

1994

## Check Fraud Litigation in Connecticut after the 1990 Revisions to the U.C.C.

Timothy Fisher

*University of Connecticut School of Law*

Follow this and additional works at: [https://opencommons.uconn.edu/law\\_papers](https://opencommons.uconn.edu/law_papers)



Part of the [Banking and Finance Law Commons](#), [Commercial Law Commons](#), and the [Contracts Commons](#)

---

### Recommended Citation

Fisher, Timothy, "Check Fraud Litigation in Connecticut after the 1990 Revisions to the U.C.C." (1994). *Faculty Articles and Papers*. 295.

[https://opencommons.uconn.edu/law\\_papers/295](https://opencommons.uconn.edu/law_papers/295)

# HEINONLINE

Citation: 68 Conn. B.J. 393 1994



Content downloaded/printed from  
HeinOnline (<http://heinonline.org>)  
Tue Aug 16 12:51:44 2016

- Your use of this HeinOnline PDF indicates your acceptance of HeinOnline's Terms and Conditions of the license agreement available at <http://heinonline.org/HOL/License>
- The search text of this PDF is generated from uncorrected OCR text.
- To obtain permission to use this article beyond the scope of your HeinOnline license, please use:

[https://www.copyright.com/ccs/basicSearch.do?  
&operation=go&searchType=0  
&lastSearch=simple&all=on&titleOrStdNo=0010-6070](https://www.copyright.com/ccs/basicSearch.do?&operation=go&searchType=0&lastSearch=simple&all=on&titleOrStdNo=0010-6070)

## CHECK FRAUD LITIGATION IN CONNECTICUT AFTER THE 1990 REVISIONS TO THE U.C.C.

BY TIMOTHY S. FISHER\*

For as long as people have used checks to transfer money some individuals have found ways to steal funds using checks. The usual result is a contest between two innocent parties over who should bear the loss from the fraud committed by a third. In most check fraud cases the plaintiff is the owner of the checking account involved in the fraud and is suing one or more of the banks which honored the checks in question. In larger cases the victim is usually a business which has been victimized by an employee who had access to its check processing system.

Check fraud litigation is governed by Articles 3 and 4 of the Uniform Commercial Code ("U.C.C." or the "Code"). While the Code's treatment of check fraud law is comprehensive, the first three decades of experience under the U.C.C. were not entirely satisfactory. Readers of the Code found it dense and confusing. Litigants found results unpredictable. Commentators found numerous points for debate about construction of the statute, highlighted by occasional conflicting interpretations in different jurisdictions.

In response to these concerns, and to a perceived need to modernize the statute, the Commissioners of Uniform Laws promulgated revisions to Articles 3 and 4 in 1990 (the "Revisions"). The Revisions were adopted in Connecticut in P.A. 91-304 and have been enacted so far in 36 other states. The Revisions do much to clarify the law and to resolve inconsistent interpretations among various courts. They also make some substantive changes to the law which have an important bearing on how check fraud disputes are resolved.<sup>1</sup>

This article provides an overview of check fraud law, with a focus on the changes brought about by the Revisions.<sup>2</sup> The

---

\* Of the Farmington Bar. The author gratefully acknowledges the assistance of Donn A. Randall, Managing Counsel, Shawmut Bank, N.A.

<sup>1</sup> Since they are substantive changes in the law the Revisions apply prospectively, i.e., only to claims arising after October 1, 1991. *B & B Corporation v. Lafayette American Bank and Trust Co.*, 1994 Conn. Super. Lexis 1303 (1994).

<sup>2</sup> For a more detailed discussion of the law of check fraud before the Revisions, see Timothy S. Fisher, *THE CONNECTICUT LAW OF CHECK FRAUD* (Atlantic Law Books, 1991).

article starts with an introduction to how check frauds are perpetrated and discovered, followed by discussion of the principal causes of action and defenses employed in check fraud cases. This article focuses on Connecticut cases but will often refer to authorities in other jurisdictions, since they are persuasive in construing a uniform law.<sup>3</sup> The article concludes with observations regarding litigation strategies and some general comments regarding this area of the law.

### I. WHAT IS CHECK FRAUD?

The majority of check fraud cases arise when a thief gets possession of someone else's check, forges either the drawer's signature on the front of the check or the payee's endorsement on the reverse, and then deposits it in an account under the thief's control.<sup>4</sup> Thus, the thief interrupts the normal route followed by a check to divert it to the thief's own account. The thief may do this before a check is issued (e.g., stealing a blank check and filling it out), or by intercepting a check after it is issued.

To understand check fraud it helps to remember the usual route followed by a check and the role of each party to that process. This process is illustrated by this sequence of events:

DRAWER: Person on whose account the check is drawn. Signer of the check.

Delivers check to pay money to:

PAYEE: The person to whose order the check is written on the front.

Endorses the back of the check and deposits it in:

DEPOSITARY BANK: The first bank in the collection chain.

Forwards the check for collection to:

DRAWEE BANK: The bank on which the check is drawn.

Returns check to its customer, the drawer, in a monthly statement.

---

<sup>3</sup>In re Boardwalk Marketing Securities Litigation, 668 F.Supp. 115, 4 UCC Rep. Serv. 2d 1464 (D.Conn. 1987).

<sup>4</sup>There are other less common forms of check fraud which are beyond the scope of this article, such as altered checks and check kiting schemes. This article will focus only on those frauds which include an unauthorized signature or endorsement.

### *A. Typical Check Fraud Schemes*

In the simplest check frauds the thief steals a blank check from the owner of an account (the drawer). The thief then forges the drawer's signature and makes the check payable to the thief. The thief then deposits the check in his or her account. Once the check clears (assuming no one discovers the fraud in time to stop payment) the thief can take the proceeds and spend them or disappear.

In a second common scheme the thief holds a job which includes responsibility for issuing checks. (For example, the thief approves invoices for payment.) The thief prompts the company to issue a check (e.g. by approving a phony invoice), then he gets possession of the check and forges the payee's endorsement and deposits the check in his own account.

A third common check fraud involves a thief who works inside the payee's business. In this case the thief steals the check after it is received by the payee. (This can happen, for example, when the thief works in the payee's mail room where checks are received, or in the department which processes checks received from customers.) The thief forges the endorsement of his or her employer, the payee, and deposits the check in his or her own account.

### *B. Common Elements of Check Fraud Cases*

There are three features common to virtually every check fraud case discussed in this article. First, the thief has either disappeared or is judgment-proof (otherwise, the victim could recover the funds from the wrongdoer).

Second, each fraud discussed in this article involves either an unauthorized signature on the front of the check (where the drawer signs) or an unauthorized endorsement on behalf of the payee on the reverse.

Third, the great majority of check fraud cases involve a claim against one or more banks by a business (since frauds relating to personal checking accounts rarely involve enough money to reach litigation).<sup>5</sup>

---

<sup>5</sup>Less commonly, check fraud litigation involves actions between two banks over allocation of a business victim's loss which has already been reimbursed by one of the banks. Disputes between banks are governed chiefly by the warranties of presentment, discussed in Part II.D below. The Revisions also create a new warranty regarding the microencoding at the bottom of checks. That warranty governs a new type of check fraud, counterfeit checks.

### C. *Prevention and Discovery of Check Fraud*

Many checks pass through the hands of persons other than the drawer and payee (such as bookkeepers, messengers, and postal workers), so there are many opportunities for misappropriation. But check fraud leaves a "paper trail" such as bank records which show what account the check was deposited in, and who took funds out of that account. Thus, a thief will generally not undertake a fraud unless the thief believes it will not be detected. This is especially true with extended check frauds, where the thief must be in a position not only to get possession of checks but also to conceal the fraud.

