Comment

CHECK FORGERIES: VARIATIONS OF RULES OF LIABILITY BASED ON FAULT—U.C.C. DEFENSE SECTIONS 3-406 AND 4-406

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A forger's civil liability for the loss occasioned by a check[1] he had forged provides little solace to the party who suffers that loss. By the time the forgery[2] is discovered, the guilty party is typically nowhere to be found. Even if he can be located, he may not be able to reimburse the party who has sustained the loss. The question then arises as to which of the many innocent parties who dealt with the forged instrument must bear the loss. In virtually every jurisdiction[3] the answer is provided by articles three and four of the *Uniform Commercial Code*.[4]

Actions to recover for check forgeries may arise under various circumstances. The first event in every check forgery is the forger's acquisition of the check. Most often the check is intercepted while in possession of a non-bank party.[5] Once in possession of the check the forger may change or supply the drawer's signature or the payee's indorsement. The

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[1] UNIFORM COMMERCIAL CODE § 3-104 [ARIZ. REV. STAT. ANN. § 44-2504 (1967)] sets out the requisites for a writing to constitute a negotiable instrument or check. It must (1) be signed by the maker or drawer; (2) contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by Article 3 of the Code; (3) be payable on demand or at a definite time; (4) be payable to order or to bearer; and (5) be a draft drawn on a bank. Hereinafter, all citations to Code sections are to the particular section number of the *Uniform Commercial Code* (1962 Official Text), followed by the *Arizona Revised Statutes Annotated* section number in parenthesis.

[2] "Forgery" is not specifically defined in the Code. The generally accepted rule is that "forgery may be committed through the use of a fictitious or assumed name." *Annot.*, 49 A.L.R. 852, 854 (1956). The narrow definition of forgery is the false making or alteration of a written instrument with intent to defraud so as to make the writing appear to be that of one other than the person actually making it. *Id.* at 863. The broad definition of forgery is the false making of any writing under a fictitious or assumed name. *Id.* at 861. Under the broad definition, a forgery *may* occur by the signing of a fictitious name in the presence of the person defrauded, while under the narrow definition, this is not true. *Id.* at 854. Under pre-Code law the majority of jurisdictions had adopted the broad definition. The broad definition would seem most consonant with the Code since its relevant provisions speak in terms of "unauthorized signatures" and "alterations," and since the term "unauthorized signatures" is broad enough to include both pre-Code definitions.

[3] The *Uniform Commercial Code* has been adopted in 49 of the 50 states. The sole exception is Louisiana.

[4] Article 3 applies to "Commercial Paper." Article 4 covers "Bank Deposits and Collections." In case of conflict between the two articles, article 4 prevails. 3-103(2)(44-2503(B)); 4-102(1)(44-2602(A)).

[5] The obvious reasons for interception of the check while it is in the posees-sion of non-bank parties are the inferior security precautions exercised.

wrongdoer might also alter or fill in the amount for which the check is drawn.

To explore the defenses afforded by sections 3-406 (44-2543) and 4-406 (44-2632), it is first necessary to outline the Code's scheme of liability for checks containing unauthorized signatures or alterations. These are the affirmative Code principles against which the defenses in 3-406 and 4-406 will operate. Because the determination of who is to bear the loss largely depends upon the nature of the wrongful alteration or addition, each type of change will be considered separately.[6]

BASES OF LIABILITY

Forged Indorsement

Notwithstanding defenses and other risk shifting devices available, in the case of a forged indorsement the underlying principle of the Code is to apply its warranty provisions[7] and shift the resultant losses backward

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[6] *Compare* 3-417(1) (44-2554(A)) *and* 3-418 (44-2555), *with* 3-417(2) (44-2554(B)). *See text* accompanying notes 7-19, *infra.*

[7] 3-417 (44-2554); 4-207 (44-2616). Section 3-417 reads:

(1) Any person who obtains payment or acceptance and any prior transferor warrants to a person who in good faith pays or accepts that
- (a) he has a good title to the instrument or is authorized to obtain payment or acceptance on behalf of one who has a good title; and
- (b) he has no knowledge that the signature of the maker or drawer is unauthorized, except that this warranty is not given by a holder in due course acting in good faith
  - (i) to a maker with respect to the maker's own signature, or
  - (ii) to a drawer with respect to the drawer's own signature, whether or not the drawer is also the drawee; or
  - (iii) to an acceptor of a draft if the holder in due course took the draft after the acceptance or obtained the acceptance without knowledge that the drawer's signature was unauthorized; and
- (c) the instrument has not been materially altered, except that this warranty is not given by a holder in due course acting in good faith
  - (i) to the maker of a note; or
  - (ii) to the drawer of a draft whether or not the drawer is also the drawee; or
  - (iii) to the acceptor of a draft with respect to an alteration made prior to the acceptance if the holder in due course took the draft after the acceptance, even though the acceptance provided 'payable as originally drawn' or equivalent terms; or
  - (iv) to the acceptor of a draft with respect to an alteration made after the acceptance.

(2) Any person who transfers an instrument and receives consideration warrants to his transferee and if the transfer is by indorsement to any subsequent holder who takes the instrument in good faith that
- (a) he has a good title to the instrument or is authorized to obtain payment or acceptance on behalf of one who has a good title and the transfer is otherwise rightful; and
- (b) all signatures are genuine or authorized; and
- (c) the instrument has not been materially altered; and
- (d) no defense of any party is good against him; and
- (e) he has no knowledge of any insolvency proceeding instituted with respect to the maker or acceptor or the drawer of an unaccepted

to the party who dealt with the forger. Any party presenting an item for payment, as well as any transferor, warrants that "he has a good title to the instrument or is authorized to obtain payment or acceptance on behalf of one who has a good title."[8] This warranty permits every party, including the drawee, to recover from prior parties until the loss occasioned by a fraudulent indorsement eventually reaches the forger.[9] Even if the drawer accepts the debit of his account with the drawee as releasing some debt owed to the payee whose indorsement has been forged,[10] the payee may recover from a party within the warranty scheme,[11] with the loss ultimately falling on the party who takes from the forger.

