THE DOUBLE PRECLUSION OF U.C.C. SECTION 3-406: DUTIES OF CARE AND REASONABLE COMMERCIAL STANDARDS

Peter Young, an Englishman, was going on a business trip, so he left several presigned checks with his wife to be used to fulfill any needs of his business during his absence. While he was gone, Young's wife directed his clerk, William Worcester, to fill in one of the checks for the amount of fifty pounds, two shillings. This Worcester did, making the check payable for wages. In so doing, however, he wrote the digits at a conspicuous distance from the printed pound symbol and started the words in the middle of the line, beginning with a small letter "f." Worcester showed the check to Mrs. Young who told him to cash it. Prior to presenting the check to Grote and Company, Young's banker, Worcester inserted the numeral "3" between the pound symbol and the previously written digits and wrote the words "Three Hundred" on the first half of the other line. Grote and Company paid this raised sum to Worcester and charged Young's account accordingly.[1]

Young brought an action against the bank to reduce the charge against his account. The Court of Common Pleas held that Young had to bear the loss caused by his clerk's misdeed in *Young v. Grote*.[2] No person could have discovered through the exercise of "due and ordinary diligence" that the check had been raised from the amount intended, all the writing having been done by Worcester.[3] Peter Young was deemed grossly negligent in delivering the check to his clerk in a condition so readily susceptible to alteration; indeed, it was Young's negligence that caused Grote and Company to pay the larger sum.[4]

Though some courts followed the lead of *Young v. Grote* in holding that a negligent drawer is estopped from asserting a claim against the drawee bank,[5] other courts, both in England and the United States, limited the applicability of the decision in *Young v. Grote* to the particular facts of that

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1. Young v. Grote, 130 Eng. Rep. 764, 764-65 (C.P. 1827). Cases involving a person wrongfully raising the amount of a check by filling in spaces left by the drawer are not merely problems of an earlier, less sophisticated day. *See* Owensboro Nat'l Bank v. Crisp, 608 S.W.2d 51, 52 (Ky. 1980).

2. 130 Eng. Rep. 764, 764 (C.P. 1827).

3. *Id.* at 765.

4. *Id.* Justices Best and Park sharply criticized the plaintiff for entrusting the presigned checks to a "female" rather than to a "man of business." *Id.* at 767.

5. *E.g.*, Basch v. Bank of America Trust and Sav. Ass'n, 22 Cal. 2d 316, 321, 139 P.2d 1, 5 (1943). *See generally* CAL. COM. CODE § 3406 comment 2 (West 1964) (alternative common law theories for imposing loss on negligent drawer).

case and imposed liability on the bank.[6] The contrary result reached in these cases rests upon the policy determination that the drawer could not have anticipated that his negligence would cause someone to commit a crime, and, therefore, he should not be required to bear the loss resulting from that unlawful conduct.[7] Even where the drawer wrote a check in pencil and a third person erased the original amount and substituted a larger sum, the bank could only charge its customer's account for the original amount.[8]

Against this background stands section 3-406 of the Uniform Commercial Code (hereinafter "U.C.C." or "Code"). From the two conflicting lines of authority discussed above, the National Conference of Commissioners on Uniform State Laws chose to adopt the doctrine of *Young v. Grote*.[9] Section 3-406 of the Code provides as follows:

> Any person who by his negligence substantially contributes to a material alternation 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.[10]

The section establishes three requirements for the application of its preclusion in a given case. First, the party sought to be precluded must be guilty of an act or omission which is negligent. That negligence in turn must have contributed substantially to the happening of the alteration or unauthorized signature which is the subject matter of the lawsuit.[11] Finally, the party seeking the protection of the preclusion must either be a holder in due course or have paid the instrument in good faith and in accordance with the reasonable commercial standards of its business.[12] The efforts of the courts to construe and apply these requirements is the subject of this Note.

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6. *E.g.*, Knoxville Nat'l Bank v. Clark, 51 Iowa 264, 266-67, 1 N.W. 491, 492-93 (1879) (alteration of check); Governor & Co. of the Bank of Ireland v. Trustees of Evans' Charities, 10 Eng. Rep. 950, 959 (H.L. 1855) (unauthorized drawer's endorsement); Baxendale v. Bennett, 3 Q.B.D. 525, 530, 533-34 (1878) (unauthorized drawer's endorsement). For a review of the pre-U.C.C.. case law, see Whaley, *Negligence and Negotiable Instruments*, 53 N.C.L. Rev. 1, 4-10 (1974) [hereinafter cited as Whaley, *Negligence*].

7. Knoxville Nat'l Bank v. Clark, 51 Iowa at 272, 1 N.W. at 497. The criminal's conduct is an intervening cause which relieves the negligent party of liability. W. Prosser, Law of Torts § 44, at 282-83 (4th ed. 1971).

8. Glasscock v. First Nat'l Bank, 114 Tex. 207, 266 S.W. 393 (1924).

9. U.C.C. § 3-406 comment 1 (1972). This comment describes that doctrine as holding that "a drawer who so negligently draws an instrument as to facilitate its material alteration is liable to a drawee who pays the altered instrument in good faith." *Id.*

10. U.C.C. § 3-406 (1972).

11. *Id. See supra* text accompanying note 4.

12. U.C.C. § 3-406 (1972). *See supra* text accompanying note 3.

I. Loss Allocation Under U.C.C. Articles 3 and 4

Section 3-406[13] provides, by means of an affirmative defense, a mechanism for the allocation of losses resulting from the negotiation of materially altered and fraudulently endorsed instruments where the alteration or endorsement was caused[14] by the negligence of the complaining party.[15] An understanding of the statutory machinery of articles 3 and 4 of the Code for allocating such losses is essential to a full appreciation of the role and significance of section 3-406.

Where a check has been negotiated in an altered form[16] or over an unauthorized endorsement,[17] liability clearly should rest on the wrongdoer.[18] But "[t]o utter what is almost a truism, when the dust settles, the wrongdoer will either be off the scene or insolvent."[19] It is in this context that the loss shifting mechanisms of U.C.C. articles 3 and 4 come into play.

A. *General Rules of Liability*

The relationship between a bank and a depositing customer is a contractual one.[20] A drawee bank has the duty to disburse funds from a drawer's account only in accord with the agreement between them, and the signature card is a key part of that agreement.[21] This duty is implicit in Code section 4-401(1), which permits a bank to charge only those items "properly payable" against its customer's account.[22] If the drawee pays a

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13. As part of U.C.C. article 3, section 3-406 applies to disputes involving any type of commercial paper. U.C.C. § 3-103 comment 1 (1972). *See generally id.* § 3-104 (definition of negotiable instrument). This Note will focus on disputes involving checks and drafts and accordingly will discuss section 3-406 as it has been applied in conjunction with the provisions of U.C.C. article 4, as well as with other provisions found in article 3.

14. To be the "cause" of the alteration or the unauthorized endorsement, the negligence of the complaining party must "substantially contribute" to the alteration of or to the making of the endorsement. *See id.* § 3-406. The nature of the causal connection necessary to satisfy the section's substantial contribution requirement is the subject of much disagreement among courts and commentators. *See infra* text accompanying notes 98-164.

15. Section 3-406 is worded in terms of a preclusion, but its effect is that the complaining party is liable for the payment of the altered or fraudulently endorsed instrument. Cal. Com. Code § 3406 comment 1 (West 1964).

16. For the definition of a material alteration, see U.C.C. § 3-407.

17. U.C.C. § 1-201(43) defines an unauthorized signature or endorsement as "one made without actual, implied or apparent authority and includes a forgery."

18. *See* U.C.C. § 3-404 comment 2 (1972). The liability of the wrongdoer is not affected by section 3-406. 2 R. Anderson, Uniform Commercial Code § 3-406:7, at 943 (2d ed. 1971).

19. J. White, & R. Summers, Handbook of the Law Under the Uniform Commercial Code § 15-1, at 578 (2d ed. 1980).

20. *Id.* at 579.

21. R. Anderson, *supra* note 18, § 3-404:8, at 924. Chief Justice Best in *Young v. Grote* recognized "the duty of the banker to be acquainted with his customer's hand-writing." *Id.*

22. Maddox v. First Westroads Bank, 199 Neb. 81, ___, 256 N.W.2d 647, 652 (1977); Ray v. Farmers' State Bank, 576 S.W.2d 607, 608 (Tex. 1979); J. White & R. Summers, *supra* note

check bearing an unauthorized drawer's signature, the drawer has a right of action against the drawee for the latter's breach of duty.[23] Where the drawee pays a check which has been altered, Code section 4-401(2) authorizes the drawee to charge the drawer, "but only according to the original tenor of the altered item."[24]

The payment of an instrument on a forged payee's endorsement constitutes conversion under U.C.C. section 3-419(1)(c). The cause of action afforded by that section may be asserted by the drawer or the payee.[25] The party named on the instrument as payee is the "owner" thereof.[26] Payment of the check by those who trace their title to it through the forger, even though made in good faith,[27] is an act of dominion over the instrument in derogation of the payee's property rights.[28]

Liability for the payment of an item which has been altered or on which the payee's endorsement has been forged can be shifted to the party who dealt with the wrongdoer under the warranty provisions of sections 3-417 and 4-207 of the Code.[29] Section 4-207 places the loss caused by the improper payment of a forged or altered check on the first bank in the chain of collection.[30] The rationale behind this rule is that the first bank to deal with

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19, § 15-1, at 579.

23. R. ANDERSON, *supra* note 18, § 3-404:13, at 927. A drawee held liable to drawer for payment of an item over an unauthorized signature will, in most situations, bear ultimate liability for the loss. J. WHITE & R. SUMMERS, *supra* note 19, § 16-1, at 607.

24. Ray v. Farmers' State Bank, 576 S.W.2d at 608-09. The drawee can do so only if it paid the item in good faith. *Id.* at 608; U.C.C. § 4-401(2) (1972).

25. J. WHITE & R. SUMMERS, *supra* note 19, § 15-1 at 580-81.

26. R. ANDERSON, *supra* note 18, § 3-404:14, at 927-28.

27. The Code defines conversion liability for payment over a forged endorsement "in absolute terms." Thornton & Co. v. Gwinett Bank, 151 Ga. App. 641, ___, 260 S.E.2d 765, 768 (1979); *see* U.C.C. § 3-419 (1)(c).

28. R. ANDERSON, *supra* note 18, § 3-404:14, at 927-28. "[T]he measure of liability [for conversion] is presumed to be the face amount of the instrument." U.C.C. § 3-419(2). In the rare case where partial recovery is had from the forger, the defendant is entitled to a set-off in the amount of the reimbursement obtained by the plaintiff from the forger. Thornton & Co. v. Gwinett Bank, 151 Ga. App. at ___, 260 S.E.2d at 769; Twellman v. Lindell Trust Co., 534 S.W.2d 83, 96 (Mo. Ct. App. 1976). Where the damage sustained by the complaining party at the hands of the wrongdoer is not limited to forgery losses, the defendant is not entitled to a set-off so long as the reimbursement received from the forger is in an amount less than the non-forgery losses. *See* Aetna Casualty & Sur. Co. v. Helper State Bank, 6 Kan. App. 2d 543, ___, 630 P.2d 721, 730 (1981).

29. Comment, *Check Forgeries: Variations of Rules of Liability Based on Fault—U.C.C. Defense Sections 3-406 and 4-406*, 12 ARIZ. L. REV. 417, 418-19 (1970) [hereinafter cited as Comment, *Check Forgeries*]. In most cases an analysis of the warranties provided by section 4-207 is sufficient; however, where the forged or altered instrument was transfered outside the check collection process, reference must be made to section 3-417. J. WHITE & R. SUMMERS, *supra* note 19, § 15-5, at 601. For a discussion of the significant differences between the two warranty provisions, see *id.* at 600 n.47.

30. Fireman's Fund Ins. Co. v. Security Pac. Nat'l Bank, 85 Cal. App. 3d 797, 830, 149 Cal. Rptr. 883, 905 (1978); Atlantic Bank v. Israel Discount Ltd., 108 Misc. 2d 342, 346, 441

the item is in the best position in the chain of collection to ensure that the person presenting the check has good title to the instrument and has made a valid endorsement thereto.[31]

B. *Limitations on Liability*

Though sometimes vague and inconclusive in their application to a particular factual situation, the provisions of the U.C.C. were designed "to facilitate commercial transactions without resort to litigation."[32] To that end, the loss which results from the negotiation of a forged or altered instrument is allocated according to the general rules discussed above, absent certain limited circumstances.[33] Where special circumstances are present, the Code provides defenses that cut off the right to reimbursement to which a party would otherwise be entitled under the general rules of liability.[34]

The defenses available to a defendant[35] in an action on an instrument which was materially altered or negotiated over an unauthorized endorsement are of three basic types.[36] The first two defenses, apparent authority

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N.Y.S.2d 315, 317 (App. Term. 1981). Of course the bank can attempt to shift the loss to the actual wrongdoer using the same warranty provisions. *See* U.C.C. §§ 3-417, 4-207(2) (1972).

31. Birmingham Trust Nat'l Bank v. Central Bank & Trust Co., 49 Ala. App. 630, ___, 275 So. 2d 148, 151 (1973); Maddox v. First Westroads Bank, 199 Neb. at ___, 256 N.W.2d at 653; Atlantic Bank v. Israel Discount Ltd., 108 Misc. 2d at 346, 441 N.Y.S.2d at 217. The duty placed on the first bank is to verify the validity of *all* endorsements placed on a check subsequent to the drawer's signature and not merely the validity of the endorsement made by the person actually presenting the check. Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d 671, 685, 582 P.2d 920, 930, 148 Cal. Rptr. 329, 339 (1978); Fireman's Fund Ins. Co. v. Security Pac. Nat'l Bank, 85 Cal. App. 3d at 830, 149 Cal. Rptr. at 905. The Code imposes no duty on a drawee bank to verify the validity of the payee's endorsement on a check presented to it for payment by a collecting bank. Birmingham Trust Nat'l Bank v. Central Bank & Trust, 49 Ala. App. at ___, 275 So. 2d at 152; Fireman's Fund Ins. Co. v. Security Pac. Nat'l Bank, 85 Cal. App. 3d at 830, 149 Cal. Rptr. at 905. The practical purpose of the Code's warranty provisions is " 'to speed up the collection and transfer of checks' " by relieving subsequent banks in the chain of collection of the burden of " 'meticulously check[ing] the endorsements of each item transfered.' " Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d at 685, 582 P.2d at 930, 148 Cal. Rptr. at 339 (1978) (quoting Federal Deposit Ins. Corp. v. Marine Nat'l Bank, 303 F. Supp. 401, 403 (M.D. Fla. 1969)).

32. Von Gohren v. Pacific Nat'l Bank, 8 Wash. App. 245, ___, 505 P.2d 467, 474 (1973).

33. Perley v. Glastonbury Bank & Trust Co., 170 Conn. 618, ___, 368 A.2d 149, 153 (1976); Salsman v. National Community Bank, 102 N.J. Super. 482, ___, 246 A.2d 162, 166 (1968); Von Gohren v. Pacific Nat'l Bank, 8 Wash. App. at ___, 505 P.2d at 474.

34. Ray v. Farmers' State Bank, 576 S.W.2d at 609. Section 3-406, for example, estops a complaining party who is negligent from asserting its claim; it does not make the complaining party liable in tort for the loss caused by his negligence. U.C.C. § 3-406 comment 5 (1972). The court in *Girard Bank v. Mount Holly State Bank*, 474 F. Supp. 1225 (1979), however, created a common law cause of action sounding in tort, patterned after section 3-406, by which a collecting bank could recover against a negligent drawer. *Id.* at 1238-42.

35. In most cases, the defendant is a bank. Unless otherwise indicated, subsequent references to banks in this Note will be in the context of their capacity as defendants.

36. Whaley, *Negligence*, *supra* note 6, at 11.

and ratification or estoppel, have the effect of transforming the unauthorized signature asserted by the plaintiff into one that is authorized and, hence, effective. The third category of defenses is a broad one—negligence—and applies to material alterations as well as to unauthorized endorsements.