The way to avoid such extended check frauds is by "separation of functions." In a business, no single employee should have complete control over the flow of funds.<sup>6</sup> A prudent business examines the route followed by both incoming and outgoing funds and makes sure that at least two people (preferably in two departments) are aware of every check and would know if it were misappropriated. This is generally accomplished by balancing the company's own bank account and by reconciling all incoming checks to the company's general ledger. Absent such precautions, many extended check frauds are discovered simply because they continue so long that a significant amount of money is missing. In a small business, a check fraud might be discovered when legitimate checks bounce. In a larger company, the fraud might be discovered when financial reviews show unusually low revenues or high expenses in one department or another.

Once the victim starts to investigate, it usually can see how the fraud occurred by following the checks' paper trail. Bank records will reflect not only the ownership of the account into which the check was deposited, but also the path followed by all funds out of that account when the thief later removed the funds. Moreover, banks make microfilm photocopies of the front and back of every check. The company can (at some expense) get microfilm copies of its own checks from its bank and compare those to its record of legitimate expenses. The company might also contact a customer who according to the victim's books has not paid an invoice, then find that the customer can

---

<sup>6</sup>See, e.g., *Menichini v. Grant*, 995 F.2d 1224, 20 UCC Rep. Serv. 2d 959 (3d Cir. 1993).

produce a canceled check reflecting that payment. The back of that check will show the thief's forgery of the named payee's endorsement.

## II. LEGAL ANALYSIS OF A CHECK FRAUD CASE

Once the victim of a check fraud learns of the fraud and concludes that it will not be repaid by the thief, it usually looks to be made whole by the banks through which the fraudulent checks were deposited and paid. We will now turn to the law governing such claims, first by determining what parties may assert which check fraud claims, and against whom. This is followed by a review of the elements of their causes of action, then an examination of the defenses available to the banks.

### A. *Who Can Be The Plaintiff?*

The drawer is the primary party entitled to assert a claim in most check fraud cases. Where the drawer's own signature is unauthorized, the drawer is clearly the victim; it is the one who has "standing" to sue. The drawer is also the victim where the drawer actually signed the check but unknowingly was induced by the thief to issue it to a fictitious payee (e.g., to pay a fake invoice). In these cases the drawer has lost its funds without paying any debt it owes.

Even when the check was properly issued to a real payee, if the check is stolen before reaching the payee, the drawer is still the only party with the right to sue. This is because until the payee receives the check, the drawer's obligation to pay the payee is not considered discharged.<sup>7</sup> The drawer must, therefore, pay twice, so it is the party who has suffered the loss. (In some cases the drawer will refuse to issue a second check, thereby forcing the payee to sue the drawer who then may implead the banks.) Only when the payee actually receives the check before the thief steals it is the payee the party with the standing to sue.<sup>8</sup>

A person who is neither drawer nor payee will have difficulty establishing a sufficient interest to bring an action over a check fraud.<sup>9</sup>

---

<sup>7</sup> CONN. GEN. STAT. § 42a-3-420, Comment 1: "[I]f the check is never delivered to the payee, the obligation owed to the payee is not affected." The U.C.C. in Connecticut is found in CONN. GEN. STAT. § 42a-1-101, *et seq.* For the sake of brevity, this article will cite to the abbreviated form "§ 1-101," *et cetera*.

<sup>8</sup> § 3-420(a)(ii), Comment 1.

<sup>9</sup> See *Sheiman v. Lafayette Bank & Trust Co.*, 4 Conn. App. 39, 492 A.2d 219, 40 UCC Rep. Serv. 1789 (1985).

### B. *What Cause of Action?*

The Revisions have created, in effect, two "tiers" of courses of action for check fraud. They have adjusted but preserved the pre-1990 "primary" causes of action, which do not require any proof of negligence by a bank. The Revisions have also created a new, more open-ended cause of action based purely on shared culpability. That new theory of recovery is untested in the reported caselaw so interpretation and prediction of its effect can have little certainty. We address the primary causes of action first.

There is only one section of the revised U.C.C. which establishes a "primary" cause of action for drawers. That is the "not properly payable" provision found in section 4-401. Under section 4-401, any drawee bank which pays a check which is "not properly payable" (e.g., the drawer's signature or the payee's endorsement is unauthorized) may not deduct the amount of that check from the drawer's account. If the bank does debit its customer's account and refuses to recredit the funds, its customer, the drawer, may sue under section 4-401.

The language of section 4-401 does not expressly state a cause of action; it merely states that a bank may charge its customers for a check that is properly payable. An argument can be made that this merely is the statutory element which defines the type of check which may be sued upon under some other cause of action, such as the contractual account agreement between customers and bank. In practice, however, the cases have treated section 4-401 as if it established its own cause of action.<sup>10</sup>

While jurisdictions were previously split on the issue, the Revisions make it clear that drawers may not bring suit directly against depository banks under the two causes of action applicable to such banks: conversion (§ 3-420 Comment 1) and the warranties of presentment (§ 3-417, Comment 2 and § 4-208).

By limiting drawers to direct suit against their own drawee bank, the Revisions have accomplished a major change in the law: they have channeled a majority of check fraud claims through the customer-bank relationship between the drawer and the drawee bank. The bank and customer are in privity; their

---

<sup>10</sup> See, e.g., *Tonelli v. Chase Manhattan Bank*, 41 N.Y.2d 667, 394 N.Y.S.2d 858, 363 N.E.2d 564, 21 UCC Rep. Serv. 1344 (1977).



relationship is generally governed by an account agreement.<sup>11</sup> Since the vast majority of checking account agreements are written by banks and are not negotiated, they give banks the opportunity to impose variations on the statutory scheme imposed by the U.C.C. (see Part III.B. below).

A payee, as mentioned above, has standing to sue only where a check it has already received is then stolen. In that situation, the payee's cause of action is conversion under section 3-420. The payee may sue either the depository or drawee bank which paid a check bearing an unauthorized endorsement in the payee's name.

As mentioned above, the Revisions have created an entirely new cause of action for apportionment of check fraud loss according to shared culpability between victims and banks. Those claims (discussed in more detail below, Part II.F.7) appear to create a secondary cause of action available to a check fraud victim whose primary claim is defeated by defenses related to the victim's own negligence or responsibility for the fraud. The "shared loss" provisions seem to allow a claim against any culpable bank, thus reopening the potential for drawer claims against depository banks.<sup>12</sup>

There are other causes of action used in various check fraud cases, depending on the particular facts. A Connecticut court has, for example, recognized separate causes of action for breach of restrictive endorsements and for common law negligence.<sup>13</sup>

---

<sup>11</sup>But see *Air One, Inc. v. United Bank*, 1991 Conn. Super Lexis 426 (1991) where the plaintiff's count alleging breach of the customer-bank contract prompted a defense based on the statute of frauds.

<sup>12</sup>The "shared loss" provisions probably do not enable payees to sue on checks they never received. The clauses allowing allocation of the loss are triggered by a bank's culpability-based defense; a payee without standing to sue would be barred before reaching those defenses.

<sup>13</sup>*Healthcare, Inc. v. Dime Savings Bank of Wallingford*, 1991 Conn. Super Lexis 925 (1991). *Contra*, *Equitable Life Assurance Soc'y of the United States v. Okey*, 812 F.2d 906, 3 UCC Rep. Serv. 2d 1035 (4th Cir. 1987) (holding that the common law cause of action of negligence was "displaced" by the Code under the language of section 1-103). See also *Insurance Company of North America v. Chemical Bank*, 13 Conn. L. Trib. No. 42 at 16 (October 26, 1987) (holding that the one year limitation period in § 4-406 governs common law causes of action as well as claims under the Code).

### C. *Elements of the Cause of Action*

Once the proper plaintiff, defendant, and cause of action are determined, the elements of a check fraud claim are simple. Whether the claim is that the check was not properly payable, or that it was converted under section 3-420, the key element of either claim is that a signature or endorsement was forged or otherwise unauthorized.

This means that check fraud claims, in their first instance, do not require proof that the bank was negligent. If the signature is unauthorized, then there is a cause of action. Issues of culpability only come into play in defenses, or in backup claims to apportion the loss where the initial claim fails.

