt. 2 (1990).

ing by the bank that the customer's negligence substantially contributed to the unauthorized signature, which may be difficult for the financial institution in many cases, the banking system will absorb the loss. In cases of corporate embezzlement, if a company has established adequate bookkeeping procedures that will alert the company to theft by employees, the banking system will also often be the loss-bearer, unless one of the defenses applies under the facts of the case.

Given that a certain number of events of check fraud do not involve provable negligence or trigger any of the defenses available to banks, the banking industry is still absorbing significant losses.²⁵³ To some extent, therefore, banks and other financial institutions still have some incentives to take precautions to minimize those inevitable losses. Given that the financial services industry has the resources and expertise to develop technology and procedures designed to reduce check fraud, it is sound policy to support such incentives.²⁵⁴ In cases where there is customer negligence, however, the recent cases suggest that losses are often being shifted almost entirely onto the customers.²⁵⁵ This is occurring not only because the new definition of ordinary care insulates payor banks from claims that a failure to examine the instrument constitutes a lack of ordinary care, thus paving the way for free use of the defenses by payor banks. In addition, as will be discussed in Parts III.A and III.B, case law that both rejects common law actions by the customers and that expansively interprets the bank statement defense has contributed to the shifting of losses to customers.²⁵⁶ The addition of powerful defenses for the banks, coupled with limited means of customers to shift those losses back into the banking system, has left customers bearing the loss.

In the most extreme cases of customer negligence, it is proper as a matter of policy that the law requires customers to bear the loss. Many reported cases suggest clearly negligent behavior by the customers, most particularly in the corporate context. For example, as will be discussed in Part III.B, the most significant defense that impacts customers' ability to raise claims is section 4-406, the bank statement defense. Timely review of one's bank statements is becoming a threshold for asserting bank liability under the Code, a threshold that is difficult for a substantial number of customers to meet.²⁵⁷ Unless a customer reviews their bank statement within thirty days of the bank's sending it, significant losses in a continuing fraud ultimately may be borne by the customer through the "same wrongdoer" rule. Should a customer fail to review a statement within a one-year period—a seemingly not uncommon event given the recent cases that involve exactly such a fail-

253. For recent data on, and analysis of, the current check-fraud-loss exposure of financial institutions, see Grengs & Adams, *supra* note 54, at 185-86.

254. *See id.* at 180, 184-86 (stating that the effect of *Price v. Neal* is to create incentives for payors to adopt fraud detection and deterrence procedures and technologies).

255. *See infra* Parts III.A & III.B.

256. *See infra* Parts III.A.1 & III.B.1.

257. *See infra* Part III.B.1.

ure²⁵⁸—that failure will lead to the customer bearing the complete loss. Given the relatively low cost of performing such a review, the current judicial trend toward imposing these losses on these most negligent customers, where the basic requirements of the bank statement defense have not been met, is appropriate. In these cases, the customer is clearly in the best position to protect against many losses through the timely and adequate review of their statements.

Consider companies which delegate both the payment and review functions to one party. This creates an environment facilitating a successful long term fraud, and in fact, in some instances, it is almost a requirement for a successful corporate theft.²⁵⁹ In addition to limiting the possibility of theft, statement review by multiple parties will usually allow quick discovery of the thefts and increase the chance of recovery against the bank. While requiring statement review involves some costs to businesses, particularly small businesses, this basic requirement is a significant measure which advances the effort to reduce the overall incidence of fraud.²⁶⁰

However, as will be discussed in this Part III, many cases have shifted to an even more extreme position beyond basic application of the bank statement defense and other aspects of the revisions, a position that is wholesale against customers and in favor of banks. This is a disturbing development: The underlying policy of the revisions clearly was to reject such a “winner take all” approach and to allocate losses on a percentage fault basis.²⁶¹ A clear conflict of case law with the policy supporting the revisions exists. The next sections argue in favor of a limited common law negligence action²⁶² that a drawer could raise against the depository bank, and the following sections also argue that the courts’ current tendency to validate agreements that shorten the period of limitations under the bank statement defense of section 4-406²⁶³ is erroneous and inconsistent with the underlying policies of the U.C.C.²⁶⁴

A. *Viability of Common Law Claims*

1. *Sources of the Dispute Over Common Law Claims*

As discussed in Part I, one goal of the revisions to Articles 3 and 4 was to cut down on causes of action not explicitly established by the exact language of the Code.²⁶⁵ In spite of this effort, recent cases indicate that ques-

258. See *infra* text notes 352-354.

259. Fisher, *supra* note 48, at 396 (“In a business, no single employee should have complete control over the flow of funds.”).

260. *Id.*

261. See, e.g., *id.* at 407; Rapson, *supra* note 48, at 460-61.

262. See *infra* Part III.A.

263. U.C.C. § 4-406 (1990). Section 4-406 is discussed *supra* text accompanying notes 135-148.

264. See *infra* Part III.B.

265. See *supra* text accompanying notes 108-117.

tions of the viability of non-Code actions are still the issue in a significant number of cases. In many cases, the plaintiff's desire to pursue a common law, or non-Code, action as an alternative to the U.C.C. is often motivated by purely pragmatic reasons. For example, where an action specifically based on the U.C.C. is barred by the statute of limitations, pleading a non-Code common law action with a longer limitations period might be the only means for recovery.²⁶⁶ Additionally, common law actions may potentially provide greater recovery.²⁶⁷ Finally, reliance upon a common law theory of recovery may avoid the preclusion established under the bank statement defense of section 4-406.²⁶⁸ In cases such as these, non-Code actions may provide the plaintiff a route to recovery otherwise barred by the U.C.C.

The continuing and prominent role that non-Code actions play in recent litigation exists for a number of reasons, but it is primarily caused by the U.C.C.'s vague general position on the survival of non-Code actions alongside that of the U.C.C.²⁶⁹ Section 1-103 covers the matter and provides support both for the position that such claims are displaced by the Code and also for the opposite claim. Section 1-103 states:

(a) [The Uniform Commercial Code] must be liberally construed and applied to promote its underlying purposes and policies, which are: (1) to simplify, clarify, and modernize the law governing commercial transactions; (2) to permit the continued expansion of commercial practices through custom, usage, and agreement of the parties; and (3) to make uniform the law among the various jurisdictions.

(b) Unless displaced by the particular provisions of [the Uniform Commercial Code], the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal

266. See, e.g., *Ohio Cas. Ins. Co. v. Bank One*, No. 95-C-6613, 1996 WL 507292, at *4-*5 (N.D. Ill. Sept. 5, 1996) (involving a defrauded employer who argued that the U.C.C.'s limitations periods are inapplicable to common-law claims); *Mills v. First Union Nat'l Bank of Md.*, 54 U.C.C. Rep. Serv. 2d 259 (Cal. Ct. App. June 24, 2004) (rejecting the argument that a negligence action allows for a longer statute of limitations than a Code-based action); *Greenwoods Scholarship Found., Inc. v. Nw. Cmty. Bank*, No. CV 960558956S, 1999 WL 417939, at *5 (Conn. Super. Ct. June 4, 1999) (allowing good faith and fair dealing claims using a six-year statute of limitations).

267. See *Hancock Bank v. Ensenat*, 819 So. 2d 3 (Miss. Ct. App. 2001) (holding that recovery for common law actions included consequential damages and "bad faith" damages). In this case, the court found that the "Code did not eliminate the potential for punitive damages arising from acts that contribute to conversion of a negotiable instrument." *Id.* at 12.

268. See *Cagle's Inc. v. Valley Nat'l Bank*, 153 F. Supp. 2d 1288, 1298 (M.D. Ala. 2001) (commenting that liability for negligence would establish liability for claims otherwise barred under the bank-statement defense); *Commerce Bank & Trust Co. v. Vulcan Indus., Inc.*, No. 012464A, 2002 WL 1554389, at *1 (Mass. Super. Ct. May 17, 2002) (determining that a recipient of embezzled funds cannot raise a section 4-406 defense because plaintiff was not a "customer" of the recipient); *White Sands Forest Prods., Inc. v. First Nat'l Bank of Alamogordo*, 50 P.3d 202, 204 (N.M. Ct. App. 2002). The impact that U.C.C. section 4-406 (1990) has on customer's claims is discussed *infra* text accompanying notes 340-404.

269. U.C.C. § 1-103 (2001).

and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, and other validating or invalidating cause supplement its provisions.²⁷⁰

The critical question under section 1-103 is whether, and when, the U.C.C. “displaces” common law claims under subsection (b). The Code does not provide an immediate answer to this question generally in the area of fraud loss. Articles 3 and 4 contain no express “displacement” provision, an absence that leaves to the courts the question of whether common law claims are allowed by the Code.²⁷¹

It is this silence which has led courts to wrestle over whether the Code provisions displace alternative common law routes to recovery.²⁷² Section 1-103 can be interpreted to support a finding that rejects the use of common law actions, given the concerns that the reliability, certainty, and predictability of the U.C.C. would be undermined by allowing common law claims to be raised alongside of, or in substitution for, those expressly authorized by the U.C.C.²⁷³ As stated by one court, “[t]he certainty which the Uniform Commercial Code seeks to achieve in respect to commercial transactions would quickly dissipate if *ad hoc* exceptions to its commands were too eagerly crafted to accommodate the occasional ‘hard case.’”²⁷⁴ Thus, a large number of courts refuse to allow any general common law claims,²⁷⁵ conversion claims,²⁷⁶ or negligence actions when not expressly authorized by

270. *Id.* (brackets in original).

271. Compare cases listed *supra* notes 266-268 with cases listed *infra* notes 275-278.

272. *Id.*

273. See cases *infra* notes 275-276.

274. *Brown v. Cash Mgmt. Trust of Am.*, 963 F. Supp. 504, 506 (D. Md. 1997) (applying New York’s version of the original Article 4).

275. See *City of Wellston v. Jackson*, 965 S.W.2d 867, 870 (Mo. Ct. App. 1998) (stating that a depository bank “owe[s] no common law, contractual or statutory duty to [the drawer]”); *Hartford Fire Ins. Co. v. First Union Nat’l Bank*, No. 190126, 2003 WL 23341353, at *2 (Va. Cir. Ct. July 22, 1998) (refusing to allow a claim of breach of restriction because it would be inconsistent with section 1-103); *Hancock Bank v. Ensenat*, 819 So. 2d 3 (Miss. Ct. App. 2001) (stating that the Code governs over common law forms of action); *Gallagher v. Santa Fe Fed. Employees Fed. Credit Union*, 52 P.3d 412, 416 (N.M. Ct. App. 2002) (“[C]ommon law claims are displaced by . . . the UCC.”); *Amzee Corp. v. Comerica Bank-Midwest*, 48 U.C.C. Rep. Serv. 2d 833, 840 (Ohio Ct. App. 2002) (rejecting common law claims as inconsistent with the goals of the U.C.C. and potentially upsetting the comprehensive loss allocation scheme established by the U.C.C.).