The defense of apparent authority is based on Code section 3-403(1). Apparent authority may be established in the same manner as in any other case.[37]

U.C.C. section 3-404 provides that an "unauthorized signature is wholly inoperative as that of the person whose name is signed unless he *ratifies* it or is *precluded from denying* it."[38] To establish ratification, a defendant must show that the plaintiff had full knowledge of all the material facts and intended to adopt the signature as his own.[39] The ratification can be express or implied, and the intent to ratify "may be inferred from the failure to repudiate an unauthorized act, or from conduct on the part of the [plaintiff] which is inconsistent with any other position than intent to adopt the act."[40]

The preclusion from denying an unauthorized signature established by section 3-404(1) encompasses both an estoppel to deny the authority of another and negligence which is given the same effect.[41] A finding of estoppel will be based on general, common law principles which, pursuant to U.C.C. section 1-103, are to be applied as a supplement to the provisions of the Code.[42] Where the 3-404(1) preclusion is sought to be established on a negli-

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37. U.C.C. § 3-403 comment 1 (1972). *See* RESTATEMENT (SECOND) OF AGENCY § 27 (1958) for a concise statement of the requirements for a finding of apparent authority. *See generally* U.C.C. § 1-103 (1972).

38. U.C.C. § 3-404(1) (1972) (emphasis added).

39. Guaranty Bank & Trust Co. v. Federal Reserve Bank, 454 F. Supp. 488, 492 (W.D. Okla. 1977); Thermo Contracting Corp. v. Bank of N.J., 69 N.J. 352, ___, 354 A.2d 291, 296 (1976).

40. Thermo Contracting Corp. v. Bank of N.J., 69 N.J. at ___, 354 A.2d at 296. Retention of benefits from the unauthorized transaction is an example of conduct from which an intent to ratify may be inferred. Guaranty Bank & Trust Co. v. Federal Reserve Bank, 454 F. Supp. at 492; U.C.C. § 3-404 comment 3 (1972).

41. Trust Co. of Ga. Bank v. Port Terminal & Warehousing Co., 153 Ga. App. 735, ___, 266 S.E.2d 254, 257 (1980); U.C.C. § 3-404 comment 4 (1972).

42. The application of a common law estoppel in the context of negotiation of checks on an unauthorized endorsement is demonstrated by the decision in *West Penn Admin., Inc. v. Union Nat'l Bank*, 233 Pa. Super. 311, 335 A.2d 725 (1975).

West Penn Admin., Inc. was created to manage certain union trust funds. *Id.* at ___, 335 A.2d at 728. Union employers submitted their contributions to West Penn by check; West Penn and its depositary bank, Pittsburgh National Bank, agreed that the employers' checks be drawn payable to the bank. *Id.* at ___, 335 A.2d at 728-29. A West Penn employee embezzled 122 of the contribution checks, typing the endorsement of the payee and depositing the items into an account with defendant Union National Bank. *Id.* at ___, 335 A.2d at 729. Twenty-one of these forged checks were drawn by employers against accounts at Pittsburgh National Bank. *Id.* at ___, 335 A.2d at 735.

Union National Bank accepted the first forged checks with hesitancy. *Id.* at ___, 335 A.2d

gence theory, the question arises as to the nature of the relationship between section 3-404(1) and section 3-406, which also raises a preclusion against a negligent plaintiff. One commentator has urged that section 3-406 is a "nonexhaustive specification" of the preclusion by negligence recognized in comment 4 to section 3-404;[43] but a court which considered this issue concluded that, where a defendant who has paid an instrument on an unauthorized endorsement asserts that the plaintiff is precluded by his negligence from denying the endorsement, the provisions of section 3-406 control.[44] The determination of the proper relationship between sections 3-404 and 3-406 is important because section 3-406 estops a negligent plaintiff only if the defendant is a holder in due course or paid the check in good faith and in accordance with the reasonable commercial standards of its business.[45] Section 3-404(1) places no such restrictions on the availability of the preclusion which it provides.

The defense of negligence is codified in three sections of the Code: 3-405, 3-406, and 4-406.[46] These sections "give statutory sanction to the duty of a drawer or other person to protect the drawee and other holders of an instrument against forgeries and material alterations."[47] Through this policy of deterring the careless conduct which often makes such wrongdoing possible,[48] the Code seeks to promote the stability and transferability of negotiable instruments.[49]

Section 3-406 raises a preclusion against a plaintiff whose negligence *prior to* the negotiation of a check[50] substantially contributed to the making of an alteration of or an unauthorized signature on that check.[51] The unau-

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at 729. The first of the forged checks "drawn on Pittsburgh National Bank cleared the collection process without objection." *Id.* at ___, 335 A.2d at 736. In reliance upon Pittsburgh National Bank's payment as well as its silence, Union National Bank continued to accept the forged checks for deposit. *Id.*

The court found that Pittsburgh National Bank, through its paying clerks, had imputed knowledge that the bank's endorsement had been forged on the checks drawn against it. *Id.* at ___, 335 A.2d at 735. Therefore, the court held that the bank was estopped by its silent payment of the forged checks from denying the validity of the endorsements. *Id.*

43. Dugan, *Stolen Checks—the Payee's Predicament*, 53 B.U.L. Rev. 955, 961 n.35 (1973) [hereinafter cited as Dugan].

44. Trust Co. of Ga. Bank v. Port Terminal & Warehousing Co., 153 Ga. App. at ___, 266 S.E.2d at 257. The court found that section 3-404(1) "does *not* establish a separate and distinct estoppel by negligence defense." *Id.*

45. *Id.*; R. Anderson, *supra* note 18, § 3-406:7, at 942.

46. Whaley, *Negligence*, *supra* note 6, at 12.

47. N.Y.U.C.C. § 3-406 practice commentary (McKinney 1964).

48. Girard Bank v. Mount Holly State Bank, 474 F. Supp. 1225, 1235 (D.N.J. 1979).

49. Comment, *Check Forgeries*, *supra* note 29, at 433-34.

50. Bank of S. Md. v. Robertson's Crab House, Inc., 39 Md. App. 707, ___, 389 A.2d 388, 395-96 (1978).

51. R. Anderson, *supra* note 18, § 3-406:7, at 942. If there has not been a material alteration as defined in section 3-407 or an unauthorized signature as defined in sections 1-201(43) and 3-404, the defense of section 3-406 is unavailable according to its express terms. Tran-

thorized signature need not be that of the negligent party; thus, a drawer, for example, can be precluded by section 3-406 if his negligence substantially contributed to the making of a fraudulent endorsement of the payee's name.[52] Section 3-406 is not merely a codification of the common law doctrine of contributory negligence. The section modifies that doctrine to the extent that it requires the defendant either to be a holder in due course or to pay the item in good faith and in accordance with the reasonable commercial standards of its business.[53] If the defendant is not a holder in due course and failed to act in a good faith, commercially reasonable manner, he is liable under section 3-406 regardless of whether the plaintiff was negligent or not.[54]

In contrast to section 3-406, the preclusion provided by section 4-406 applies where the plaintiff is negligent *subsequent to* the negotiation of a forged or altered check.[55] Section 4-406(1) imposes an affirmative duty on a bank customer to promptly and with reasonable care examine his bank statement[56] for unauthorized signatures of his own name or alterations of any checks charged against his account by the bank and to report the same to the bank.[57] Thus, whereas the preclusion of section 3-406 may be asserted by a holder in due course, drawee, or other payor against "any person,"[58] the defense provided by section 4-406 is available only to a drawee bank against

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samerica Ins. Co. v. United States Nat'l Bank, 276 Or. 945, ___, 558 P.2d 328, 334 (1976). Notwithstanding the technical inapplicability of section 3-406 under such circumstances, the court in *Transamerica Insurance Co.* applied the section in order to give full effect to the public policy expressed therein. *Id.; cf.* Jacoby Transp. Sys. v. Continental Bank, 277 Pa. Super. 440, ___, 419 A.2d 1227, 1231 (1980) (court liberally construed phrase "making of an unauthorized signature" in section 3-406 to bring case within its reach).

52. Fidelity & Casualty Co. v. Constitution Nat'l Bank, 167 Conn. 478, ___, 356 A.2d 117, 120-21, 123 (1975).

53. Perley v. Glastonbury Bank & Trust Co., 170 Conn. at ___, 368 A.2d at 153.

54. Salsman v. National Community Bank, 102 N.J. Super. at ___, 246 A.2d at 168; U.C.C. § 3-406 comment 6 (1972). The requirement that the defendant be a holder in due course or have paid the check in good faith and in accordance with reasonable commercial standards might be loosely analogized to the common law doctrine of last clear chance.

55. Bank of S. Md. v. Robertson's Crab House, Inc., 39 Md. App. at ___, 389 A.2d at 396.

56. To invoke the duty placed on its customer by section 4-406, a bank must first fulfill its own duty under the section to send or otherwise make reasonably available to the customer a statement of account together with the items which it has paid on the customer's behalf. Kiernan v. Union Bank, 55 Cal. App. 3d 111, 115, 127 Cal. Rptr. 441, 444 (1976); U.C.C. § 4-406 comment 2 (1972).

57. K & K Mfg., Inc. v. Union Bank, 129 Ariz. 7, ___, 628 P.2d 44, 47 (Ct. App. 1981); Kiernan v. Union Bank, 55 Cal. App. 3d at 115, 127 Cal. Rptr. at 444; Whaley, *Negligence, supra* note 6, at 14. This duty is not discharged merely by comparing the amounts of the cancelled checks with the bank statement to find any errors made by the drawee in calculating the balance shown on the bank statement; rather, the drawer must examine the checks for forgeries or alterations and compare the cancelled items to the company checkbook. Nu-Way Servs. Inc. v. Mercantile Trust Co. Nat'l Ass'n, 530 S.W.2d 743, 744-45 (Mo. Ct. App. 1975).

58. U.C.C. § 3-406 (1972).

its own customers.[59] Moreover, though both sections apply to any material alteration, section 4-406 applies only where the unauthorized signature is that of the drawer.[60]

If the drawer fails to perform the duty of inspection imposed by section 4-406(1), he is precluded by section 4-406(2)(a) from asserting against his bank the forgeries and alterations which he should have discovered and reported, provided that the bank establishes that it has suffered a loss as to those items.[61] The drawer is also precluded under section 4-406(2)(b) from complaining about forgeries or alterations made by the same wrongdoer on checks paid in good faith by his bank after the expiration of fourteen calender days from the time the statement of account containing the first forged or altered item was made available to the customer and before the first such item is reported to the bank.[62] However, if the bank fails to exercise ordinary care in paying a forged or altered item, the drawer is not estopped by his failure to perform the duty imposed on him by section 4-406(1).[63] Just as in the case of section 3-406, "there is no balancing test or rule of contributory negligence [under section 4-406]; if the bank failed to use ordinary care it always loses, whether the customer was negligent or not."[64]

Section 4-406(5) precludes a drawee from seeking to recover against a collecting bank or other prior party for an unauthorized signature or altera-

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59. East Gadsden Bank v. First City Nat'l Bank, 50 Ala. App. 576, ___, 281 So. 2d 431, 435 (1973). The use of the word "bank" in U.C.C. section 4-406(1)-(2) supports the assertion by the *East Gadsden Bank* court that the defense of section 4-406 may be asserted only by the drawee bank. However, other courts have held that the 4-406 defense is also available to a collecting bank where the bank customer brings a direct action against it. Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d at 683-84, 582 P.2d at 929, 148 Cal. Rptr. at 338; Insurance Co. of N. Am. v. Purdue Nat'l Bank, ___ Ind. App. ___, ___, 401 N.E.2d 708, 714 (1980) (citing Sun 'n Sand, Inc. v. United Cal. Bank). Certainly this extension of the 4-406 defense is consistent with the policy underlying section 4-406(5). *See* U.C.C. § 4-406(5) (1972).

60. *Compare* U.C.C. § 3-406 (1972) ("an unauthorized signature") *with id.* § 4-406(1) ("his unauthorized signature"). Section 4-406 places no duty on a drawer to discover unauthorized payee signatures on the cancelled checks returned to him; that is the responsibility of collecting banks under the warranty provisions of Code sections 3-417 and 4-207. East Gadsden Bank v. First City Nat'l Bank, 50 Ala. App. at ___, 281 So. 2d at 435. *But cf.* U.C.C. § 4-406 comment 6 (1972) ("Nothing in this section is intended to affect any decision holding that a customer who has notice of something wrong with an indorsement must exercise reasonable care to investigate and to notify the bank.")

61. Whaley, *Negligence, supra* note 6, at 14.

62. U.C.C. § 4-406 comment 3 (1972); Whaley, *Negligence, supra* note 6, at 14.

63. U.C.C. § 4-406(3) (1972); Whaley, *Negligence, supra* note 6, at 14.

64. Whaley, *Negligence, supra* note 6, at 14. There is an outer limit on the drawee bank's liability, however, under section 4-406(4). "[S]ubsection (4) places an absolute time limit on the right of a customer to make a claim for payment of altered or forged paper *without regard to care or lack of care of* either the customer or *the bank.*" U.C.C. § 4-406 comment 5 (1972) (emphasis added). The drawer must assert any claim based on his own unauthorized signature or an alteration within one year of receiving the paid items from the drawee. *Id.* Moreover, he must raise any claim based on an unauthorized signature other than his own within three years. *Id.*

tion under the warranties of sections 3-417 and 4-207 if the bank has a valid defense against the claim of its customer. At least one court has held that this preclusion applies to a drawee who fails to assert a section 3-406 negligence defense against its customer.[65] A drawee bank will likely ignore the negligence of its own customer which contributed to the making of an alteration or unauthorized signature and credit the customer's account if it is free to recover its customer's loss from another bank under the warranties of endorsement.[66] Though it is clearly arbitrary to allow the drawee to determine whether the loss from a forgery or alteration will be borne by its customer or another bank, especially where the bank was diligent and, therefore, would have prevailed on a section 3-406 defense had the customer proceeded directly against it, the plain language of section 4-406(5)[67] and comment 7 thereto[68] bars incorporation of the section 3-406 defense into the preclusion of section 4-406(5).[69] Only the defenses created by section 4-406[70] can serve as the basis for the 4-406(5) preclusion.[71]

The final Code section creating a defense based on negligence is 3-405. The operation of this section does not require proof of any negligence on the part of the complaining party but rather imposes strict liability on that party under certain carefully circumscribed circumstances.[72] Conspicuously absent from section 3-405 is any requirement that the defendant act in accordance with reasonable commercial standards or exercise ordinary care as

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65. Canadian Imperial Bank of Commerce v. Federal Reserve Bank, 64 Misc. 2d 959, ___, 316 N.Y.S. 2d 507, 509 (N.Y. Sup. Ct. 1970).

66. Girard Bank v. Mount Holly State Bank, 474 F. Supp. at 1235.

67. Subsection (5) begins "If under this section a payor bank has a valid defense." U.C.C. § 4-406(5) (1972).

68. "Although the principle of subsection (5) might well be applied to other types of claims of customers against banks and defenses to these claims, the rule of the subsection is limited to defenses of a payor bank under this section." U.C.C. § 4-406(5) comment 7 (1972).

69. Girard Bank v. Mount Holly State Bank, 474 F. Supp. at 1235-36. The contrary construction of section 4-406(5) would have the undesirable effect of requiring the drawer to litigate all claims made against it by its customers before seeking reimbursement from a collecting bank for breach of its section 3-417 and 4-207 warranties. East Gadsden Bank v. First City Nat'l Bank, 50 Ala. App. at ___, 281 So. at 436. To remove the inequity resulting from strict construction of section 4-406(5), the court in *Girard Bank* created a common law cause of action sounding in tort, patterned after section 3-406, by which the collecting bank could proceed against the negligent drawer. 474 F. Supp. at 1238-42. Presumably the defendant collecting bank would be able to assert the drawer's negligence by impleading him as a third party defendant. East Gadsden Bank v. First City Nat'l Bank, 50 Ala. App. at ___, 281 So. 2d at 436.

70. Section 4-406 establishes two defenses. Girard Bank v. Mount Holly State Bank, 474 F. Supp. at 1235. The first is the preclusion set forth in subsection (2). *See supra* text accompanying notes 55-64. The second, established by subsection (4), is essentially a statute of limitations. *See supra* note 64.