The question of whether a signature or endorsement is "unauthorized" is not as simple as it may at first appear, however. The term "unauthorized signature" (which includes unauthorized endorsements) is defined at section 1-201(43) in quite broad terms. "'Unauthorized' signature means one made without actual, implied or apparent authority and includes a forgery." The reference to "implied or apparent" authority is very important since that refers to caselaw under the law of agency.<sup>14</sup> Agency law may enable banks to argue that even though a check was signed by somebody without actual authority, there was nonetheless either implied or apparent authority for the signature.<sup>15</sup> If successful, this argument negates the most important element of a check fraud cause of action.

When a check requires more than one signature and endorsement and is missing one but not all, the Code expressly at § 3-403(b) defines the result as an unauthorized signature. The U.C.C. does not, however, address the situation where a check is presented without any endorsement, or without any drawer's signature. Certainly such checks (which are not unheard of<sup>16</sup>) are

---

<sup>14</sup>Hartford Accident & Indemnity Co. v. South Windsor Bank & Trust Co., 171 Conn. 63, 69, 368 A.2d 76, 19 UCC Rep. Serv. 578 (1976).

<sup>15</sup>See Hilltop Farm Inc. v. People's Savings Bank of New Britain, 1993 Conn. Super. Lexis 475 (1993). See also Hutzler v. Hertz Corp., 39 N.Y.2d 209, 383 N.Y.S.2d 266, 347 N.E.2d 627, 18 UCC Rep. Serv. 1089 (1976), where an attorney forged his client's endorsement on dual payee check conveying settlement proceeds. The New York Court of Appeals stated: "our resolution of the issue before us is based on the principles of agency. . . ." Hutzler and other cases regarding lawyers' forgeries of client endorsements are discussed in ROBERT A. HILLMAN, JULIAN B. McDONELL & STEVEN H. NICKLES, COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE, pp 14-4 to 14-9 (1984).

<sup>16</sup>See, e.g., Sheiman v. Lafayette Bank & Trust Co., 4 Conn. App. 39, 492 A.2d 219, 40 UCC Rep. Serv. 1789 (1985).

“not properly payable” and thus actionable under section 4-401. Less clear is whether the bank may assert various defenses to claims based on such checks (see Part II.F.10 below).

#### D. Banks' Causes of Action.

Aside from causes of action available to the victim, there are causes of action which enable banks to shift the loss to other banks under certain circumstances. These are the warranties of presentment in sections 3-417 and 4-208 of the Code. These warranties put into effect the doctrine established by the ancient case of *Price v. Neal*.<sup>17</sup>

*Price v. Neal* established a fundamental policy of allocating responsibility for check fraud among banks. Generally speaking, a drawee bank is responsible for any unauthorized signature on behalf of its customer, the drawer. This responsibility follows from the fact that the drawee bank has a signature card to which it could compare the drawer's signature on any check presented to it.

Forgeries of the payee's endorsement, in contrast, are the responsibility of depositary banks. The depositary bank is the first bank in the chain of collection to deal with the thief; it has the opportunity to question the thief's authority to deposit the check on the payee's behalf. Further, since checks are usually deposited into the account of the payee, the depositary bank is the bank which has the opportunity to detect whether the payee's endorsement is proper.

The warranties of presentment sections in 3-417 and 4-208 implement these policies by imposing a warranty by the depositary bank that flows “downstream” through the collection process along with the check.<sup>18</sup> The depositary bank warrants that it was “entitled to enforce” the check, meaning that it obtained the check by “negotiation” through the authorized endorsement of the payee. The depositary bank does not warrant that the drawer's own signature is authorized, however, since as established in *Price v. Neal*, the drawee bank is responsible for fraud in connection with the signature of the drawer, its own customer.

---

<sup>17</sup> 3 Burr. 1354, 97 Eng. Rep. 871 (1762).

<sup>18</sup> The depositor also makes these warranties, but since the depositor is usually the thief, his or her warranties rarely have practical importance. For a case where they could have helped but where the depositary bank instead unsuccessfully attempted a common law indemnification claim against the thief, see *Keyes Funeral Home v. Sanders*, 1992 Conn. Super. Lexis 2344 (1992).

With the benefit of these warranties, a drawee bank which is sued over an unauthorized endorsement can pass the liability on to the depositary bank. In practice, a drawee bank will prefer not to have to hire a lawyer and participate in litigation, even if it has impleaded the depositary bank and is unlikely to face any exposure itself. Fortunately for drawee banks, the Code provides a mechanism to drawee banks to "tender defense" of the claim or "vouch-in" the depositary bank where the depositary bank will bear the ultimate exposure for the claim.

"Vouching-in" under section 3-119 of the Code enables the drawee bank to give notice of the claim to the depositary bank and demand that the depositary bank take over the defense of the claim. In practice this means that the depositary bank retains counsel to defend the action in the name of the drawee bank. A depositary bank which declines the invitation to defend the litigation on behalf of the drawee bank will be bound by any facts determined in that litigation.

Usually a depositary bank will accept the responsibility for a claim and take over the defense. Failure to do so could lead to a claim for the drawee bank's attorneys fees under section 3-417(d)(2), Comment 5. One court, however, has held that no such attorneys fees claim is available to the drawee which successfully defended the claim after the depositary bank refused to take over the defense.<sup>19</sup>

The Revisions include a new warranty regarding the microencoding information at the bottom of checks. That warranty governs a new type of check fraud which is growing with the use of computers: counterfeit checks. A thief can use a laser printer to create an instrument that looks like a check, typically appearing to be drawn on a large commercial account (like an insurance claim payment or dividend). The counterfeit check will even appear to have a bank's microencoding at the bottom of the check.<sup>20</sup> Commercially available ink is not readable by banks' machine readers, however, so the check will be rejected by the machinery and then examined by a bank employee. Traditionally banks would reencode rejected checks

---

<sup>19</sup> *McCarthy Kenny & Reidy, P.C. v. First Nat. Bank of Boston*, 402 Mass. 630, 524 N.E.2d 390, 6 UCC Rep. Serv.2d 454 (1988).

<sup>20</sup> Such a fraud is described in *United States Fidelity & Guaranty Co. v. Federal Revenue Bank of New York*, 620 F.Supp. 361 (S.D.N.Y. 1985) and in James J. White, *Goldstein's Curse: A Curious Case of Bank Fraud*, 21 *TOLEDO LAW REV.* 599 (1990).

so that they could still be processed, on the assumption that the check was legitimate and was rejected because of machine error or damage to the check itself.

If a bank does reencode a non-machine readable check, not realizing that it is counterfeit, the check will clear and the funds will be taken from the victim's account, leading to a dispute as to who should bear that loss. Although the bank which reencoded the check arguably should first have made inquiry as to the reason it was not machine readable, the Code does not clearly impose that result. The Revisions' new warranty of encoding states that the person applying microencoding warrants that the "information is correctly encoded." 4-209(a). If "correctly" means that the reencoding accurately copies the original counterfeit, there is no breach of warranty. On the other hand, if "correctly" encoding a check means that it is encoded only so as to accurately reflect the depositor's interest in the check, then the warranty in section 4-209 will reinforce the duty of inquiry suggested above.

#### *E. Damages*

The Code says almost nothing about damages. That is understandable, since the great majority of check fraud actions involve the loss of the entire proceeds of one or more checks. Common law principles usually answer those questions that do arise.

The only explicit provision on compensatory damages is in section 3-420(b) which states that in a conversion claim "the measure of liability is presumed to be the amount payable on the instrument, but recovery may not exceed the amount of the plaintiff's interest in the instrument." This language addresses one of the most common issues regarding damages: the claim by one of two co-payees where the other co-payee forged the plaintiff's endorsement.<sup>21</sup>

Damages disputes also occur where fraudulent checks were used to pay valid debts of the plaintiff.<sup>22</sup> This happens in particular in disputes over corporate control, where two groups simultaneously claim to be authorized to operate the business.<sup>23</sup>

---

<sup>21</sup> *E.g.*, *Southern Calif. Permanente Medical Group v. Bozinouski*, 148 Cal. App. 3d 503, 196 Cal. Rptr. 150, 37 UCC Rep. Serv. 7 (1983).