Alteration

As in the case of a forged indorsement, where a check has been "materially altered,"[12] the Code directs that the loss be passed backward toward the wrongdoer. This is accomplished by providing that the presentor for payment and all transferors warrant that "the instrument has not been materially altered."[13]

Forged Drawer's Signature

Where the drawer's signature has been forged, the Code withdraws somewhat from the theory that the taker from the forger should bear the

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instrument.

(3) By transferring 'without recourse' the transferor limits the obligation stated in subsection (2)(d) to a warranty that he has no knowledge of such a defense.

(4) A selling agent or broker who does not disclose the fact that he is acting only as such gives the warranties provided in this section, but if he makes such disclosure warrants only his good faith and authority.

[8] 3-417(1)(a), (2)(a) (44-2544(A)(1), (B)(1)).

[9] Where there is an indorsement the warranty runs with the instrument and the remote holder may sue an earlier warrantor directly and thus avoid a multiplicity of suits which might be interrupted by the insolvency of an intermediate transferor. *See* 3-417 (44-2544), Comment 8.

[10] When a drawee bank pays a holder of a stolen bearer instrument and thus causes the drawer's liability on the instrument to be discharged under 3-603 (44-2570), that discharge ipso facto will cause a discharge of the underlying obligation for which it is given. 3-802(1)(b) (44-2576(A)(2)).

[11] The payee may sue any party who has paid the item over a forged indorsement. 3-419(1)(c) (44-2556(A)(3)). This section does not refer to any specific parties, but it is broad enough to include any party except a "representative . . . who has in good faith and in accordance with the reasonable commercial standards applicable to the business of such representative dealt with an instrument or its proceeds on behalf of one who was not the true owner." 3-419(3) (44-2556(C)). Once the loss is passed to a party within the warranty scheme, the loss may then be transferred back toward the forger. See 3-419 (44-2556), Comment 6.

[12] 3-407(1) (44-2544(A)):

Any alteration of an instrument is material which changes the contract of any party thereto in any respect, including any such change in

(a) the number or relations of the parties; or

(b) an incomplete instrument, by completing it otherwise than as authorized; or

(c) the writing as signed, by adding to it or by removing any part of it.

[13] 3-417(2)(c) (44-2554(B)(3)).

loss. Instead, the Code seeks to impose the liability scheme applied to forged indorsements only before the drawee has made final payment or has accepted the instrument.[14] Up to this point, the Code shifts the loss back by imposing upon transferors the warranty that they have "good title" and that "all signatures are genuine."[15] The warranty that the transferor has "no knowledge that the signature of the maker or drawer is unauthorized" is not given, however, by a "holder in due course acting in good faith" to a drawee or drawer after the drawee's payment or acceptance[16] because the drawee and drawer are charged with the responsibility of recognizing the drawer's signature.[17] This provision effectively precludes a drawee or drawer from shifting the loss to a prior party who has dealt with the item as a holder and who acted honestly, regardless of the care exercised.[18] The drawee is bound by his acceptance or payment, and will bear the loss if the drawer gives timely notice of his unauthorized signature.[19]

The Code's scheme for allocation of losses caused by check forgeries and alterations may be modified by the many loss shifting devices available under the Code.[20] Among these risk shifting mechanisms, the defenses most frequently asserted are those afforded by sections 4-406 and 3-406. Both of these sections operate on a theory of negligence: a party who has been negligent should not be permitted to transfer the loss to someone who has not.[21]

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[14] Regarding finality of payment or acceptance, 3-418 (44-2555) states:

> Except for recovery of bank payments as provided in the Article on Bank Deposits and Collections (Article 4) and except for liability for breach of warranty on presentment under the preceding section, payment or acceptance of any instrument is final in favor of a holder in due course, or a person who has in good faith changed his position in reliance on the payment.

For a definition of "final payment," see 4-213(1) (44-2622(A)). "Acceptance" is defined in 3-410 (44-2547).

[15] 3-417(2) (44-2554(B)).

[16] 3-417(1)(b) (44-2554(A)(2)) *quoted* in note 7, *supra*.

[17] 3-418 (44-2555), Comment 1:

> The traditional justification for the result is that the drawee is in a superior position to detect a forgery because he has the maker's signature and is expected to know and compare it; a less fictional rationalization is 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.
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> The rule [3-418 (44-2555) *quoted* in note 14, *supra*] is not limited to drawees, but applies equally to the maker of a note or to any other party who pays an instrument.

[18] *See* notes 93-97 and accompanying text *infra*.

[19] The drawer, in giving timely notice to the drawee of the improper debit, 4-406 (44-2632), can force the drawee to recredit his account.

[20] *E.g.*, 4-103(1) (44-2603(A)) and 3-417 (44-2554), Comment 1, expressly acknowledge the validity of separate agreements modifying warranty liabilities imposed by the Code. *See* notes 54-59 and accompanying text *infra*. However, customers and collecting banks are not afforded these rights. *Compare* 3-417 (44-2554), Comment 1, *with* 4-207(3) (44-2616(C)).

The direction of liability imposed by the warranty sections may also be disrupted by 3-405 (44-2542), which shifts loss to the drawer where the check is drawn to an imposter or fictitious payee and thereafter signed in that name.

[21] *See* 4-406 (44-2632), 3-406 (44-2543) *quoted* in notes 23 and 80 *infra*. The

The defenses provided by these two sections are novel innovations to uniform laws.[22] Consequently, each has raised unprecedented inquiries, many of which have been left unanswered by the Code. The judicial discretion resulting from the draftsmen's failure to deal adequately with these problems makes the progress of these two defense sections worthy of separate analysis.