71. Girard Bank v. Mount Holly State Bank, 474 F. Supp. at 1236.

72. Whaley, *Negligence*, *supra* note 6, at 13. Section 3-405 does not affect the liability of the wrongdoer. U.C.C. § 3-405 comment 5 (1972).

found in sections 3-406 and 4-406 respectively.[73] Thus, a bank may avail itself of the defense provided by section 3-405 even if it was negligent.[74] The 3-405 defense is not truly absolute, however, since the bank must still satisfy the good faith requirement of section 1-203.[75]

Section 3-405 applies where the drawer, his agent, or an employee draws an instrument in which he does not intend the named payee to have an interest.[76] Such instruments are encountered where an employee "pads the payroll by adding phoney employees or submits nonexistent bills from supposed creditors," forges the endorsement of the named payee and absconds with the proceeds of the checks.[77] The section operates by deeming the forged payee's endorsement "effective," leaving the plaintiff without a forgery on which to base a claim.[78] The policy underlying section 3-405 is that losses from such fraudulent behavior constitute a risk of the employer's business, "not of the banking community."[79] The employer, by exercising reasonable care in the selection and supervision of his employees, is in a better position than a bank to prevent the losses resulting from such schemes.[80]

This, then, is the statutory context in which section 3-406 is interpreted and applied. The comparison of that section to the other defenses available under U.C.C. articles 3 and 4 highlights the distinguishing characteristics of the 3-406 defense and demonstrates the interaction of the several defensive provisions. An appreciation of the role and significance of section 3-406 as an exception to the general rules of loss allocation serves as a sound foundation upon which to build a more detailed analysis of the requirements of the section.

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73. Prudential Ins. Co. v. Marine Nat'l Exch. Bank, 371 F. Supp. 1002, 1003 (E.D. Wis. 1974).

74. *Id.;* Hicks-Costarino Co. v. Pinto, 23 U.C.C. Rep. Serv. (Callaghan) 680, 683 (N.Y. Sup. Ct. 1978); Whaley, *Negligence, supra* note 6, at 13.

75. Prudential Ins. Co. v. Marine Nat'l Exch. Bank, 371 F. Supp. at 1003; Whaley, *Negligence, supra* note 6, at 13 n.46.

76. U.C.C. § 3-405(1)(b)-(c) (1972); Whaley, *Negligence, supra* note 6, at 12. The defense provided by section 3-405 also applies where an "impostor" induces another to issue a check to him in the name of a third person who is likewise not intended to have any interest in the check. U.C.C. § 3-405(1)(a) (1972). This impostor rule does not apply, however, where the recipient of the check falsely represents that he is an agent of the payee named by the drawer; in this situation, delivery of the check to the self-proclaimed agent does not relieve a collecting bank of its duty to ensure that the payee's endorsement is valid. Thieme v. Seattle-First Nat'l Bank, 7 Wash. App. 845, ___, 502 P.2d 1240, 1244 (1972); U.C.C. § 3-405 comment 2 (1972).

77. Whaley, *Negligence, supra* note 6, at 12. *See also* U.C.C. § 3-405 comments 3-4 (1972).

78. Whaley, *Negligence, supra* note 6, at 35.

79. Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d at 696, 582 P.2d at 937, 148 Cal. Rptr. at 346; U.C.C. § 3-405 comment 4 (1972); Whaley, *Negligence, supra* note 6, at 12-13.

80. Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d at 696, 582 P.2d at 397, 148 Cal. Rptr. at 346; U.C.C. § 3-405 comment 4 (1972).

II. The Conduct of the Plaintiff

A. *"Any person who by his negligence . . ."*[81]

The defense of section 3-406 can be raised against *any* "person" asserting a claim based on a material alteration or an unauthorized signature.[82] That claim may be for charging an account for an item not properly payable,[83] conversion,[84] or breach of warranty.[85] The Code defines "person" to include "an individual or an organization."[86] An "organization" is in turn defined to include "a corporation, government or governmental subdivision or agency, business trust, estate, trust, partnership or association, two or more persons having a joint or common interest, or any other legal or commercial entity."[87] Thus, the class of potential plaintiffs who may be precluded by their own negligence from asserting their rights under the Code's general rules of loss allocation includes not only bank customers but the banks as well.[88]

The drafters of the Code did not attempt to define what constitutes "negligence" which substantially contributes to a material alteration[89] of or to the making of an unauthorized signature[90] on an instrument. The courts, in construing the word "negligence" in the context of section 3-406, have maintained its customary, tort law definition: the failure to exercise reasonable or ordinary care.[91] Where the risk of injury or loss is sufficiently great to cause a reasonable man in the actor's position to recognize that risk and to guard against it, the actor's failure to take the same precautions is negligence.[92] Translated into the context of banking transactions, negligence " 'means the neglect to do those things dictated by ordinary business cus-

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81. U.C.C. § 3-406 (1972).

82. U.C.C. § 3-406 (1972).

83. *See supra* text accompanying notes 20-24.

84. *See supra* text accompanying notes 25-28.

85. *See supra* text accompanying notes 29-31. The complaining party in such cases is a bank. The issue of whether the plaintiff bank is guilty of negligence which contributed substantially to the making of a forgery or alteration will arise where the bank is both drawer and drawee, such as in the issuance of cashier's checks or loan checks. *E.g.*, Fidelity & Deposit Co. v. First Nat'l Bank, 98 Wis. 2d 474, 297 N.W.2d 46 (Ct. App. 1980) (bank's claim for breach of U.C.C. § 4-207 warranty barred by its own negligence in issuance of mortgage checks).

86. U.C.C. § 1-201(30) (1972).

87. *Id.* § 1-201(28).

88. *See e.g.*, United States Fidelity & Guar. Co. v. Merchant's Bank & Trust Co., 28 U.C.C. Rep. Serv. (Callaghan) 108 (Conn. Super. Ct. 1979); Insurance Co. of N. Am. v. Purdue Nat'l Bank, ___ Ind. App. ___, 401 N.E.2d 708 (1980); First Fed. Sav. & Loan Ass'n v. Union Bank & Trust, 291 N.W.2d 282 (S.D. 1980); Fidelity & Deposit Co. v. First Nat'l Bank, 98 Wis. 2d 474, 297 N.W.2d 46 (Ct. App. 1980).

89. U.C.C. § 3-406 comment 3 (1972).

90. *Id.* § 3-406 comment 7.

91. Fidelity & Casualty Co. v. Constitution Nat'l Bank, 167 Conn. at ___, 356 A.2d at 121; Dominion Constr., Inc. v. First Nat'l Bank, 271 Md. 154, ___, 315 A.2d 69, 72 (1974).

92. W. Prosser, *supra* note 7, § 31, at 145.

toms and prudence and fair dealing toward the bank, which if done would have prevented the wrongdoing which resulted from their omission.' "[93]

B. *"substantially contributes . . ."*[94]

Although section 3-406 has no exact predecessor in the Uniform Negotiable Instruments Act,[95] section 23 of that Act did provide for a preclusion similar to that now available under U.C.C. section 3-406.[96] In construing section 23 of the Negotiable Instruments Act, the courts applied the preclusion provided therein against a negligent plaintiff if his negligence directly and proximately caused the defendant bank to accept an instrument on a forged or unauthorized endorsement.[97] Some courts have perpetuated this pre-Code proximate cause requirement in their interpretation and application of the preclusion afforded by U.C.C. section 3-406.[98]

In one such case, *East Gadsden Bank v. First City National Bank*,[99] Family Savings Federal Credit Union, a customer of plaintiff First City National Bank, issued a loan check drawn payable jointly to John Mathis, one of its members, and a car dealer. In obtaining the loan check, Mathis had forged the signature of the dealer on the buyer's order which had to be submitted with his loan application. Mathis forged the endorsement of the dealer on the check and deposited the proceeds into his personal account.[100]

According to the *East Gadsden Bank* court, the negligence necessary under section 3-406 to preclude a plaintiff from asserting a forged endorsement must be "some act upon which the [defendant] relied or which affirm-

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93. Westport Bank & Trust Co. v. Lodge, 164 Conn. 604, ___, 325 A.2d 222, 227 (1973) (quoting Morgan v. United States Mortgage & Trust Co., 208 N.Y. 218, 224, 101 N.E. 871, 873 (1913)).

94. U.C.C. § 3-406 (1972). The word " 'substantially' unquestionably modifies the word 'contributes', not the word 'negligence.' " Commonwealth v. National Bank & Trust Co., 469 Pa. 188, ___, 364 A.2d 1331, 1334 (1976). Thus, section 3-406 does not require a showing of more than ordinary negligence on the part of the plaintiff. Gast v. American Casualty Co., 99 N.J. Super. 538, ___, 240 A.2d 682, 685 (1968). The contribution to the alteration or forgery, and not the plaintiff's negligence, must be substantial. *Id.*

95. U.C.C. § 3-406 comment on prior uniform statutory provision (1972).

96. Section 23 of the Uniform Negotiable Instruments Act reads as follows:

> When a signature is forged or made without the authority of the person whose signature it purports to be, it is wholly inoperative, and no right to retain the instrument, or to give a discharge therefor, or to enforce payment thereof against any party thereto, can be acquired through or under such signature, *unless the party* against whom it is sought to enforce such right, *is precluded* from setting up the forgery or want of authority.

UNIF. NEGOTIABLE INSTRUMENTS ACT, § 23, 5 U.L.A. 224 (1943) (emphasis added).

97. *E.g.*, Fargo Nat'l Bank v. Massey-Ferguson, Inc., 400 F.2d 223, 226-27 (8th Cir. 1968).

98. *E.g.*, Commercial Credit Equip. Corp. v. First Ala. Bank, 636 F.2d 1051, 1055-56 (5th Cir. 1981); East Gadsden Bank v. First City Nat'l Bank, 50 Ala. App. 576, ___, 281 So. 2d 431, 436 (1973).

99. 50 Ala. App. 576, 281 So. 2d 431 (1973).

100. *Id.* at ___, 281 So. 2d at 432-33.

atively induced and contributed to the [defendant's] acceptance of the forged indorsement."[101] Though the credit union may have been guilty of a "lax or negligent business practice" which contributed to the *making of the check*,[102] its conduct did not cause or induce the depository bank to *accept the forged endorsement*.[103] In short, the credit union's conduct was not the proximate cause of the loss resulting from the forgery, and therefore, the preclusion of section 3-406 did not apply.[104]

The majority of courts which have construed the language of section 3-406, however, have not equated the section's "substantially contributes" requirement with the pre-Code proximate cause requirement.[105] Had the National Conference of Commissioners on Uniform State Laws intended section 3-406 to embody a strict estoppel doctrine requiring a showing that the plaintiff's negligence was the direct and proximate cause of the loss, it could have simply opted to retain the word "precluded," without qualification, as it had in drafting section 23 of the Uniform Negotiable Instruments Act.[106] Instead, the Code's drafters chose to modify the pre-Code law on preclusion by negligence, specifying that the plaintiff is precluded if his negligence "substantially contributes to a material alteration of the instrument or to the making of an unauthorized signature."[107]

According to the weight of authority, the "substantially contributes" requirement of section 3-406 is equivalent to the "substantial factor" test of the Restatement (Second) of Torts section 431.[108] The "substantial factor" test measures factual causation.[109] It is a clear improvement over the older

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101. *Id.* at ___, 281 So. 2d at 435-36.

102. "The [plaintiff] must have acted negligently so as to contribute to the *making* of the alteration or unauthorized signature," not merely to the making of the check. Commercial Credit Equip. Corp. v. First Ala. Bank, 636 F.2d at 1055.

103. *Id.* at 1054-55 (explaining decision in East Gadsden Bank v. First City Nat'l Bank); East Gadsden Bank v. First City Nat'l Bank, 50 Ala. App. at ___, 281 So. 2d at 436.

104. East Gadsden Bank v. First City Nat'l Bank, 50 Ala. App. at ___, 281 So. 2d at 436.

105. Dominion Constr., Inc. v. First Nat'l Bank, 271 Md. at ___, 315 A.2d at 73.

106. Thompson Maple Prods., Inc. v. Citizens Nat'l Bank, 211 Pa. Super. 42, ___, 234 A.2d 32, 34 (1967). *See supra* text accompanying notes 96-97.

107. Thompson Maple Prods., Inc. v. Citizens Nat'l Bank, 211 Pa. Super. at ___, 234 A.2d at 34; U.C.C. § 3-406 (1972).

108. *E.g.*, Dominion Constr., Inc. v. First Nat'l Bank, 271 Md. at ___, 315 A.2d at 74; Twellman v. Lindell Trust Co., 534 S.W.2d at 90; Gast v. American Casualty Co., 99 N.J. Super. at ___, 240 A.2d at 685; Gresham State Bank v. O & K Constr. Co., 231 Or. 106, ___, 370 P.2d 726, 732 (1962).

Section 431 of the Restatement states:

> The actor's negligent conduct is a legal cause of harm to another if
>
> (a) his conduct is a *substantial factor* in bringing about the harm, and
>
> (b) there is no rule of law relieving the actor from liability because of the manner in which his negligence has resulted in the harm.

RESTATEMENT (SECOND) OF TORTS § 431 (1965) (emphasis added).

109. Gresham State Bank v. O & K Constr. Co., 231 Or. at ___, 370 P.2d at 732; W. PROSSER, *supra* note 7, § 42, at 248.

"but for" test.[110]

Under the "but for" test, a person's conduct is not a cause of an event if the event would have occurred even without that conduct.[111] This test is inadequate, however, where two forces, set in motion by the conduct of two different actors, are each equally capable of causing the harm of which the plaintiff complains. In such situations, neither actor can be absolved from liability on the ground that the plaintiff would have suffered the identical harm without his conduct, for there would then be no liability at all.[112]

The "substantial factor" test improves on the "but for" test in three ways. First, in the situation just discussed, where either of the two forces by itself could have caused the harm, each actor's negligent conduct "may be found to be a substantial factor in bringing . . . about [that harm]."[113] Second, where the actor has made a "proven but quite insignificant contribution to the occurrence of the [harm],"[114] the actor's conduct is not a *substantial* factor in bringing about the harm.[115] Finally, an actor's conduct is not a substantial factor in bringing about harm to another if the harm would have been sustained even if the actor had not been negligent *and* the actor's negligence was not sufficient by itself to bring about that harm.[116] In such a case, the negligence of the actor "is not even a perceptible factor in bringing . . . about [the harm]."[117] Outside of these three special cases, the "substantial factor" test leads to the same result as would be reached under the "but for" test.[118]

The third special feature of the "substantial factor" test is relevant in the context of allocating liability under U.C.C. section 3-406. Spaces left on a check by a negligent drawer do not by themselves cause a loss; a loss occurs only when a wrongdoer takes advantage of the opportunity afforded by those spaces and alters the check. If the wrongdoer, rather than simply inserting numbers and words in the spaces, uses chemicals to erase the amount and substitutes completely new numbers and words, the drawer's

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110. W. Prosser, *supra* note 7, § 41, at 240.

111. *Id.* at 239.

112. *Id.*

113. Restatement (Second) of Torts § 432(2) (1965). *See also* W. Prosser, *supra* note 7, § 41, at 240.

114. The classic example of such a situation is the throwing of a lighted match into a forest fire. W. Prosser, *supra* note 7, § 41, at 240.

115. *Id.*

116. Restatement (Second) of Torts § 432(1) (1965). Where the harm would have occurred even without the actor's negligent conduct, the general rule of Restatement section 432(1) controls unless the exception stated in section 432(2) applies. *Id.* § 432(1). The only apparent difference between the two subsections is the requirement in subsection (2) that each of the forces, acting alone, be sufficient to bring about the harm. *Compare id.* § 432(1) *with id.* § 432(2).

117. *Id.* § 432 comment b.

118. W. Prosser, *supra* note 7, § 41, at 240.

negligence is not a substantial factor in bringing about the alteration.[119] That the drafters of section 3-406 approved of decisions refusing to impose liability on negligent drawers in such situations[120] indicates that they intended the section's "substantially contributes" requirement to be construed so as to reach the same result as in the third special case of the Restatement of Torts' "substantial factor" test.[121] In short, a person's negligence substantially contributes to the making of an alteration or an unauthorized signature only where that negligence "afford[s] an opportunity of which advantage is in fact taken."[122]

Though the majority of courts have acknowledged that the "substantially contributes" requirement of section 3-406 is the equivalent of the "substantial factor" test and not proximate cause, some of those same courts have construed section 3-406 to reach results indistinguishable from those reached by the courts which continue to require proximate cause.[123] One such case is the decision of the Eighth Circuit Court of Appeals in *Bagby v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[124]

Mrs. Bagby, upon the death of her husband, retained an attorney to obtain an appointment of guardianship on behalf of her children. This was necessary for the issuance of certain stock to the children as beneficiaries of a profit-sharing pension fund in which their father had participated. The attorney opened two accounts with Merrill Lynch on behalf of Mrs. Bagby. Merrill Lynch did not contact Mrs. Bagby to confirm the attorney's authority to open the accounts nor did the attorney give her any notification that the accounts had been opened. Later, at the direction of the attorney, Merrill Lynch sold Mrs. Bagby's stock in four separate transactions. The stock certifications were endorsed with a stamped facsimile signature, but Merrill Lynch did not contact Mrs. Bagby to confirm that she had authorized such an endorsement. Merrill Lynch disbursed the proceeds of the stock sales by four checks drawn payable to Mrs. Bagby. The checks were sent to the attorney, who forged the payee's endorsement and deposited the proceeds into

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119. Whaley, *Negligence*, *supra* note 6, at 26. The loss caused by the wrongdoer's conduct would have been sustained even if the drawer had not negligently left spaces on his check. *See supra* text accompanying note 116.