276. See *Citizens Bank of Pa. v. Chevy Chase Bank*, No. Civ. A. 03-CV-5208, 2004 WL 875499, at *2-*3 (E.D. Pa. Mar. 22, 2004) (“If we were to allow Plaintiff to bring [an action for conversion], we would thwart the purposes of the UCC, one of which is to standardize the commercial laws of the various jurisdictions.”); *Sebastian v. D&S Express, Inc.*, 61 F. Supp. 2d 386, 390-91 (D.N.J. 1999) (stating that revisions make clear that the drawer has no action in conversion); *IBP, Inc. v. Mercantile Bank of Topeka*, 6 F. Supp. 2d 1258, 1262 (D. Kan. 1998) (suggesting in dicta that the Code displaces common law conversion actions); *Stefano v. First Union Nat’l Bank of Va.*, 981 F. Supp. 417, 420 (E.D. Va. 1997) (determining that the U.C.C. conversion action displaces common law conversion claims); *Halla v. Norwest Bank Minn.*, 601 N.W.2d 449, 451 (Minn. Ct. App. 1999) (stating that revisions of section 3-420 do not allow separate common law claims for conversion); *Halifax Corp. v. Wachovia Bank*, No. 190126, 2003 WL 23341353, at *2 (Va. Cir. Ct. July 22, 2003) (determining that drawer has no common law action in conversion), *aff’d*, 604 S.E.2d 403 (Va. 2004); *Metro Waste, Inc. v. Wilson Check Cashing, Inc.*, 52 U.C.C. Rep. Serv. 2d 213, 215 (Pa. Ct. Com. Pl. 2003) (determining that conversion claims are displaced by section 3-420); *United Catholic Parish Sch. of Beaver Dam Educ. Ass’n v. Card Servs.*

the U.C.C.²⁷⁷ They also reject breach of warranty claims raised by the drawer, an action clearly rejected by the revised U.C.C.²⁷⁸

However, courts are far from unanimous on the matter of the viability of non-Code claims, although the weight of case law appears to be coming down against the actions.²⁷⁹ Section 1-103's textual vagueness permits the opposite argument, in favor of non-Code claims, to be made. As section 1-103 states, the U.C.C. should be "liberally construed" to promote the policies of the U.C.C.²⁸⁰ Common law claims can promote a policy of placing the risk of loss on the party most able to minimize the loss.²⁸¹ This, of course, will only occur if the court carefully monitors the use of common law claims consistent with the achievement of the loss minimization rationale. Such a goal, furthermore, is consistent with the Code's comparative fault rules.²⁸² Particularly given the absence of an express displacement provision in Articles 3 and 4, common law claims in many cases can be viewed as advancing rather than hindering the policies of the Code. Thus, a number of courts do allow non-Code claims to proceed.²⁸³

Ctr., 636 N.W.2d 206, 213 (Wis. Ct. App. 2001) (rejected conversion claim and stated that "while some claims for relief may exist side-by-side with claims under Wisconsin's commercial code, they cannot prevail if they conflict with code provisions").

277. See *Mack v. CTC Ill. Trust Co.*, 54 U.C.C. Rep. Serv. 2d 295 (E.D. Pa. 2004) (holding that negligence claim was displaced by U.C.C.); *Gress v. PNC Bank*, 100 F. Supp. 2d 289, 292 (E.D. Pa. 2000) ("[D]isplacing common law tort liability . . . is vital to [the U.C.C.] project."); *Cagle's Inc. v. Valley Nat'l Bank*, 153 F. Supp. 2d 1288, 1298 (M.D. Ala. 2001) (holding that embezzlement victim's common law and gross negligence claims were displaced by the U.C.C.); *Sebastian v. D&S Express, Inc.*, 61 F. Supp. 2d 386, 390-91 (D.N.J. 1999) (holding that the drawer's conversion action was subsumed by U.C.C.); *Lee Newman, M.D., Inc. v. Wells Fargo Bank*, 104 Cal. Rptr. 2d 310, 317 (Cal. Ct. App. 2001) ("We therefore conclude that the common law cause of action for negligence has been displaced."); *Mahaffy & Assocs., Inc. v. Long*, 52 U.C.C. Rep. Serv. 2d 477, 485 (Del. Super. Ct. 2003) (determining that the Code preempts common law actions for negligence and breach of contract); *Johnson Dev. Co. v. First Nat'l Bank of St. Louis*, 999 S.W.2d 314, 318-19 (Mo. Ct. App. 1999) (holding that the U.C.C. displaces common law negligence claims for an action precluded by section 4-406(f) but does not displace negligence claims related to checks for which there is a still viable U.C.C. claim); *Metro Waste*, 48 U.C.C. Rep. Serv. 2d at 215 (determining that negligence claims are displaced by section 3-420).

278. See *Cassello v. Allegiant Bank*, 288 F.3d 339, 341 (8th Cir. 2002) (determining that warranties do not extend to the drawer); see also *supra* text accompanying notes 113-117 (discussing the Code's rejection of warranty actions by the drawer).

279. See *supra* note 277.

280. For the text of section 1-103 (2001), see *supra* text accompanying note 270.

281. Cf. *Progressive Cas. Ins. Co. v. PNC Bank*, No. Civ.A. 98-6840, 1999 WL 557292, at *7 (W.D. Pa. July 26, 1999) (relying upon an Article 8 case, *New Jersey Bank v. Bradford Securities Operations, Inc.*, 690 F.2d 339, 340 (3d Cir. 1982)).

282. U.C.C. § 3-406 (1990). See also WHITE & SUMMERS, *supra* note 209, § 19-1, at 239.

283. See *Williams v. Metro. Life Ins. Co.*, 367 F. Supp. 2d 844, 849-50 (M.D.N.C. 2005) (denying motion to dismiss negligence claims but suggesting that perhaps a different result might occur at the summary judgment stage); *Nat'l Union Fire Ins. Co. v. Bank of Am.*, 240 F. Supp. 2d 455, 458 (D. Md. 2003) (stating in dicta that common law claims for conversion are not displaced by the U.C.C., as long as the owner, rather than the drawer, is the plaintiff), *vacated*, No. Civ.A. S 02 CV-3719, 2003 WL 22508090 (D. Md. July 15, 2003); *Cassello*, 288 F.3d at 340 (allowing negligence action against a depository bank for negligently handling the drawer's checks); *In re McMullen Oil Co.*, 251 B.R. 558, 571-72 (Bankr. C.D. Cal. 2000) (allowing action for negligence against depository bank that took checks with missing indorsements); *Progressive Cas. Ins. Co. v. PNC Bank*, 73 F. Supp. 2d 485, 488-89 (E.D. Pa. 1999) (allowing drawer of instrument to raise negligence claim against depository bank); *Progressive Cas. Ins. Co.*, 1999 WL 557292, at *6 (holding that there was sufficient allegations for a common law

The widely differing judicial views on the viability of common law claims can present a thorny issue for federal courts obliged to apply state law in diversity cases. For example, in *Cassello v. Allegiant Bank*,²⁸⁴ the plaintiffs alleged that they were fraudulently induced to issue over \$2.5 million in checks to two persons, or to entities controlled by them.²⁸⁵ The plaintiffs raised a common law negligence action against the depository bank.²⁸⁶ The parties cited conflicting cases from the Missouri courts, one in favor of allowing a common law claim for negligence,²⁸⁷ and the other weighing against allowing common law claims.²⁸⁸ The Eighth Circuit concluded that under Missouri law a common law claim could be raised.²⁸⁹ In the court's view, such a conclusion also was supported by a sound construction of the U.C.C.:

But it is important to our reasoning that the UCC itself quite specifically reserves common-law claims unless they are particularly displaced by one of its provisions. The code, in other words, does not purport to occupy the field so completely as to preempt altogether any other law dealing with bank collections. In short, it is not the only place to look to determine whether an action lies in the present circumstances."²⁹⁰

Although section 1-103 is usually the keystone for addressing the availability of common law actions, section 3-420 can be at issue when the question is whether common law claims for conversion are allowed. This section establishes the ability of owners to pursue an action based on conversion of

negligence claim); *Greenwoods Scholarship Found., Inc. v. Nw. Cmty. Bank*, No. CV 9605589565, 1999 WL 417939, at *5 (Conn. Super. Ct. June 4, 1999) (allowing claims for breach of good faith and fair dealing, negligence, conversion, and unfair trade practices, but finding that most were time-barred under the relevant statutes of limitations); *Stamford Athletic Club v. Union Trust Co.*, No. CV 94136922, 1997 WL 155376, at *2-*3 (Conn. Super. Ct. Mar. 25, 1997) (allowing claims for negligence and breach of good faith and fair dealing to proceed); *see also Diamond Jewelry, Inc. v. Premier Am. Credit Union*, No. 8150962, 2002 WL 1379282, at *2 (Cal. Ct. App. June 26, 2002) (allowing the drawer to raise a negligence claim against the depository bank, but denying the drawer the ability to raise a conversion claim). In *Diamond Jewelry*, the court found that the revisions only impacted the opinion in *Sun 'n Sand, Inc. v. United California Bank*, 582 P.2d 920 (Cal. 1978), by merely providing a comparative negligence approach. *Diamond Jewelry*, 2002 WL 1379282, at *2.

284. 288 F.3d 339 (8th Cir. 2002).

285. *Id.* at 340.

286. *Id.*

287. *Id.* at 340-41 (discussing *Dalton & Marberry, P.C. v. NationsBank*, 982 S.W.2d 231 (Mo. 1998)). In *Dalton*, the Missouri Supreme Court allowed a common law negligence action against a depository bank for violation of a duty of inquiry. 982 S.W.2d at 232.

288. *Cassello*, 288 F.3d at 340 (discussing *City of Wellston v. Jackson*, 965 S.W.2d 867 (Mo. Ct. App. 1998)). In *Jackson*, the Missouri Court of Appeals found that "[t]he legal relationship of a drawer and the collecting bank is circumscribed in the commercial code. The U.C.C. pre-empts the claims and defenses regulating negotiable instruments, bank deposits and collections." 965 S.W.2d at 869.

289. *Cassello*, 288 F.3d at 341. Because the case allowing the common law claim was decided by the state's Supreme Court, while the case denying the claim was from the court of appeals, the former had greater weight as a statement of state policy on the matter.