CUSTOMER'S DUTY TO DISCOVER AND REPORT UNAUTHORIZED SIGNATURE OR ALTERATION UNDER 4-406

Section 4-406(1)[23] imposes a duty of reasonable care and promptness on the customer to examine the statement of his account for unauthorized charges and to report such charges promptly upon discovery.[24]

Code has been criticized for allowing negligent parties to recover in check forgery suits. *See* Comment, *Allocation of Losses from Check Forgeries Under the Law of Negotiable Instruments and the Uniform Commercial Code*, 62 YALE L.J. 417, 466-70 (1953).

[22] 3-406 (44-2643), Comment 1; 4-406 (44-2632), Comment 1.

[23] 4-406 (44-2632):

(1) When a bank sends to its customer a statement of account accompanied by items paid in good faith in support of the debit entries or holds the statement and items pursuant to a request or instructions of its customer or otherwise in a reasonable manner makes the statement and items available to the customer, the customer must exercise reasonable care and promptness to examine the statement and items to discover his unauthorized signature or any alteration on an item and must notify the bank promptly after discovery thereof.

(2) If the bank establishes that the customer failed with respect to an item to comply with the duties imposed on the customer by subsection (1) the customer is 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.

(3) The preclusion under subsection (2) does not apply if the customer establishes lack of ordinary care on the part of the bank in paying the item(s).

(4) Without regard to care or lack of care of either the customer or the bank a customer who does not within one year from the time the statement and items are made available to the customer (subsection (1)) discover and report his unauthorized signature or any alteration on the face or back of the item or does not within three years from that time discover and report any unauthorized indorsement is precluded from asserting against the bank such unauthorized signature or indorsement or such alteration.

(5) If under this section a payor bank has a valid defense against a claim of a customer upon or resulting from payment of an item and waives or fails upon request to assert the defense the bank may not assert against any collecting bank or other prior party presenting or transferring the item a claim based upon the unauthorized signature or alteration giving rise to the customer's claim.

[24] Before enactment of the Code, courts generally imposed a similar duty to examine bank statements and cancelled checks. *Annot.*, 103 A.L.R. 1147 (1936); *e.g.*, Deer Island Fish & Oyster Co. v. First Nat'l Bank, 166 Miss. 162, 146 So. 116 (1933).

If drawee bank has exercised ordinary care,[25] and if it proves that the customer has breached his duty under 4-406(1) resulting in a loss to the bank, the customer will be precluded from asserting "his unauthorized signature or any alteration on the item."[26] Moreover, under 4-406(2)(b), if the customer has breached a duty imposed by subsection (1), and if the drawee has exercised ordinary care, the customer will not be allowed to assert

> 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.[27]

The use of "his" in 4-406(2)(a) apparently is intended to limit that subsection to alterations or forged signatures of the drawer. The use of "an" in 4-406(2)(b), on the other hand, makes that subsection applicable to forged indorsements as well as to alterations and forged signatures of the drawer.[28]

Regardless of the degree of care exercised by the drawer or drawee, section 4-406(4) imposes absolute time limits within which the customer must notify the bank of unauthorized signatures or alterations if he is to shift the loss to the drawee. This subsection precludes the customer from asserting his unauthorized signature or any alteration after one year from the time his bank statement and items are made available for inspection.[29] Three years is the limit beyond which a customer will not be allowed to assert an unauthorized indorsement.[30] Finally, 4-406(5) estops the drawee bank from asserting any claim against a collecting bank or any prior party if the drawee's claim arose by accepting the loss from a customer after waiving or failing, upon request, to assert a valid section 4-406 defense against the customer.[31]

Time of Notice

The time limitations imposed by 4-406(4) within which a customer must notify the bank begin to run when the cancelled checks are made

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25 Proof by the customer that the bank has failed to exercise ordinary care will deprive the bank of any defense it might otherwise have had under 4-406 (1) (44-2632(A)). *See* 4-406(3) (44-2632(C)) *quoted* in note 23 *supra.*

26 *Id.* (2)(a) (44-2632(B)(1)).

27 *Id.* (2)(b), (3) (44-2632(B)(2), (C)).

28 *Compare* 4-406(2)(a) (44-2632(B)(1)), *with* 4-406(2)(b) (44-2632(B)(2)) *quoted* in note 23 *supra.* This theory is supported further by 4-406 (44-2632), Comment 3.

29 4-406(4) (44-2632(D)).

30 *Id.*

31 *Id.* (5) (44-2632(E)) has not only been imposed to protect a collecting bank in a suit by the drawee bank but has been extended in a few jurisdictions to protect a collecting bank in a suit brought by the drawer. *See* notes 75-79 and accompanying text *infra.*

available for inspection. This may occur when the bank does one of three things: (1) sends the statement and items to the customer; (2) holds such statement and items available for the customer pursuant to a request for instructions of the customer; (3) or otherwise in a reasonable manner makes the statement and items available to the customer.[32] To avoid the sanctions imposed by section 4-406(4), the customer must give notice to the bank of the unauthorized signature or alteration within the time limits imposed.[33] Nevertheless, these requirements for notice, as well as those imposed by 4-406(2), represent only the outer limits within which notice must be given. Upon discovery by the customer of any forgery or alteration, a separate duty arises to notify the bank "promptly," regardless of the amount of time remaining within these periods of limitations.[34]

Notice

Giving notice is defined in the Code as "taking such steps as may be reasonably required to inform the other in ordinary course whether or not such other actually comes to know of it."[35] Since the provisions of section 4-406 place an affirmative duty on the customer to notify the bank, actual or constructive notice to the bank from a source other than the customer does not relieve the customer of his duty.[36] If before payment or acceptance, however, the bank had actual knowledge of an unauthorized signature or alteration from a source other than its customer, or if it otherwise had constructive notice,[37] it may, nevertheless, be deprived of the defenses in 4-406(1) and (2) because it has failed to exercise "ordinary care" in paying or accepting the item,[38] and because its loss was not

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32 4-406 (44-2632), Comment 2.

33 Notice requirements under 4-406 (44-2632) are most liberal. Oral notice is sufficient. *See* definition of "notifies" in 1-201(26) (44-2208(26)).