120. U.C.C. § 3-406 comment 4 (1972).

121. *See supra* text accompanying notes 116-17.

122. U.C.C. § 3-406 comment 4 (1972).

123. *Compare* Bagby v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 491 F.2d 192 (8th Cir. 1974) (purporting to adopt substantial factor test) *with* East Gadsden Bank v. First City Nat'l Bank, 50 Ala. App. 576, 281 So. 2d 431 (1973) (requiring plaintiff's negligence to be proximate cause). The *Bagby* court's adoption of the "substantial factor" test may be in name only, however, for the court, while announcing its adoption of that test, further states that section 3-406 does not materially change pre-Code Missouri law which required that the plaintiff's negligence be the proximate cause. 491 F.2d at 196. Indeed, one court has even classified the *Bagby* court among those continuing to require proximate cause. Insurance Co. of N. Am. v. Purdue Nat'l Bank, ___ Ind. App. at ___, 401 N.E.2d at 714.

124. 491 F.2d 192 (8th Cir. 1974).

his personal account.[125]

Merrill Lynch admitted its liability to Mrs. Bagby for the wrongful sale of her stock in violation of New York Stock Exchange rules. With regard to Merrill Lynch's claim against its bank, the court noted that Merrill Lynch had properly made the checks payable to Mrs. Bagby and that the mailing of the checks to the attorney was consistent with standard business practices. Concluding that the negligence of Merrill Lynch brought about the mistaken issuance of the checks but not the forgeries themselves, the court allowed Merrill Lynch to recover on its claim against the drawee. Section 3-406, the court explained, precludes a complaining party from recovering under the Code's general rules of loss allocation "only where his negligent conduct contributes to the *forgery*, not merely to the unwarranted issuance of the checks."[126]

In its discussion of the "substantial factor" test, the *Bagby* court cites to section 433 of the Restatement (Second) of Torts and comment "e" thereto.[127] This section of the Restatement lists important factors to consider in determining whether a given actor's negligence is a substantial factor in bringing about harm.[128] Subsection (b) suggests that one consider "whether the actor's conduct has created a force or series of forces which are in continuous and active operation up to the time of the harm, or has created a situation harmless unless acted upon by other forces for which the actor is not responsible."[129] The second half of subsection (b) describes in general terms the scenario encountered in all cases arising under Code section 3-406: the complaining party's negligence creates a situation which is harmless until a wrongdoer sees the opportunity to make an alteration or unauthorized endorsement and takes advantage of it. Indeed, the harmlessness of the situation created by Merrill Lynch, the checks having been made payable to Mrs. Bagby, was the key factor in the *Bagby* decision.[130]

Where "the actor's negligent conduct has merely created a situation which is harmless unless acted upon by other forces," the effect of that fact on the determination of whether his negligence is a substantial factor in bringing about the harm is governed by the rules set forth in Restatement sections 440 through 461.[131] These sections discuss whether a third person's conduct subsequent to the actor's negligence is a superseding cause which relieves the actor of liability for a harm which his negligence "was a substantial factor in bringing about."[132] Among these sections, Restatement section

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125. *Id.* at 194-95.
126. *Id.* at 197.
127. *Id.*
128. RESTATEMENT (SECOND) OF TORTS § 433 (1965).
129. *Id.* § 433(b).
130. *See supra* text accompanying note 126.
131. RESTATEMENT (SECOND) OF TORTS § 433 comment e (1965). *See supra* text accompanying note 127.
132. RESTATEMENT (SECOND) OF TORTS § 440 (1965).

449 is the most relevant for purposes of analyzing the allocation of losses resulting from forgeries and material alterations.

Restatement section 449 provides that where "the likelihood that a third person may act in a particular manner is the hazard or one of the harzards which makes the actor negligent, such an act whether innocent, negligent, intentionally tortious, or criminal does not prevent the actor from being liable for harm caused thereby."[133] Since the actor is being held to a duty of care because of the likelihood that his failure to fulfill that duty will be followed by conduct of a third party which is harmful to another, the occurrence of that harmful conduct, even though the act is committed by a person not subject to the control of the actor, cannot be allowed to relieve the actor of liability for his negligence.[134] To do so would be to destroy the duty imposed on the actor in the first instance.[135]

An inquiry into whether an actor, who by his negligence creates a situation which is harmless until acted upon by a third party, owes a duty to the injured party to protect the latter from the harmful conduct of the third party is equally proper in making the determination of whether the actor's negligence is a substantial factor in bringing about the injury or loss inflicted by the conduct of the third party.[136] Just as the harmful conduct of the third party does not relieve an actor who owes such a duty of liability for the resulting injury or loss,[137] the third party's conduct cannot preclude a finding that the negligence of an actor in failing to fulfill that duty is a substantial factor in bringing about the injury or loss.[138] Again, to hold otherwise would render the duty of care imposed on the actor a nullity.[139]

The duty of an actor to protect another against the intentional or criminal conduct of a third party is established by Restatement section 302B.[140] Under the provisions of that section, an actor may be negligent if he "realizes or should realize that [his act or omission] involves an unreasonable risk of harm to another through the conduct of . . . a third person which is in-

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133. *Id.* § 449.

134. *Id.* § 449 comment b.

135. *Id.*

136. *See supra* text accompanying note 131.

137. *See supra* text accompanying note 133.

138. Restatement section 449, as one of the rules governing the liability of an actor for harm inflicted by a force of independent origin, does not come into play until the actor's negligence has first been found to be a substantial factor in bringing about the harm. *See* W. PROSSER, *supra* note 7, § 44, at 270. Hence, when an actor has a duty to protect another against harmful conduct by a third party and he negligently creates a harmless situation which affords the opportunity for that harmful conduct, Restatement section 449 is wholly inoperative unless the actor's negligence can be found to be a substantial factor in bringing about the harm.

139. A finding that the actor's negligence is a substantial factor in bringing about the harm must be made in order for his conduct to be a "legal cause" of the harm. RESTATEMENT (SECOND) OF TORTS § 431 (1965). A finding of legal cause is in turn required to hold the actor liable for the breach of his duty. *Id.* § 281.

140. *Id.* § 302B (1965).

tended to cause harm, even though such conduct is criminal."[141] If the risk of harm to the other is unforseeable, however, the actor owes no duty to that person and, hence, cannot be found to have acted negligently toward him.[142]

An actor ordinarily has much less reason to anticipate conduct on the part of a third party which is intended to cause injury or loss to another than to anticipate a third party's negligence; an actor has even less reason to anticipate criminal conduct by a third party.[143] However, "the proclivity of criminals to tamper with commercial paper is too well known" to say that it is a risk which banks alone should be required to anticipate and bear the resulting losses.[144]

The determination of whether, under the circumstances of a particular case, a complaining party owes a duty to the defendant in an action on a forged or altered check is a question of law to be decided by the court.[145] In making that determination, the court must necessarily balance competing public policy considerations.[146] One such consideration is the foreseeability of the harm.[147] Another is the commercial sophistication of the allegedly negligent plaintiff;[148] a plaintiff who regularly engages in formal financial transactions will be held to a higher standard of care than one who participates only infrequently in more informal transactions.[149] Other considera-

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141. *Id.* The use of such a foreseeability test is demonstrated by the court in *Fidelity & Casualty Co. v. Constitution National Bank*, 167 Conn. 478, 356 A.2d 117 (1975). Fidelity & Casualty Co. brought suit as the insurer for a finance company which accepted loan applications from an automobile salesman and delivered checks drawn payable to the purported loan applicants to the salesman. The salesman forged the payees' endorsements and absconded with the proceeds. *Id.* at ___, 356 A.2d at 120. To determine if the finance company had been negligent, the court asked "whether a prudent person in the position of the finance company's manager, . . . having at his disposal only that amount of information and experience [possessed by him] concerning the purported loan applications, would have foreseen the danger of subsequent forgery" of the loan checks issued pursuant to said applications. *Id.* at ___, 356 A.2d at 121.

142. This, of course, is the rule announced by the New York Court of Appeals in *Palsgraf v. Long Island Railroad Co.*, 248 N.Y. 339, 162 N.E. 99 (1928). W. PROSSER, *supra* note 7, § 43, at 255.

143. W. PROSSER, *supra* note 7, § 33, at 173.

144. Whaley, *Negligence*, *supra* note 6, at 28. A manifestation of the public's awareness of criminal tampering with checks is the conventional wisdom that one should score the unused portion of the amount blank. *Id.*

145. *Id.*

146. *Id.* at 27.

147. *Id.*

148. *Id.*

149. Perley v. Glastonbury Bank & Trust Co., 170 Conn. at ___, 368 A.2d at 154. The check under suit in *Perley* represented the proceeds of a loan made by the Perleys to their neighbors, the Burneys. The transaction was initiated by Mrs. Burney, a well-known local real estate agent. The Perleys had made a similar loan to Mrs. Burney on only one prior occasion. *Id.* at ___, 368 A.2d at 150. The Connecticut Supreme Court distinguished the standard of care to be used in evaluating the Perley's conduct from that used in its earlier decision in *Fidelity & Casualty Co. v. Constitution National Bank*, 167 Conn. 478, 356 A.2d 117 (1975), a case involving a loan check issued by a finance company. Perley v. Glastonbury Bank & Trust Co., 170

tions include "the financial impact of an adverse decision, . . . the ability of later parties to protect themselves from the wrongdoer, [and] the degree of fault."[150] Finally, and perhaps most importantly, the court should consider the degree to which the conduct of the complaining party deviated from that of other persons under similar circumstances.[151]

The official comment to Code section 3-406 offers some insight into the extent of the duty of care which the drafters intended to place on persons dealing with negotiable instruments. The drafters expressly rejected pre-Code decisions holding that a drawer owes no duty of care to a subsequent transferee of his instrument because there was no contract between him and the transferee at the time he drew the instrument. Instead, the drafters asserted that the drawer, by the very act of drawing an instrument and "setting it afloat upon a sea of strangers," voluntarily enters into a relationship with a subsequent transferee of the instrument which justifies the imposition of a duty of care on the drawer on behalf of the transferee.[152] This expansive view of the duty owed by a drawer to subsequent transferees should logically apply with equal force to any person asserting a claim based on a material alteration or unauthorized signature. Though a plaintiff may owe a duty of care to a broad class of persons, section 3-406 does not require him to exercise extraordinary care. This follows from comment 3 where the drafters approve decisions holding that a drawer "is under no duty to use sensitized paper, indelible ink or a protectograph."[153]

The concept of duty is a useful tool for analyzing the Eighth Circuit's application of the "substantially contributes" requirement of section 3-406 in *Bagby*.[154] Merrill Lynch admitted that it had failed to fulfill its duty to know its customer as required by New York Stock Exchange Rule 405.[155] The New York Stock Exchange, having recognized that the risk of forgery is high in transactions involving securities and negotiable instruments, requires its members to know their customers for the very purpose of preventing transfers of such items to unauthorized persons, thereby minimizing the risk of forgery.[156] Thus, the forgery of Mrs. Bagby's signature on the checks issued by Merrill Lynch is one of the hazards against which the brokerage is required to guard. Though the checks drawn by Merrill Lynch to Mrs. Bagby were harmless until the attorney forged her endorsement, Merrill Lynch's negligence was still a substantial factor in bringing about the forgeries because its failure to guard against such misconduct rendered its conduct

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Conn. at ___, 368 A.2d at 154; *see supra* note 141.

150. Whaley, *Negligence*, *supra* note 6, at 27.

151. *Id.*

152. U.C.C. § 3-406 comment 2 (1972).

153. *Id.* § 3-406 comment 3 (1972).

154. *See supra* text accompanying note 126.

155. Bagby v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 491 F.2d at 197.

156. Whaley, *Negligence*, *supra* note 6, at 29.

negligent in the first instance.[157] In short, a careful application of the "substantial factor" test of Restatement (Second) of Torts section 431 and the related Restatement provisions, some of which were cited by the *Bagby* court,[158] to the facts in *Bagby*, leads to a result opposite that reached by the Eighth Circuit in that case.[159]

As the equivalent of the Restatement's "substantial factor" test,[160] the "substantially contributes" requirement of U.C.C. section 3-406 is a test for factual causation.[161] By substituting the "substantially contributes" requirement for the pre-Code proximate cause requirements, the drafters of the U.C.C. intended to include negligent conduct on the part of the plaintiff which had previously been considered too remote in the chain of causation to preclude recovery.[162] As long as the plaintiff's negligence creates a situation which, though harmless by itself, provides the wrongdoer with the means for making a material alteration or unauthorized signature[163] and the wrongdoer does in fact take advantage of that opportunity,[164] his negligence is a substantial factor in bringing about the loss of which he complains.

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157. *See supra* text accompanying notes 131-139.

158. *See supra* text accompanying note 127.

159. Whaley, *Negligence*, *supra* note 6, at 29. The foregoing analysis based on the Restatement (Second) of Torts is consistent with the result reached in *Fidelity & Deposit Co. v. Chemical Bank of New York Trust Co.*, 65 Misc. 2d 619, 318 N.Y.S.2d 957 (App. Term 1970) (per curiam), *aff'd without opinion*, 39 A.2d 1019, 333 N.Y.S.2d 726 (1972). Under facts remarkably similar to those in *Bagby*, the court in *Fidelity & Deposit Co. v. Chemical Bank of New York Trust Co.* held that the brokerage's failure to know its customer "*substantially contributed to* the issuance of the checks in payment for the stolen securities and *the resulting unauthorized signatures* thereby breaching its duty to defendant created by UCC 3-406." *Id.* at ___, 318 N.Y.S.2d at 959 (emphasis added).

160. *See supra* text accompanying note 108.

161. Whaley, *Negligence*, *supra* note 6, at 26. *See supra* text accompanying note 109.

162. Dominion Constr., Inc. v. First Nat'l Bank, 271 Md. at ___, 315 A.2d at 73-74; Commonwealth v. Nat'l Bank & Trust Co., 469 Pa. 188, ___, 364 A.2d 1331, 1334 (1976); *see* Thompson Maple Prods., Inc. v. Citizens Nat'l Bank, 211 Pa. Super. at ___, 234 A.2d at 34 (the U.C.C. "shortened the chain of causation").

163. Fidelity & Casualty Co. v. Constitution Nat'l Bank, 167 Conn. at ___, 356 A.2d at 123; *accord* Insurance Co. of N. Am. v. Purdue Nat'l Bank, ___ Ind. App. at ___, 401 N.E.2d at 715. In *Insurance Co. of North America v. Purdue National Bank*, the plaintiff bank allowed a forger to make withdrawals from two different savings accounts solely on the basis of documents presented by him purporting to give him power of attorney to act on behalf of the depositors. As in *Bagby*, the proceeds were given to the forger in the form of checks drawn to the depositors. Though the situation created by the bank's negligence was harmless, the court found that the negligence substantially contributed to the forgeries of which the plaintiff complained because had the bank exercised due care and "verified the forger's authority to make the withdrawals, the forger would not have been in the position to have forged the payee's endorsements since the checks would have not been issued." ___ Ind. App. at ___, 401 N.E.2d at 715.

164. *See supra* text accompanying note 122.

C. *Duties of Care*

The decision as to whether the conduct of the plaintiff constitutes negligence which substantially contributes to the material alteration of or the making of the unauthorized signature of which he complains is to be made by the finder of fact under the particular circumstances of each case.[165] Nevertheless, the official comment to U.C.C. section 3-406 and case law, both pre-Code decisions and those rendered after its adoption, offer general guidance as to some of the duties of care which are and are not imposed on persons dealing with negotiable instruments.