290. *Id.*

an instrument.²⁹¹ *Heche v. Chase Manhattan Bank*²⁹² provides an example of a case in which the court did allow a common law action for conversion to be brought by the drawer against a depository bank,²⁹³ contrary to the views of a substantial number of other courts.²⁹⁴ Section 3-420(a) of the Code begins by stating that “[t]he law applicable to conversion of personal property applies to instruments.”²⁹⁵ The section then continues that instruments “also” are converted when they are taken by transfer, other than negotiation.²⁹⁶ The *Heche* court read the first two sentences of section 3-420(a) as authorizing two separate and distinct sources of liability for conversion, and thus “an act that is not conversion under the UCC does not necessarily escape liability under the common law.”²⁹⁷ Although section 3-420(a) continues by providing that the issuer of an instrument has no action in conversion, the court read this preclusion as applying only to the second sentence of section 3-420, which establishes the U.C.C. action for conversion, rather than to the liability established in the first sentence of the section that arises from the “law . . . of personal property.”²⁹⁸ The preclusion, in other words, did not apply to actions alleging common law conversion.²⁹⁹ However, the claims for conversion brought by the drawer under the U.C.C., rather than the common law, were dismissed.³⁰⁰

Alongside section 1-103 and section 3-420, other obstacles may exist for plaintiffs seeking to successfully assert a common law claim. The long-held view that a bank owes no general duty of care to a non-customer³⁰¹ may present another barrier to recovering based on negligence. For example, assume that Thief forges Payee’s indorsement on a check, and cashes the check at depository bank. The check is paid by payor bank. The U.C.C. revisions make it clear that Payee may sue depository bank for conversion in cases such as these.³⁰² However, claims based on negligence alone have

291. See *supra* text accompanying notes 105-112 (discussing conversion action).

292. No. CV0000709708, 2001 WL 893808, at *1 (Conn. Super. Ct. July 10, 2001).

293. *Id.*

294. For cases rejecting the view that common law claims in conversion are allowed by the U.C.C., see *supra* note 276.

295. U.C.C. § 3-420(a) (1990). Section 3-420(a) is quoted in full *supra* text accompanying note 105.

296. *Id.*

297. *Heche*, 2001 WL 893808, at *1.

298. *Id.* at *2. The court found persuasive the argument raised by Professors White & Summers regarding this issue. See *id.* (quoting WHITE & SUMMERS, *supra*, note 209, § 18-4, at 220). Those authors argue that, where common law claims sounding in conversion might be brought under section 3-307 (breach of fiduciary duty) and are permitted under section 3-420(a)’s first sentence, the preclusion against drawers raising a conversion ought not to apply in those circumstances. *Id.*

299. *Id.*

300. *Id.*

301. See, e.g., *Roy Supply, Inc. v. Wells Fargo Bank*, 46 Cal. Rptr. 2d 309, 325 (Cal. Ct. App. 1995); *Ramsey v. Hancock*, 79 P.3d 423, 427 (Utah Ct. App. 2003). Although generally applied, this view has been eroding somewhat in recent years. See, e.g., *Travelers Cas. & Sur. Co. of Am. v. Wells Fargo Bank*, 374 F.3d 521, 527 (7th Cir. 2004) (allowing a common law claim by a drawer against a payee where no customer relationship exists); *Murray v. Bank of Am.*, 580 S.E.2d 194, 198 (S.C. Ct. App. 2003) (upholding the jury’s finding of a duty between the bank and non-customer in the case of the bank’s involvement with identity thief since a payee owes a duty of care to a non-customer drawer).

302. See U.C.C. § 3-420 (1990); see also *supra* text accompanying notes 105-112.

been dismissed, supported by the principle that no duty is owed by a bank to a person who is not the bank's customer, Payee in this example.³⁰³

Finally, in a number of cases, the confusion in the courts on the viability of common law claims has been created by the addition of the new comparative negligence claims in the overhauled negligence defenses. The argument now making its way through the courts is that these additional claims create an independent action for negligence not tied to any particular defense, in other words that they provide the basis for affirmative relief even where a defense is not being raised by the original defendant in the case.³⁰⁴ Most case law is coming down against this argument.³⁰⁵ For example, in *National Union Fire Insurance Co. v. Allfirst Bank*,³⁰⁶ the court addressed whether a new cause of action had been created by the new comparative negligence actions.³⁰⁷ In the case, Kaiser Foundation Health Plan of the Mid-Atlantic States issued fifteen checks, totaling approximately \$1 million, in three variations of the name of a business titled "Not Just Computers."³⁰⁸ The checks were issued in response to fraudulent invoices submitted by a former payroll employee of Kaiser.³⁰⁹ After paying Kaiser for \$852,506.68 in losses, Kaiser's insurance company brought an action, as subrogee of the drawer, against the depository banks which handled the checks, alleging among other matters, common law negligence.³¹⁰ The insurance company argued that, while a common law claim for negligence would not be permitted, the revisions to the U.C.C. established a new statutory negligence action.³¹¹ The court disagreed.³¹² It interpreted the new comparative negligence sections as permitting an affirmative cause of action

303. See cases cited *supra* note 301. One has to question cases such as these that reject any duty of the depository bank toward a payee whose signature has been forged. The revisions make clear that the depository bank is directly liable in conversion. See U.C.C. § 3-420 cmt. 1. In addition, should the depository bank raise a negligence defense, the revisions establish that the payee does have a comparative negligence action based on the negligence of the depository bank. *Id.* Thus, the revisions establish a duty of care for depository banks to non-customers, as contemplated by the new comparative negligence rules for loss allocation.

304. See *Carvel Corp. v. Fleet Nat'l Bank*, 47 U.C.C. Rep. Serv. 2d 1114, 1116 (Conn. Super. Ct. 2002) (determining that section 4-406 does not permit a direct claim against a bank); *White Sands Forest Prods., Inc. v. First Nat'l Bank of Alamogordo*, 50 P.3d 202, 205-06 (N.M. Ct. App. 2002) (rejecting argument that purported drawer has a cause of action against depository bank); *Halifax Corp. v. Wachovia Bank*, 604 S.E.2d 403, 407-08 (Va. 2004) (holding section 3-406 does not create an independent action); *Hartford Fire Ins. Co. v. First Union Nat'l Bank*, No. 161145, 1998 WL 972158, at *7 (Va. Cir. Ct. Apr. 1, 1998) (determining section 3-406(b) does not create an affirmative claim in negligence unless 3-406(a) has been raised by the bank). For a case that rejects this argument and finds in favor of an affirmative cause of action, see *National Union Fire Insurance Co. v. Hibernia National Bank*, 258 F. Supp. 2d 490, 494 (W.D. La. 2003).

305. See cases cited *supra* note 304.

306. 282 F. Supp. 2d 339 (D. Md. 2003), *aff'd sub nom.*, *Nat'l Union Fire Ins. Co. v. Mfrs. & Traders Trust Co.*, No. 03-2276, 2005 U.S. App. LEXIS 4757 (4th Cir. Mar. 23, 2005).

307. *Nat'l Union Fire Ins. Co.*, 282 F. Supp. 2d at 346-47.

308. *Id.* at 342. The checks were made payable to "Not Just Computers," "Just Computers" and "DCNJC." *Id.* The owner of "Not Just Computers" was one of the primary suspects in the scheme. *Id.*

309. *Id.*

310. *Id.* at 343.

311. *Id.* at 345.

312. *Id.* at 346.

only where one of the defenses was applicable.³¹³ Absent the bank raising a defense, no negligence claim existed.³¹⁴ Because in the case no defenses applied, the insurance company could not raise an action in negligence.³¹⁵

The question over whether the comparative negligence actions are a “free floating” basis for relief or mere counteractions to a defense is, in part, generated by vagueness in some supporting commentary.³¹⁶ Nonetheless, the exact language of the new defenses seems clearly to anticipate that a condition precedent to raising the final, comparative negligence actions laid out in each defense is the raising of the defenses themselves in the first place.³¹⁷ This is at least the case with respect to sections 3-406 and 4-406, although perhaps less certain with the indorsement defenses of sections 3-404 and 3-405.³¹⁸ The former defenses make it clear that the sections can only be raised against “the person asserting the preclusion.”³¹⁹ This language makes it clear that a defense first needs to be raised, in other words

313. *Id.* at 346-48.

314. *Id.* at 346 & n.4.

315. *See id.* at 346-48. There was no fraudulent indorsement of an employee, as required by section 3-405. There were no alterations or unauthorized signatures, as required by section 3-406. *Id.* at 346-47. Finally, because Not Just Computers was a real business, the fictitious payee rule of section 3-404 did not apply. *Id.* at 348.

316. *See* Olympic Title Ins. Co. v. Fifth Third Bank of W. Ohio, 54 U.C.C. Rep. Serv. 2d 569 (Ohio Ct. App. 2004) (suggesting that Professors White & Summers’ treatise, WHITE & SUMMERS, *supra* note 209, interprets section 3-406 to allow an affirmative cause of action); Halifax Corp. v. Wachovia Bank, 604 S.E.2d 403, 407-08 (Va. 2004) (addressing the customer’s argument based on WHITE & SUMMERS, *supra* note 209); White Sands Forest Prods., Inc. v. First Nat’l Bank of Alamogordo, 50 P.3d 202, 206 (N.M. Ct. App. 2002) (citing WHITE & SUMMERS, *supra*, note 209, § 19-1, at 239; 2A FREDERICK M. HART & WILLIAM F. MILLER, NEGOTIABLE INSTRUMENTS UNDER THE UNIFORM COMMERCIAL CODE § 12.37 (2001)); Hartford Fire Ins. Co. v. First Union Nat’l Bank, No. 161145, 1998 WL 972158, at *7 (Va. Cir. Ct. Apr. 1, 1998) (discussing references in WHITE & SUMMERS, *supra* note 209). Professors White & Summers’ influential hornbook on the U.C.C. provides: “Although it does not say so in terms, the ‘loss allocated’ language in 3-406(b) must be interpreted to grant an affirmative cause of action to the [customer] as a means of recovering for that part of the loss which the bank should bear.” WHITE & SUMMERS, *supra* note 209, § 19-1, at 239; *see also* WHITE & SUMMERS, *supra* note 171, § 16-1, at 567 (making the same assertion in a one volume hornbook edition). The courts evaluating the “cause of action” language of White & Summers, *id.* at 574, appear to take the language out of its intended context, which seems to be directed at the issue of whether the reference to the loss being allocated in section 3-406 allows any basis for recovery at all. *See id.* at 573-76. This is because, while the comparative negligence provisions in sections 3-404 and 3-405 state that a party “may recover” from another negligent party, section 3-406 omits that language. *Id.* at 574. All of Professors White & Summers’ references appear to assume that a defense has been in the first instance raised in the action prior to using comparative negligence causes of action. Thus, contrary to the interpretation of some courts, the treatise does not seem to advance directly an argument in favor of a free-floating cause of action.

317. This is because each comparative negligence cause of action refers to the application of the defense in its introductory clause or uses other language to indicate that the defense might first apply. *See* U.C.C. § 3-404(d) (1990) (“With respect to an instrument to which subsection (a) or (b) applies”); *id.* § 3-405(b) (“If the person paying the instrument”); *id.* § 3-406(b) (“Under subsection (a)”); U.C.C. § 4-406(e) (1990) (“If subsection (d) applies”).

318. Some courts addressing this issue have limited their preclusion of the independent cause of actions to sections 3-406 and 4-406. *See, e.g.,* Halifax Corp., 604 S.E.2d at 406-08 (finding that differences in language between section 3-406 and sections 3-404 and 3-405 justify preclusion of independent action in the case of the former section, but not the latter sections); *see also* Nat’l Union Fire Ins. v. Hibernia Nat’l Bank, 258 F. Supp. 2d 490, 493 (W.D. La. 2003) (discussing the language of section 3-405 and finding in favor of a free-floating action for all defenses).

