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Negotiable Instruments—Forgery Insurance—Definition of Forgery as a Policy Term.—Home Federal Sav. & Loan Ass'n v. Peerless Ins. Co

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brought into natural apposition. But the tests used to categorize a man as an independent contractor do not with equal success result in the desired apposition. As to him, a preexisting body of agency law is applied which takes no account of the philosophy of the Labor Act. If such is the case, might not sympathy be a proper test in the case of the independent contractor? The Board has yet to go so far.

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Negotiable Instruments—Forgery Insurance—Definition of Forgery as a Policy Term.—*Home Federal Sav. & Loan Ass'n v. Peerless Ins. Co.*[1] —Plaintiff savings and loan association brought an action in the United States District Court in Iowa against defendant, a New Hampshire bonding company, to recover under the forgery clause of a Savings and Loan Blanket Bond (Standard Form No. 22).[2] A real estate agent, for a commission of one percent, would aid persons who had purchased homes from him in applying to plaintiff for loans. The agent submitted to plaintiff fraudulent loan applications upon the basis of which plaintiff's officers issued five checks payable to the fictitious applicants.[3] The checks were indorsed by the agent in the names of the payees and were charged to the plaintiff's account by the payor bank. By judicial interpretation in Iowa, an act must change the legal efficacy of an instrument in order to constitute a forgery. Relying upon section 541 of the Iowa Code, which makes such checks bearer paper, defendant claimed that since the indorsements by the agent did not change the legal efficacy of the instruments, being mere surplusage on bearer paper, the loss was not covered by the forgery clause of the bond.[4] The District Court rejected the defendant's contentions and allowed recovery. HELD: (1) The loss was sustained through acts amounting to forgery under a general commercial definition of that word; (2) recovery is not limited to losses sustained through acts amounting to forgery as defined by the local criminal law, but even if so limited, the acts here meet that standard; (3) defendant's reliance upon section 541 in his denial of forgery loss,

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[1] 197 F. Supp. 428 (N.D. Iowa 1961).

[2] The policy provided, "The Losses Covered By This Bond Are As Follows . . . Forgery Or Alteration. 2. Any loss through forgery or alteration of, on, or in any instrument."

[3] One of the names was that of a person in existence, but since he was not intended to have any interest therein, he is deemed a fictitious payee nonetheless. Britton, Bills and Notes § 149 (1953). The UCC has eliminated as misleading the words "fictitious or nonexisting person," since the existence or nonexistence of the named payee is important only as it may bear on the intent that he shall have no interest in the instrument. UCC § 3-405, Comment 1.

[4] Iowa Code § 541.9(3) (1958), corresponds to NIL § 9(3) and reads as follows: The instrument is payable to bearer:

. . . .

3. When it is payable to the order of a fictitious or nonexisting or living person not intended to have any interest in it, and such fact was known to the person making it so payable, or known to his employee or other agent who supplies the name of such payee . . . .

judged either by the local criminal law or by general commercial standards presumes an agency relationship that, on these facts, is nonexistent.

The problem of determining the scope of the acts covered by the term "forgery" as used in a bond has arisen many times within the fifty year history of forgery insurance.[5] Much of the case law in this area concerns interpretation of the terms "forgery" and "counterfeit" as found in Clauses D and E of the Bankers Blanket Bond (Standard Form No. 24),[6] but the difficulties found in that policy are analogous to those raised by the bond in the principal case.[7] Courts faced with this construction problem generally have agreed that the absence of a definition of a term such as "forgery" or "counterfeit" necessitates reference to criminal law principles.[8] Beyond this, however, there is a split of authority,[9] with the majority of courts contending that the insured sought protection against a criminal act and that the fraudulent act leading to loss should be judged by the standards of the local criminal law.[10] A minority of courts, noting the desirability of uniform interpretation, claim that a broader or "general" definition would be more in accord with business usage.[11] This conflict has been criticized as more apparent than real because of the similarity between the "criminal" and "general" definitions.[12]

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[5] For historical background see Farnsworth, Insurance Against Check Forgery, 60 Colum. L. Rev. 284 (1960).

[6] 2 Paton, Digest of Legal Opinions 2277 (1942). See provisions of Clause E infra note 7.

[7] Note, however, that the following provisions of Clause E (Standard Form No. 24) seem more narrow in scope than those found in the bond of the principal case. Clause E covers loss sustained through reliance upon "written instruments which prove to have been counterfeited or forged as to the signature of any maker, drawer, issuer, endorser, . . ." For a case strictly construing Clause E see U.S. Fid. & Guar. Co. v. First Nat'l Bank of Fort Morgan, 364 P.2d 202 (Colo. 1961).