A drawer, even before he writes a single check, owes a duty to exercise care in maintaining custody and control over his blank checks. In *Commercial Credit Equipment Corp. v. First Alabama Bank*,[166] the drawer business kept its checks in an unlocked cabinet in an unoccupied storeroom.[167] While recognizing that a business cannot realistically be expected to keep its checks "absolutely secure from all employees at all times," the court found the drawer's conduct both irresponsible and negligent.[168] The opposite conclusion was reached in *Mortimer Agency, Inc. v. Underwriters Trust Co.*,[169] where a blank check was apparently removed from the back of the drawer's checkbook by a burglar and then forged. The court refused to hold that the drawer was negligent in failing to discover that a check was missing from its otherwise undisturbed checkbook or that it had failed to take adequate security precautions.[170] If the drawer had a facsimile of his signature placed on a rubber stamp or other automatic signing device, he also owes a duty to exercise care in safeguarding against unauthorized use of that device.[171]

With respect to each instrument he issues, the drawer must exercise care in the act of drafting the instrument. The negligence of the drawer is clear "where spaces are left in the body of the instrument in which words or figures may be inserted."[172] When filling in the amount blank on a check, most drawers discharge their duty not to leave spaces by beginning to write at the far left end of the blank and scoring the portion of the blank which they do not need. Most drawers, however, do not take the same precaution in completing the blank for the payee's name. A wrongdoer could take ad-

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165. U.C.C. § 3-406 comment 3, 7 (1972).
166. 636 F.2d 1051 (5th Cir. 1981).
167. *Id.* at 1053.
168. *Id.* at 1056.
169. 73 Misc. 2d 970, 341 N.Y.S.2d 75 (N.Y. Civ. Ct. 1973).
170. *Id.* at ___, 341 N.Y.S.2d at 78.
171. U.C.C. § 3-406 comment 7 (1972); Whaley, *Negligence*, *supra* note 6, at 33-34. A drawer should not be found negligent for failing to safeguard against unauthorized use of a stamp bearing merely his printed name and not a facsimile signature, Whaley, *Negligence*, *supra* note 6, at 34; *see* Gresham State Bank v. O & K Constr. Co., 231 Or. at ___, 370 P.2d at 729, unless the drawer has authorized his bank to accept his printed name as his signature. *See* U.C.C. § 3-401 comment 2 (1972).
172. *Id.* § 3-406 comment 3.

vantage of the drawer's failure to score the unused portion of the payee's name blank by simply adding the word "or" followed by his own name.[173] Though such a scheme would likely fail where the true payee is a large business or a governmental entity,[174] it may succeed where the true payee is an individual.[175] One court has suggested that a drawer has a duty to score the unused portion of the payee's name blank,[176] but the current practice of drawers, including large corporations, not to take such a precaution weighs against the imposition of a duty so to act.[177]

A special duty of care may be required of a drawer who issues a check to joint payees. In *Dominion Construction, Inc. v. First National Bank*,[178] the plaintiff issued a check payable to "Town & Country Decorating and Conwed" pursuant to a joint payee agreement between Town & Country Decorating, Inc. and Conwed Corp.[179] The plaintiff brought suit against the bank for paying the check on a fraudulent endorsement which mirrored the exact words used to name the payees on the check rather than on the separate endorsements of the two corporations as intended.[180] The construction company was found negligent in failing "to draw the check so as to make it properly payable to joint payees" and in failing to advise the drawee of the joint payee agreement and, therefore, was precluded from asserting its claim.[181]

If the drawer has successfully discharged his duty to exercise care in the making of the check itself, the next issue is the extent of his duty to deliver the instrument to the named payee. Any time a check is delivered into the hands of someone other than the payee there is a risk of forgery.[182] The delivery of a check to a third person, however, should not automatically render the plaintiff negligent under Code section 3-406.[183] Unless at the time delivery was made to the third person the drawer had knowledge which should have made him suspicious, the drawer is not required to anticipate a

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173. Whaley, *Negligence*, *supra* note 6, at 32.

174. A check altered to read "Pay to the order of Sears or John Smith" or "Pay to the order of Internal Revenue Service or Jane Doe" should be sufficiently suspicious to alert a would-be transferee to the alteration. *Id.*

175. Assuming that the alteration is artfully done so as not to evoke suspicion, a subsequent transferee is justified under Code section 3-116(a) in accepting an instrument endorsed by either alternative payee. *Id.*

176. *Id.* at 32 n.102 (discussing Gutfreund v. East River Nat'l Bank, 251 N.Y. 58, 167 N.E. 171 (1929)).

177. *Id.* at 32; *see supra* text accompanying note 151.

178. 271 Md. 154, 315 A.2d 69 (1974).

179. *Id.* at ___, 315 A.2d at 70.

180. *Id.* at ___, 315 A.2d at 71.

181. *Id.* at ___, 315 A.2d at 73, 76.

182. Whaley, *Negligence*, *supra* note 6, at 34.

183. Twellman v. Lindell Trust Co., 534 S.W.2d at 90; Whaley, *Negligence*, *supra* note 6, at 34.

forgery.[184] Thus, the drawer may entrust an instrument to a third person only where he has a reasonable belief that the third party will deliver the instrument to the named payee.[185] The drawer may reasonably base his belief that the payee will ultimately receive the instrument on prior dealings with the party to whom delivery is made[186] or on accepted business practice.[187]

An unusual situation sometimes encountered is one in which the drawer mails his check to a person having the same name as the intended payee.[188] In such a situation the drawer's conduct constitutes negligence which precludes recovery.[189]

In the vast majority of cases arising under Code section 3-406, the plaintiff is an employer[190] and the wrongdoer is an employee. Duties of care are imposed on an employer in its dealings with negotiable instruments both in its capacity as a drawer and in its capacity as a payee.

The duty of an employer to exercise care begins the very moment the employer undertakes to hire people to handle its commercial paper. Jobs which require an employee to handle checks are positions of trust, and the law will not allow an employer to fill such positions in a carefree manner.[191] The plaintiff employer in *Commercial Credit Equipment Corp.* was found negligent in hiring "a person who would have been uncovered as a known defrauder had anything greater than a perfunctory inquiry to verify prior employment been made"[192] and in failing to exercise any supervision over his activities as its collection manager.[193] Though the plaintiff did contact the wrongdoer's former employer, the court was critical of the plaintiff's failure to ask any questions regarding the wrongdoer's honesty or trustworthiness or the reason he had left his employment.[194] The court also looked with disfavor on the plaintiff's admitted failure to follow its own standard procedure for investigating job applicants when it hired the wrongdoer.[195] The plaintiff's carelessness in hiring the wrongdoer, viewed by itself, was not suf-

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184. Twellman v. Lindell Trust Co., 534 S.W.2d at 90.

185. Whaley, *Negligence, supra* note 6, at 34.

186. *See* Twellman v. Lindell Trust Co., 534 S.W.2d at 90.

187. *Id. See* Gast v. American Casualty Co., 99 N.J. Super. at ___, 240 A.2d at 686.

188. *E.g.*, Park State Bank v. Arena Auto Auction, Inc., 59 Ill. App. 2d 235, 207 N.E.2d 158 (1965).

189. *Id.*; U.C.C. § 3-406 comment 7 (1972).

190. The word "employer" is used herein in the broadest sense possible so as to include a business which employs thousands of people as well as an individual who hires another as a personal secretary. In the context of an act or omission by the employer, the word "supervisor" may be substituted for "employer."

191. *See* Commercial Credit Equip. Corp. v. First Ala. Bank, 636 F.2d at 1056.

192. *Id.* The plaintiff's employee had been forced to resign from his prior employment because his former employer had uncovered his schemes to defraud it. *Id.* at 1053.

193. *Id.* at 1056.

194. *Id.* at 1053.

195. *Id.* at 1056.

ficient in the eyes of the court to constitute negligence which would preclude the plaintiff from asserting its claim,[196] but that carelessness in combination with the lack of supervision did constitute such negligence as a matter of law.[197] Consequently, the court found that the wrongdoer was put in a position of trust with "ready access to the company's checks and check embosser" which afforded him the opportunity to accomplish his misdeeds as a direct result of the plaintiff's negligence.[198]

The duty of an employer under Code section 3-406 to supervise the employees who handle negotiable instruments is an important and ongoing one since "even those [employees] with impeccable records may turn to crime."[199] The scope of the duty owed by a given employer to supervise its employees should be determined with regard to its size, its use of accepted supervision and internal control methods, the volume of checks written and/or received by the business, and the business' ability to bear the losses caused by employee misconduct.[200] Thus, the employer in *West Penn Administration, Inc. v. Union National Bank*[201] was found negligent for its failure to use a more sophisticated accounting system despite the knowledge of its chief administrative officer, a certified public accountant, that its single entry accounting system was an inferior method of internal control.[202] The employer's failure to adhere to the procedures required by its own office procedure manual was further evidence of its negligence.[203] The scope of the employer's duty of supervision is also affected by the identity of the employee guilty of the wrongdoing, his background and character references, his personal financial condition, the quality of his work, the number of years he has worked for the company, his job responsibilities, the opportunity which his job position affords him to defraud his employer, and the ease with which he could do so if he so chose. Though an employer may not be required to supervise a longtime, faithful employee as closely as a newcomer, it can never dispense with supervision altogether.[204]

The provision of a reasonable degree of supervision by an employer operates as a deterrent to employee misconduct. Supervision limits the oppor-

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196. *Id.* It should be noted that the court in *Commercial Credit Equipment Corp.* construed section 3-406 as requiring that the plaintiff's negligence be the proximate cause of the wrongdoing. *Id.* at 1055-56. Had the court adopted the less demanding "substantial factor" test utilized by most courts in applying section 3-406, it is arguable that the court would have found the plaintiff's carelessness in hiring the wrongdoer to constitute negligence which would preclude it from asserting its claim. *See supra* text accompanying notes 105-09.

197. Commercial Credit Equip. Corp. v. First Ala. Bank, 636 F.2d at 1056. *See* Whaley, *Negligence, supra* note 6, at 36.

198. Commercial Credit Equip. Corp. v. First Ala. Bank 636 F.2d at 1056.

199. Whaley, *Negligence, supra* note 6, at 36.

200. *Id.*

201. 233 Pa. Super. 311, 335 A.2d 725 (1975).

202. *Id.* at ___, 335 A.2d at 733-34.

203. *Id.* at ___, 335 A.2d at 734. *See* Whaley, *Negligence, supra* note 6, at 38.

204. Whaley, *Negligence, supra* note 6, at 36-37.

tunity for wrongdoing and reduces the incentive for an employee to act wrongfully since he knows that his actions are being monitored and that he will likely be caught if he engages in misconduct. Where the employer fails to fulfill its duty of supervision, its negligence substantially contributes to the initial instance of an employee's misconduct.[205] However, even if the employer does provide a reasonable degree of supervision, some employees will forge or alter an instrument drawn on the employer's account or forge the employer's endorsement on an instrument in which it is named payee and attempt to conceal their wrongdoing.

Once an employee has engaged in misconduct, whether due to a want of supervision or not, the employer still has a duty of supervision under Code section 3-406 but for a different purpose: to uncover the initial instance of misconduct and prevent it from being repeated.[206] If the employer fails to exercise reasonable supervision after the initial instance of misconduct, that failure substantially contributes to the making of any further forgeries or alterations by the same employee.[207]

Where the employee misconduct is a forgery or alteration of an instrument drawn on the employer's account, one means of detecting such misconduct is by the examination of the cancelled checks included in the employer's monthly bank statement.[208] The employer is already under an obligation, as is every drawer, to examine its bank statements under Code section 4-406.[209] An issue which often arises with regard to the discharge of this duty is whether an employer which has assigned the task of bank statement reconciliation to the very employee who is acting wrongfully is deemed to have notice of the forgeries or alterations and is therefore precluded from recovering under Code sections 3-406 and 4-406.[210] One court has held that

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205. Commercial Credit Equip. Corp. v. First Ala. Bank, 636 F.2d at 1056.

206. Section 3-406 not only precludes a plaintiff from asserting the first alteration or forgery which his negligence was a substantial factor in bringing about, but also precludes a plaintiff who "has *notice that forgeries of his signature have occurred and is negligent in failing to prevent further forgeries by the same person.*" U.C.C. § 3-406 comment 7 (1972) (emphasis added); *see* Whaley, *Negligence*, *supra* note 6, at 37. For a discussion of what constitutes *notice* to the employer of an employee's misconduct, *see infra* text accompanying notes 214, 224-30.

207. *See* U.C.C. § 3-406 comment 7 (1972).

208. *E.g.*, Ashley-Hall Interiors, Ltd. v. Bank of New Orleans, 389 So. 2d 850, 853 (La. Ct. App. 1980). Had plaintiff's manager in *Ashley-Hall Interiors, Ltd.* examined the cancelled checks in its bank statements, he would have discovered that the dishonest employee had gone so far as to pay her own utility bill with one of her employer's checks. *Id.*

209. *See supra* text accompanying notes 56-57.

210. *E.g.*, K & K Mfg., Inc. v. Union Bank, 129 Ariz. at ___, 628 P.2d at 47-48. This issue is typically encountered in cases involving small scale operations where the employer has entrusted a single employee with most, if not all, of the employer's banking and bookkeeping tasks, including both preparation of checks on the employer's account for signature by an authorized signator and reconciliation of the bank statements. *E.g.*, *id.* at ___, 628 P.2d at 45; Kiernan v. Union Bank, 55 Cal. App. 3d at 117, 127 Cal. Rptr. at 445; Ashley-Hall Interiors, Ltd. v. Bank of New Orleans, 389 So. 2d at 853.

knowledge of the forgeries made by an unfaithful agent who also reconciles the principal's bank statement is not imputed to the principal,[211] but that holding has been rejected by another court as "contrary to the bulk of authority."[212] The misplaced confidence of the employer in the unfaithful employee does not excuse the employer from its duty to examine its bank statements and report any forgeries or alterations to the drawee.[213] Accordingly, the employer is held chargeable with the knowledge of "such information as an honest employee, unaware of the wrongdoing, would have acquired from [a reasonable and prudent] examination of the cancelled checks and bank statements."[214] The employer "will be charged with that knowledge as of the time [it] should have discovered it."[215] This imputation of knowledge to the employer, coupled with its failure to report the initial forgery or alteration to the drawee as required by Code section 4-406,[216] renders the employer guilty of negligence which substantially contributes to any subsequent defalcations by the same employee.[217]

The techniques used by an employer in the discharge of its duty under Code section 3-406 to supervise its employees and to detect any wrongdoing may take many different forms. In a small organization, a simple review of the firm's records and books may be made.[218] In larger organizations, more

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211. Jackson v. First Nat'l Bank, 55 Tenn. App. 545, ___, 403, S.W.2d 109, 112 (1966).

212. K & K Mfg., Inc. v. Union Bank, 129 Ariz. at ___, 628 P.2d at 47-48.

213. *Id.* at ___, 628 P.2d at 48; Kiernan v. Union Bank, 55 Cal. App. 3d at 115, 127 Cal. Rptr. at 444.

214. Kiernan v. Union Bank, 55 Cal. App. 3d at 117, 127 Cal. Rptr. at 445 (quoting Basch v. Bank of Am., 22 Cal. 2d 316, 327, 139 P.2d 1, 8 (1943)); *see also* K & K Mfg., Inc. v. Union Bank, 129 Ariz. at ___, 628 P.2d at 48; Pine Bluff Nat'l Bank v. Kesterson, 257 Ark. 813, ___, 520 S.W.2d 253, 258 (1975). This is the majority rule. K & K Mfg., Inc. v. Union Bank, 129 Ariz. at ___, 628 P.2d at 48.

215. Kiernan v. Union Bank, 55 Cal. App. 3d at 117, 127 Cal. Rptr. at 445. Code section 4-406 allows the drawer a reasonable time period of up to a maximum of 14 days from the time the bank statement containing the first forged or altered item is made available to the customer by the bank. U.C.C. § 4-406 comment 3 (1972).

216. One of the purposes for imposing the duty on a drawer to examine his bank statements for forgeries of his signature or alterations and to report any such wrongdoing to the bank is to deny the wrongdoer an opportunity to repeat his misconduct. U.C.C. § 4-406 comment 3 (1972).

217. The employer has notice of the misdeed of the employee, *see supra* text accompanying note 214, and has failed to prevent that misdeed from being repeated as a result of its breach of duty imposed on it by U.C.C. section 4-406, *see supra* note 216. Therefore, the drawer's failure to examine his bank statements and report the forgery or alteration constitutes negligence which substantially contributes to the repetition of that misconduct by the wrongdoer within the meaning of section 3-406. *See supra* note 206. An equivalent result is reached under Code section 4-406(2)(b). *See supra* text accompanying note 62.