<sup>22</sup> *Gotham-Vladimir Advertising, Inc. v. First Nat'l City Bank*, 27 A.D.2d 190, 277 N.Y.S.2d 719 (1967).

<sup>23</sup> *See, e.g.*, *Air One, Inc. v. United Bank*, 1991 Conn. Super Lexis 426 (1991).

### F. *Defenses Based on Culpability*

The causes of action discussed so far provide for liability irrespective of the bank's exercise of care; if the check bears an unauthorized signature, the elements of a claim have been proven. The Code then provides defenses under five sections relating in one way or another to culpability. These defenses arise from the victim's conduct, such as its opportunity to prevent the fraud or its failure to detect or act on the fraud after detection.

The Revisions have made significant changes in the language of these defenses. The new statute improves on several inconsistencies in the prior statutory language, and closes a number of gaps among the defenses. The U.C.C. and its predecessor, the Negotiable Instruments Law, provided defenses based on the holdings of several major historical cases<sup>24</sup> rather than a comprehensive approach to the field. The Revisions depart from the narrower language of the original U.C.C., especially by a broader treatment of employee frauds where the revised language more closely applies to those situations where check fraud claims arise most often.

The first of the defenses discussed below is ratification, where the victim fails to report a fraud after learning of it. The remaining defenses are based on some form of negligence, where the plaintiff either put the thief in a position to carry out the fraud, or failed to detect an ongoing fraud once it started. These defenses are discussed in the order in which they appear in the Code.

#### 1. Ratification: § 3-403(a)

The U.C.C. incorporates the common law concept of ratification in section 3-403: "an unauthorized signature may be ratified for all purposes of this Article."<sup>25</sup> Ratification of a check fraud generally is found when the victim does three things: First, the victim learns of the check fraud. Second, the victim either "forgives" the thief (in the sense of deciding not to take action as a result of the fraud) or decides to trust the thief to reimburse the funds rather than reporting the fraud to the criminal authorities or the banks through which the checks were paid.

---

<sup>24</sup> See, e.g., § 3-406, Comment 1, and its reference to *Young v. Grote*, 4 Bing. 253 (1827).

<sup>25</sup> Some cases analyze ratification as an after-the-fact agency relationship between the victim and thief. E.g., *Rakestraw v. Rodrigues*, 8 Cal.3d 67, 104 Cal.Rptr. 57, 500 P.2d 1401, 11 UCC Rep. Serv. 780 (1972).

Third, after some delay the victim changes his or her mind and makes a claim against one of the banks.

There are several common settings where ratification defenses succeed. One is fraud within a family, where the victim is related to the thief and therefore has personal reasons not to want to see criminal prosecution. The victim may hope that the thief can be trusted to repay the funds or otherwise change his or her ways.<sup>26</sup> (While the Code does not affect criminal liability, § 3-403(c), many victims decide not to report frauds to criminal authorities out of embarrassment or because of a personal relationship with the thief.)

The lawyer-client relationship is a second common setting for ratification, where a lawyer has forged her client's endorsement on a check containing proceeds of litigation. Some clients, after learning that their attorney has taken the funds, have nonetheless trusted the attorney to "invest" or otherwise hold the funds in safekeeping. After later learning that the attorney was not to be trusted, those clients will generally be held to have ratified the initial forgery of their endorsement on the settlement check.<sup>27</sup>

A third common situation is continuing business relationships, such as between a general contractor and subcontractor on a construction project. A subcontractor may have been one of two co-payees on a check from the owner of the project, and then learned that the general contractor forged the subcontractor's endorsement and took all of the funds which were supposed to be shared between the two. If the subcontractor decides to trust the general contractor to make up for those funds out of later payments, the subcontractor will probably be held to have ratified the initial forgery of its endorsement on the dual-payee check.<sup>28</sup>

An important element of ratification is prejudice to the defendant bank. While the statute does not expressly require that the bank be prejudiced by the delay in reporting the fraud, courts have been more likely to find ratification where the bank is in fact prejudiced by the delay. This may be in part an indirect

---

<sup>26</sup>*Eutsler v. First Nat'l Bank, Pawhuska*, 639 P.2d 1245, 32 UCC Rep. Serv. 1509 (Okla. 1982).

<sup>27</sup>*E.g., Hendrix v. First Bank of Savannah*, 195 Ga.App. 510, 394 S.E.2d 134, 12 UCC Rep. Serv. 2d 761 (1990).

<sup>28</sup>*E.g., Thermo Contracting Corp. v. Bank of New Jersey*, 69 N.J. 352, 354 A.2d 291, 18 UCC Rep. Serv. 1096 (1976)

inquiry into the victim's intent. The court may conclude that the victim delayed reporting the fraud because it thought it would have more success recovering the stolen funds before the fraud was reported than afterwards. If so, that delay may not reflect an intent to ratify the fraud.<sup>29</sup>

## 2. Imposters: § 3-404(a)

Banks have a defense to claims by victims who are so careless as to issue a check to a thief impersonating the payee<sup>30</sup> or claiming to be an agent of the payee. In such cases, the thief's endorsement "is effective as the endorsement of the payee," thus negating that essential element of the cause of action.

## 3. Fictitious Payees: § 3-404(b)

Subsection 3-404(b) also makes an unauthorized endorsement "effective" under certain circumstances. Section 3-404(b) applies when a thief induces the victim to issue checks which the thief then intercepts and deposits in an account under his or her own control. The thief usually has some role in the victim's check-issuing process and prompts the victim to issue a check payable either to a non-existent payee (so that no one is expecting to receive the check), or issues the check to a real payee when that payee is not expecting to receive the check.<sup>31</sup>

The policy underlying section 3-404(b) is that a business which gives the thief control over its check-writing system should not be able to pass its resulting losses on to the bank. When the victim has not only given the thief the power to choose the payee of the check but also the ability to intercept the check, the victim has created a situation ripe for fraud.<sup>32</sup>

## 4. Embezzlements by Employees: § 3-405

Section 3-405 provides banks with a defense to claims where the fraud was committed by an employee entrusted with "responsibility" for checks. This section applies both to incoming checks (where the business is the payee on checks coming into it but are intercepted internally) and to outgoing checks (i.e., those being issued by the victim). Like the defenses under 3-

---

<sup>29</sup>Hartford Accident & Indemnity Co. v. Connecticut Bank & Trust Co., 39 Conn. Supp. 240, 476 A.2d 1083 (1982), *aff'd*, 2 Conn. App. 110, 476 A.2d 1077 (1984).

<sup>30</sup>Fair Park Nat. Bank v. Southwestern Inv. Co., 541 S.W.2d 266, 20 UCC Rep. Serv. 454 (Tex. Civ. App. 1976).

<sup>31</sup>Bank of America Nat. Trust & Savings Ass'n. v. United States, 552 F.2d 302, 21 UCC Rep. Serv. 872 (9th Cir. 1977).

<sup>32</sup>Since such thieves are usually employees of the victim, there is often an overlap between this defense and section 3-405, relating to employee theft.



404(a) and (b), this defense relates only to unauthorized endorsements, not frauds in connection with the drawer's signature.

5. Negligence: § 3-406

Section 3-406 creates a broad "comparative negligence" defense. This section applies both to drawer's signatures and endorsements, but only in the case of forgeries (not other types of unauthorized signatures). This section provides that if the victim of the fraud did not exercise ordinary care, and that failure substantially contributed to the forgery, then the victim is precluded from asserting the forgery against the bank. If the bank failed to exercise ordinary care as well, then section 3-406(b) provides for apportionment of the loss.

6. Customers' Review of Monthly Statements: § 4-406(d)

The final section creating a defense based on culpability relates to a customer's (drawer's) review of its bank statements. Section 4-406 requires that an account owner review her monthly statements to find any check on which her signature was forged or unauthorized. If the customer does not discover and report the fraud, then the bank has a defense to a claim for paying not only that check but also later checks by the same thief (after a notice period of 30 days).