34 4-406(1) (44-2632(A)) *quoted* in note 23 *supra.* A duty to notify the bank may arise even where there is no duty to inspect and discover a forgery or alteration, but where a customer, nevertheless, has reasonable grounds to suspect a forgery. An example of this situation would be where the customer has drawn a check to a close associate whose signature is well known to the customer. Although no immediate duty to discover and report the payee-associate's forged indorsement is expressed in 4-406 (44-2632), there may nevertheless be a duty to notify the bank or investigate the matter if it is shown the customer had knowledge or suspicion that there was something wrong with the indorsement. *See id.*, Comment 6.

35 1-201(26) (44-2208(26)). For the requirements of notice to an organization, see 1-201(27) (44-2208(27)).

36 4-406(1) (44-2632(A)) expresses the customer's duties as affirmative acts: "the customer *must exercise* reasonable care . . . and *must notify* the bank . . . ." (emphasis added).

37 An obvious example of a situation where the bank should have known of the unauthorized signature is where the bank pays an item bearing the forged signature of the customer-drawer. Indeed, the bank has a duty to inspect for such a forgery. 3-418 (44-2555), Comment 1.

38 4-406(3) (44-2732(C)). *See* Teas v. Third Nat'l Bank & Trust Co., 125 N.J. Eq. 224, 4 A.2d 64 (Ct. Err. & App. 1939); Jackson v. First Nat'l Bank & Trust Co., 55 Tenn. App. 545, 403 S.W.2d 109 (1966). If the bank pays an item which it actually knows is forged, it is arguable that the item was not "paid in good faith." 4-406(1) (44-2632(A)); 4-401 (44-2627).

caused by the customer's failure to give timely notice.[39] Actual or constructive notice cannot deprive the bank of the defenses available in 4-406(4), however.[40]

Customers' Duty of Reasonable Care on Examination

Section 4-406(1) places a duty on the customer to exercise "reasonable care" in examining his cancelled checks and bank statement.[41] The term "reasonable care" is left undefined in the Code, however. Its limits are presumably to be measured by the trier of fact under all the circumstances in a given case.[42] Before Code enactment it was stated that, as a minimum, the duty of a customer included the following steps: (1) a comparison of the cancelled checks with his check stubs; (2) a comparison of the statement balance with the check book balance; and (3) a comparison of the returned checks with the debits indicated on the statement.[43] Whatever a particular jurisdiction may prescribe as fulfilling the customer's duty of reasonable care, the Code places the burden of proving the breach of this duty on the payor bank.[44]

The Code does not address itself to the question of "reasonable care" where a customer-employer has delegated the duty of examing checks to an employee who is in a position to participate in a forgery and, in fact, takes advantage of such position. There are two approaches which courts may take to this issue. On the one hand, the knowledge of the dishonest employee may be imputed to the drawer-employer who will then be held accountable for failure to discover and report the forgery.[45]

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[39] For example, even though the customer has failed to notify the bank, notice might have been received from the payee of the check before payment was made. A prerequisite to the bank's assertion of these defenses is that the bank show it suffered a loss *by reason of* the customer's failure to notify. 4-406(2)(a) (44-2632(B)(1)). If the loss was avoidable by the bank by reason of notice received from the payee, it is arguable that the bank suffered loss by reason of its own negligence and, therefore, the bank should not be allowed the defenses in 4-406(2) (44-2632(B)).

[40] The maximum time limitations in 4-406(4) (44-2632(D)) apply regardless of whether the bank was negligent. Allied Concord Financial Corp. v. Bank of America Nat'l Trust & Sav. Ass'n, 275 A.C.A. 586, 80 Cal. Rptr. 622 (1969); Bank of Thomas County v. Dekle, 119 Ga. App. 753, 168 S.E.2d 834 (1969). The only restrictions on the operation of 4-406(4) (44-2632(D)) are the Code's overall requirements that the parties acted in good faith (1-203 (44-2210)), and that any separate agreement to modify the time limits cannot be manifestly unreasonable. 4-103 (1) (44-2603(A)).

[41] *See* note 23 *supra.*

[42] *See* 3-406 (44-2543), Comment 3.

[43] Huber Glass Co. v. First Nat'l Bank, 29 Wis. 2d 106, 111, 138 N.W.2d 157, 161 (1965), *citing* Stumpp v. Bank of New York, 212 App. Div. 608, 614, 209 N.Y.S. 396, 402 (1925). *See* J. BRADY, THE LAW OF BANK CHECKS 549 (H. Bailey ed., 3d ed. 1962) [hereinafter cited as BRADY].

[44] 4-406(2) (44-2632(B)). Conversely, the burden of proving the bank's breach of duty under 4-406(3) (44-2632(C)) is on the customer. See note 53 *infra* for the rationale behind this risk distribution.

[45] This approach was occasionally taken at common law. *E.g.*, First Nat'l Bank v. Richmond Elec. Co., 106 Va. 347, 56 S.E. 152 (1907). One authority has stated that this is the intended result of 4-406 (44-2632). W. BRITTON, BILLS AND NOTES 372 (2d ed. 1961) [hereinafter cited as BRITTON].

On the other hand, some courts have elected to hold the employer accountable only for exercising reasonable care in entrusting the dishonest employee with the responsibility of examining the employer's cancelled checks and bank statements.[46]

In *Jackson v. First National Bank*,[47] the Tennessee Court of Appeals adopted this latter approach where the dishonest financial secretary of a church was entrusted with examination of cancelled checks and bank statements. The employee had forged the name of another officer of the church and converted funds to his own use. Because the employee had been a faithful and trusted member of the church for more than 20 years, the court refused to impute his knowledge to the church. It held that the church had exercised reasonable care in entrusting these duties to the employee,[48] thereby excusing the church of its "discovery" and "notice" responsibilities under 4-406(1). The approach taken by the *Jackson* court would not be available, however, to modify the customer's duty after the maximum time limitations of section 4-406(4) had elapsed.