218. *See, e.g.*, Cooper v. Union Bank, 9 Cal. 3d 125, 135, 507 P.2d 609, 618, 107 Cal. Rptr. 1, 10 (1973) (plaintiff never reviewed books); Ashley-Hall Interiors, Ltd. v. Bank of New Orleans, 389 So. 2d at 853 (manager failed to examine cash disbursements journal); Gresham State Bank v. O & K Constr. Co., 231 Or. at ___, 370 P.2d at 730, 733 (owners made little effort to examine the books).

sophisticated measures such as security systems, cross-checks,[219] or audits are commonly used.[220] Regardless of the method used, a review of the employer's bank statements should be incorporated therein.[221] Comparison of the bank statements to the firm's books will uncover not only an employee who is forging or altering checks drawn against his employer's account[222] but also an employee who is embezzling the proceeds of checks made payable to his employer.[223] If the supervisory techniques used by the employer expose an irregularity, the employer is under a duty to make a reasonably diligent inquiry into the matter; the failure to do so constitutes negligence which substantially contributes to the making of subsequent forgeries or alterations which would have been prevented had such an inquiry been made.[224]

In addition to the duty to investigate irregularities uncovered in the course of supervising its employees' conduct, the employer has a duty to investigate the possibility of employee misconduct in the handling of checks upon obtaining knowledge of certain suspicious circumstances.[225] This additional duty of investigation has typically been imposed on employers which have only one or a few employees.[226] The employer is negligent if it fails to investigate unexplained overdrafts of its account.[227] The failure to receive monthly bank statements imposes a duty on the employer to contact its bank since the statements may have been diverted by an unfaithful employee.[228] An employer should check its financial records if it observes a

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219. *See* West Penn Admin., Inc. v. Union Nat'l Bank, 233 Pa. Super. at ___, 335 A.2d at 734 (failed to keep records necessary to cross-check validity of adjustive journal entries).

220. Whaley, *Negligence, supra* note 6, at 36.

221. Gresham State Bank v. O & K Constr. Co., 231, Or. at ___, 370 P.2d at 730; *see* Ashley-Hall Interiors, Ltd. v. Bank of New Orleans, 389 So. 2d at 853.

222. *E.g.*, Ashley-Hall Interiors, Ltd. v. Bank of New Orleans, 389 So. 2d at 853. *See supra* text accompanying notes 207-08.

223. *E.g.*, Cooper v. Union Bank, 9 Cal. 3d at 127, 135, 507 P.2d at 612, 618, 107 Cal. Rptr. at 4, 10; Gresham State Bank v. O & K Constr. Co., 231 Or. at ___, 370 P.2d at 730.

224. West Penn Admin., Inc. v. Union Nat'l Bank, 233 Pa. Super. at ___, 335 A.2d at 734 (negligently failed to conduct follow-up inquiry after initial cursory investigation provided no satisfactory explanation).

225. Whaley, *Negligence, supra* note 6, at 37. The knowledge of the suspicious circumstance puts the employer on implied or inquiry notice of the employee's wrongdoing. BLACK'S LAW DICTIONARY 958 (rev. 5th ed. 1979); *see* U.C.C. § 1-201(25)(c) (1972).

226. *E.g.*, Westport Bank & Trust Co. v. Lodge, 164 Conn. 604, 325 A.2d 222 (1973) (wrongdoer was personal secretary); Ashley-Hall Interiors, Ltd. v. Bank of New Orleans, 389 So. 2d 850 (La. Ct. App. 1980) (wrongdoer was bookkeeper in small office).

227. K & K Mfg., Inc. v. Union Bank, 129 Ariz. at ___, 628 P.2d at 47; Westport Bank & Trust Co. v. Lodge, 164 Conn. at ___, 325 A.2d at 225-26.

228. *See* Westport Bank & Trust Co. v. Lodge, 164 Conn. at ___, 325 A.2d at 223-26 (employer found negligent for failure to act after learning that her bank statements were being sent directly to her bookkeeper rather than to her, though she had not authorized bank to do so); Myrick v. National Sav. & Trust Co., 268 A.2d 526, 528 (D.C. 1970) (drawer's failure to contact bank about her failure to receive bank statements held negligence which substantially contributed to forgeries; identity of forger unknown).

marked increase in an employee's purchasing power, especially where it should realize that the explanation given by the employee is false.[229] Finally, the employer is negligent in failing to investigate complaints from the payees of checks which have been paid and returned to the employer stating that the payees have not received payment of the sums owed them.[230]

A business must exercise care not only in supervising its employees but also in issuing checks to the persons with whom it transacts business. Where the wrongdoer induces the business to issue a check payable to a third person, forges the endorsement of the named payee, and absconds with the proceeds from the check, the issue is whether the drawer failed to follow a reasonable procedure in issuing the check which would have frustrated the wrongdoer's scheme.

In *Thompson Maple Products, Inc. v. Citizens National Bank*,[231] for example, the forger, a log hauler, induced the plaintiff's bookkeeper to issue checks to him in the names of plaintiff's timber suppliers by submitting receipts for wholly fictitious deliveries of logs. Though the same employee who weighed in the deliveries for the plaintiff was supposed to transmit the receipts directly to plaintiff's bookkeeper for the drawing of the checks, the employee at the weigh station would give the receipts to the log hauler for the latter to take to the bookkeeper.[232] This practice, coupled with the plaintiff's failure to guard against unauthorized use of blank receipts[233] and failure to keep accurate inventory records,[234] enabled the log hauler's fraudulent scheme to succeed. The plaintiff was held precluded by its negligence from asserting the forgeries of the payees' endorsements against the bank.[235]

An analogous factual situation was before the court in *Fidelity & Casualty Co. v. Constitution National Bank*.[236] That court described the decision in *Thompson Maple Products, Inc.* as holding that "the failure to verify

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229. Ashley-Hall Interiors, Ltd. v. Bank of New Orleans, 389 So. 2d at 853 (employee's supervisor accepted employee's explanation that her husband had just received a substantial inheritance despite his knowledge that the employee and her husband were separated).

230. Whaley, *Negligence, supra* note 6, at 39 n.135 (citing Prudential Ins. Co. v. National Bank of Commerce, 227 N.Y. 510, 125 N.E. 824 (1929)). Though Code section 4-406 requires only that the drawer examine his cancelled checks for alterations or forgeries of his own signature and thereby allows him to presume that the other endorsements on the checks are valid, the circumstances described in the text impose a duty upon him under section 3-406 to investigate the validity of those other signatures. *Id. See supra* note 60.

231. 211 Pa. Super. 42, 234 A.2d 32 (1967).

232. *Id.* at ___, 234 A.2d at 33.

233. *Id.* at ___, 234 A.2d at 35. Plaintiff's employees left pads of the blank receipts in places readily accessible to outsiders and even gave several pads directly to the wrongdoer. The plaintiff had no means of monitoring the use of the blank receipts because they were not consecutively numbered. *Id.*

234. *Id.* at ___, 234 A.2d at 36 n.6.

235. *Id.* at ___, 234 A.2d at 35-36.

236. 167 Conn. 478, 356 A.2d 117 (1975). For a summary of the facts in that case, *see supra* note 141.

information on reports prior to drawing and issuing checks pursuant thereto amounts to negligent business conduct."[237] Applying this rule, the *Fidelity & Casualty Co.* court found that the finance company was negligent in failing to make any investigation to verify that the purported loan applicants were in fact seeking to obtain loans from it.[238]

In short, a plaintiff seeking recovery for a material alteration of or an unauthorized signature on a negotiable instrument may be found guilty of negligence which substantially contributed to the occurrence of the wrongdoing of which he complains for a variety of reasons.[239] Even if the plaintiff's conduct constitutes such negligence, however, he will not be precluded from the recovery to which he is otherwise entitled under the Code's general rules of loss allocation if the defendant does not qualify as "a holder in due course or . . . [as] a drawee or other payor who [paid] the instrument in good faith and in accordance with the reasonable commercial standards of the drawee's or payor's business."[240]

III. The Conduct of the Defendant

A. *"a holder in due course . . ."*[241]

U.C.C. section 3-302(1) defines a holder in due course as "a holder who takes the instrument (a) for value; and (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."[242]

Implicit in this definition is a requirement that the person seeking holder in due course status qualify as a "holder."[243] A person in possession

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237. 167 Conn. at ___, 356 A.2d at 121 (citing Fidelity & Deposit Co. v. Chemical Bank N.Y. Trust Co., 65 Misc. 2d 619, 318 N.Y.S.2d 957 (App. Term 1970) (per curiam), *aff'd without opinion*, 39 A.D.2d 1019, 333 N.Y.S.2d 726 (1972) and Thompson Maple Prods., Inc. v. Citizens Nat'l Bank, 211 Pa. Super. 42, 234 A.2d 32 (1967)). In *Fidelity & Deposit Co.* the New York court reached a result opposite that reached by the Eighth Circuit in *Bagby*. *See supra* note 159.

238. 167 Conn. at ___, 356 A.2d at 121. The facts in *Fidelity & Casualty Co.* may have supported a defense based on U.C.C. section 3-406(1)(a), *see supra* note 76, making resort to section 3-406 unnecessary. *See supra* text accompanying note 78. Whereas Code section 3-405(1)(a) may apply to the fraudulent conduct of the automobile salesman in *Fidelity & Casualty Co.* since he impersonated the purported loan applicants, that section would not apply to the conduct of the log hauler in *Thompson Maple Products, Inc.* who obtained the checks from the bookkeeper by representing that he would deliver them to the named payees. U.C.C. § 3-405 comment 2 (1972).

239. An exhaustive list of the acts or omissions of a plaintiff which will be deemed negligence which substantially contributes to the making of an alteration or unauthorized signature cannot be made since that determination is to be made by the finder of fact under the particular facts and circumstances of each case. *Id.* § 3-406 comments 3, 7.

240. *Id.* § 3-406; *see supra* text accompanying notes 53-54.

241. U.C.C. § 3-406 (1972).

242. *Id.* § 3-302(1).

243. J. White & R. Summers, *supra* note 19, § 14-2, at 551.

of an instrument qualifies as a holder under U.C.C. section 1-201(20) if the instrument was "drawn, issued, or indorsed to him or his order or to bearer or in blank."[244] Any possessor of an instrument payable to the bearer, the instrument having been either originally drawn to be so payable[245] or endorsed in blank by a holder,[246] is a holder even if the bearer paper passed through the hands of a thief prior to coming into his possession.[247] If, on the other hand, the thief steals the check while it is an order instrument[248] and forges the endorsement of the last party named on the instrument, no possessor who traces his title to the instrument through the forger qualifies as a holder.[249]

The forger "is not *himself* a holder because the instrument is neither payable to nor indorsed to his order" as required by Code section 1-201(20).[250] Code section 3-202(2) in turn requires that an endorsement "be written by or on behalf of the holder."[251] Since the forger neither qualifies as a holder nor is capable of making an endorsement, the person who takes the instrument from the forger and any subsequent transferees cannot qualify as holders under Code section 1-201(20).[252]

Accordingly, several courts have held that a person who takes possession of an instrument after a forged endorsement has been made thereon cannot be a holder and, therefore, cannot be a holder in due course.[253] The problem with such an interpretation of the Code is that it limits the applicability of the "holder in due course" language of section 3-406 to cases involving material alterations[254] although no such limitation is apparent on a read-

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244. U.C.C. § 1-201(20) (1972); J. WHITE & R. SUMMERS, *supra* note 19, § 14-3, at 552.

245. U.C.C. § 3-111 (1972).

246. *Id.* § 3-204(2).

247. J. WHITE & R. SUMMERS, *supra* note 19, § 14-3 at 552.

248. An order instrument is one drawn payable to the order of a particular person to which no endorsements have been made or, if endorsements have been made, one on which the last endorsement is a special endorsement. *See* U.C.C. § 3-204 for definition of special endorsement.

249. J. WHITE & R. SUMMERS, *supra* note 19, § 14-3, at 552-53; Whaley, *Negligence, supra* note 6, at 18; Whaley, *Forged Indorsements and the UCC's "Holder,"* 6 IND. L. REV. 45, 46 (1972).

250. J. WHITE & R. SUMMERS, *supra* note 19, § 14-3, at 553. *See supra* text accompanying note 244.

251. U.C.C. § 3-202(2) (1972); J. WHITE & R. SUMMERS, *supra* note 19, § 14-3, at 553.

252. J. WHITE & R. SUMMERS, *supra* note 19, § 14-3, at 553. *See supra* text accompanying note 244.

253. Stone & Webster Eng'g Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, ___, 184 N.E.2d 358, 361 (1962); Salsman v. National Community Bank, 102 N.J. Super. at ___, 246 A.2d at 167. The requirement of section 3-202(2) that an endorsement be made by or on behalf of the holder seems to render ineffective all unauthorized endorsements and not only forged ones. *See supra* note 17. Neither White and Summers nor Whaley discuss the effect of an unauthorized drawer's signature, as opposed to an unauthorized endorsement of the name of the payee or a party named in a special endorsement, on a possessor's status as a holder.

254. *See* Whaley, *Negligence, supra* note 6, at 18.

ing of the section itself. The best solution to this problem is to use the preclusion of section 3-406 to validate the forged endorsement and thereby bootstrap the possessor into holder status.[255] This result can be achieved through the operation of the Code's procedural section, section 3-307. If the defendant establishes that the plaintiff's negligence substantially contributed to the making of the forgery and that it otherwise qualifies as a holder in due course,[256] section 3-307 should, as a procedural matter, preclude the plaintiff from challenging the validity of the endorsement for purposes of establishing the defendant's status as a holder under sections 1-201(20) and 3-202(2).[257]

A second requirement for holder in due course status is that the defendant take the instrument "for value."[258] If the defendant is a bank, the determination of whether it has given value for purposes of qualifying as a holder in due course is governed by Code section 4-209.[259] Under that section a bank is deemed to have given value to the extent that it has a security interest in the instrument.[260] Whether the bank has acquired a security interest in the instrument is determined according to U.C.C. section 4-208(1).[261] The bank obtains a security interest in a check and, hence, gives value when it cashes the check[262] or its depositor withdraws funds representing the credit extended by the bank prior to receiving final settlement of the item.[263] If the credit extended by the bank is not withdrawn, the bank does not give value until the credit is "available for withdrawal as of right."[264] The right of the depositor to withdraw the credit is "determined by his agreement with his bank or, in the absence of such an agreement, by 4-213."[265] The depositor may withdraw the funds as of right under section 4-213(4)(a) and the bank has given value under section 4-209 when the bank has received final settlement on the check and "has had a reasonable time to

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255. Dugan, *supra* note 43, at 961 n.35; *see* Whaley, *Negligence*, *supra* note 6, at 19. For a summary of other possible resolutions of this tension between section 3-406 and the sections governing holder status, see Whaley, *Negligence*, *supra* note 6, at 18-19.

256. A negligent plaintiff is not precluded from asserting the forgery unless the defendant satisfies *all* the requirements for holder in due course status. Thus, a defendant seeking to bootstrap himself into "holder" status must prove that he took the instrument "in due course." Whaley, *Negligence*, *supra* note 6, at 19 n.70.

257. *Id.* at 19.

258. U.C.C. § 3-302(1)(a) (1972).

259. U.C.C. § 4-209 (1972).

260. Fireman's Fund Ins. Co. v. Security Pac. Nat'l Bank, 85 Cal. App. 3d 797, 823 n.31, 149 Cal. Rptr. 883, 900 n.31 (1978); U.C.C. § 4-209 (1972).