[8] Provident Trust Co. v. Nat'l Sur. Co., 138 F.2d 252 (3rd Cir. 1943); Rockland-Atlas Nat'l Bank v. Mass. Bonding & Ins. Co., 338 Mass. 730, 157 N.E.2d 239 (1959); Int'l Union Bank v. Nat'l Sur. Corp., 245 N.Y. 368, 157 N.E. 269 (1927); Manufacturers & Traders Trust Co. v. Meyer Malt & Grain Corp., 132 Misc. 138, 229 N.Y.S. 615 (Sup. Ct. 1928). Forgery is not defined in either the NIL or UCC, but for the effect of a forged signature see NIL § 23. The UCC uses the term "unauthorized signature" and it includes both forgery and a signature made by an agent exceeding his actual or apparent authority. UCC § 3-404, Comment 1.

[9] Security Nat'l Bank of Durand v. Fidelity § Cas. Co., 246 F.2d 581 (7th Cir. 1957).

[10] State Bank of Poplar Bluff v. Maryland Cas. Co., 289 F.2d 544 (8th Cir. 1961); Torrance Nat'l Bank v. Aetna Cas. § Sur. Co., 251 F.2d 666 (9th Cir. 1958); Fitzgibbons Boiler Co. v. Employer's Liab. Assur. Corp., 105 F.2d 893 (2nd Cir. 1939); Pasadena Inv. Co. v. Peerless Cas. Co., 132 Cal. App. 2d 328, 282 P.2d 124 (1955). See criminal definition infra note 12.

[11] Fidelity Trust Co. v. American Sur. Co., 268 F.2d 805 (3rd Cir. 1961); Security Nat'l Bank of Durand v. Fid. and Cas. Co., 246 F.2d 581 (7th Cir. 1957); Quick Service Box Co. v. St. Paul Mercury Indem. Co., 95 F.2d 15 (7th Cir. 1938); First Nat'l Bank of S.C. of Columbia v. Glens Falls Ins. Co., 197 F. Supp. 264 (E.D.S.C. 1961). See general definition infra note 12.

[12] Forgery is not defined in the Iowa Code, but the Iowa Supreme Court has adopted the following definition, as found in State v. Johnson, 26 Iowa 407, 413 (1869): "[F]orgery is the false making or materially altering, with intent to defraud, of any

It has long been established that the execution of an instrument in a fictitious name with intent to defraud constitutes criminal forgery.[13] Situations involving fictitious payees have raised problems in the commercial law as well. Under the Negotiable Instruments Law, as originally enacted, a payor bank was liable to its drawer-depositor for cashing a check in the name of a fictitious payee in any instance where the drawer himself had no knowledge of the falsity.[14] Thus, the bank suffered the loss where the drawer's agent supplied the fictitious name and the drawer unwittingly executed the instrument. The Fictitious Payees Act of 1942 proposed an amendment to section 9(3) of the NIL[15] which would shift the loss in the latter situation from the bank to the drawer, for the reason that the drawer could best control his agent or protect himself with fidelity or forgery insurance.[16] The amendment was adopted by half of the states operating under the NIL and its principles applied in drafting its counterpart in the Uniform Commercial Code.[17]

Extension of forgery coverage in blanket bonds to fictitious payee situations had not been considered prior to the principal case.[18] The Iowa Supreme Court has never been faced with the problem of defining the term "forgery" as used in an insurance policy, nor has it passed upon the question of whether a forged indorsement on what is technically bearer paper comes within the scope of the Iowa penal statute relating to forgeries.[19] In answer to the defendant's contention in the principal case that such indorsement is surplusage and therefore not a forgery, the court concluded that any finding that these acts did not amount to forgery would be contrary to the weight

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writing, which, if genuine might be of legal efficacy, or the foundation of legal liability." A striking similarity was found by the court in the principal case between this and a so-called "general" definition applied in Dexter Horton Nat'l Bank v. U.S. Fid. & Guar. Co., 149 Wash. 343, 270 Pac. 799 (1928). But see Mid-City Trust and Sav. Bank v. Nat'l Sur. Co., 202 Ill. App. 6 (1916), where the court said that it is "forgery within the meaning of the bond, if the checks are false writings apparently capable of defrauding and manifestly made with an intent to defraud, and the act of uttering is unnecessary." The Oxford Standard Dictionary (1953) defines forgery as "the making of a thing in fraudulent imitation of something." For cases applying "general" definitions see supra note 11.

[13] United States v. Turner, 32 U.S. (7 Pet.) 132 (1833); United States v. Greever, 116 F. Supp. 755 (D.D.C. 1953); Commonwealth v. Costello, 120 Mass. 358 (1876).

[14] 5 Uniform Laws Ann. § 9(3) (1943).

[15] Britton, op. cit. supra note 3.

[16] Id. at 710. See Note, 2 Drake L. Rev. 70 (1953).

[17] For list of states see, 2 Paton. Digest of Legal Opinions (Supp. 1957). UCC § 3-405 reads, in part, as follows:

> (1) An indorsement by any person in the name of the named payee is effective if . . .
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> (b) a person signing as or on behalf of the drawer intends the payee to have no interest in the instrument or
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> (c) an agent or employee of the drawer has supplied him with the name of the payee intending the latter to have no such interest. (See comment 4.)

[18] Supra note 5, at 297.

