Bills and Notes

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THE AFTERMATH OF A FORGERY UNDER ARTICLES 
THREE AND FOUR

Two recent cases involving negotiable instruments have raised several questions concerning the Uniform Commercial Code's treatment of forgery. Where the forger can be found and is solvent, there is no doubt as to who will bear the loss; the forger will make restitution. All too often, however, the courts must place the loss on one of the several innocent parties who dealt with the instrument and such a task usually presents complex problems of statutory interpretation.

In *Jackson v. First Nat'l Bank*, a church employee forged several checks over a thirteen-month period. The church brought this action against the drawee bank seeking to recover the value of the many forged checks which had been paid out of its account. The court rejected defendant's contention that the church had been negligent in supervising the employee and that it should have thus been precluded from asserting the forgeries. It held that the bank had been negligent in not examining the signatures on the checks and that under sections 4-406(3) and 3-406, the bank would have been liable even if plaintiff had been negligent. In order to demonstrate that the result in the instant case is correct, the following analysis of the relevant Code sections is necessary.

The bank's principal contention was that it had exercised due care and that the officials of the church had been negligent in failing to examine the monthly statements. The bank argued that if they had done so, the first forgeries would have been detected, and the forger could have been stopped at that point. The bank contended further that, in order to fulfill the duty of care imposed by section 4-406, the church officials should have periodically demanded an accounting from the employee. The court found, however, that when the church had done so, the employee had made plausible excuses and, in view of his reputation and his twenty-year record of faithful service, the fact that the church had accepted these excuses did not constitute negligence. It is important to note that the fourteen-day period of subsection (3)(b) does not purport to establish a maximum reasonable time for examination; it does not establish negligence as a matter of law. If a customer is in fact negligent, this is simply the longest period of time that a bank can be held liable for the subsequent payment of items forged by the same wrongdoer. In the instant case, then, since the church was not negligent, the fourteen-day period was never in issue, and it was thus no bar to the church's recovery that the forgeries had occurred over a thirteen-month period.

1 All citations to the Code are to the 1962 Official Text.
3 U.C.C. § 4-406.
4 Actually, not all the forgeries were governed by the Code, which became effective only two months before the last forgery. This explains why the court did not mention
The rules of section 4-406 properly protect a drawee bank and its customer by placing the loss on the party who was in the best position to prevent the forger from succeeding. If the customer was not negligent in providing the opportunity for the forgeries, then it is unlikely that he will be aware of them before receiving his statements. The drawee bank has a duty to know the signature of its customer, and, therefore, it normally has a signature card on file. Given these facts, it is generally the drawee who is in the best position to detect the forgery, and, if it pays the forged instrument, it will rightly suffer the loss. After he receives his statement, however, the customer is in the best position to prevent further forgeries. If he fails to do so, it is not unreasonable that the loss should be shifted to him. It is apparent then that this shifting of the liability is designed to comport with the commercial realities of these transactions.

Although the instant case was concerned primarily with section 4-406, it is clear that the question of a drawer's potential negligence cannot be adequately discussed without reference to at least one other section, namely section 3-406. This section penalizes the drawer's negligence in permitting the forgery to occur as opposed to the penalty of section 4-406 for failure to detect the first forgery. This provision is like section 4-406, however, in that its effect is to preclude a negligent drawer from asserting a forgery of his signature. An examination of the Code reveals that the operation of this section is closely related to sections 3-401 and -404. Under section 3-401, "no person is liable on an instrument unless his signature appears thereon." Under section 3-404, moreover, 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 . . . ." Although it would appear that the named drawer of a forged instrument can escape liability under these sections, it is not quite that simple. Under section 3-307(1), each signature on an instrument is admitted unless specifically denied in the pleadings, and, under section 3-406, a negligent drawer will be precluded from such a denial. According to section 3-307(2), then, the holder would be entitled to recover on the check unless another defense could be established.

The key words in section 3-406 are "... who by his negligence substantially contributes . . . ." It is submitted that this provision operates as the statute of limitations imposed by U.C.C. § 4-406(4). If the Code had been in effect during the entire period, this statute of limitations would have prevented the church from bringing an action as to at least some of the checks.


Had section 3-406 been in effect during the entire period, the holder of the check would have been precluded from asserting the alteration or lack of authority against a holder in due course or 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.