261. Fireman's Fund Ins. Co. v. Security Pac. Nat'l Bank, 85 Cal. App. 3d at 823 n.31, 149 Cal. Rptr. at 900 n.31.

262. Suit & Wells Equip. Co. v. Citizens Nat'l Bank, 263 Md. 133, ___, 282 A.2d 109, 111 (1971).

263. U.C.C. § 4-208(1)(a) (1972); J. WHITE & R. SUMMERS, *supra* note 19, § 14-5, at 558.

264. U.C.C. § 4-208(1)(b) (1972); J. WHITE & R. SUMMERS, *supra* note 19, § 14-5, at 558.

265. J. WHITE & R. SUMMERS, *supra* note 19, § 14-5, at 558.

learn that the settlement is final."[266]

To qualify as a holder in due course, the defendant must also have taken the instrument in good faith.[267] Code section 1-201(19) defines good faith as "honesty in fact in the conduct or transaction concerned."[268] The history of the Code's definition of good faith clearly establishes that "honesty in fact" is a subjective and not an objective test.[269] The Proposed Final Draft of the Code defined good faith as including "observance by a person of the reasonable commercial standards of any business or trade in which he is engaged,"[270] but that language was dropped in the 1952 Official Draft.[271] The drafters of the Code thus intentionally eliminated an objective reasonable care standard from the good faith requirement.[272] Consequently, so long as a person takes an instrument without any knowledge of wrongdoing involving that instrument, he takes the instrument in good faith.[273]

The final condition which the possessor of an instrument must satisfy in order to attain holder in due course status is that he must have acquired the instrument "without notice."[274] Code section 3-304 defines what constitutes notice of a claim or defense which will deprive the possessor of an instrument of holder in due course status.[275] The face of an instrument itself imparts notice of a claim or defense under Code section 3-304(1)(a) if it "is so incomplete, bears such visible evidence of forgery or alteration, or is otherwise so irregular as to call into question its validity, terms or ownership or to create an ambiguity as to the party to pay."[276] The possessor is not disqualified from holder in due course status, however, solely because the instrument is blank in some unnecessary particular, contains minor erasures[277] or has been completed in handwriting different than that of the drawer.[278]

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266. U.C.C. § 4-213(4)(a) (1972); *see also* Fireman's Fund Ins. Co. v. Security Pac. Nat'l Bank, 85 Cal. App. 3d at 823 n.31, 149 Cal. Rptr. at 900 n.31; J. White & R. Summers, *supra* note 19, § 14-5, at 558. Section 4-213(4)(b) sets forth a special rule which applies where the depository bank and the drawee bank are one in the same. U.C.C. § 4-213(4)(b) (1972).

267. U.C.C. § 3-302(1)(b) (1972).

268. *Id.* § 1-201(19).

269. Von Gohren v. Pacific Nat'l Bank, 8 Wash. App. at ___, 505 P.2d at 471-72; Dugan, *supra* note 43, at 981.

270. U.C.C. § 1-201(18) (Proposed Final Draft 1950).

271. U.C.C. § 1-201(19) (Official Draft 1952). The Editorial Board of the National Conference of Commissioners on Uniform State Laws described this omission as a "major change of substance." U.C.C. § 1-201(19) (Proposed Final Draft No. 2, Text ed. 1951).

272. Von Gohren v. Pacific Nat'l Bank, 8 Wash. App. at ___, 505 P.2d at 471-72. "The presence of suspicious circumstances sufficient to put a reasonable prudent person on inquiry does not negative the existence of good faith." Cal. Com. Code § 3302 comment 2 (West 1964).

273. Dugan, *supra* note 43, at 981.

274. U.C.C. § 3-302(1)(c) (1972); *see supra* text accompanying note 242.

275. Industrial Nat'l Bank v. Leo's Used Car Exch., Inc., 362 Mass. 797, ___, 291 N.E.2d 603, 606 (1973).

276. U.C.C. § 3-304(1)(a) (1972); J. White & R. Summers, *supra* note 19, § 14-6, at 565.

277. U.C.C. § 3-304 comment 2 (1972).

278. *Id.* § 3-304(4)(d); J. White & R. Summers, *supra* note 19, § 14-6, at 565. The posses-

The irregularities which impart notice of a claim or defense to a person when he takes an instrument are not limited to those which may be seen on the face of the instrument itself but also include irregularities in the manner in which the instrument is negotiated.[279] The court in *Sun 'n Sand, Inc. v. United California Bank*[280] asserted that Code section 3-304(1)(a), even though it expressly addresses only irregularities on the face of an instrument, supports an inference "that notice is imparted by other irregularities such as in the manner of negotiation of an instrument which create ambiguities as to the party entitled to be paid."[281] The ambiguity in *Sun 'n Sand, Inc.* was created by the conduct of the drawer's employee who presented checks drawn payable to the defendant bank for deposit to her personal checking account.[282] The *Sun 'n Sand, Inc.* court also looked to Code section 3-304(2) which provides that a person takes an instrument with notice of a claim or defense "when he has knowledge that a fiduciary has negotiated the instrument in payment of or as security for his own debt or in any transaction for his own benefit or otherwise in breach of duty."[283] Applying this subsection to the facts of the case, the court found that the acts of the employee, a fiduciary, constituted the "affirmative indications that an improper party is attempting to procure payment" necessary to impart notice under the subsection.[284] The court concluded, therefore, that a person who takes an instrument under such circumstances has notice of a claim or defense and is thereby denied holder in due course status.[285]

In *Sun 'n Sand, Inc.*, the facts which were held to impart notice to the defendant bank within the meaning of Code section 3-304(1)(a) and (2) also supplied the basis for finding that the bank had breached a duty of care by failing "to respond reasonably to the 'notice' conveyed by such suspicious circumstances." Given its resolution of the case under the provisions of section 3-304, the court concluded that it need not decide whether, as a general

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sor does have notice of a claim or defense if he has notice of an improper completion of the instrument. U.C.C. § 3-304(4)(d) (1972). See Code section 3-115 for the rules governing the completion of an incomplete instrument.

279. Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d at 689, 582 P.2d at 933, 148 Cal. Rptr. at 342.

280. 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978).

281. *Id.* at 689-90, 582 P.2d at 933, 148 Cal. Rptr. at 342.

282. *Id.* at 678, 690, 582 P.2d at 926, 933, 148 Cal. Rptr. at 335, 342.

283. U.C.C. § 3-304(2) (1972).

284. Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d at 690, 582 P.2d at 933, 148 Cal. Rptr. at 342. A similar interpretation of section 3-304(2) is found in *Von Gohren v. Pacific National Bank*, 8 Wash. App. 245, 505 P.2d 467 (1973). The court there concluded, as did the court in *Sun 'n Sand, Inc.*, that deposits made by an employee into her personal account of checks payable to her employer impart notice to the defendant as transactions by a fiduciary dealing with instruments for her own benefit. *Id.* at ___, 505 P.2d at 473; *accord* Mott Grain Co. v. First Nat'l Bank & Trust Co., 259 N.W.2d 667, 670 (N.D. 1977).

285. Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d at 690, 582 P.2d at 933, 148 Cal. Rptr. at 342.

proposition, the facts the presence of which require the exercise of reasonable care also constitute notice for purposes of section 3-304.[286]

The majority of courts have answered this question in the negative, holding that "mere suspicious circumstances" do not impart notice of a claim or defense for purposes of determining a party's status as a holder in due course.[287] Those courts do not find notice unless the negligence of the possessor of the instrument is "so gross as to amount to bad faith."[288] The flaw in this position is that it confuses the tests of "good faith" and "notice."[289]

"Good faith" and "notice" are defined separately in section 1-201[290] and are listed as separate qualifications for holder in due course status in section 3-302.[291] Section 3-302 expressly incorporates the section 1-201(25) definition of notice as part of its notice provisions.[292] Notice as defined in 1-201(25) can be grouped into two categories: actual notice[293] and "reason to know."[294] "Reason to know" is an objective test[295] "premised on the use of reasonable commercial practices."[296] The "good faith" test, on the other hand, is a subjective test of "honesty in fact."[297] Thus, where a person takes an instrument with actual notice of a claim or defense, he fails both the good faith and notice requirements for holder in due course status. If he

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286. *Id.* at 697 n.21, 582 P.2d at 938 n.21, 148 Cal. Rptr. at 347 n.21; *see* Mott Grain Co. v. First Nat'l Bank & Trust Co., 259 N.W.2d at 670.

287. Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d at 697 n.21, 582 P.2d at 938 n.21, 148 Cal. Rptr. at 347 n.21; Fireman's Fund Ins. Co. v. Security Pac. Nat'l Bank, 85 Cal. App. 3d at 824, 149 Cal. Rptr. at 901.

288. Fireman's Fund Ins. Co. v. Security Pac. Nat'l Bank, 85 Cal. App. 3d at 824, 149 Cal. Rptr. at 901 (discussing Eldon's Super Fresh Stores, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 296 Minn. 130, ___, 207 N.W.2d 282, 287-88 (1973) (check drawn payable to brokerage by principal applied to debt owed brokerage by agent rather than for benefit of principal; held, no notice to brokerage) and Richardson Co. v. First Nat'l Bank, 504 S.W.2d 812, 815-16 (Tex. Civ. App. 1974) (check drawn payable to bank by employer applied to debt owed bank by employee; held, no notice to bank)).

289. Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d at 697 n.21, 582 P.2d at 938 n.21, 148 Cal. Rptr. at 347 n.21.

290. "Good faith" is defined in subsection (19) and "notice," in subsection (25). U.C.C. § 1-201(19), (25) (1972).

291. Sun ' Sand, Inc. v. United Cal. Bank, 21 Cal. 3d at 697 n.21, 582 P.2d at 938 n.21, 148 Cal. Rptr. at 347 n.21; U.C.C. § 3-302(1)(b)-(c) (1972).

292. Fireman's Fund Ins. Co. v. Security Pac. Nat'l Bank, 85 Cal. App. 3d at 824, 149 Cal. Rptr. at 901; U.C.C. § 3-302 comment 1 (1972).

293. U.C.C. § 1-201(25)(a)-(b) (1972).

294. Code section 1-201(25)(c) provides that a person has notice of a fact if "from all the facts and circumstances known to him at the time in question he has reason to know that it exists." U.C.C. § 1-201(25)(c) (1972).

295. Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d at 697 n.21, 582 P.2d at 938 n.21, 148 Cal. Rptr. at 347 n.21.

296. Kaw Valley State Bank & Trust Co. v. Riddle, 219 Kan. 550, ___, 549 P.2d 927, 933 (1976).

297. *See supra* text accompanying notes 268-69.

takes the instrument with only "reason to know" of a claim or defense, he still fails to qualify as a holder in due course, for although he takes the instrument in good faith,[298] he does not take it without notice.[299]

Thus, an objective negligence standard does play a role in determining whether the "without notice" requirement of Code section 3-302(1)(c) has been violated.[300] The use of such a test for determining whether a person had notice of a claim or defense when he acquired an instrument and therefore should be denied holder in due course status is consistent with the purpose of U.C.C. sections 1-201(25) and 3-304 "to prevent those dealing in the commercial world from obtaining various rights when, from a reasonable inquiry into the true facts that person would have discovered that a fact existed which prevented him from obtaining the rights which he was seeking."[301]

Code section 3-304 is an explication of what constitutes "reason to know" in the context of qualification as a holder in due course.[302] For purposes of Code section 3-406, a person who takes an instrument has reason to know of a claim or defense against the instrument if, on the basis of the information known by him, the likelihood of wrongdoing of the type specified in section 3-304(1)(a) or (2) is so great that the reasonable commercial standards of his business require that he conduct himself as if such wrongdoing had been or was about to be perpetrated until he determines that such wrongdoing is not in fact present.[303] If the information known by the taker of the instrument would not give rise to a reasonable suspicion of

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298. *See supra* text accompanying notes 272-73.

299. Kaw Valley State Bank & Trust Co. v. Riddle, 219 Kan. at ___, 549 P.2d at 933.

300. Industrial Nat'l Bank v. Leo's Used Car Exch., Inc., 362 Mass. at ___, 291 N.E.2d at 606.

301. Winter & Hirsch, Inc. v. Passarelli, 122 Ill. App. 2d 372, ___, 259 N.E.2d 312, 317 (1970).

302. Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d at 689, 582 P.2d at 933, 148 Cal. Rptr. at 342.

Code section 3-304(2) uses the word "knowledge." *See supra* text accompanying note 283. Under the Code "[a] person has 'knowledge' of a fact when he has actual knowledge of it." U.C.C. § 1-201(25) (1972). The court in *Von Gohren v. Pacific National Bank*, however, rejected the defendant's argument

> that the drafters of the code intended to eliminate a reasonable care standard from the duty of one dealing with a fiduciary; and that the code permits one to be a holder in due course whether negligent or not, unless one acted with *actual knowledge* of the breach or *in bad faith*.

8 Wash. App. at ___, 505 P.2d at 473. Mere knowledge that the person negotiating a check is a fiduciary under circumstances which do not suggest any wrongdoing does not constitute notice under the "reason to know" test. Fireman's Fund Ins. Co. v. Security Pac. Nat'l Bank, 85 Cal. App. 3d at 824-25, 149 Cal. Rptr. at 901-02; U.C.C. § 3-304(4)(e) (1972).

303. *See* RESTATEMENT (SECOND) OF AGENCY § 9 comment d (1958). The Code does not define the phrase "reason to know," however, comment d to section 9 of the Restatement offers a "useful explanation of the phrase." Von Gohren v. Pacific Nat'l Bank, 8 Wash. App. at ___, 505 P.2d at 472.

wrongdoing and he otherwise qualifies as a holder in due course, he may raise the preclusion afforded by section 3-406 against a negligent plaintiff.[304] If, however, the information known by him does give rise to such a suspicion, he has notice of a claim or defense against the instrument, thereby denying him holder in due course status, and, as will be seen below, he must act in good faith and in accordance with the reasonable commercial standards of his business in order to avail himself of the 3-406 defense.[305]

B. "a drawee or other payor . . ."[306]

A possessor of an instrument who does not qualify as a holder in due course must be "a drawee or other payor" in order to raise the defense of the plaintiff's negligence.[307] The requirements for being a "drawee" need no explanation.[308] Who qualifies as an "other payor" is not as clear. The "other payor" language was not included in section 3-406 as originally worded[309] but was added in the 1951 Proposed Final Draft of the Code.[310] It is reasonable to conclude that the addition of that language was intended to broaden the class of persons protected by the defense.[311] One class of persons which may seek to invoke the section 3-406 negligence defense as "other payors" is drawers.[312] Another class of "other payors" is collecting banks.[313] Extending the class of defendants who can raise section 3-406 to include collecting

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304. U.C.C. § 3-406 (1972).

305. Mott Grain Co. v. First Nat'l Bank & Trust Co., 259 N.W.2d at 670; U.C.C. § 3-406 (1972).

306. U.C.C. § 3-406 (1972).

307. *Id.*

308. For a definition of "drawee," see BLACK'S LAW DICTIONARY 444 (rev. 5th ed. 1979).

309. U.C.C. § 3-406 (Proposed Final Draft 1950).

310. U.C.C. § 3-406 (Proposed Final Draft No. 2, Text ed. 1951). The Editorial Board described the addition of "other payor" as a "minor change of substance." *Id.*

311. Fidelity & Deposit Co. v. First Nat'l Bank, 98 Wis. 2d 474, ___, 297 N.W.2d 46, 50 (Ct. App. 1980). *Compare* U.C.C. § 3-406 comment 2 (Proposed Final Draft 1950) ("The section extends the above principle to the protection of a holder in due course.") *with* U.C.C. § 3-406 comment 2 (1972) ("The section extends the above principle to the protection of a holder in due course and of *payors who may not technically be drawees.*" (emphasis added)).

312. Dugan, *supra* note 43, at 961 n.35.

313. *E.g.*, Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d at 683, 582 P.2d at 929, 148 Cal. Rptr. at 338; Fidelity & Deposit Co. v. First Nat'l Bank, 98 Wis. 2d at ___, 297 N.W.2d at 50. *Contra* Dugan, *supra* note 43, at 961 n.35. Dugan reasons that a collecting bank does not "pay" an instrument which it accepts for deposit, but rather acts as an agent for the depositor in presenting the item to the drawee bank and becomes a debtor to its customer upon receiving payment from the drawee. *Id.* at 964 n.47. Therefore, he asserts, a collecting bank is not a "payor" and can only assert the plaintiff's negligence if it qualifies as a holder in due course. *Id.* at 961 n.35. Though the text of the section does state "other payor who *pays* the instrument," U.C.C. § 3-406 (1972) (emphasis added), comment 6 describes the defendant in less restrictive terms: "any bank which *takes or pays* an altered check." *Id.* § 3-406 comment 6 (emphasis added); *see also* Fidelity & Deposit Co. v. First Nat'l Bank, 98 Wis. 2d at ___, 297 N.W.2d at 50.

banks is important because where a negligent drawer brings an action against a collecting bank directly, the latter is entitled to the same defenses which the drawee bank could have asserted against the drawer had he proceeded against the drawee instead.[314]

1. *"in good faith and . . ."*[315]

The good faith requirement of section 3-406 is the same subjective, "honesty in fact" standard required of a holder in due course.[316] To be able to assert section 3-406 against the complaining party, the defendant must have acted both in good faith and in accordance with the reasonable commercial standards of its business.[317] Since the good faith test is usually satisfied, the determination of "what is and what is not commercially reasonable will effectively determine the scope and impact" of the protection afforded drawees and other payors who are not holders in due course by Code section 3-406.[318]

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314. Note, *Depositary Bank Liability Under § 3-419(3) of the Uniform Commercial Code*, 31 WASH. & LEE L. REV. 676, 696 n.109 (1974) [hereinafter cited as Note, *Depositary Bank Liability*].