319. U.C.C. § 3-406(b); U.C.C. § 4-406(e) (stating in similar terms “the bank asserting the preclusion”).

the preclusion asserted, in order for the statutory claim in comparative negligence to be raised. In the latter defenses, the action by the terms of those sections is allowed against “the person failing to exercise ordinary care.”³²⁰ The absence of the term “party asserting the preclusion,” found in sections 3-406 and 4-406,³²¹ in the remaining two defenses makes it less certain that raising the defense in the first place by the original defendant is a condition precedent to a comparative negligence cause of action.

Nonetheless, as some courts suggest, there are sound policy reasons weighing against an interpretation of the defenses as creating a free floating negligence action for the original plaintiff. As argued in the case of *Lee Newman, M.D., Inc. v. Wells Fargo Bank*,³²² the new comparative negligence defenses establish a comprehensive framework for allocating losses.³²³ In the court’s view, cases such as *Sun ‘n Sand, Inc. v. United California Bank*,³²⁴ discussed earlier in this Article,³²⁵ which supported such actions were overruled by the enactment of the new loss allocation schemes.³²⁶ This evidences a desire to lessen the ability of plaintiffs to raise non-Code claims alongside of those authorized expressly by the Code. Most importantly, allowing a claim in negligence would undermine the comprehensive scheme established by the Code. At least as judged from the Code, should a party have a U.C.C.-based claim centered on the bank’s lack of ordinary care, that claim should be raised as a counteraction to a successful defense, but not as an independent cause of action.

To summarize, courts have taken widely different positions on the ability of victims of check fraud to pursue non-Code causes of action alongside of, or in substitution for, the actions established under sections 4-401 (bank-depositor agreement) and 3-420 (conversion).³²⁷ The failure of the Code specifically to state whether and when such actions are “displaced” provides the main source for the dispute, coupled with the vagueness in the language of the new fraud loss provisions of Articles 3 and 4. Because a common law action may provide defrauded plaintiffs a means for recovery in cases where the Code denies it, the issue continues to be the focus of much litigation after the revisions. The continued uncertainty on whether or not these claims are viable significantly raises the cost of litigation, generates unpredictable results, and can reduce incentives for corporate officers to supervise and control their employees.

320. U.C.C. §§ 3-404, 3-405.

321. *Id.* § 3-406(b) (“the person asserting the preclusion”); *id.* § 4-406(e) (“the bank asserting the preclusion”).

322. 104 Cal. Rptr. 2d 310 (Cal. Ct. App. 2001).

323. *Id.* at 316-17.

324. 582 P.2d 920 (Cal. 1978).

325. *See supra* text accompanying notes 113-117.

326. *Lee Newman*, 104 Cal. Rptr. at 316-17.

327. U.C.C. § 3-420 (1990); U.C.C. § 4-401 (1990).

2. *Resolving the Issue in Favor of a Limited Right to Bring Common Law Claims*

As a general matter, the tendency of courts to view common law actions with some skepticism is appropriate. The revisions do evidence an attempt to establish a comprehensive allocation scheme for check fraud losses. Widespread tolerance of common law actions alongside those expressly established by the Code would undermine the ability of the statutory scheme to adequately function. Thus, courts should interpret the revisions as generally displacing common law actions when the actions are inconsistent with the loss allocation rules in the Code.

However, in a narrow category of cases, a common law action can advance, rather than impede, the principles of the Code. These cases generally involve the drawer's rights against a negligent depositary bank, where the Code fails to provide an adequate means for drawers to recover directly from the depositary bank. As an example, consider a case in which a corporate drawer hires a new bookkeeper without performing an adequate background check. It allows Bookkeeper complete and sole access to the company's financial records and bank statements. Bookkeeper forges ten checks for \$1,000 payable to herself over a three-month period. Payor bank pays all the checks, and has adopted a bulk processing method to process checks incoming for payment. Under this method, adopted by most similar banks in the area, no sight review of checks is performed. Bookkeeper cashes the checks, sometimes without indorsements, at depositary bank, under circumstances that ought to have placed a reasonable bank on notice of fraud.³²⁸ Assume that it can be shown that Depositary Bank's negligence contributed to 40% of the loss, and that Corporate Drawer's negligence contributed the remaining 60%. Due to the new definition of ordinary care,³²⁹ Payor Bank's failure to examine the checks cannot be considered negligence (assume no other facts suggests the payor bank failed to exercise ordinary care). The original intention of the comparative fault provisions would suggest that a 40/60% allocation of the loss between Depositary Bank and Corporate Drawer is warranted.

However, under the revisions this result cannot be obtained through the statute itself. Corporate Drawer, upon discovering the theft, could attempt to assert a claim against the Payor Bank, based upon the bank/depositor agreement, for paying items not properly payable. Payor Bank most likely would raise defenses based on section 3-406 (before the fact negligence) and section 4-406 (the bank statement defense). Given that we have assumed a 60% negligent Corporate Drawer, the Bank's section 3-406 claim would successfully preclude Corporate Drawer from raising its unauthorized signature. If Corporate Drawer failed to notify Payor Bank of the unau-

328. For a discussion of these types of circumstances, see *supra* text accompanying notes 207-215.

329. U.C.C. § 3-103 (a)(7).

thorized check within a reasonable time (not exceeding thirty days) after the first statement containing one of the checks, section 4-406's "same wrongdoer" rule would apply, precluding Corporate Drawer from raising its unauthorized signature on all items paid by the Payor Bank thirty days after the first statement was made available.

In light of the likely success of the payor bank's defenses, Corporate Drawer, who is 60% negligent, is bearing 100% of the losses. The Code itself provides no means for the drawer to assert the negligence of the depository bank. The express language of the Code does not provide for a direct comparative negligence cause of action against the negligent depository bank. Under sections 3-406 and 4-406 (the defenses raised by the payor bank) the party precluded (in this case, Corporate Drawer) is only expressly allowed, by the literal terms of these sections, to raise the negligence of "the person asserting the preclusion" (in this case, the payor bank).³³⁰ However, Corporate Drawer seeks to assert the negligence of Depository Bank. The defenses related to indorsements, sections 3-404 and 3-405, also apparently limit the person impacted by those defenses to raising the negligence of "the person paying the instrument or taking it for value or for collection,"³³¹ suggesting that unless the depository bank is raising the defense, its negligence cannot be raised to allocate losses in the manner envisioned. In this case, however, Payor Bank is the party raising the defense. Thus, absent a means to recover from the negligent Depository Bank, Corporate Drawer will bear 100% of the losses, a result completely inconsistent with that suggested by the Code. Common law negligence claims should be allowed to obtain recovery in such circumstances.

Confusion over the issue of the liability of the depository bank can be seen in *Gina Chin & Associates v. First Union Bank*,³³² where a drawer attempted to raise an action against the depository bank.³³³ The thief had forged both the drawer's signature and the indorsement on several checks.³³⁴ The indorsements were found to be effective under sections 3-404 and 3-405, defenses which, however, did not impact the lack of authorization of the drawer's signature.³³⁵ The depository bank argued that, because a forged drawer's signature was at issue, the drawer had no right to recover for the negligence of the depository bank.³³⁶ The court rejected this argument as inconsistent with the Code and its underlying policy of loss-sharing.³³⁷ The court, furthermore, interpreted sections 3-404 and 3-405 as

330. *Id.* § 3-406(b); U.C.C. § 4-406(e) (stating in similar terms "the bank asserting the preclusion").

331. U.C.C. § 3-405(b) (emphasis added). *See supra* note 175.

332. 500 S.E.2d 516 (Va. 1998).

333. *Id.* at 517.

334. *Id.*

335. *Id.*

336. *Id.*

337. *Id.* at 517-18.

authorizing an action for recovery for the losses caused by any person's negligence, including depository banks.³³⁸

The court's decision in *Gina Chin* that allows a claim for negligence against the depository bank is correct, although a straightforward reading of the indorsement defenses allows such a claim under the language of the statute without reliance upon the common law to support such a claim. A contrary holding—one to disallow a negligence action—would be contrary to the intention of the revisions to shift to a comparative negligence method for allocating losses—the keystone of the revision project.³³⁹ In cases where a common law negligence action against the depository bank would further the Code's intention to allocate losses according to the parties' respective fault, courts should allow the pleading of the action. In this small number of cases, common law claims would advance, rather than undermine, the policies of the U.C.C. Therefore, they ought not to be viewed as displaced by the Code under section 1-103.

B. The Impact of the Bank Statement Defense (Section 4-406)

1. Application of the Defense in Court

Along with the dismissal of common law claims, the other significant reason why many cases are never tried is due to the fact that many customers simply fail to comply with their duty to examine their statements with reasonable promptness under the bank statement defense in section 4-406.³⁴⁰ The defense is presenting a high bar to recovery, judging at least from the reported cases.³⁴¹ Some cases do withstand the application of the defense.³⁴² When customers review their statements in a timely manner and report any unauthorized or altered checks to the payor bank, the defense creates no serious obstacles for the customer in recovering from the payor: under the Code's initial loss allocation rules, the payment system providers—either the payor or the depository bank—bear the loss when no defenses are available to the banks.³⁴³ Of course, when a customer meets his duties under section 4-406, the likelihood of the occurrence of an ongoing fraud leading to litigation is also substantially lower. It is perhaps, therefore, not surprising that in many of the litigated cases, which often involve instances of frauds that occurred over a period of time and resulted in substantial losses,

338. *Id.*

339. *See generally* U.C.C. art. 3, Prefatory Note (1990) (describing the alterations to liability incorporated into Revised Article 3).

340. *See supra* text accompanying notes 136-148 for a discussion of section 4-406.

341. *See, e.g.*, cases listed *infra* notes 345-54.

342. *See, e.g.*, *Travelers Indem. Co. v. Good*, 737 A.2d 690, 696 (N.J. Super. Ct. App. Div. 1999) (finding that claims were not time barred by the requirement that the customers review statements, using the time of receipt of the statement as the time when the duty arises).