Banks' Duty of Ordinary Care

Lack of ordinary care by the drawee bank in paying an item will deprive it of any defenses which would otherwise have been available under 4-406(1) and (2) with respect to such item.[49] The Code does not define the term "ordinary care." Once again, therefore, its limits are probably to be deduced from the totality of circumstances.[50] The mere fact the bank has paid an item bearing the unauthorized signature of the drawer does not constitute a breach of ordinary care and will not necessarily deprive that bank of its potential defenses under 4-406(1) or (2).[51] Proof of the failure to exercise ordinary care necessitates the additional inquiry of whether ordinary care in comparing the unauthorized signature with the authentic version on file would have disclosed the forgery. In measuring the bank's care, courts have looked to the surrounding circumstances to determine whether there were sufficient facts to put the bank on notice before payment.[52] The burden of proving lack of ordinary care is on the drawer.[53]

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[46] *E.g.*, Jackson v. First Nat'l Bank & Trust Co., 55 Tenn. App. 545, 403 S.W.2d 109 (1966). For citations to authorities taking this view without the Code see *Annot.*, 103 A.L.R. 1147 *et seq.* (1936).

[47] 55 Tenn. App. 545, 403 S.W.2d 109 (1966).

[48] *Id.* at —, 403 S.W.2d at 112.

[49] 4-406(3) (44-2632(C)).

[50] *See* 3-406 (44-2643), Comment 3.

[51] The bank is responsible for knowing and comparing the signature. See 3-418 (44-2555), Comment 1.

If the term "ordinary care" is construed to prescribe a duty to live up to a standard acceptable to contemporary bank standards, there is authority to support the argument that modern day banks handling large volumes of checks do not inspect each item for its customer's forged signature. Penney, *Bank Statements, Cancelled Checks, and Article Four in the Electronic Age*, 65 MICH. L. REV. 1341, 1344 n.13 (1967).

[52] *See* notes 98-100 and accompanying text *infra*.

[53] 4-406(3) (44-2632(C)). The reason for placing the burden of proving the

Modifying 4-406(4) Time Limits by Separate Agreements

Many banks include in their depositor's contract or periodic bank voucher a provision that the customer waives protest on any charge not objected to within a specified period of time. Typically these provisions considerably modify the time limits prescribed by 4-406(4).[54] Prior to the Code, courts generally looked upon such agreements with disfavor.[55] The Code, however, expressly acknowledges the validity of such agreements,[56] with the only limitations being that they cannot be "manifestly unreasonable"[57] and that the parties must act in "good faith."[58] A complete disclaimer by the bank of any responsibilities would surely fail as being manifestly unreasonable, although pre-Code agreements limiting the time for discovering and reporting improper charges to ten days had occasionally been upheld in the face of restrictions similar to those imposed by the Code.[59] In light of the Code's express acknowledgement of the validity of such agreements, pre-Code decisions upholding these agreements will have continued validity.

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bank's negligence on the customer, and of proving the customer's negligence on the bank is explained by the draftsmen:

> This distribution of the burden of establishing between the customer and the bank provides reasonable equality of treatment and requires each person asserting the negligence to establish such negligence rather than requiring either person to establish that his entire course of conduct constituted ordinary care. 4-406 (44-2632), Comment 4.

For some comments on the evidentiary procedure in proving the bank's negligence, see Penney, *supra* note 51, at 1350-52.

54 An example of such an agreement in a checking account is as follows:

> Cancelled vouchers and statement of account will be prepared each month, . . . and mailed at the depositor's risk to his last address of record unless otherwise instructed by authorized signer(s) and the depositor shall make examination of same, and all objections to any item thereof, for any cause whatsoever, whether then known or unknown, not made on or before the fifteenth day of the month succeeding that covered thereby, shall be absolutely barred and waived. R. SPEIDEL, R. SUMMERS, & J. WHITE, TEACHING MATERIALS ON COMMERCIAL TRANSACTIONS 987 (1969).

55 *See* BRADY, *supra* note 43, at 550-51.

56 4-103(1) (44-2603(A)):

> The effect of the provisions of this Article may be varied by agreement except that no agreement can disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care or can limit the measure of damages for such lack or failure; but the parties may by agreement determine the standards by which such responsibility is to be measured if such standards are not manifestly unreasonable.

Such "agreement" sections of the Code have been sharply criticized. *See* Gilmore, *Uniform Commercial Code: A Reply,* 61 YALE L.J. 364, 375 (1952).

57 The term "manifestly unreasonable" is not defined by the Code. Comment 2 to 4-103 (44-2603), however, gives a few examples of what is manifestly unreasonable: "The agreements may not disclaim a bank's responsibility for its . . . failure to exercise ordinary care and may not limit the measure of damages for such lack or failure . . . ."

58 The Code imposes an overall obligation of good faith on persons acting within its scope. 1-203 (44-2210). *See* 4-103 (44-2603), Comment 2.

59 *See, e.g.,* Brunswick Corp. v. Northwestern Nat'l Bank & Trust Co., 214 Minn. 370, 8 N.W.2d 333 (1943) (court upheld 10-day agreement because it was not unreasonable under circumstances). *See also* BRADY, *supra* note 43, at 550-51; 2 PATON'S DIGEST OF LEGAL OPINIONS 1875-77 (1942).

Application of 4-406(4) to Double Forgeries

Section 4-406(4) provides two periods within which a customer must give notice to the bank. The maximum time permitted to report the customer's unauthorized signature or an alteration is one year, while the limit within which to report an unauthorized indorsement is three years.[60] The Code is silent, however, as to which applies when an item bears both a forged indorsement and either the customer's unauthorized signature or an alteration. Prior to enactment of the Code, courts generally treated checks bearing both a forged drawer's signature and a forged indorsement as if it contained only a forged drawer's signature.[61] The effect of this construction under pre-Code law usually placed the loss on the drawee.[62] A similar construction under the Code, however, would favor the drawee since it would cause the drawer to sustain the loss after lapse of the shorter time period.