7. Allocation of Loss in the Case of Shared Culpability

The preceding five defenses each incorporates a new concept to the Uniform Commercial Code, the allocation of a loss between two culpable parties "according to the extent to which" their failure "to exercise ordinary care contributed to the loss." (§§ 3-404(d), 3-405(b), 3-406(b), 4-406(c) ) Before the Revisions to Articles 3 and 4, the rule was quite different. Negligence by the victim precluded any recovery from the bank, but if the bank was also negligent it could not assert the defense at all.

The Revisions reject this "all or nothing" approach and call for a comparison of the negligence on each side.<sup>33</sup> As of this writing, no cases have been officially reported dealing with this feature of revised Articles 3 and 4, so it is not yet possible to say

---

<sup>33</sup>This approach is criticized by Henry Bailey, former author of *BRADY ON BANK CHECKS*. Henry Bailey, *New 1990 Uniform Commercial Code: Article 3, Negotiable Instruments, and Article 4, Bank Deposits and Collections* 29 WILLIAMETTE LAW REV. 409 (1993). The Revisions introduce "a tort concept of comparative negligence that does not belong in a commercial law statute." *Id.* at 487.

what impact the shared liability provisions will have.<sup>34</sup> Most likely they will be pled as “fall-back” claims by a victim against a bank, where the victim anticipates a culpability-based defense by the bank. In the event of such a defense, the claim for shared liability will provide a source for at least a partial recovery.

The shared loss clauses of the revised Code are drafted broadly enough to be used in other situations, as well. For example, the language of the shared culpability provisions would allow them to be used as a third-party cause of action by a bank defendant against any other person who contributed to the loss. (An example of that is given in Case Study No. 5 of Comment 2 to section 3-404, and also in the discussion at the very end of Comment 3 to that section.)

Two of the sections which state the comparative fault rule also address the burden of proof. Sections 3-406(c) and 4-406 place the burden on each party to prove the other’s negligence.<sup>35</sup> The Revisions do not say whether this is also the case in the other sections on comparative fault.

#### 8. Examples of Negligence by the Business Victims

The concept of “failure to exercise ordinary care” is of great importance in check fraud cases. Negligence on the part of the victim is the chief means available to banks to avoid liability for check fraud claims which are not time-barred. “Ordinary care” is inherently an issue of fact, and therefore somewhat unpredictable. Over the years, however, the caselaw has developed a number of situations where the courts will generally find negligence by a business victim to check fraud.<sup>36</sup> They include:

- hiring a new employee without any background check which would have disclosed a history of misconduct;<sup>37</sup>
- leaving checks unguarded at the office (Section 3-405, Comment 3, Case No. 1);

---

<sup>34</sup> Arkansas adopted a comparative negligence rule on its own several years earlier by amending § 3-406 to incorporate Arkansas’ general comparative negligence rule. An attempt to apply its provisions is found in *Union National Bank of Little Rock v. Daneshvan*, 33 Ark. App. 171, 803 S.W.2d 567 (1991).

<sup>35</sup> This is a change from prior law under 3-406 in Connecticut, which imposed on the bank the burden of proving its own due care. *Perley v. Glastonbury Bank & Trust Co.*, 170 Conn. 691, 368 A.2d 149, 19 UCC Rep. Serv. 188 (1976).

<sup>36</sup> See also cases discussed in John M. Norwood, *Negligence as an Exception to the Forgery Doctrine: When Does It Exist?* 25 *UNIFORM COMMERCIAL LAW REPTR.* 169 (1992).

<sup>37</sup> *Commercial Credit Equipment Corp. v. First Alabama Bank of Montgomery*, 636 F.2d 1051, 30 UCC Rep. Serv. 1185 (5th Cir. 1981).

- insufficient supervision of the employee;<sup>38</sup>
- allowing the employee to keep the company's books out of the office;<sup>39</sup>
- allowing the thief both to have possession of the checks and some control over the bookkeeping of the company, such as the responsibility for balancing the checking account,<sup>40</sup> the authority to write off reportedly bad debts, or the authority to approve invoices;
- lack of audits (either internal audits in the case of large businesses, or external audits by an accounting firm, in the case of any business);<sup>41</sup>
- failure to inquire into irregularities such as insufficient funds or other notices from the bank.<sup>42</sup>

#### 9. Bank Negligence

It is difficult to compare the negligence of banks to the negligence of businesses victimized by check frauds. Businesses usually have several ways to avoid or detect a fraud; their negligence usually continues throughout the scheme. Thus, their negligence is multi-faceted and continuing. Banks, in contrast, usually have only a single opportunity to exercise ordinary care as to each check.

Consider this point first with regard to fraudulent endorsements. The banking system can interrupt a fraudulent endorsement scheme at the moment that the check is presented for deposit. This is a single opportunity, but a big opportunity, since a bank employee is actually looking at the check which bears the unauthorized endorsement. (In some cases a bank is found negligent for letting the thief open the account into which he later deposits the checks. Especially where the thief opens an account in the name of a business, the bank is expected to demand documentary evidence of a legitimate corporate existence, such as a banking resolution by the corporate board

---

<sup>38</sup>Menichini v. Grant, 995 F.2d 1224, 20 UCC Rep. Serv. 2d 949 (3d Cir. 1993).

<sup>39</sup>Husker News Co. v. South Ottumwa Sav. Bank, 482 N.W.2d 404, 19 UCC Rep. Serv. 2d 203 (Iowa 1992).

<sup>40</sup>Read v. South Carolina Nat. Bank, 286 S.C. 534, 335 S.E.2d 359, 42 UCC Rep. Serv. 974 (1985).

<sup>41</sup>American Nat. Ins. Co. v. Fidelity, 691 F.2d 464, 34 UCC Rep. Serv. 1228 (8th Cir. 1982).

<sup>42</sup>Westport Bank & Trust Co. v. Lodge, 164 Conn. 604, 325 A.2d 222 (1973).

of directors and a tax identification number.<sup>43)</sup>

The cases have identified several situations that are commonly identified as negligence on the part of a bank when a check with an unauthorized endorsement is deposited. Several jurisdictions have held that when a check payable to a business is deposited into a personal account, that is an "unreasonable commercial banking practice as a matter of law,"<sup>44</sup> since businesses usually deposit their revenues into their own accounts rather than endorsing them over to other parties. (The opposite conclusion was reached in a Connecticut case, however, where the payee's employee endorsed the checks with his employer's company name, followed by "For Deposit Only A/C 4284186" which was his personal account.<sup>45</sup>) The plaintiff may also prevail by proving that the bank did not follow its own procedures.<sup>46</sup> Finally, the bank may be negligent if one of its officers has actual knowledge of some irregularity relating to the check or the account involved.<sup>47</sup>

While there is extensive caselaw relating to bank negligence in connection with unauthorized endorsements, there is less guidance relating to bank negligence as to unauthorized drawers' signatures. Moreover, this is an area which has been dramatically changed by the Revisions. The courts previously struggled over a drawee bank's duty to detect a forged or unauthorized drawer's signature by comparing each check to the drawer's signature card on file. As the number of checks cleared daily by banks has increased, fewer and fewer banks actually have employees routinely looking at signature cards. One court found this to be negligence *per se*, precluding any defense based on the victim's own negligence.<sup>48</sup>

---

<sup>43</sup> *E.g.*, *Walters v. Alden State Bank*, 155 Mich. App. 29, 399 N.W.2d 432, 3 UCC Rep. Serv. 2d 174, *app. den.*, 428 Mich. 866 (1987); *Wheat State Service Corp. v. Volfax Nat'l Bank*, 44 Colo. App. 376, 618 P.2d 696, 31 UCC Rep. Serv. 638 (Col. Ct. App. 1980); *Keyes Funeral Home v. Sanders*, 1992 Conn. Super. Lexis 2344 (1992); 33-406, Comment 4. *Compare*, *Hilltop Farm, Inc. v. People's Savings Bank of New Britain*, 1993 Conn. Super. Lexis 475 (1993).