343. *See supra* notes 49-117 and accompanying text.

the customer's compliance with his duties under section 4-406 become the focus of the case.³⁴⁴

Even as written, section 4-406 provides payor banks with a strong defense against a customer's claim that the bank paid checks over a customer's forged signature. The section establishes two time periods that act to preclude a customer's claim of an unauthorized customer's signature or alteration.³⁴⁵ The customer is first given a reasonable period, not exceeding thirty days from the time the statement is sent, after which a customer is precluded from asserting the signature of the same wrongdoer on any items subsequently paid.³⁴⁶ Second, there is a one-year period under section 4-406(f), which provides that after a year from the time the statement is made available, all claims are barred regardless of the exercise or absence of ordinary care on the part of the parties.³⁴⁷ Thus, customers who do not immediately review their statements do so at a substantial risk. Even where customers do examine their statements, or otherwise discover the fraud within the required period, the requirement that he give "notice" to the payor bank of that fact may be construed against the customer.³⁴⁸ For example, general notice to the payor bank that a theft has, or might have, occurred is not sufficient "notice" under section 4-406.³⁴⁹ Rather, specific notice of the specific items that are forged or altered is required. As stated by another court, "[I]t is clear that the customer must deal in specifics . . . [I]n order to satisfy the statute, he must notify the bank of exactly which items bear the forged signatures."³⁵⁰

344. See, e.g., *supra* notes 140-148 and accompanying text.

345. See U.C.C. § 4-406(d), (f) (1990).

346. See *supra* text accompanying note 138. Most courts are in agreement that the time for reviewing statements begins with the time the statement is sent. See, e.g., *Stowell v. Cloquet Co-op Credit Union*, 557 N.W.2d 567, 571 (Minn. 1997) ("The statutory language thus clearly indicates that the account holder's duty to inspect the account statements with reasonable promptness commences at the time the statements are mailed by the bank."); *Union Planters Bank v. Rogers*, 57 U.C.C. Rep. Serv. 2d 236, 240 (Miss. 2005) (finding that time begins on sending and stating that "[a] reasonable person who has not received a monthly statement from the bank would promptly ask the bank for a copy of the statement"). But, some leniency with the sending rule sometimes occurs, albeit rarely. See, e.g., *Mac v. Bank of Am.*, 90 Cal. Rptr. 2d 476, 481 (Cal. Ct. App. 1999) (finding that where customer had died, statements were not "made available," and the one-year period did not begin until the customer's executor received the statements). Sending the statement to an authorized party, even if that party is the thief is sufficient. *Greenwoods Scholarship Found., Inc. v. Nw. Cmty. Bank*, No. CV 9605589563, 1999 WL 417939, at *3 (Conn. Ct. Super. June 4, 1999) (finding that delivery of statements to thief, who was treasurer for both the customer and the bank during one period, constituted making the statement available); *Henrichs v. Peoples Bank*, 992 P.2d 1241, 1244 (Kan. Ct. App. 1999) (finding that mailing to a person with power of attorney, in accordance with the customer's instructions, was sufficient).

347. See *supra* text accompanying note 139.

348. See, e.g., *First Place Computers, Inc. v. Sec. Nat'l Bank of Omaha*, 558 N.W.2d 57, 61 (Neb. 1997) (stating that general notice is not sufficient).

349. See *id.* In *First Place Computers*, the party whose signature allegedly was forged or missing on 155 checks first discovered that fact in June 1989. *Id.* at 59. He then talked with the bank about the irregularities. *Id.* It was not until 1992 that the party gave the bank a list of checks that allegedly had forged or missing signatures. *Id.*

350. *Villa Contracting Co. v. Summit Bancorporation*, 695 A.2d 762, 766 (N.J. Super. Ct. Civ. Law Div. 1996). In this case, the plaintiff failed to tell the bank of the specific checks that had forged signatures, although he provided lists of checks drawn on the account and had several conversations with bank employees to the effect that some of the company's checks had been forged. *Id.*

For whatever reasons, many customers in the litigated cases nonetheless demonstrate an astonishing inability to perform even the most basic review of their bank statements. Many cases suggest an extreme lack of care on the part of at least some customers.³⁵¹ For example, a number of courts dismiss claims where the notice required within one year is absent.³⁵² Moreover, a number of cases involve claims barred by the even longer three-year statute of limitations established under 3-118,³⁵³ with an open debate on when the statute is tolled (an issue left to state law under 1-103).³⁵⁴ The bank statement defense is therefore acting to cut off many customers' claims raised in the litigation context.

Even though the statute as written provides a formidable defense for payor banks, the emerging trend in the courts is to go much further and enforce agreements that modify the rules in section 4-406 in a Bank's favor by shortening the period within which customers must report unauthorized signatures and alterations.³⁵⁵ Most courts addressing the issue have found

351. See cases listed *infra* notes 352-53.

352. See *Cagle's Inc. v. Valley Nat'l Bank*, 153 F. Supp. 2d 1288, 1291-93 (M.D. Ala. 2001) (applying Alabama's 180-day period, which was a non-uniform amendment to section 4-406(f)); *Spancom Servs., Inc. v. SouthTrust Bank*, 744 So. 2d 931, 933 (Ala. Civ. App. 1999); *Arney v. Glendale Fed. Bank*, No. B138813, 2001 WL 1613811, *3-*4 (Cal. Ct. App. Dec. 18, 2001); *Euro Motors, Inc. v. Sw. Fin. Bank & Trust Co.*, 696 N.E.2d 711, 716 (Ill. App. Ct. 1998); *First Place Computers, Inc.*, 558 N.W.2d at 61.

353. *Ogundele v. Wachovia Bank*, No. Civ.A. 1:04-CV-1852-C, 2004 WL 2823232, *1 (N.D. Ga. Dec. 6, 2004); *Haddad's of Ill., Inc. v. Credit Union 1 Credit Union*, 678 N.E.2d 322, 324 (Ill. App. Ct. 1997); *Yarbro, Ltd. v. Missoula Fed. Credit Union*, 50 P.3d 158, 163 (Mont. 2002); *Gallagher v. Santa Fe Fed. Employees Fed. Credit Union*, 52 P.3d 412, 416 (N.M. Ct. App. 2002).

354. See U.C.C. § 3-118 cmt. 1 (1990) ("Section 3-118 does not define when a cause of action accrues" and "the circumstances under which the running of a limitations period may be tolled is left to other law pursuant to Section 1-103."). Compare *John Hancock Fin. Servs., Inc. v. Old Kent Bank*, 185 F. Supp. 2d 771, 779-80 (E.D. Mich. 2002) (rejecting discovery rule in conversion case), *aff'd*, 346 F.3d 727 (6th Cir. 2003); *Yarbro, Ltd.*, 50 P.3d at 161-63 (rejecting time of discovery as an event that triggers the statute of limitations); *Haddad's of Illinois*, 678 N.E.2d at 324-26 (rejecting time of discovery as an event that triggers the statute of limitations), *with Cont'l Cas. Co. v. Am. Nat'l Bank & Trust Co. of Chi.*, 768 N.E.2d 352, 364-65 (Ill. App. Ct. 2002) (applying discovery rule to conversion claim); *Commerce Bank & Trust Co. v. Vulcan Indus., Inc.*, No. 012464A, 2002 WL 1554389, at *1 (Mass. Super. Ct. May 17, 2002) (applying discovery rule to a three-year statute of limitations), *and Gallagher*, 52 P.3d at 416 (applying discovery rule). For a comprehensive discussion of the policies that support the rejection of the discovery rule in this context, see *Rodrigue v. Olin Employees Credit Union*, 406 F.3d 434, 440-48 (7th Cir. 2005).

355. Although the contractual language varies, a typical clause in an agreement in one case provided:

You should carefully examine the statement and canceled checks when you receive them. If you feel there is an error on the statement, or that some unauthorized person has withdrawn funds from the account, notify us immediately. The statement is considered correct unless you notify us promptly after any error is discovered. Moreover, because you are in the best position to discover an unauthorized signature, an unauthorized [i]ndorsement or a material alteration, you agree that we will not be liable for paying such items if . . . (b) you have not reported an unauthorized signature, an unauthorized [i]ndorsement or material alterations to us within 60 days of the mailing date of the earliest statement describing these items

Nat'l Title Ins. Corp. Agency v. First Union Nat'l Bank, 559 S.E.2d 668, 669 (Va. 2002) (brackets and ellipsis in original) (quoting the parties' Deposit Agreement). While it may arguably be the case that the customer is "in the best position to discover an unauthorized signature . . . or a material alteration," it is highly questionable whether that is the case with respect to unauthorized indorsements. *Id.* Customers in the usual case do not have any superior ability to recognize the indorsement of their payees. Rather, the best party to discover an unauthorized indorsement is the party who takes the check from the indorser, as

that agreements to shorten the one-year period found in section 4-406(f) of the bank statement defense are enforceable.³⁵⁶ In enforcing the agreements, courts either expressly or implicitly view such contractual modifications as not involving a bank's duty to exercise ordinary care.³⁵⁷ Rather, because the relationship between the payor bank and the drawer/customer is based on the contract established between the two,³⁵⁸ many courts view the issue simply as a matter of contract and choice, thus broadly validating agreements to shorten the period within which unauthorized checks must be reported to the bank.³⁵⁹ In a similar vein, courts will enforce agreements that authorize the Bank to pay any item that bears or purports to bear the facsimile signature on file with the bank.³⁶⁰ This, too, is consistent with principles of freedom of contract.

The judicial attitude of leniency toward section 4-406 in favor of banks, generally, and toward agreements that modify the time periods otherwise established therein places customers in a difficult position in litigation. Arguments circumventing the bank statement defense, as applied in many courts, are few. One argument, nearly always unsuccessful in undercutting the effectiveness of bank-customer agreements to modify the time periods established by the Code, is that the Code creates a statutory time period that is a "statute of limitations" and therefore not subject to modification by agreement. For example, in *W.J. Miranda Construction Corp. v. First Union National Bank*,³⁶¹ the applicable Florida law made void contractual provisions to limit a time for bringing an action at a time less than that provided

that party could ask for identification.

356. See *Reliance Ins. Co. v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 43 U.C.C. Rep. Serv. 2d 946, 953 (N.D. Ill. 2001); *Mercantile Bank of Ark. v. Vowell*, 117 S.W.3d 603, 612 (Ark. Ct. App. 2003) (enforcing thirty-day limit); *W.J. Miranda Contr. Corp. v. First Union Nat'l Bank*, 40 U.C.C. Rep. Serv. 2d 8, 13 (Fla. Cir. Ct. 1999) (enforcing sixty-day period as reasonable); *Concrete Materials Corp. v. Bank of Danville & Trust Co.*, 938 S.W.2d 254, 257 (Ky. 1997) (suggesting that a sixty-day period was effective); *Peak v. Tuscaloosa Commerce Bank*, 707 So. 2d 59, 64-65 (La. Ct. App. 1997) (enforcing thirty-day period); *Stowell v. Cloquet Co-op Credit Union*, 557 N.W.2d 567, 571-72 (Minn. 1997) (enforcing twenty-day contractual period); *Am. Airlines Employees Fed. Credit Union v. Martin*, 29 S.W.3d 86, 96 (Tex. 2000) (upholding sixty-day limit); *Basse Truck Line, Inc. v. First State Bank, Bandera, Tex.*, 949 S.W.2d 17, 21-22 (Tex. App. 1997); *Nat'l Title Ins. Corp. Agency*, 559 S.E.2d at 671-72 (enforcing sixty-day period in deposit agreement); *Borowski v. Firststar Bank Milwaukee*, 579 N.W.2d 247, 252-53 (Wis. Ct. App. 1998). Contractual determinations of what constitutes a reasonable period of time for inspection under section 4-406(d)(2) (same wrongdoer rule) similarly are being enforced. *E.g.*, *Cross Creek Invs., Inc. v. First State Bank*, 44 U.C.C. Rep. Serv. 2d 827, 832 (Tex. App. 2001).

357. *E.g.*, *Stowell*, 557 N.W.2d at 574-75; *Am. Airlines Employees Fed. Credit Union*, 29 S.W.3d at 97; see also *infra* text accompanying notes 406-417 (discussing section 4-103(a) and its application to ordinary care issues).