It has been argued that related provisions of the Code support treatment of a double forgery as a forged indorsement, the effect of which would allow the customer the longer time period in which to notify the bank. The argument is that since the warranty provisions covering paid items bearing a forged drawer's signature (3-418) are subordinated to the warranty provisions covering forged indorsements (3-417(2)), the Code suggests that a double forgery should be treated as a forged indorsement.[63] It might also be argued, however, that Comment 5 to 4-406 implies that the customer should be held to the shorter time limitation.[64]

In *Bank of Thomas County v. Dekle*,[65] the only judicial decision which has approached the issue within the context of the Code, the court held that the longer time period applied to an item containing a double forgery. In reaching its decision, however, the court made no reference to the Code for support. Rather, it simply found "no reason" to apply the shorter time period.[66] Indeed, there is no express Code language to the contrary.

Drawer v. Collecting Bank—Availability of 4-406 Defenses— 4-406(5)

The Code provides for separate actions in order to shift loss from the drawer to the collecting bank in check forgery suits. It provides for

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60 4-406(4) (44-2632(D)), *quoted* in note 23 *supra*.

61 Comment, *Allocation of Losses from Check Forgeries Under the Law of Negotiable Instruments and the Uniform Commercial Code*, 62 YALE L.J. 417, 455 n.191 and accompanying text (1953).

62 *Id.*

63 *Id.* at 455.

64 Comment 5 implies that the consequences of 4-406(4) (44-2632(D)) are meant to induce the customer to inspect his bank statement and returned items promptly and with care. If this attitude is accepted by the courts, customers may be held to the shorter time period in the case of a double forgery.

65 119 Ga. App. 753, 168 S.E.2d 834 (1969).

66 *Id.* at 758, 168 S.E.2d at 837 (on motion for rehearing).

an action by the customer-drawer against the drawee bank[67] and by the drawee bank against the collecting bank.[68] The Code is silent as to whether the drawer may sue the collecting bank directly, and the split of authority[69] which existed prior to its enactment is still present.[70]

This issue was first met under the Code in *Stone & Webster Engineering Corp. v. First National Bank & Trust Co.*,[71] where the court denied the customer's suit against the collecting bank. The court reasoned that the customer had no right of action against the collecting bank, and to hold otherwise would disrupt the operation of the Code's system of defenses.

The Code is in complete harmony with this reasoning. The collecting bank does not warrant "to a drawer with respect to the drawer's own signature."[72] In the case of a forged indorsement, the customer-drawer has no rights in an item payable to the order of another.[73] Moreover, the 4-406 defenses which may be available to the drawee bank arising out of its relationship with its customer are not expressly made available to a collecting bank. To allow the customer-drawer to sue the collecting bank directly would permit him to avoid valid section 4-406 defenses and thereby recover against a collecting bank when he could not have recovered against the drawee.[74]

Notwithstanding the sound arguments raised in *Stone & Webster*, courts subsequent to that decision have devised a fiction to permit the drawer-customer's suit against the collecting bank.[75] These courts have

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[67] An unauthorized signature is wholly inoperative as that of the person whose name is signed. 3-404 (44-2541).

[68] 3-417 (44-2544). Assuming both these actions are successful, the collecting bank may also be able to shift loss to a prior party under the warranties of 3-417 (44-2544) and 4-207 (44-2616).

[69] For pre-Code cases denying the drawer-customer's suit against the collecting bank, *see* California Mill Supply Corp. v. Bank of America Nat'l Trust & Sav. Ass'n, 36 Cal. 2d 334, 223 P.2d 849 (1950); First Nat'l Bank v. North Jersey Trust Co., 18 N.J. Misc. 449, 451-52, 14 A.2d 765 (1940); Lavanier v. Cosmopolitan Bank & Trust Co., 36 Ohio App. 285, 173 N.E. 216 (1929). *See also* BRITTON, *supra* note 45, at 417. *Contra*, Home Indem. Co. v. State Bank, 233 Iowa 103, 8 N.W.2d 757 (1943); Sidles Co. v. Pioneer Valley Sav. Bank, 233 Iowa 1057, 1063, 8 N.W.2d 794 (1943); Railroad Bldg. Loan & Sav. Ass'n v. Bankers Mortgage Co., 142 Kan. 564, 51 P.2d 61 (1935); Levin v. Union Nat'l Bank, 224 Md. 603, 168 A.2d 889 (1961).

[70] For authority denying the customer suit against the collecting bank under the Code, *see* Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 184 N.E.2d 358 (1962). *Contra*, Allied Concord Financial Corp. v. Bank of America Nat'l Trust & Sav. Ass'n, 275 A.C.A. 586, 80 Cal. Rptr. 622 (1969); Commonwealth v. Nat'l Bank & Trust Co., 46 Pa. D. & C.2d 141 (C.P. 1968).

[71] 345 Mass. 1, 184 N.E.2d 358 (1962).

[72] *See* 3-417(1)(b)(ii) (44-2554(A)(2)(b)); 4-207(1)(b)(ii) (44-2616(A)(2)(b)).

[73] Having no rights in the check, he may not sue for conversion under 3-419 (44-2556).

[74] If the drawee were to waive available section 4-406 defenses against its customer, it would be barred from recovery against a collecting bank. 4-406(5) (44-2632(E)), *quoted* in note 23 *supra*.