<sup>44</sup> *Aetna Casualty & Surety Co. v. Hepler State Bank*, 6 Kan. App. 2d 543, 640 P.2d 721, 32 UCC Rep. Serv. 187 (1981).

<sup>45</sup> *Hartford Accident & Indemnity v. Conn. Bank & Trust Co.*, 39 Conn. Supp. 240, 476 A.2d 1083 (1982), *aff'd*, 2 Conn. App. 110, 476 A.2d 1077 (1984). (The trial court opinion describes effective testimony by the defendant's expert witness regarding banks' reliance on due care by their business account holders.)

<sup>46</sup> *E.g.*, *Sun Bank/Miami, N.A. v. First Nat. Bank of Maryland*, 698 F.Supp. 1298 (D.Md. 1988).

<sup>47</sup> *Dykstra v. Nat'l Bank of South Dakota*, 328 N.W.2d 862, 35 UCC Rep. Serv. 553 (S.D. 1983).

<sup>48</sup> *Medford Irrigation District v. Western Bank*, 66 Or. App. 589, 676 P.2d 329, 38 UCC Rep. Serv. 411 (1984).

This is no longer necessarily the case under the new definition of "ordinary care" with respect to banks, section 3-103(7). That subsection states that it is not negligent for a bank to pay a check without actually looking at the signature, let alone comparing it to the signature card, if that procedure is in accordance with the bank's own practice and industry standards. (Industry standards are by no means uniform on this point; many banks still claim to examine all drawers' signatures, at least on all checks above a threshold amount.)

If the drawee bank does not look at checks presented for payment to examine the drawer's signature, then there will probably be no contact with the check by any employee of the drawee bank. (A teller at the depository bank will have handled the check, and then another employee of the depository bank will have read the check to determine its dollar amount and apply the microencoding at the bottom of the check. Thereafter, only machines handle the check, sorting it and charging accounts based on the microencoding information.) Thus, it will be uncommon for a drawee bank to be found negligent based on the appearance of the check itself.<sup>49</sup> Moreover, the drawee bank will generally have no contract with the thief. The thief usually opens an account at the depository bank where he deposits the misappropriated checks. The drawee bank, however, has the account only of the innocent drawer. Those situations where a drawee bank may still be found negligent will probably be where the thief was the drawer's employee responsible for banking, and acted in a way which suggested improprieties.<sup>50</sup>

#### 10. Missing Signatures

The Code is silent about defenses to checks which lack any drawer's signature or any endorsement. While earlier drafts of the Revisions provided defenses to claims that a check "lacked authorized signature," the final version rejected that approach. Instead, the culpability-based defenses only are effective against claims based on "unauthorized signatures" and "unauthorized endorsements." This rejects pre-Revision authority in some

---

<sup>49</sup> See discussion in John J. A. Burke, *Loss Allocation Rules of the Check Payment System With Respect to Forged Drawer Signatures and Forged Indorsements: An Explanation of the Present and Revised UCC Articles 3 and 4*, 25 UNIFORM COMMERCIAL CODE LAW JOURNAL 318 at 346-48 (1993).

<sup>50</sup> E.g., *D&G Equipment Co. v. First Nat'l Bank of Greencastle, Pennsylvania*, 764 F.2d 950, 41 UCC Rep. Serv. 154 (3d Cir. 1985).

jurisdictions,<sup>51</sup> but confirms pre-Revision authority in Connecticut.<sup>52</sup> When only one of two required signatures is missing, however, the Revisions at section 3-403(b) and most pre-Revision cases<sup>53</sup> deem there to be an unauthorized signature, thus giving recourse to the statutory defenses.

The Revisions change the test for determining whether a check naming two payees requires endorsements by both or just one. Old section 3-116 stated a requirement that all payees must endorse an instrument if not payable to them "in the alternative."<sup>54</sup> New section 3-110(d) says that if the instrument "is ambiguous as to whether it is payable to the persons alternatively, the instrument is payable to the persons alternatively," i.e., any one can endorse for them all.

### *G. Time-based Defenses*

The defenses discussed so far arise from negligence and other concepts related to culpability; those are nearly always questions of fact. Unless a case falls within a well-defined area of reasonable or unreasonable conduct under the caselaw and the negligence is all on one side, the outcome of the dispute will be hard to predict. Such cases will not be susceptible to summary judgment.

Defenses based on the passage of time, in contrast, are easy to prove. The paper trail of each check includes machine stamps of the dates on which it is handled by each bank. Therefore each check (and if the check is lost, banks' microfilm copies of the check) contains most information necessary to prove or disprove a defense under the statute of limitations.

The Revisions complement this factual clarity by simplifying the limitations periods for check fraud claims. Section 3-118(g) establishes a universal three-year period for all check fraud claims brought under the U.C.C.

Before the Revisions, the U.C.C. did not state a limitations period for check fraud cases. The Code left the courts to look to local law for the limitations period applicable to the particular

---

<sup>51</sup>Jacoby Transportation Systems, Inc. v. Continental Bank, 277 Pa. Super. 440, 419 A.2d 1227, 28 UCC Rep. Serv. 1398 (1980).

<sup>52</sup>Travelers Ins. Co. v. Connecticut Bank & Trust Co., 40 Conn. Supp. 70, 481 A.2d 111, 39 UCC Rep. Serv. 253 (1984).

<sup>53</sup>Summarized and approved in B & B Corporation v. Lafayette American Bank and Trust Co., 11 Conn.L.Rptr. No 17, 1994 Conn. Super. Lexis 1303 (1994).

<sup>54</sup>"Robert M. and Geraldine C. Burney" was held to require both endorsements in Perley v. Glastonbury Bank & Trust Co., 170 Conn. 691, 368 A.2d 149, 19 UCC Rep. Serv. 188 (1976).

cause of action.<sup>55</sup> The problem with that approach was that some check fraud claims could be expressed alternatively as either a tort-based cause of action or a contract-based cause of action. In Connecticut, like most states, tort and contract claims followed different limitations periods (usually longer for contract actions). This dichotomy encouraged plaintiffs to use circuitous actions in order to claim longer limitations periods.<sup>56</sup> The situation was confused further by the use of the ancient cause of action of "money had and received," an implied contract claim originally used to recover money mistakenly paid when in fact no obligation existed to pay.<sup>57</sup>

The new section 3-118(g) establishes a three-year limitations period for claims in conversion, money had and received, and breach of warranty, as well as any other claims arising under Article 3 for which a limitations period is not otherwise established, such as a drawer's claim against its bank under section 4-401 for honoring a check which was not properly payable.

The Code has several other time limitations applicable to check fraud claims. A customer has only one year under Section 4-406(f) to report a claim against its own bank for paying a check on which the drawer's own signature is unauthorized or which is altered in its amount. (Note this is a deadline for notice, not for filing suit. Problems inherent in that distinction are discussed in *Bailey, supra*, n.34, at 561-564.)

Section 3-118(g) does not expressly state a limitations period for a customer's claim against its drawee bank brought under their account agreement. Arguably, such a claim alleges breach of a written contract, and thus does not assert a "right arising under this Article." (3-118(g)(iii)). In Connecticut such a claim would probably be subject to the six-year limitations period for claims on written contracts. (Conn. Gen. Stat. § 52-584). Banks could shorten that period by the terms of the account agreement,

---

<sup>55</sup> *Kuwait Airways Corp. v. American Security Bank, N.A.*, 890 F.2d 456, 10 UCC Rep. Serv. 2d 21 (D.C. Cir. 1989).

<sup>56</sup> A different effort to avoid the statute of limitations failed in *Aduskevich v. Connecticut National Bank*, 1990 Conn. Super. Lexis 1695 (1990), where the plaintiffs had alleged that the bank had a duty to warn them that their claim could become time-barred.