358. The bank-depositor agreement is discussed *supra* text accompanying notes 67-70.

359. See, *e.g.*, *Mercantile Bank of Ark.*, 117 S.W.3d at 612-14 (Ark. Ct. App. 2003) (using a contract analysis to enforce thirty-day limit).

360. See *Spears Ins. Co. v. Bank of Am.*, 40 U.C.C. Rep. Serv. 2d 807, 817 (N.D. Ill. 2000); *Jefferson Parrish School Bd. v. First Commerce Corp.*, 669 So. 2d 1298, 1300-01 (La. Ct. App. 1996); see generally *Rogers*, *supra* note 64 (arguing that such agreements are invalid under the Code). A discussion of the case law in this area can be found in *Lor-Mar/Toto, Inc. v. 1st Constitution Bank*, 871 A.2d 110, 116-17 (N.J. Super. Ct. App. Div. 2005). In *Lor-Mar*, the court refused to enforce an agreement regarding the use of facsimile signatures where there was no evidence that the forged signature was produced with the facsimile stamp. *Id.* at 119-20.

361. 40 U.C.C. Rep. Serv. 2d 8 (Fla. Cir. Ct. 1999).

by the applicable statute of limitations.³⁶² However, the court in that case, supported by precedent, found the limitation in the U.C.C. was simply a notice requirement acting as a condition precedent to suit, rather than a formal statute of limitations.³⁶³ In a similar vein, the court in *Arkwright Mutual Insurance Co. v. Nationsbank*,³⁶⁴ the court found that an agreement that the drawer would be responsible for all checks that bore, or purported to bear, the drawer's signature was enforceable despite a strong state law disfavoring exculpatory clauses.³⁶⁵ The court found that the Florida law permitted loss-shifting, as long as it did not completely abrogate a party's duty of ordinary care.³⁶⁶ The contractual provision, therefore, did not run afoul of the general prohibition against exculpatory clauses.³⁶⁷

Yet, an important point is that enforcing contractual modifications to section 4-406 has the effect of significantly limiting the bank's exposure to fraud claims in the first instance and then of shifting any losses onto their customers. This equally insulates the bank from claims that the bank failed to exercise ordinary care. While perhaps consistent with freedom of contract, enforcement of such agreements also alters the comparative fault loss allocation envisioned by the revisions. Therefore, courts are not entirely unanimous in permitting the enforcement of such agreements that limit the bank's potential exposure for forged or unauthorized checks.³⁶⁸ As will be discussed later in this Part III.B, the enforcement of such agreements is contrary to the comparative negligence principles that underscore the revisions.³⁶⁹

The sweeping effect of the bank statement defense in its official form has persuaded some other courts to undercut the section's powerful effect

362. See FLA. STAT. § 95.03 (1990) (voiding any contractual provision that fixes a period for beginning an action at a time less than the applicable statute of limitations).

363. *W.J. Miranda Constr. Co.*, 40 U.C.C. Rep. Serv. 2d at 14-15. This result is consistent with case law decided under the original U.C.C. See *First Place Computers, Inc. v. Sec. Nat'l Bank of Omaha*, 558 N.W.2d 57, 60 (Neb. 1997) (discussing case law). Other cases in this area decided under the revised Code include *Euro Motors, Inc. v. Southwest Financial Bank & Trust Co.*, 696 N.E.2d 711, 716 (Ill. App. Ct. 1998) (finding that section 4-406(f) is a statutory prerequisite to suit, not a statute of limitations), *First Place Computers*, 558 N.W.2d at 60 (finding that the section 4-406 one-year period is a condition precedent to bringing an action rather than a statute of limitations subject to being tolled), *Gerber v. City National Bank of Florida*, 619 So. 2d 328, 329 (Fla. Dist. Ct. App. 1993) (finding that the section 4-406 time periods are conditions to suit, not statutes of limitation), *American Airlines Employees Federal Credit Union v. Martin*, 29 S.W.3d 86, 96-97 (Tex. 2000) (rejecting the customer's claim that the shortened period violated fair notice doctrine limiting disclaimers of liability for negligence), and *National Title Insurance Corp. v. First Union National Bank*, 559 S.E.2d 668, 670-71 (Va. 2002) (rejecting the argument that section 4-406(f) is a statute of repose not subject to modification).

364. 212 F.3d 1224 (11th Cir. 2000), *withdrawn*, 251 F.3d 918 (11th Cir. 2001) (vacated and withdrawn after settlement).

365. 212 F.3d at 1228-29.

366. *Id.*

367. *Id.*

368. See *Crescent Women's Med. Group, Inc. v. Keycorp.*, 806 N.E.2d 201, 205 (Ohio Ct. Com. Pl. 2003) (refusing to enforce contractual time period); see also *Kaiser Aluminum & Chem. Corp. v. Mellon Bank*, 43 U.C.C. Rep. Serv. 2d 928, 937-38 (W.D. Pa. June 24, 1997), *aff'd*, 162 F.3d 1151 (3d Cir. 1998) (unpublished table decision) (finding an agreement relieving bank from liability for payment of instruments bearing facsimile signature to be void and unenforceable).

369. See *infra* Part III.B.2.

that denies the customer any recovery, using statutory interpretation. One argument to circumvent section 4-406(f) is that the one-year period for reporting unauthorized items or alterations does not apply to cases in which the bank acted in bad faith or with actual knowledge of the unauthorized signature. This line of argument resurrects in many respects the requirement in the original Code that a bank had to exercise ordinary care in order to raise defenses,³⁷⁰ substituting a requirement of good faith for that of ordinary care. The support for the argument is the fact that the subsection in section 4-406(f), which establishes the one-year notice period, begins with the language “[w]ithout regard to care or lack of care of either the customer or the bank.”³⁷¹ This language obviously does not include the term “good faith,” thus leading to the claim that when a bank *does not* exercise good faith the subsection—and the one-year preclusion—should not apply; if it does not apply to cut off the customer’s claim, the customer can still recover from the payor bank.

In the case of *Falk v. Northern Trust Co.*,³⁷² the Illinois Court of Appeals accepted this argument. The absence of the term “good faith” in subsection (f) was one of a number of arguments based on construction of section 4-406 that persuaded the court.³⁷³ In addition, subsection (e) of 4-406, which establishes the customer’s comparative negligence claim against a bank,³⁷⁴ states that “the preclusion under subsection (d) does not apply” if the customer can prove that the bank did not pay the item in good faith.³⁷⁵ This suggests that a finding of bad faith should also prevent a bank from relying upon the one-year period as a defense to the customer’s claim.³⁷⁶ The general duty of good faith established under the Code also suggests that the duty to act in good faith is an ongoing duty not conditioned by a one-year notice period.³⁷⁷ Finally, the policy behind the bank statement defense of encouraging customers promptly to review their statements “is not served when the bank is a party, either actively or passively, to a scheme to defraud the customer.”³⁷⁸ While *Falk* stands for a narrow construction of the defense, one in favor of tardy customers disfavoring a payor bank, other courts take a position contrary to that in *Falk*.³⁷⁹

370. See *supra* text accompanying notes 124-128.

371. U.C.C. § 4-406(f) (1990); see also *supra* text accompanying note 139 (discussing rule).

372. 763 N.E.2d 380 (Ill. App. Ct. 2001).

373. *Id.* at 386-87.

374. U.C.C. section 4-406(e) is quoted in full *supra* note 173.

375. U.C.C. § 4-406(e).

376. See *Falk*, 763 N.E.2d at 385-86.

377. *Id.* at 386.

378. *Id.* at 387.

379. See *Halifax Corp. v. First Union Nat’l Bank*, 546 S.E.2d 696, 702-03 (Va. 2002), *aff’d sub nom.*, *Halifax Corp. v. Wachovia Bank*, 604 S.E.2d 403 (Va. 2004) (determining that the absence of the term “good faith” in section 4-406(f) allowed a defense to be raised by bank regardless of the bank’s good faith or lack thereof); *Henrichs v. Peoples Bank*, 992 P.2d 1241, 1243 (Kan. Ct. App. 1999) (finding that the preclusion in section 4-406(f) applies even where the customer alleged that the bank had knowledge of the thief’s misappropriation).

These small divergences suggest that the potentially sweeping effect of the bank statement defense has created a body of case law after the revisions that is sometimes divided, with a group of courts (such as *Falk*) that apply the defense in a manner that preserves a customer's right to pursue a negligent bank, and other courts, perhaps a far greater majority, that apply the defense liberally in favor of the payor bank. Broadly construed by the latter group, the defense's impact can even extend beyond the case where a customer merely delays or fails to report unauthorized signatures on checks in a timely manner.³⁸⁰ For example, *American Airlines Employees Federal Credit Union v. Martin*³⁸¹ involved \$49,800 in unauthorized transfers rather than instruments that bore unauthorized signatures.³⁸² The thief, after fraudulently adding herself as a joint owner of the account in June of 1995, transferred the funds either by telephone or, on two occasions, in person.³⁸³ The transfers were represented by "journal vouchers" that were either allegedly sent to the customer or given to the thief at the time of deposit.³⁸⁴ The Credit Union allegedly also sent two quarterly statements that reflected the unauthorized transfers during the period covered by the statement.³⁸⁵ When the customer discovered in December of 1995 that his balance was not as expected, he notified the Credit Union of the matter and ultimately sued to recover the amount of the unauthorized withdrawals.³⁸⁶

A provision in the deposit agreement provided that the depositor had sixty days from the date of mailing a bank statement to make objections to items shown in the statement.³⁸⁷ Despite the customer's failure to report the transfers within the sixty-day period after the statements were sent, the trial court and Texas Court of Appeals found in the customer's favor and allowed recovery of the full amount of unauthorized transfers.³⁸⁸ The Texas Supreme Court reversed, holding that section 4-406 applied to the with-

380. See, e.g., *Am. Airlines Employees Fed. Credit Union v. Martin*, 29 S.W.3d 86 (Tex. 2000).

381. *Id.* at 90.

382. *Id.*

383. *Id.* at 89-90.