This section adopts the doctrine of Young v. Grote, 4 Bing. 253, 130 Eng. Rep. 764 (C.P. 1827). That case held that a drawer who so negligently draws an instrument as to facilitate its material alteration is liable to a drawee who pays the instrument in good faith.

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an important proximate cause test; not only must negligence be shown, but it must be the cause of the loss. An excellent example of proximate causation in a forgery context is *First Pa. Banking & Trust Co. v. Montgomery County Bank & Trust Co.*, where the drawee paid some checks upon presentment by defendant collecting bank, even though its customer did not have sufficient funds to cover them. When the drawee found that the indorsements on the checks had been forged, it tried to recover from the collecting bank, claiming a breach of the warranty that all indorsements were genuine. The court held that even though there was a forgery, the drawee could not prevail. It stated that the loss had occurred not because of a breach of warranty, but because the drawee had honored checks of a depositor who had insufficient funds. Even if the signatures had been genuine, the drawee would have still suffered the loss. Similarly, the protection of section 3-406 can be claimed only by a drawee who has paid the instrument in good faith and has generally acted in accordance with the reasonable standards of its business. This requirement coincides with section 4-406(3), which provides that even if a drawer was negligent in not discovering a forgery, the drawee cannot charge its customer's account if it too was negligent.

In the *Jackson* case, then, if plaintiff had been negligent, the defendant bank's standard of conduct would have been an issue of decisive significance, and, although the finding was unnecessary to reach the result, the court here stated that the bank had been negligent in not examining the checks to determine the genuineness of the drawer's signature. In reaching this conclusion, the court was careful to point out that many of the checks bore the indorsements of a racetrack. It was the subsequent negligence of the bank which allowed payment of the forged instrument and was the proximate cause of the loss. Even if both parties had been negligent in the instant case, the result would have been no different. The bank could have prevailed only if the church had been negligent in some way and if the bank had at the same time been free of any negligence. If, for example, the church's treatment of its statements was held to be negligent, then the bank, as drawee, would not have been liable for checks paid after the statements carrying the first item had been available to the church for a reasonable period not exceeding fourteen days. Subsection (2)(a) of section 4-406 provides, however, that the burden of proof is on the bank to show a loss resulting from the negligence of its customer, but, where there is a series of forgeries, "the depositor's failure to give timely notice is presumed to have caused the loss since otherwise the wrongdoer could not have successfully repeated the act." Three general patterns thus emerge, regardless of the form taken by any negligence involved. In the ordinary situation where there is no negligence, the drawee bears the loss resulting from a forgery, since under sections 3-401

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8 U.C.C. § 4-207(1)(a).
9 U.C.C. § 3-406, Comment 6.
10 Jackson v. First Nat'l Bank, supra note 2, at 113-14.
11 U.C.C. § 4-406(2).
and -404 the drawer cannot be held liable on an instrument which he has not signed. If both parties are negligent, it is still the drawee who must bear the loss, since the negligence of the drawer is not deemed sufficiently causative to warrant a reversal of the ordinary situation. Where, however, it is only the drawer who is negligent, he is denied the protection of sections 3-401 and -404. Since it was he who caused the loss, it is only reasonable that he should not recover from the innocent drawee.

There is another complex forgery problem which requires examination even though it was not raised in *Jackson*. Where the drawee has taken a worthless check, and its customer's negligence has in some manner contributed to the success of the forgery, an important question is whether the bank can sue one of the innocent intermediary parties and shift the loss from its negligent customer. If the drawee properly charges the customer's account, as did the drawee in *Jackson*, then it will be necessary for the customer to bring an action against the bank to have the debited amount restored. For one reason or another, however, notably customer relations, a drawee might fail to charge the account, accede to the customer's request to restore the funds, or fail in litigation to assert a valid defense to the drawer's action. Obviously the drawee bank does not intend to suffer the loss, and if it does any of the above, it will seek to recover from another party on the warranties given it under sections 3-417 and 4-207. If the customer's negligence is a breach of the duty imposed by section 4-406 to check his bank statements, it is clear that no such shift of liability is possible. Section 4-406(5) provides that a drawee bank which has a valid defense to a customer's claim must assert that defense or it cannot bring an action upon the unauthorized signature or alteration which gave rise to the customer's claim. This simply means that a drawee bank cannot protect its negligent customer at the expense of some innocent party by suing upon its warranty rights. If, however, the customer's negligence is a breach of the general duty of due care under section 3-406, there is no express prohibition of such a suit by the drawee bank. Such an inconsistency demands analysis. One writer, after tracing the drafting history of the Code, suggested that the draftsmen did not intend to limit this prohibition to section 4-406, and that its omission from section 3-406 was probably "inadvertent." Comment 7 to section 4-406 clearly indicates, however, that the omission was by no means inadvertent. The comment states that "no present need is known to give the rule wider effect." This comment does not, however, reconcile the inconsistency noted above. The question remains whether such an anti-waiver provision should be drawn to apply to section 3-406. Conversely, of course, it must be obvious that the inconsistency would be removed equally well by eliminating the provision from section 4-406. The question thus becomes the broader one of whether such a provision has any place in the Code at all and, if so, what is its proper scope and breadth.