315. U.C.C. § 3-406 comment 6 (1972).

316. *Id.; see supra* text accompanying notes 267-73.

317. U.C.C. § 3-406 comment 6 (1972).

318. Dugan, *supra* note 43, at 981 (discussing Code section 3-419(3) which provides a defense to conversion liability which is similarly conditioned on the defendant having acted in good faith and in accordance with reasonable commercial standards). Given the importance of the determination of whether the defendant acted in a good faith, commercially reasonable manner, the allocation of the burden of proof on this issue deserves discussion.

Prior to the adoption of the Code, the defendant bank bore the burden of proving its own due diligence in accepting a forged or altered check. Penney, *Bank Statements, Cancelled Checks, and Article Four in the Electronic Age*, 65 MICH. L. REV. 1341, 1349-50 (1967). The courts placed this burden on the defendant notwithstanding the fact that the burden of proof on the issue of contributory negligence in negligence cases rests not on the allegedly contributorily negligent party but on his opponent. Wussow v. Badger State Bank, 204 Wis. 467, ___, 234 N.W. 720, 722-23 (1931). According to these courts, a bank's defense that the plaintiff's negligence caused the forgery or alteration of which he complains is an estoppel which, as a creature of equity, must be governed by equitable principles. Since an estoppel does not arise in equity "unless the one asserting it has acted with due diligence," the pre-Code courts required the defendant to establish its own due diligence before permitting it to assert the plaintiff's negligence. *Id.* at ___, 234 N.W. at 722; *see also* Union Tool Co. v. Farmers' & Merchants' Nat'l Bank, 192 Cal. 40, ___, 218 P. 424, 427 (1923).

Neither the text of Code section 3-406 nor the official comments thereto expressly addresses the allocation of the burden of proof on the issue of the defendant's conduct. The section presumably continues the pre-Code case law requirement that the defendant first prove its own freedom from negligence. CAL. COM. CODE § 3406 comment 1 (West 1964) (cited in Hermetic Refrigeration Co. v. Central Valley Nat'l Bank, Inc., 493 F.2d 476, 477 (9th Cir. 1974)). Indeed, the overwhelming majority of courts have placed the burden of proof on this issue on the defendant. First Nat'l Bank v. Hovey, 1980 Mass. App. Ct. Adv. Sh. 2017, ___, 412 N.E.2d 889, 894 (1980). This allocation of the burden of proof is equitable in the typical case where the defendant is a bank since the bank has knowledge and control of its own check-handling proce-

2. *"in accordance with the reasonable commercial standards of the drawee's or payor's business."*[319]

The "reasonable commercial standards" requirement is an objective standard.[320] A defendant is not automatically entitled to assert Code section 3-406 upon establishing its conformity with the local practices of its industry; the defendant's conduct must also be reasonable from an absolute as opposed to a relative point of view.[321] The defendant may be found to have failed to act in a commercially reasonable manner for either of two reasons: (1) the procedures established by it may fall below the standard of commerical reasonableness or (2) the defendant's employees failed to exercise due care in implementing its procedures in this particular instance.[322]

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dures. *See* Penney, *supra*, note 1350 n.41.

The Fifth Circuit, however, in *Commercial Credit Equipment Corp. v. First Alabama Bank*, 636 F.2d 1051 (5th Cir. 1981), did not hold the defendant to its burden of proving its own due care. The court refused "to indulge in the presumption that the fact of negotiation established failure to follow reasonable commercial standards." *Id.* at 1055-56. To adopt that presumption, the court asserted, would render section 3-406 meaningless. The court justified its change in the allocation of the burden of proof on the basis of the particular facts of the case before it: the plaintiff drawer did not notify the bank of the forgery until after the ninety day period, for which the bank kept its check-handling records, had expired. *Id.* at 1056; *cf.* Myrick v. National Sav. & Trust Co., 268 A.2d 526, 528 n.6 (D.C. 1970) (held for defendant, finding plaintiff negligent as a matter of law and no evidence that bank had not paid checks in good faith and in accordance with reasonable commercial standards).

The construction of section 3-406 as requiring the defendant to prove its own due care is consistent with the construction of the "in good faith and in accordance with the reasonable commercial standards" language used in Code section 3-419(3). The courts have uniformly construed section 3-419 (3) as creating an affirmative defense, with the burden of proof resting on the defendant bank. *E.g.*, National Bank v. Refrigerated Transp. Co., 147 Ga. App. 240, ___, 248 S.E.2d 496, 499 (1978); Montgomery v. First Nat'l Bank, 265 Or. 55, ___, 508 P.2d 428, 432 (1973).

The allocation of the burden of proof on the issue of the defendant's conduct under sections 3-406 and 3-419(3) should be contrasted to that under section 4-406(3). The language of section 4-406(3) specifically provides that the plaintiff bank customer must establish the defendant bank's lack of ordinary care. Westport Bank & Trust Co. v. Lodge, 164 Conn. 604, ___, 325 A.2d 222, 227 (1973); U.C.C. § 4-406 comment 4 (1972).

319. U.C.C. § 3-406 (1972).

320. Note, *Depositary Bank Liability*, *supra* note 314, at 685 n.50. This requirement has no exact predecessor in the Uniform Negotiable Instruments Act. Empire Moving & Warehouse Corp. v. Hyde Park Bank & Trust Co., 43 Ill. App. 3d 991, ___, 357 N.E.2d 1196, 1200 (1976); *see supra* note 96.

321. Hanover Ins. Cos. v. Brotherhood State Bank, 482 F. Supp. 501, 506 (D. Kan. 1979); Perley v. Glastonbury Bank & Trust Co., 170 Conn. at ___, 368 A.2d at 155.

322. Hanover Ins. Cos. v. Brotherhood State Bank, 482 F. Supp. at 505 (discussing Code section 4-406). Code section 4-406 conditions the availability of the defense which it provides on the bank having acted with "ordinary care." U.C.C. § 4-406(3) (1972). The "ordinary care" requirement of section 4-406 and the "reasonable commercial standards" requirement of section 3-406 are generally viewed as equivalents. Whaley, *Negligence*, *supra* note 6, at 14 n.50; *see* Hanover Ins. Cos. v. Brotherhood State Bank, 482 F. Supp. at 508. One explanation for the different language used in the two sections is that section 4-406 applies strictly to banking

The tension between conformity with local practices and reasonableness in an absolute sense is perhaps most acute in regard to the duty of a drawee bank, if any, to examine checks presented for payment. Some courts, while recognizing the impracticality of examination by a bank of the checks presented to it for payment, given the massive volume of checks handled by even small banks, hold that banks have a duty to examine checks purportedly drawn by their customers for unauthorized signatures or alterations.[323] This duty derives from the bank's obligation to charge its customer's account for only those items properly payable.[324] Other courts, however, have been impressed by the heavy burden which would be imposed on banks, and the check clearing process as a whole, if such a duty of examination were strictly enforced.[325] These courts have limited the duty of examination so as to relieve banks of the duty to examine ostensibly valid endorsements; the banks are still under a duty to investigate suspicious situations.[326] The viewpoint of these courts is that the duty of examination should not be thrust upon the banks alone; rather, the banks should be entitled to expect their customers to exercise some degree of care on their own behalf.[327] The rejoinder to this more practical construction of the reasonable commercial standards requirement is that a bank which decides that it is economically impractical to hire the additional people needed to examine the checks has made its choice and will not be relieved of liability for the resulting losses.[328]

A duty of inquiry, on which the courts are in general agreement, is imposed where an individual seeks to cash or deposit to his personal account a check payable to his corporate employer.[329] A bank should realize that the general practice of corporations is to deposit and disburse funds through its checking account. Moreover, the cancelled checks are returned to the respective drawers and not to the corporate payee, making it difficult for the injured party to discover the wrongdoing.[330] With these considerations in

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transactions whereas section 3-406 is applicable to commercial paper transactions in general. Note, *Forgeries and Material Alterations: Allocation of Risks under the Uniform Commercial Code*, 50 B.U.L. Rev. 536, 548 (1970).

323. Hanover Ins. Cos. v. Brotherhood State Bank, 482 F. Supp. at 510; Perley v. Glastonbury Bank & Trust Co., 170 Conn. at ___, 368 A.2d at 155; Jackson v. First Nat'l Bank, 55 Tenn. App. at ___, 403 S.W.2d at 113.

324. Hanover Ins. Cos. v. Brotherhood State Bank, 482 F. Supp. at 510.

325. *E.g.*, Cooper v. Union Bank, 27 Cal. App. 3d 85, ___, 103 Cal. Rptr. 610, 616 (1972), *vacated*, 9 Cal. 3d 123, 507 P.2d 609, 107 Cal. Rptr. 1 (1973).

326. Trust Co. of Ga. Bank v. Port Terminal & Warehousing Co., 153 Ga. App. at ___, 266 S.E.2d at 258; Cooper v. Union Bank, 9 Cal. 3d at 137, 507 P.2d at 620, 107 Cal. Rptr. at 12.

327. Jacoby Transp. Sys. v. Continental Bank, 277 Pa. Super. at ___, 419 A.2d at 1233.

328. *See* Hanover Ins. Cos. v. Brotherhood State Bank, 482 F. Supp. at 510; Perley v. Glastonbury Bank & Trust Co., 170 Conn. at ___, 368 A.2d at 155.

329. *E.g.*, National Bank v. Refrigerated Transp. Co., 147 Ga. App. 240, ___, 248 S.E.2d 496, 500 (1978); Aetna Casualty & Sur. Co. v. Helper State Bank, 6 Kan. App. 2d at ___, 630 P.2d at 728.

330. Senate Motors, Inc. v. Industrial Bank, 9 U.C.C. Rep. Serv. (Callaghan) 387, 390-91

mind, courts have consistently held as a matter of law that a bank's failure to inquire as to the depositor's authority to negotiate a corporate check is commercially unreasonable conduct.[331]

The duty of a bank to inquire as to the authority of an agent to negotiate for his own benefit checks payable to his principal is not absolute, however.[332] The bank may rely on the actual, implied or apparent authority of the agent to make endorsements on the checks payable to the principal,[333] but such authority will not be lightly inferred.[334] Statements by or actions of the agent do not by themselves establish apparent authority.[335] Unless the bank relies on conduct which is known to and acquiesced in by the principal, it will bear the loss resulting from the unauthorized endorsement made by the agent.[336] Given the uncertainties of the apparent authority doctrine, the better practice would be for the bank to "communicate with the principal to verify the agent's authority."[337]

Just as in the case of determining whether the plaintiff is guilty of negligence which was a substantial factor in bringing about the wrongdoing, the question of whether the defendant acted in a commercially reasonable manner must be decided on the facts of each case.[338] The Code does, however, provide some standards for evaluating the reasonableness of the defendant's conduct. U.C.C. section 3-401 provides that a valid signature may be "made by use of any name, including any trade or assumed name, upon an instrument, or by any word or mark used in lieu of a written signature."[339] The defendant must acquire the instrument in compliance with the Code provi-

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(D.C. Super. Ct. 1971).

331. *E.g.*, Aetna Casualty & Sur. Co. v. Helper State Bank, 6 Kan. App. 2d at ___, 630 P.2d at 728.

332. Senate Motors, Inc. v. Industrial Bank, 9 U.C.C. Rep. Serv. at 391; Gresham State Bank v. O & K Constr. Co., 231 Or. at ___, 370 P.2d at 733.

333. Senate Motors, Inc. v. Industrial Bank, 9 U.C.C. Rep. Serv. at 391; Gresham State Bank v. O & K Constr. Co., 231 Or. at ___, 370 P.2d at 733. Thus, there is an overlap of the section 3-406 defense and the defenses afforded by Code section 3-404. *See supra* text accompanying notes 38-45.

334. Taylor v. Equitable Trust Co., 269 Md. 149, ___, 304 A.2d 838, 842 (1973).

335. Bank of S. Md. v. Robertson's Crab House, Inc., 39 Md. App. at ___, 389 A.2d at 394.

336. Taylor v. Equitable Trust Co., 269 Md. at ___, 304 A.2d at 846.

337. R. ANDERSON, *supra* note 18, § 3-404:3, at 922. "A written statement from the principal as to the agent's authority may also aid in avoiding any subsequent dispute as to whether such authority existed, or whether the principal had made any statement as to the authority of the apparent agent." *Id.*

338. *See supra* note 239. For instance, whether the defendant should have detected a forgery or alteration will depend upon the skill of the wrongdoer. *See* Hanover Ins. Cos. v. Brotherhood State Bank, 482 F. Supp. at 510; Nu-Way Servs. Inc. v. Mercantile Trust Co. Nat'l Ass'n, 530 S.W.2d at 747-48 ("Whereas the forgeries were skillfully written, the alterations were maladroitly performed . . . .").

339. U.C.C. § 3-401 comment 2 (1972); *see* West Penn Admin., Inc. v. Union Nat'l Bank, 233 Pa. Super. at ___, 335 A.2d at 736.

sions governing restrictive[340] and special[341] endorsements as well as those governing items payable to joint payees.[342] Where the instrument is payable to bearer[343] or alternative payees[344] or is endorsed in blank,[345] the defendant need only comply with the minimal standards required of persons dealing with such instruments in order to satisfy the reasonable commercial standards requirement of section 3-406.[346] Finally, if the defendant is a bank, as is true in most cases, conduct in compliance with regulations and operating letters promulgated by the Federal Reserve is conduct in accordance with reasonable commercial standards; conduct consistent with clearing house rules and the like or with general banking usage is prima facie evidence of commercially reasonable conduct.[347]

IV. Conclusion

Code section 3-406 establishes a double preclusion. If the complaining party is guilty of negligence which substantially contributed to the making of the material alteration or unauthorized signature of which he complains, the section precludes him from the recovery to which he would otherwise be entitled under the general rules of loss allocation of U.C.C. articles 3 and 4. If, however, the defendant does not qualify as a holder in due course or as a drawee or other payor who pays the instrument in good faith and in accordance with the reasonable commercial standards of its business, section 3-406 precludes him from asserting the plaintiff's breach of his duty of care. The courts which have imposed a proximate cause limitation on the preclusion which the section raises against a negligent plaintiff do not give due recognition to the function of the preclusion which the section raises against

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340. U.C.C. § 3-206 (1972).

341. *Id.* § 3-204(1).

342. *Id.* § 3-116(b); Comment, *Forged Indorsements, Depository Banks, and the Defense of Section 3-419(3) of the Uniform Commercial Code*, 18 Hous. L. Rev. 173, 186-87 (1980).

343. U.C.C. § 3-111 (1972).

344. *Id.* § 3-116(a).

345. *Id.* § 3-204(2).

346. Thompson Maple Prods., Inc. v. Citizens Nat'l Bank, 211 Pa. Super. at ___, 234 A.2d at 36. Of course, the instrument must appear regular on its face. *Id.*

347. U.C.C. § 4-103(3) comment 4 (1972); Whaley, *Negligence, supra* note 6, at 15. Though section 4-103(3) defines conduct which constitutes the exercise of "ordinary care," the "reasonable commercial standards" requirement of section 3-406 is considered the equivalent of article 4's "ordinary care" requirement. *See supra* note 322. For definitions of the phrases "Federal Reserve regulations or operating letters" and "clearing house rules and the like" as used in section 4-103(3), see comment 3 thereto; for a definition of the phrase "general banking usage," see comment 4 thereto. *See also* Coleman v. Brotherhood State Bank, 3 Kan. App. 2d 162, ___, 592 P.2d 103, 109 (1979) ("At the very least, [section 4-103(3)] allows banking custom to be given some weight."); Nu-Way Servs. Inc. v. Mercantile Trust Co. Nat'l Ass'n, 530 S.W.2d 743, 748 (Mo. Ct. App. 1975) (defendant bank's use of a signature checking procedure consistent with the procedure used by another bank in the area established that bank's conduct was consistent with "general banking usage.").

the defendant. The apparent objective of the courts which require proximate cause is to preserve the right to recovery of the plaintiff even though his negligence was a substantial factor in bringing about the alteration or unauthorized endorsement. The drafters of the Code designed section 3-406 to achieve that result, but only where the defendant is neither a holder in due course nor a drawee or other payor who acted in a good faith, commercially reasonable manner. The "substantially contributes" requirement of section 3-406 should not be compromised in order to reach the result envisioned by the drafters on conditions other than those specified in the statute. In short, the double preclusion of U.C.C. section 3-406, taken as a *whole*, functions as a statutory rule of proximate cause.

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