384. *Id.* at 90. When the transfer was by telephone, the Credit Union completed the transfer by preparing a "journal voucher" identifying the date of the transfer, the amount, and the account. *Id.* These vouchers were sent to the customer's address. *Id.* When the thief transferred the funds in person, she received the completed journal voucher from the Credit Union. *Id.*

385. *Id.* Martin denied ever receiving the statements or the vouchers. *Id.* The first statement, allegedly sent in July, reflected \$8,000 in authorized withdrawals and the second, received in early to mid-October, revealed another \$36,500 in authorized withdrawals. *Id.*

386. *Id.*

387. *Id.*

388. See *id.* at 90-91; see also *Am. Airlines Employees Fed. Credit Union v. Martin*, 991 S.W.2d 887 (Tex. Ct. App. 1999) (refusing to enforce sixty-day limit), *rev'd*, 29 S.W.3d at 99. In the Texas Court of Appeals' view, section 4-406 did not even apply, because there were no "unauthorized signatures" of Martin on any "items," a condition to the application of section 4-406. *Am. Airlines Employees Fed. Credit Union*, 991 S.W.2d at 894-95. In addition, the court did not enforce the sixty-day limitation in the deposit agreement because the evidence supported the trial court's finding that Martin did not agree to the provision. *Id.* at 899. For a defense of the appellate court's position, see M.H. Cersonsky, *Deposit Agreements Between Banks and Their Customers—A Wall of Protection or a Wall with a False Foundation?*, 31 TEX. TECH. L. REV. 1, 52-57 (2000).

drawals at issue and enforced the sixty-day period in the agreement.³⁸⁹ The Texas Supreme Court found that the journal vouchers prepared by the Credit Union constituted “items” under section 4-406 and contained Martin’s “unauthorized signature.”³⁹⁰ “Item[s]” under the U.C.C., are defined to include “any instrument for the payment of money even though it is not negotiable”³⁹¹ In the court’s view, the vouchers constituted “instruments” and thus were “items” that bore Martin’s unauthorized signature because the teller initialed the vouchers.³⁹² The court then enforced the sixty-day limitation in the bank/depositor agreement, and therefore limited the bank’s liability to unauthorized withdrawals that were not documented on any statement sent to the customer.³⁹³ Thus, section 4-406 was interpreted to apply to a fraud that did not even involve any checks.³⁹⁴

The divergence in case law, and among majorities and dissents, is a significant one when the bank has been negligent. The distinction can become one of disallowing the customer’s claim because of the bank statement defense versus one permitting the customer to raise the claim subject to a bank’s other defenses and the plaintiff’s possible cause of action for comparative negligence. In this manner the use of the bank statement defense as the basis for preventing customers’ claims can allow banks to escape liability entirely, even when they are negligent. The case of *Concrete Materials Corp. v. Bank of Danville and Trust Co.*³⁹⁵ demonstrates this problem. In *Concrete Materials*, the plant manager of a corporate customer engaged in an eight-year embezzlement scheme.³⁹⁶ He had the duty of depositing corporate checks.³⁹⁷ When he arrived at the bank to make deposits, the bank gave him cash back in the amount of one of the checks.³⁹⁸ In addition, the

389. *Am. Airlines Employees Fed. Credit Union*, 29 S.W.3d at 99.

390. *Id.* at 92-93.

391. U.C.C. § 4-104(1)(g) (1952). This pre-1990 definition of “items” is similar to the current definition: “an instrument or a promise or order to pay money handled by a bank for collection or payment.” *Id.* § 4-104(a)(9) (1990).

392. *Am. Airlines Employees Fed. Credit Union*, 29 S.W.3d at 93. The Texas Supreme Court’s line of reasoning was as follows: Although the voucher slips did not contain Martin’s forged signature, they did have a signature—the teller’s initials. *Id.* The court reasoned that the initials in the usual case would be signed with the authority of its customer. *Id.* In the case of theft, the initials, therefore, would be unauthorized by the customer. *Id.* Therefore, the initials in Martin’s case were, in effect, his unauthorized signature. *Id.*

The majority’s decision in *Martin* was accompanied by a strong dissent from two justices. *See id.* 99-103. In the dissenting judges’ view, the majority’s finding that the withdrawal slips were unauthorized items required that “the Court . . . fabricate a fiction that a bank teller’s signature is Martin’s signature, even though Martin was a stranger to the transaction.” *Id.* at 99 (Abbott, J., dissenting). Thus, the transfers were not covered by Article 4 at all. *Id.* at 99, 102. Moreover, the dissenting judges would find that the sixty-day limitation was unenforceable because the customer did not “knowingly, voluntarily, and intentionally agree to [that] provision.” *Id.* at 102.

393. *Id.* at 89.

394. *See, e.g., Concrete Materials Corp. v. Bank of Danville & Trust Co.*, 938 S.W.2d 254, 257-58 (Ky. 1997) (finding that deposit slips included in bank statement are “items” and that the customer had a duty to report alterations on the slips by employee within sixty days).

395. *Id.*

396. *Id.* at 256.

397. *Id.*

398. *Id.*

bank teller stamped a blank duplicate deposit slip for the thief as well as stamping the original.³⁹⁹ The thief would then fill in the new deposit slip without the amount of the check for which he had received cash and return that deposit slip to his employer.⁴⁰⁰ The original deposit slips, which did reflect the unauthorized withdrawals, were sent to the corporation in its bank statement.⁴⁰¹ However, the corporate customer did not inspect these slips.⁴⁰²

A good case can be made that the depository bank in *Concrete Materials* was negligent and that its actions substantially contributed to the loss. The foundation of the negligence argument lies in the fact that the bank gave cash back to an employee on what obviously was a corporate deposit, and moreover, the bank facilitated the fraud even further by providing duplicate stamped deposit slips to the employee.⁴⁰³ Nonetheless, the court affirmed a decision largely in favor of the bank, finding a significant part of the company's claim was barred by the one-year time limit in section 4-406.⁴⁰⁴ Thus, the company bore 100% of the loss for those checks. However, had the company been able to raise the claim, the customer also would be able to raise the bank's lack of ordinary care in response to the bank's own defense. If the claims had not been time barred, the loss allocation scheme envisioned by the revisions would result in a pro rata sharing of losses. Courts' strictness in enforcing time limitations for reporting of checks in this way and their leniency in enforcing agreements that shorten those limitations even further in the banks' favor, can allow negligent banks to escape potential liability.

2. *The Invalidity of Agreements That Modify Section 4-406*

A number of courts are now enforcing agreements between the payor bank and its customer which modify the time periods for reviewing bank statements established in the bank statement defense in section 4-406. The impact of this trend is to strengthen the already powerful defense in favor of the payor bank. Judicial enforcement of these agreements reflects a fundamental misunderstanding of the true nature of the bank/depositor relationship and overlooks the realities of the modern banking system. In the usual case, the bank/depositor agreement hardly represents a freely entered into contract with the opportunity to negotiate terms as desired. They are not agreements where a customer has a meaningful choice in the matter of the substance of the agreement. The agreements modifying section 4-406 of the U.C.C. usually are boilerplate provisions in intricately worded and lengthy

399. *Id.*

400. *Id.*

401. *Id.*

402. *Id.*

403. *Id.* at 256-57.

404. *Id.* at 258-59. A majority of the court found that the deposits slips were "items" that fell within section 4-406. *Id.* at 258.

form contracts. Frequently, they are included in routine notices periodically sent to the bank's customers and are discarded unread. Even if read, few customers are fully aware of the impact of shortening the period of time within which to raise claims of unauthorized signatures or material alterations.

Consumers and small businesses, particularly, lack the power to compel banks to change these terms even if the agreements are read and understood. Threatening to terminate the relationship as a negotiating stance is simply not viable for many persons. In the case of existing accounts, it is now no small matter to change banks. Even in the consumer context, such a move requires not only reprinting of checks and other usual matters, but also now necessitates terminating and then re-establishing scheduled automated clearing house transactions, such as automated bill pay and deposit arrangements. Customers who use the checking account as a source of funds for Internet payments must reprogram all computer-based payment services to reflect the change in accounts. The transformation of the checking account from merely a checking account to a source of funds for multiple types of payment forms makes leaving the existing relationship much harder for ordinary customers. Even if leaving is an option, given the widespread use by banks of agreements modifying section 4-406, there is small likelihood that better terms could be secured elsewhere. A bank's customers, simply put, often do not have the option of easy exit from the relationship. This situation allows banks to draft their terms on a take-it-or-leave-it basis, with the costs of leaving often being high.

Section 4-103 of the Code seems at first glance to justify the enforcement of agreements that modify section 4-406.⁴⁰⁵ It is true that section 4-103 grants to contracting parties the broad latitude to vary by agreement the terms of Article 4.⁴⁰⁶ Section 4-103(a) provides:

The effect of the provisions of this Article may be varied by agreement, but the parties to the agreement cannot disclaim a bank's responsibility for its lack of good faith or failure to exercise ordinary care or limit the measure of damages for the lack or failure. However, the parties may determine by agreement the standards by which the bank's responsibility is to be measured if those standards are not manifestly unreasonable.⁴⁰⁷

However, the official comments to this section make it clear that these rules do not undercut the use of traditional contract theories, such as unconscionability, to attack the agreement.⁴⁰⁸ Section 4-103 therefore cannot be

405. See U.C.C. § 4-103 (1990).

406. See, e.g., *id.* § 4-103 cmt. 2 (stating that "[s]ubsection (a) confers blanket power to vary all provisions of the Article by agreements of the ordinary kind").

407. *Id.* § 4-103(a).

408. Comment 2 to U.C.C. section 4-103 refers to "agreements of the ordinary kind." *Id.* § 4-103 cmt. 2; see also text quoted *supra* note 406. Where an agreement is found to be unconscionable, it hardly

read as a license that permits banks to write themselves out of the Code's rules in any context or in any manner.

Attempts to establish by agreement a shorter time period within which to raise claims of fraud arguably could be viewed as an attempt to disclaim liability, or at least to establish a standard (albeit a manifestly unreasonable one) for a bank's exercise of ordinary care. Section 4-103 does not give parties unrestrained latitude to vary these matters by agreement.⁴⁰⁹ Rather, disclaimers of liability for ordinary care are prohibited outright under section 4-103(a), and agreements setting the standards by which the bank's duty of ordinary care is to be governed cannot be "manifestly unreasonable."⁴¹⁰ A shorter period for reporting unauthorized checks obviously establishes a standard for the *customer's* responsibility to exercise ordinary care, while section 4-103 only addresses standards and disclaimers regarding the *bank's* duty of ordinary care.⁴¹¹ However, agreements to modify section 4-406 do have at least an effect on a bank's duty, too.⁴¹² This is the case because, as was discussed at the end of the previous section, the modifications limit the bank's general exposure to claims by the customer that the bank also failed to exercise ordinary care.⁴¹³ Absent the time limit in the agreement, a customer would have a full year to raise a claim and assert the negligence of the bank using the new comparative negligence causes of action.⁴¹⁴ By constricting the time period within which a claim can be bought, the potential for establishing the bank's liability for negligence is reduced.

However, an agreement shortening the period within which to report unauthorized checks does not purport *specifically* to disclaim responsibility for the exercise of ordinary care.⁴¹⁵ Rather, it is only the *effect* of the agreement that limits substantially the bank's exposure to claims of negligence. In many respects, this argument elevates the form of the agreement over its substance. Simply because an agreement does not specifically mention ordinary care should not cause courts to overlook the effect of the agreement, which certainly has ordinary care implications. If a time limitation had been drafted in the "user-friendly" language of bank/depositor agreements today, it might accurately provide: "This [agreement] means, for example, that you

should be said to be "ordinary." At numerous points throughout the Code, reference is made to good faith and other fairness doctrines as being baseline protections for customers against over-reaching. See U.C.C. § 3-103 cmt. 5 (1990) ("Nothing in [the definition of ordinary care] is intended to prevent a customer from proving that the procedures followed by a bank are unreasonable, arbitrary, or unfair."); U.C.C. § 4-103 cmt. 4 ("Under this Article banks come under the general obligations of the use of good faith and the exercise of ordinary care."); *Id.* § 4-401 cmt. 3 (validating judicial applications of unconscionability and good faith in fee setting context).