[19] Supra note 1, at 436.

of authority in jurisdictions having a criminal statute similar to section 541 of the Iowa Code.[20] The court went on to say, however, that strict compliance with the local criminal law should not be necessary to satisfy the terms of the bond.[21] This decision, nonetheless, cannot be categorized within the majority or minority positions on the question of the standards applicable to policy term construction because the ruling against the defendant on the agency question removed the technical fictitious payee issue from the case.[22] Thus, the instruments were payable to order, as they would be under the Uniform Commercial Code, and the indorsements of the named payees, fictitious or not, which are necessary for negotiation, were clearly forgeries within the meaning of the bond, irrespective of their effect upon the drawer or its bank.[23]

That the distinction between the majority and minority positions on term construction is not as insignificant as is suggested in the principal case[24] is evidenced by a recent case exemplifying the liberal minority position. In *Fidelity Trust Co. v. American Surety Co. of New York*,[25] a third party induced the insured to make loans secured by assigned accounts receivable, with the value of the accounts misrepresented through the use of false invoices. The insured recovered for the loss, the court deeming the instruments "counterfeit" within the terms of the bond, even though these acts would not sustain a conviction for counterfeiting under the Pennsylvania criminal law.[26] The court stated "that common usage would indicate that counterfeit is something that purports to be something that it is not," and went on to observe that "blanket bonds" connoted wide coverage and that such instruments are to be construed against the drafting party.[27] The majority of courts would reach a contrary result, but it is submitted that the majority position does not take an intelligent view of the purposes of the bond. The commercial law is now characterized by a realistic attitude concerning fair placement of loss. Considerations of fairness served as the background against which section 9(3) and its amendment have freed the bank of liability in the fictitious payee situations mentioned above. Deviation from the

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[20] Id. at 437.

[21] Ibid.

[22] NIL § 9(3) applies only when the proper agency relationship exists. The courts finding that the real estate agent was not the agent of plaintiff was fatal to defendant's reliance upon the bearer paper technicalities. See provisions of NIL § 9(3), supra note 4.

[23] UCC § 3-405(c). This section does not preserve the "bearer paper" concept of NIL § 9(3), but the same results are reached. If the instrument purports to be payable to order it remains an order instrument under this section, despite the fictitious character of the payee, and a regular chain of indorsements is required.

[24] Supra note 1, at 433.

[25] Supra note 11.

[26] The acts committed would constitute a misdemeanor under the personal property-fraud section. Pa. Stat. Ann. tit. 18, § 4837 (1945), entitled "False Statement As To Financial Condition." They would not, however, constitute "counterfeiting" under tit. 18, §§ 5001-5013.

[27] Fidelity Trust Co. v. American Sur. Co., supra note 11, at 807. But see article by Maurice, Forgery In The Law of Insurance, 76 Banking L.J. 737 (1959), severely criticizing minority position in general, and Fidelity case in particular.

normally operative rule leaves the drawer without remedy in this one instance. By the shifting of liability, this amendment serves as a conduit through which the commercial world has forced the drawer to rely upon insurance. Relegated to this position, the drawer then seeks to protect himself from commercial loss and is not concerned with the labels placed by the criminal law upon the acts causing his loss. Under these circumstances, a court cannot fairly conclude that the insured intended to be subjected to the modern counterparts of common law anomalies such as the larceny-false pretenses distinction. Based also upon considerations of fairness, Article 2 of the UCC provides that risk of loss falls upon a breaching party only to the extent to which it exceeds the other party's insurance.[28] Thus, insurance coverage is now an item to be pleaded at the trial of a contract action and ambiguous policy terms should be construed in accordance with business usage.

The law regarding fictitious payees is not relevant to the definition of forgery as used in the bond. Plaintiff's claim in the principal case could have been sustained without the agency holding. Given the proper agency relationship, and assuming for a moment that the standards of the local criminal law must be met, defendant's contention still lacks merit. Section 9(3) of the NIL relieves the bank from liability for cashing the forged check for purposes of commercial loss placement. In doing so, it does not state that the indorsement is not forged nor that it in any way purports to change the criminal law. The indorsements are still essential as a practical matter, since the instruments are not known as bearer paper until the fraud is discovered. But compliance with criminal law standards should not be necessary. The burden of placing a definition more narrow in scope within the four corners of the policy rests with the drafting party. In the absence of such stipulation, the intent of the parties must be sought. Principles of fairness are contravened when a construction contrary to that of common business usage is adopted as having been intended by a party who relies upon insurance out of commercial necessity. This is especially true when such construction favors the party who has received consideration for assuming the risk of loss.

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Public Utility Company—Rates—Judicial Review.—***Pacific Tel. & Tel. Co. v. Hill.***[1]—In May, 1958, the plaintiff, the Pacific Telephone and Telegraph Co., filed new tariffs with the Public Utilities Commission in order that its rate of return on investment, plant materials and supplies would be raised from 5.42 per cent to 7.04 per cent on the basis that the present 5.42 per cent return was confiscatory. The commissioner held a hearing at which it was determined that the 5.42 per cent rate was confiscatory

[28] UCC § 2-510.

[1] 365 P.2d 1021 (Ore. 1961).