At the outset, it must be made clear that such an anti-waiver provision affects only a drawee bank. A collecting bank or other holder is obviously in no position to attempt to shift the loss in this fashion. The question is fur-

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ther delimited by the fact that any cause of action which would be prohibited by an anti-waiver provision is based upon the warranty sections of the Code. Within these sections there is a major division which must be acknowledged. All the warranty rights of a drawee bank are given by subsection (1). The warranties of subsection (2) are not involved in any way; they are not affected by an anti-waiver provision. These subsection (2) warranties protect intermediary parties who have come into contact with the check in the course of negotiation. The Code protects these parties by setting up a chain of liability which renders each prior holder liable to his transferee and to subsequent holders. Conversely, of course, each transferee acquires warranty rights against all prior transferors. In order to understand why subsection (2) warranties do not inure to the benefit of a drawee, it is necessary to examine the effect of one of the most important policies underlying Articles 3 and 4 of the Code—the free negotiability of commercial paper. As to intermediary parties, such as collecting banks, free negotiability is fostered by providing maximum protection to the transferee, that is by permitting it to sue all prior parties. An intermediary party such as a collecting bank has little opportunity to ascertain the likelihood of successfully recovering the moneys paid out on the thousands of negotiable instruments it handles each day. Even if these parties had such an opportunity, it would be commercially impossible for many of them to take advantage of it without seriously congesting the orderly flow of commercial paper. Given the exigencies of the above situation, the sweeping protection of subsection (2) is inescapably necessary to induce these parties to abandon what would otherwise be their understandable reluctance to take a great many instruments. As to the drawee, however, the policy of promoting free negotiability is not in jeopardy. The drawee has one significant advantage which removes the need for the broad protection of subsection (2): it is never compelled to pay out any of its own funds in taking an instrument. The customer's money is already on deposit and the drawee can protect itself simply by debiting the drawer's account immediately. Consequently, there is no need to encourage the drawee to accept the instrument. The uncertainty faced by the other takers is simply not present, and thus the warranties which are designed to overcome this uncertainty need not be implemented. In sum, then, it has been demonstrated that the anti-waiver provision can affect only a drawee bank and that since the drawee bank receives no subsection (2) warranties, the anti-waiver provision is limited in its application to the subsection (1) warranties of the drawee bank.

The principal reason for the existence of any anti-waiver provision—even in this limited area—is the operation of another important Code policy. The Code seeks, wherever possible, to discourage multiplicity and circuity

14 U.C.C. §§ 3-417 and 4-207. For the purposes of this comment these sections are identical. In the following discussion, then, no distinction is made, and a reference to subsection (1)(b), for example, covers both §§ 3-417(1)(b) and 4-207(1)(b).

15 See, e.g., U.C.C. §§ 3-112, -118, Comment 1, -201, Comment 1, -203, -207, -305, -307, Comment 1, -501, Comment 1, -504, Comment 1.

16 See U.C.C. § 3-206, Comment 3.
of litigation.\textsuperscript{17} In the case of a collecting bank or other intermediary, this policy has had to be submerged in favor of the paramount interest in the free negotiability of commercial paper. In the case of the drawee bank discussed above, however, this paramount policy is satisfied without the infusion of artificial stimuli such as subsection (2) warranties. In this situation, then, the second policy becomes dominant and the anti-waiver provision is imposed largely to diminish the number of potential litigations. The policy thus implemented by the anti-waiver provision has two aspects, either of which could alone justify its existence. The first of these recognizes the basic equities of the situation; it is designed to eliminate the harrassment of innocent parties when it is clear that the loss ought to be borne by the negligent drawer. The second aspect of this policy is a salutary concern for judicial administration. What will be done in two or three lawsuits ought to be done, if possible, in one. These policy considerations manifest themselves within subsection (1), as the anti-waiver provision operates to limit even these warranties. In order to fully understand the implications of these limitations, it is necessary to examine the anti-waiver provision as it operates upon each of the drawee's rights under subsection (1).