409. See U.C.C. § 4-103(a).

410. *Id.*

411. *Id.* § 4-103.

412. *Id.* § 4-406.

413. *Id.*

414. *Id.*

415. See *Borowski v. Firststar Bank Milwaukee*, 579 N.W.2d 247, 251 (Wis. 1998) ("[I]t is not the agreement . . . that gives the bank immunity even if it is negligent . . .").

cannot bring a lawsuit against us, *even if we are at fault*, for paying checks bearing a forgery of your signature unless you reported the forgery within sixty (60) days.”⁴¹⁶ One court has found that this language makes clear that the time limitation is a disclaimer of liability and unenforceable.⁴¹⁷ The result should not be different simply because some contract omits that the effect of the agreement is to limit the ability of customers to bring claims against a bank for negligence.

Because most agreements modifying section 4-406 in the bank’s favor only indirectly impact a bank’s duties of ordinary care, there are some uncertainties with employing section 4-103(a)’s standards for ordinary care issues to invalidate such agreements. Certainly the attention given to ordinary care issues in section 4-103(a) suggests a cautious attitude toward wholesale enforcement of the agreements, which bear so significantly on a bank’s duties. Section 4-103(a) also makes clear that general contract law fairness doctrines apply regardless of the section’s general freedom of contract stance.⁴¹⁸ Given the imbalance of power between banks and their customers, under contract law doctrines such as unconscionability, good faith and fair dealing, and adhesions contracts, terms in the bank/depositor agreement that purport to modify section 4-406 should be considered unconscionable and unenforceable. Consider the doctrine of unconscionability. The Code contains a general unconscionability section in Article 2, for contracts for the sale of goods,⁴¹⁹ and the common law of contracts also recognizes the doctrine.⁴²⁰ The doctrine of unconscionability is recognized in Article 4 itself as a viable customer defense to unfair terms in bank/depositor agreements.⁴²¹ Whether under the Code or the common law, unconscionability generally is interpreted to require both a finding of substantive unconscionability and procedural unconscionability.⁴²² Substantive unconscionability requires a finding that a term is excessively unfair, while procedural unconscionability addresses the fairness of the bargaining process.

A finding of unconscionability is warranted in the case of agreements attempting to modify the time periods in section 4-406. Customers’ inability, in the usual case, to participate meaningfully in negotiating the terms of the agreement establishes procedural unconscionability. On the substantive side, although the Code gives broad latitude to parties to contract out of the Code, allowing Banks the unchecked liberty in effect to opt out of the comprehensive comparative fault rules established by the revisions undermines

416. *Crescent Women’s Med. Group, Inc. v. Keycorp.*, 806 N.E.2d 201, 205 (Ohio Ct. Com. Pl. 2003).

417. *See id.*

418. *See* U.C.C. § 4-103(a); *supra* note 408 and accompanying text.

419. U.C.C. § 2-302 (Revised 2003).

420. *See* RESTATEMENT (SECOND) OF CONTRACTS § 208 & cmts. a & f (1981).

421. *See* U.C.C. § 4-401 cmt. 3 (suggesting that unconscionability is a viable doctrine to attack bank agreements).

422. *See* 8 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 18:10 (4th ed. 2005).

the loss allocation principles that underlie the revisions. The basic loss allocation system imposes many of the inevitable losses due to check fraud on the banking system. The validation of agreements to shorten the periods of section 4-406 undermines this policy because the enforcement insulates banks from liability for their own lack of ordinary care.

The reduction in time to report under section 4-406 also shifts potentially significant fraud losses onto the customer. For example, while a customer may have up to a year to raise a claim based upon section 4-406 as written,⁴²³ shortening the period by agreement substantially increases the potential losses, unrelated to actual negligence, that a customer might bear. Agreements to modify section 4-406, while seemingly innocuous when read in the abstract, are harmful to customers when applied in real cases of fraud. The widespread judicial acceptance of these agreements overlooks the real financial harm shifted to bank customers in a contractual relationship that lacks any equality of bargaining power.

Courts also ought to find agreements that modify section 4-406 to be unenforceable adhesionary terms in the consumer context. Section 211 of the *Restatement (Second) of Contracts* provides that where a standardized contract (such as a bank/depositor agreement)⁴²⁴ is involved and “the other party [(in this case the bank sending the standardized agreement)] has reason to believe that the party manifesting . . . assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement.”⁴²⁵ The effect of modification agreements is to limit substantially a customer’s ability to hold a bank accountable for an unauthorized check, resulting in a release of a significant right. If the term is enforced by a court, the customer is assuming greater liability for fraud, which may be substantial. The customer may bear 100% of a loss when the percentage fault may have been significantly less. Given the effect of such time limitations, no reasonable customer would knowingly agree to such a term.

Finally, the obligation of good faith and fair dealing would suggest a finding that such agreements are unenforceable, although the application of good faith to regulate terms in a contract, rather than the parties’ behavior during contract performance, is a debatable point.⁴²⁶ Under the new definition of good faith in Article 4, “good faith” includes not only “honesty in

423. U.C.C. § 4-406(f).

424. A standardized contract is one where “like writings are regularly used to embody terms of agreements of the same type.” RESTATEMENT (SECOND) OF CONTRACTS § 211(1) (1981). The party manifesting assent to the writing must have “reason to believe” that a standardized contract is involved in order for the assenting party to adopt the writing as an integrated agreement. *Id.* § 211(3). In the case of a typical bank-depositor agreement, these requirements are likely to be met.

425. *Id.* § 211(3).

426. See, e.g., U.C.C. § 3-103 cmt. 4 (1990) (“Although fair dealing is a broad term that must be defined in context, it is clear that it is concerned with the fairness of *conduct*”) (emphasis added). However, the parties’ conduct in contract creation can be a matter addressed by the obligation of good faith. See U.C.C. § 1-304 cmt. 1 (2001) (“[T]he doctrine of good faith merely directs a court towards interpreting contracts within the commercial context in which they are created, performed, and enforced . . .”).

fact” but also “the observance of reasonable commercial standards of fair dealing.”⁴²⁷ Along with unconscionability, Article 4 recognizes that good faith may place limits on a bank’s discretion to dictate terms of the bank-depositor relationship.⁴²⁸ Where a bank unilaterally alters by agreement the time periods established under section 4-406, such a move should be found to be contrary to fair dealing for the same reasons as those discussed for unconscionability and adhesionary terms.

A rule that rejects outright agreements that purport to modify section 4-406 would not have a serious or detrimental impact on checking service providers. Judging from recent case law, these types of agreements often are unnecessary to establish an effective defense in many instances. As discussed in Part III.B.1, the bank statement defense, as written, is already a formidable defense for banks. The case law applying the revised defense suggests that a significant number of customers victimized by fraud, often corporate customers, do not review their statements. In many cases, even the one-year preclusion established by the defense acts to bar many claims. The thirty-day rule that precludes customers from asserting items bearing unauthorized signatures by the same wrongdoer also will shift losses to the customer in a number of other cases. The proposal to prohibit modifications of section 4-406 will not impact those cases. Simply put, finding these agreements unenforceable will not impose substantially greater losses on financial institutions unrelated to their exercise of ordinary care because the effect of the bank statement defense alone will still be substantial. Rather, what will be affected are cases where the customer failed to abide by a shorter time period for reporting established unilaterally by the bank and, in most cases, unknown to the customer himself.

In addition, the current judicial approach that allows financial institutions to modify section 4-406 by agreement reduces the incentives for financial institutions to establish minimal safeguards to prevent check fraud. This is contrary to the basic policy of the revisions: the principle of the loss allocation provisions is to place losses within the banking system.⁴²⁹ Placing losses on the payment service provider makes good sense. In many cases, they are best able either to absorb or spread the losses and also have the resources and expertise to establish loss reduction procedures and technologies.⁴³⁰ Giving banks a free license to limit their liability beyond that established in the Code reduces the incentive of financial institutions to maintain and develop loss reduction systems.

In sum, the trend in the courts to enforce agreements that shorten the period within which a customer can report forged checks, or that otherwise

427. U.C.C. § 1-201(20).

428. U.C.C. § 4-401 cmt. 3 (suggesting that good faith may police a bank’s behavior under the parties’ agreement); *see also supra* note 421 (discussing unconscionability).

429. *See Rogers, supra* note 64, at 504-15 (arguing that agreements validating facsimile signatures should be unenforceable because they are contrary to the basic loss allocation structure of the U.C.C.).

430. Indeed, the checking system is unique among all payment systems for not placing the loss entirely on the service providers. *See supra* note 41.

modify section 4-406, is manifestly against the Code's policy of comparative loss sharing. The broad effect given by courts to these agreements is erroneous and misguided. Such agreements, when not individually negotiated, should be found to be unconscionable and unenforceable under section 4-103 of the U.C.C. State legislatures, moreover, should consider amending their version of section 4-406 to make clear that these agreements are not enforceable.⁴³¹ The Code's existing provisions provide sufficient insulation for the banking system from excessive check fraud losses. Courts should not extend that favor by permitting banks unilaterally to restrict their liability even further.

CONCLUSION

The state law versions of the revisions to Articles 3 and 4 of the U.C.C. have been in effect for about a decade.⁴³² A significant change brought about by the revisions was to allocate losses due to check fraud using comparative negligence concepts. This Article has reviewed the substantial amount of litigation that has followed from the revisions. The case law suggests that many of the problems that existed prior to the revisions, such as litigation over common law claims and over ordinary care, have continued even after the revisions. In addition, the revisions, as applied in the courts, have allowed banks, sometimes nearly completely, to avoid losses for check fraud, primarily through widespread enforcement of contractual agreements that modify the rules in section 4-406's bank statement defense.

It was anticipated that the revisions would have the effect of limiting at least some bank liability for fraud losses, and this was a controversial aspect of the revisions. Banks have been able to utilize the court system to insulate themselves from liability even further. As this Article has discussed, in some areas the judicial tendency toward favoring banks has acted to undermine the comparative negligence principles of the Code. Courts should permit negligence claims against depository banks when such claims are consistent with the basic policy of the Code that losses should be borne on a pro rata basis according to the parties' respective fault. Moreover, a significant number of cases are being dismissed due to failure to give timely notice under section 4-406. This Article has argued that the current freedom of contract approach that courts employ when enforcing contractual modifications to section 4-406 undermines, too, the comparative negligence provisions carefully crafted by the revisions. Such agreements are unconscionable attempts by financial institutions to limit even further their liability for

431. This can be accomplished by amending the state version of section 4-406(f) to add a sentence that states: "The time period established in this subsection (f) may not be shortened by agreement." States also should consider whether the "reasonable time" requirement in subsection (d)(2) should be capable of determination by agreement. Other sections in Articles 3 and 4 contain mandatory rules. *See e.g.*, U.C.C. §§ 4-207(d), 4-208(e) (providing that transfer and presentment warranties may not be disclaimed by agreement with respect to checks).

432. *See* U.C.C. art. 3 (1990); U.C.C. art. 4 (1990).

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check fraud and should be found to be unenforceable under traditional contract law fairness doctrines.