[75] *E.g.*, Allied Concord Financial Corp. v. Bank of America Nat'l Trust & Sav. Ass'n, 275 A.C.A. 586, 80 Cal. Rptr. 622 (1969); Commonwealth v. Nat'l Bank & Trust Co., 46 Pa. D. & C.2d 141 (C.P. 1968).

reasoned that the drawer is subrogated to the rights of the drawee against the collecting bank on principles of assignment, thus permitting the drawer to sue the collecting bank under the warranties given the drawee.[76] To avoid conflict with the Code, these courts have allowed the collecting bank to avail itself of any defenses which would have been available to the drawee against the customer under 4-406.[77] Despite the haphazard nature of this application of the Code, the result obtained avoids multiplicity of suits[78] and, if the provisions stated in 4-406(5) are followed, the results reached will be the same as separate suits would have afforded.[79]

NEGLIGENCE CONTRIBUTING TO ALTERATION OR UNAUTHORIZED SIGNATURE—SECTION 3-406

Section 3-406[80] prevents a party, who by his negligence has substantially contributed to a forgery or alteration, from asserting the illegality against a non-negligent party. It may operate as a defense against any person who handles the instrument.[81] It extends the common law which protected only drawees by also affording protection to holders in due course and other payors who may not technically be drawees.[82]

For section 3-406 to operate, two conditions must exist. First, the plaintiff's negligence must have substantially contributed to the making of the unauthorized signature or alteration. Secondly, the defendant must have taken the instrument in accordance with holder in due course requirements,[83] or made payment on the instrument in good faith and in accordance with the reasonable commercial standards of the payor's business.[84]

Plaintiff's Care—"Substantially Contributes"

The Code makes no attempt to define the expression "substantially

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[76] 3-417 (44-2554); 4-207 (44-2616).

[77] To secure the result intended by the Code, courts adopting this approach will also have to give the collecting bank any defenses it had against the drawee bank.

[78] *See e.g.*, Commonwealth v. Nat'l Bank & Trust Co., 46 Pa. D. & C.2d 141 (C.P. 1968) (plaintiff would have been forced to proceed against 20 different drawee banks had the court not allowed it to pursue one collecting bank instead).

[79] 4-406(5) (44-2632(E)) prohibits the drawee bank from waiving a defense available under 4-406 and then proceeding against the collecting bank. *But see* note 104 and accompanying text *infra*.

[80] 3-406 (44-2543):

> 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.

[81] 1-201(30) (44-2208(30)) defines a "person" as including "an individual or an organization."

[82] *See* BRITTON, *supra* note 45, at 665-66 (by implication).

[83] *See* note 93 *infra*.

[84] Gresham State Bank v. O & K Constr. Co., 231 Ore. 106, 119, 370 P.2d 726, 732, *rehearing denied*, 372 P.2d 187 (1962).

contributes."[85] Section 3-406 does prescribe, however, that the conduct embodied in this expression must not only contribute substantially to an opportunity for a forgery or alteration, but that the opportunity must actually be taken advantage of by the wrongdoer.[86] Courts construing the term "substantially contributes" within the context of 3-406 have agreed that the term is analogous to the nebulous concept of factual causation in the law of negligence, and the applicable test in each case is the same as the substantial factor test generally applied in negligence law.[87]

Conduct amounting to a "substantial contribution" has been found where a drawer has negligently mailed his signed check to a wrong payee having the same name as the true payee[88] and where a payee failed to examine its records over a three-year period when examination would have revealed the unauthorized charges and halted further forgeries.[89] These examples can only serve as illustrations, however, since each case must be decided in light of its particular circumstances.[90]

The Code is silent as to whether the negligent contribution by an employee who participates in a forgery is imputable to his employer. Courts which dealt with the issue before Code enactment were in hopeless conflict,[91] while courts acting under the Code support the view that a dishonest employee's conduct is not imputed automatically to the employer. Instead, these courts have inquired as to whether the employer was afforded reasonable grounds to suspect the misconduct or whether the exercise of reasonable care would have aroused suspicion of the misconduct.[92]

Defendant's Care—Holder in Due Course

The defense provided by 3-406 is available only to holders in due course[93] and drawees, or other payors, who pay the instrument in good

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85 3-406 (44-2543), Comment 3. However, the Code affords some guidance by providing examples. *See* 3-406 (44-2543), Comments 1 & 7.

86 3-406 (44-2543), Comment 4.

87 *See, e.g.*, Gast v. American Cas. Co., 99 N.J. Super. 538, 240 A.2d 682 (1968); Gresham State Bank v. O & K Constr. Co., 231 Ore. 106, 370 P.2d 726, *rehearing denied*, 372 P.2d 187 (1962). For an analysis of the "substantial factor" test, see W. PROSSER, TORTS § 41, at 240 (3d ed. 1964).

88 3-406 (44-2543), Comment 3; *see e.g.*, Park State Bank v. Arena Auto Auction, Inc., 59 Ill. App. 2d 235, 207 N.E.2d 158 (1965).

89 Gresham State Bank v. O & K Constr. Co., 231 Ore. 106, 370 P.2d 726, *rehearing denied*, 372 P.2d 187 (1962).

90 3-406 (44-2543), Comment 3.

91 *See* Gresham State Bank v. O & K Constr. Co., 231 Ore. 106, 115, 370 P.2d 726, 731 nn.4 & 5 (1962).

92 Gast v. American Cas. Co., 99 N.J. Super. 538, 240 A.2d 682 (1968); Gresham State Bank v. O & K Constr. Co., 331 Ore. 106, 370 P.2d 726, *rehearing denied*, 372 P.2d 187 (1962); Jackson v. First Nat'l Bank, 55 Tenn. App. 545, 403 S.W.2d 109 (1966). *Cf.* Salsman v. National Community Bank, 102 N.J. Super. 482, 246 A.2d 162 (1968), *aff'd per curiam*, 105 N.J. Super. 164, 251 A.2d 460 (1969) (principal-agent relation). *Jackson* also involved this same point within the context of 4-406. The previous discussion of imputing the knowledge of a dishonest employee to an employer with regard to 4-406, should apply to 3-406 as well. *See* notes 45-48 and accompanying text *supra*.