<sup>57</sup> *Stelco Industries, Inc., d/b/a Stevenson Lumber Co. v. State Nat'l Bank of Connecticut, et. al.*, 4 Conn L. Trib. No. 51 (Nov. 22, 1978) (No. 171931); *Peerless Insurance Co. v. Texas Commerce Bank-New Braunfels, N.A.*, 791 F.2d 1177, 1 UCC Rep. Serv. 2d 622 (5th Cir. 1986); *Hechter v. New York Life Ins. Co.*, 46 N.Y.2d 34, 412 N.Y.S.2d 812, 385 N.E.2d 551, 25 UCC Rep. Serv. 537 (1978).

however.<sup>58</sup>

The warranties of presentment between banks have their own notice periods. Sections 3-417(c) and 4-208(e) now require that the "claimant" (drawee bank) give notice of a claim for breach of warranty to the "warrantor" (depository bank) within thirty days after the drawee bank learns of the breach.<sup>59</sup> Absent prompt notice, the depository bank is discharged to the extent of any loss caused by the delay. § 3-417(c).

### III. OVERALL IMPACT OF THE REVISIONS

#### A. Clarification

One of the most important things which the Articles 3 and 4 Revisions have done is to "clean up" the existing statute. The wording of Articles 3 and 4 was often problematical, with inconsistent provisions between the two articles<sup>60</sup> and rules which seemed counter to common sense.<sup>61</sup> These anomalies led to inconsistent holdings in different jurisdictions.<sup>62</sup> By eliminating these drafting problems, the Revisions have reduced some of the uncertainty in check fraud cases and should reduce some of the time and energy which has been spent on court battles.

A second major change of the Revisions has been the universal three-year limitations period for check fraud claims. This will eliminate the unpredictability and confusion regarding the limitations periods under the prior Code.

#### B. Expanded Role of Bank-Customer Relationship

A third major change is that a larger percentage of check fraud claims will be asserted by drawers against their own banks.<sup>63</sup> The Revisions have accomplished this by eliminating two other avenues of recourse which had been asserted under the previous code. After the Revisions a payee is no longer entitled to sue on a check unless it had possession of it before

---

<sup>58</sup> *New York Credit Men's Adjustment Bureau, Inc. v. Manufacturers Hanover Trust Co.*, 41 A.D.2d 912, 343 N.Y.S.2d 538, 12 UCC Rep. Serv. 717 (1973).

<sup>59</sup> The rule before the Revisions required notice "within a reasonable time," a standard which led to varying results. *Compare Home Indemnity Co. v. First Nat'l Bank of Waukegan*, 659 F.2d 796, 31 UCC Rep. Serv. 1664 (7th Cir 1981) (six weeks delay held to be unreasonable) *with* *First Nat'l Bank of Neenah v. Security Nat'l Bank of Springfield*, 32 UCC Rep. Serv. 926 (D. Mass. 1981) (five months not unreasonable).

<sup>60</sup> For example, it was unclear whether "negligence" in old section 3-406, "reasonable commercial standards" in old section 3-419(3), and "ordinary care" in old section 4-406(3) were all the same standard.

<sup>61</sup> For example, the two different damages rules in old section 3-419(2).

<sup>62</sup> For example, see the discussion in Comment 1 to new section 3-420.

<sup>63</sup> At the same time the Revisions create a new cause of action for comparative fault against any culpable party. This discussion relates only to a plaintiff's first recourse: the causes of action for full recovery irrespective of negligence.



the fraud. § 3-420, Comment 1. Instead, the drawer will have to pay twice and then sue its own bank for the fraud. The second cause of action eliminated by the Revisions existed in several jurisdictions where drawers were allowed to sue depository banks directly for breach of the warranties of presentment. The Revisions have rejected that approach, concluding that the warranties are only for the benefit of the banks in the check collection system. § 3-417, Comment 1.

There are important implications to channeling check fraud claims through the customer-drawee bank relationship. In cases of forged endorsements it brings the drawee bank, an innocent party, into the dispute where the depository bank is the ultimate bearer of the loss. Requiring a drawer to make a claim against its own drawee bank instead of the ultimate defendant could entail some loss of judicial economy, and forces the drawee bank to deal with a claim which is ultimately not its responsibility.<sup>64</sup> This is of limited importance, however, since in most cases the drawee bank is able to induce the depository bank to step in and defend the claim directly. (See the discussion of "vouching in" in part II.D above.)

The channeling of check fraud claims through the bank-customer relationship has an even more important implication. The parties to such claims are in an ongoing business relationship which may facilitate prompt settlement of the claim. Where the customer is important to the bank and has a long-standing relationship, the bank will be more likely to give the customer the benefit of the doubt regarding the claim. Any personal relationship between representatives of the bank and the customer may make it easier for them to discuss settlement without resort to litigation.

Above all, claims between customers and their banks will usually be governed by a written checking account agreement. That will give the bank the opportunity to add terms to the agreement which will control the resolution of check fraud claims. This is expressly sanctioned by section 4-103 which allows the parties, within certain limits, to vary the terms of Article 4 by agreement. (Section 1-103 of the U.C.C. has a comparable provision with respect to the entire Code.) Just as banks have

---

<sup>64</sup>Stone & Webster Engineering Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 184 N.E.2d 358, 1 UCC Rep. Serv. 195 (1962).

used the account agreement to impose shorter notice periods, banks might provide for binding arbitration or other forms of alternative dispute resolution instead of or as a prerequisite to litigation.

### C. *Comparative Fault*

Perhaps the greatest change in the law of check fraud is the Revisions' introduction of the concept of comparative fault. Check fraud litigation will no longer necessarily yield "all or nothing" results. This change may reflect the drafters' experience in litigation where slight variations in facts could cause dramatically different results. (Any negligence on the part of the bank precluded a defense under old sections 3-406 and 4-406(e).) The authors of the Revisions believed that comparative fault will facilitate settlements since parties will be less likely to hold out for total victory in litigation.<sup>65</sup> Comparative fault in check fraud will be hard to apply, however, because the negligent conduct of check fraud victims is different in kind from banks' negligence. As discussed above (Part II.F.9), check fraud victims' negligence is generally a collection of many incidents of carelessness; bank negligence, in contrast, arises out of direct contact with the fraudulent checks, but contact which is isolated in time and with little knowledge of the relationship between the thief and the victim. It may prove hard in practice for triers of fact to compare degrees of two very different types of negligence.

## IV. LITIGATION STRATEGIES

### A. *Plaintiffs*

Several litigation strategies can be particularly effective for check fraud victims asserting claims against banks. One is to make a large "blow up" of the check for the jury. That will make it easier for the jury to visualize the instrument that the bank teller looked at when he or she accepted the check for deposit.

Often plaintiffs may find that the bank failed to follow its own procedures in some way. Discovery of the bank's operations manuals can disclose this. Teller training material may give even more detailed descriptions of the steps tellers can take to detect and prevent frauds.

---

<sup>65</sup> See "Prefatory Note" to the Revisions: "by the provisions of sections 3-404 through 3-406 which reform rules for allocation of loss from forgeries and alterations, the Revisions should significantly reduce litigation."

Plaintiffs should always, in addition to the primary cause of action, plead alternatively for apportionment of the loss according to shared culpability. This has several advantages. First, it allows the plaintiff to sue multiple banks, rather than simply the bank against which it has a primary claim. The more defendants there are, the more contributors to a settlement fund there may be. Further, it would be risky for the plaintiff to rely exclusively on recovery under the primary theory when there is any possibility of a culpability-based defense. Third, by pleading the apportionment claims, the plaintiff will introduce bank culpability as a relevant issue in the litigation. (The plaintiff's own neglect will already be relevant if a bank asserts any of the defenses based on culpability.) This will broaden discovery of bank operations, and provide additional arguments either for settlement or for recovery.

Finally, plaintiffs can allege claims under the Connecticut Unfair Trade Practices Act against banks.<sup>66</sup> The potential for attorneys fees, punitive damages, and even class actions (where the plaintiff is challenging a practice applied to all bank customers, for example) can improve the plaintiff's bargaining position.