Under subsection (1)(a), a party who obtains payment or acceptance warrants that it has good title, and, if there has been a forged indorsement, it is in breach of this warranty.\textsuperscript{18} Normally, then, the drawee has an action against any party who has transferred the instrument after the forged indorsement. The rationale underlying this warranty right is that a drawee acting with reasonable care cannot ascertain the genuineness of prior indorsements; therefore it is entitled to protection.\textsuperscript{19} Where, however, the drawee's customer has been negligent in examining his bank statements, the drawee will be prohibited by the anti-waiver provision\textsuperscript{20} from asserting its subsection (1)(a) warranties against these prior transferors. Under subsection (1)(c), the prior transferors warrant that the instrument has not been materially altered. If the drawer is again negligent as above, the drawee will similarly be prevented from asserting his rights under this warranty. The application of the anti-waiver provision to both the above warranties clearly produces a good result. The drawee should charge the customer's account, and he will thus have no need to sue these prior parties.\textsuperscript{21} Subsection (1)(b), which deals with the forgery of the drawer's signature, presents a somewhat different warranty. It provides that the drawee cannot recover from any party unless that party "had knowledge" that the signature was unauthorized. There are several reasons given for the drawee's limited remedy under this subsection.\textsuperscript{22}

\textsuperscript{17} E.g., U.C.C. § 4-207, Comment 2.
\textsuperscript{19} U.C.C. § 3-417, Comment 3.
\textsuperscript{20} U.C.C. § 4-406(5).
\textsuperscript{21} See p. 96 supra.
\textsuperscript{22} The section is based upon Price v. Neal, supra note 5. See Ames, The Doctrine of Price v. Neal, 4 Harv. L. Rev. 297 (1891); Britton, Defenses, Claims of Ownership and Equities—A Comparison of the Provisions of the Negotiable Instrument Law with
The most persuasive reason is that the drawee is in the best position to discover a forgery of a drawer's signature; thus, there is no compelling reason for him to be protected. Because of the unique limitations of this particular warranty, there is good cause to doubt whether the anti-waiver provision should be applied to it at all. Since the section is limited on its face to those parties who "had knowledge," any need for the anti-waiver provision is eliminated. Any legitimate purpose of such an anti-waiver provision has already been served by the fact that the section does not apply to parties who have acted in good faith. As presently drafted, however, the anti-waiver provision of section 4-406(5) protects not only good faith parties, but also those who negotiated the check with knowledge of the forgery—including the forger himself. It is submitted that this is not a satisfactory result and that the anti-waiver provision of subsection (5) should be modified so as to limit its protection to good faith parties. This could be done quite simply by inserting the three words "in good faith" as suggested below:

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

If the statute is thus amended, the desired effect of the anti-waiver provision is in no way compromised, and a potentially dangerous side effect is eliminated.

The anti-waiver provision as presently drafted applies only when the customer has been negligent in his treatment of his bank statements. If the customer has negligently provided the occasion for the forgery in some other manner, the anti-waiver provision is not invoked to prevent the drawee from shifting the loss from its negligent customer to a good faith transferor. It is submitted that an anti-waiver provision should be equally applicable to these other forms of negligence. This means simply that the modified anti-waiver provision suggested above should be engrafted upon section 3-406. An even more satisfactory solution would be to join sections 3-406 and 4-406 under one general negligence section. It is clear that section 3-406 includes the negligence described in detail by section 4-406. Under section 3-406 any party can raise the issue of a drawer's negligence in handling his bank statements; section 4-406 describes in detail the drawee's rights to defend on this ground. It is submitted that the present separation of these sections does not serve any useful purpose; it does, however, produce the inconsistent and even

23 U.C.C. § 3-417, Comment 3.
24 U.C.C. § 4-406(5).
25 U.C.C. § 3-406, Comment 7.
capricious result discussed above.\textsuperscript{26} The substantive rights of several parties are determined, not according to the material question of which party was negligent, but rather according to the irrelevant question of what form the negligence assumed.

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\textsuperscript{26} See p. 99 supra.