93 3-302(1) (44-2532(A)): A holder in due course is a holder who takes the

faith and in accordance with reasonable commercial standards.[94] The distinction reflects the favored position of holders, who may raise the defense providing they are "honest in fact" in taking the item, regardless of the standard of care exercised.[95] Drawees and other payors, on the other hand, must pay an item in good faith and in accordance with the reasonable standards of their business to avail themselves of the 3-406 defense.[96] The basis of the distinction is that a holder takes an instrument by indorsement in the item's course of collection and therefore may attain the status of "holder in due course," while a drawee cannot take by indorsement and therefore is deprived of "holder" and "holder in due course" status.[97]

Duty of Drawee or Payor—Reasonable Commercial Standards

Courts have been uniform in evaluating the quantum of care required by the term "reasonable commercial standards" of the section 3-406 defense. Generally, the test applied has been whether the drawee or other payor should reasonably have suspected an unauthorized signature or alteration.[98] To illustrate, where a drawee bank pays an item drawn on the bank by a drawer-customer, the drawee is under a duty to inspect the item for the drawer's unauthorized signature before paying the item.[99] If an inspection satisfying reasonable commercial standards of banking would have revealed the forged signature, the bank has failed in its duty and therefore is deprived of the defense of 3-406. On the other hand, where a drawee or other payor pays an item directly to a wrongdoer, courts have generally looked for abnormal circumstances which should have aroused the payor's suspicion enough to warrant an inquiry as to the authority of the party indorsing the instrument.[100]

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instrument (a) for value; (b) in good faith; and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person. *See* 3-303 (44-2533), 3-304 (44-2534), 4-209 (44-2618).

[94] *See* 3-406 (44-2543).

[95] *See* 3-201(1) (44-2532(A)); 1-201(19) (44-2208 (19)) (definition of good faith).

[96] *See* 3-406 (44-2543).

[97] *See* 3-302(1) (44-2532(A)). *See also* 1-201(20) (44-2208(20)).

[98] *E.g.*, Thompson Maple Prods. Inc. v. Citizens Nat'l Bank, 211 Pa. Super. 42, 234 A.2d 32 (1967). *See* cases cited note 100 *infra*.

[99] 3-417 (44-2554) *quoted* in note 7 *supra*; 3-418 (44-2555) *quoted* in note 14 *supra* (by implication).

[100] Salsman v. National Community Bank, 102 N.J. Super. 482, 246 A.2d 162 (1968), *aff'd per curiam*, 105 N.J. Super. 164, 251 A.2d 460 (1969) (not reasonable commercial business standard for depositary bank to pay purported trustee without making inquiry of authority to indorse); Gresham State Bank v. O & K Constr. Co., 231 Ore. 106, 370 P.2d 726, *rehearing denied*, 372 P.2d 187 (1962) (court judicially noticed that reasonable commercial standards of a businessman requires an inquiry of authority where an agent purports to have authority to make indorsements for principal); Jackson v. First Nat'l Bank, 55 Tenn. App. 545, 403 S.W.2d 109 (1966) (bank should have inquired as to trust funds withdrawn for personal benefit of trustee). *Cf.* Teas v. Third Nat'l Bank & Trust Co., 125 N.J. Eq. 224, 4 A.2d 64 (Ct. Err. & App. 1939) (depositary bank was derelict in failing to inquire as to an attorney's right to indorse check as "trustee" and place the proceeds in his own

Drawer's Choice of Defendants

In jurisdictions recognizing the customer-drawer's right to sue the collecting bank,[101] the drawer will be afforded a choice of defendants. The customer-drawer's action against the drawee bank for breach of the contract of deposit[102] gives rise to a suit against the collecting bank under the judicially innovated fiction of subrogation to the rights of the drawee bank.[103] A customer-drawer may thus avoid suit against a drawee bank which has exercised reasonable commercial standards in order to pursue a collecting bank which may not have exercised such care.

Assume, for example, that a collecting bank has negligently paid a check bearing the unauthorized indorsement of the presentor and that the item is transferred through banking channels. The drawee bank pays the item in good faith and in accordance with reasonable commercial standards and then charges the customer's account. If the customer has substantially contributed to the forged indorsement, he will sustain the loss in jurisdictions denying the drawer's suit against the collecting bank[104] because the drawee is protected by 3-406. In jurisdictions permitting the drawer to sue the collecting bank, however, the drawer may recover since the defense of 3-406 will not be available to the collecting bank. Although the issue has not been litigated to this point, it is conceivable that courts allowing direct suit against the collecting bank might avoid inequities by allowing the collecting bank to assert the 3-406 defense available to the drawee bank. Thus, the same result would be reached in all Code jurisdictions regardless of whether direct suit against the collecting bank was permitted.

CONCLUSION

The effect of the defenses afforded by 3-406 and 4-406 is, in most instances, to prevent negligent non-bank parties from shifting losses caused by unauthorized signatures or alterations to banks which have exercised care. By deterring careless conduct, the operation of these defenses enhances both stability and transferability of checks.

The many questions left unanswered by the Code have afforded courts the opportunity to withdraw from the strict letter of the Code and place loss on the party best able to afford it, with minimum regard for the quantum of care exercised. The very nature of the negligence concepts

account to his own credit); Hartford Acc. & Indem. Co. v. Farmers Nat'l Bank, 24 Tenn. App. 699, 149 S.W.2d 473 (1941) (withdrawal of funds from trust account for personal benefit of trustee charged bank with knowledge that funds were being illegally withdrawn).

101 *E.g.*, Allied Concord Financial Corp. v. Bank of America Nat'l Trust & Sav. Ass'n, 275 A.C.A. 586, 80 Cal. Rptr. 622 (1969); Commonwealth v. Nat'l Bank & Trust Co., 46 Pa. D. & C.2d 141 (C.P. 1968).

102 *See* 3-404(1) (44-2541(A)).

103 *See* notes 75-79 and accompanying text *supra*.

104 *E.g.*, Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 184 N.E.2d 358 (1962).

affords further opportunity to avoid the effects of 3-406 and 4-406. While opportunity to escape from the Code rules is inevitable under rules containing negligence standards, this opportunity may be minimized by uniform rules addressed to the many unanswered questions. By permitting judicial discretion to revert to the diverse rules which prevailed prior to Code enactment, application of the Code becomes a matter of judicial choice, a result sharply in contrast to the Code's quest for uniformity and certainty of the law among the states.