### B. Defendants

One of the most important things a bank can do once sued in check fraud is to make contact with the thief. The person who carried out the fraud will usually be a former employee of the victim. Before the thief could carry out the fraud, he or she had to spend a lot of time and energy thinking through the weaknesses in his or her employer's bookkeeping system. The thief will have a wealth of information about what the victim could have done to stop the fraud.

Banks are required promptly to report check frauds to regulatory authorities, so the thief will either be subject to criminal prosecution already or be aware that prosecution is pending. While a bank cannot withhold a criminal referral in return for cooperation by the thief, the bank can bargain with the thief over the bank's position at a sentencing hearing.

---

<sup>66</sup> *Normand Josef Enterprises Inc. v. Connecticut National Bank*, 230 Conn. 486, A.2d \_\_\_\_ (1994). *But cf. Dwyer Products Corp. v. Lafayette Bank & Trust Co.*, 1991 Conn. Super. Lexis 349 (1991) and *Westwood Group, Inc. v. Polis*, 1991 Conn. Super. Lexis 1241 (1991), where the plaintiffs alleged insufficient facts to assert an unfair trade practice.

A second important strategy for banks is discovery of the victim's outside accountants. Most plaintiffs in large check frauds are businesses whose books are reviewed to some extent by certified public accountants. Accountants have well-defined rules about reporting to management any material weakness in a company's systems which might allow a fraud. In some instances the accountant will have written a management letter to the business warning it of such a weakness. Even in the absence of a formal management letter, work papers prepared by the accounting firm staff during its periodic reviews may show some awareness of potential weaknesses. In some instances the accounting firm will have delivered an opinion to the defendant bank about the plaintiff's financial condition (e.g., in connection with loans to the plaintiff from the bank); in such cases the bank might have a cause of action directly against the accounting firm for misrepresenting the company's condition due to the accountant's failure to detect and disclose a fraud.<sup>67</sup>

Another strategy for banks is to prepare "flow charts" for the jury to demonstrate how the fraud was carried out. Depending on the nature of the fraud, such an exhibit might enable the bank to illustrate how small the bank's role in the fraud was and how large was the role of the plaintiff's own negligence. A related strategy is to prepare an enlarged list of the different things the plaintiff did which allowed the fraud to occur. The bank wants to create the impression that the plaintiff had multiple opportunities to detect or prevent the fraud, in contrast to the bank's more limited opportunity.

A final strategy for defendants (and perhaps for plaintiffs as well) is to prepare a chart for the court illustrating the "layout" of the litigation: the different counts of the complaint, the theories of liability, and the relevant defenses. Check fraud cases are difficult to understand, due to their technical terminology and complicated statutory provisions. It can be of great assistance to the court, whether on a motion for summary judgment or at trial, to be able to visualize the role of each issue in the overall litigation.

---

<sup>67</sup> Cf. Samuel S. Paschall, *Liability to Non-Clients: The Accountant's Role and Responsibility*, 53 MISSOURI LAW REVIEW 693 (1988); R. James Gormley, *The Foreseen, the Foreseeable and Beyond — Accountant's Liability to Nonclients*, 14 SETON HALL LAW REVIEW 528 (1984).

### V. WHY IS CHECK FRAUD LAW SO CONFUSING?

The law of check fraud is difficult to master partly because the terminology is so arcane and the transactions can be so complicated. Also, the layout of Articles 3 and 4 is not easy for the unfamiliar reader to follow. But a large part of the difficulty of check fraud loss follows from its unpredictability. Even under the revised U.C.C., seemingly minor variations in factual patterns can yield very different results. Also, some situations can be analyzed in different ways, again yielding variable outcomes.

One would expect that the law of check fraud would not be so unpredictable. After all, every check fraud case involves the same instrument: a check, which always has the same basic components and the same parties. Moreover, every check is processed for collection by the banking system in the same way. A comprehensive code like the U.C.C. can address all issues presented in check fraud cases consistently with each other rather than piecemeal. And the U.C.C. has been adopted in close to a uniform fashion in all states, thereby giving the opportunity for the law of check fraud to be consistent through all jurisdictions.

In spite of favorable conditions for a consistent and predictable body of law, however, the outcomes of check fraud cases in practice too often are not predictable. There are several reasons for this, starting with drafting problems. Much of the Uniform Commercial Code was written by expanding upon the provisions of the Negotiable Instrument Law which in turn largely consisted of codifications of the holdings of major cases from prior history. The result was that no single theory explained all related provisions of the Code;<sup>68</sup> the Code's approach was to make generalizations from old cases, without necessarily covering all the ground between those cases' holdings.<sup>69</sup>

The process of drafting of Articles 3 and 4 in the 1950s also contributed to the problem. The two articles interrelated but their language was sometimes inconsistent. Moreover, both articles were written by attorneys who chiefly represented

---

<sup>68</sup> HILLMAN, McDONNELL & NICKLES, *COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE*, *supra*, n15, pp 14-4 to 14-9.

<sup>69</sup> *Daube v. Bruno*, 493 So.2d 606, 608, 2 UCC Rep. Serv. 2d 277, 230 (La. 1986): "Article 3 . . . is not a preemptive, systematic and comprehensive treatment of its area of coverage. . . . Rather, it sets forth a few particular rules which were singled out for treatment because they either resolved a conflict in or were a change from the former rules found under the NIL."

financial institutions; there was no significant consumer movement with regard to financial transactions in the 1950s. As a result, much of the language of the Code was very favorable to banks. This may have induced courts to apply tortured reasoning to achieve what they perceived as more fair results than the language would allow. This occurred especially because check fraud cases are heard by courts of common jurisdiction, rather than a specialty court. As a result, the judges who hear check fraud cases tend to rely heavily on common law doctrines and bring concern for equity and fairness in the immediate case, with less concern for the overall statutory scheme of the Code than could be the case if there were a special court for U.C.C. cases.

Even if all of these factors were eliminated, however, check fraud cases would still be unpredictable. It will always be difficult to allocate the loss from check fraud because we look to checks to perform so many different functions, and serve so many different, competing goals.<sup>70</sup> Society as a whole looks to checks to be a safe form of payment, so that they can, for example, be sent through the mail without the risk of losing the funds if the check itself is lost. This necessarily means that a stolen check which is paid by the bank should be the bank's loss, not the consumer's loss. At the same time, however, banks cannot be expected to absorb the loss of all check frauds and still keep checking account fees reasonable, nor can banks be expected to process checks with the speed that we desire if banks are also expected to examine each check in detail for any fraud detectable on the face of the check.

Because of these and other policies, the law of check fraud will always present a challenge in drawing the line between losses to be borne by the banks and losses to be born by the victims of fraud. By choosing to balance these competing goals instead of leaning entirely to one side or the other of these disputes, we require parties and the courts to examine close cases and make the difficult judgment of how to allocate the loss. Where the loss will ultimately fall depends on too many factors to predict in every instance.

---

<sup>70</sup>HILLMAN, McDONALD & NICKLES, *supra*, at 14-2 to 14-4.

## VI. WILL THE REVISIONS BE FURTHER REVISED?

As mentioned at the outset, the Revisions have been adopted in 36 states. Several leading jurisdictions, including New York, have not enacted the Revisions, however. It is possible that those states will make certain changes instead of adopting the Revisions in their current form, but will make certain changes. In fact, there is already some ferment to that effect among commentators.<sup>71</sup> It may be that deliberations in New York's legislature and elsewhere will lead to a movement to further revise the Revisions. There is precedent for this. The original U.C.C. was reworked in the early 1960's after deliberation in the New York Law Revision Commission and the resulting 1962 act was later adopted by all states. Thus Connecticut's P.A. 91-304 may not be the end of the process of reform and modernization of check fraud law in Connecticut.

---

<sup>71</sup>See H. Bailey, *supra*, n34, *New 1990 Uniform Commercial Code: Article 3, Negotiable Instruments, and Article 4, Bank Deposits and Collections*, 29 WILLIAMETTE LAW REV. 409 (Summer 1993); *Uniform Commercial Code Law Letter*, January 1994, p.1.