Defense Of Common Claims Under The California Commercial Code

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I. INTRODUCTION.

Checking and savings accounts and other deposit arrangements are the "anchor" retail consumer service provided by banks and credit unions.

Additionally, internet and e-commerce transactions notwithstanding, checks and share drafts remain popular and are still the most popular medium of payment. Such an important component of commercial transactions and the daily lives of ordinary men and women has merited the development of a specialized body of law and terms to go with it. The Uniform Commercial Code, adopted in California as the Commercial Code, together with the account agreement are the primary sources of law governing the responsibility of all parties to the check transaction.[1] Additional terms will be referenced as they arise in the course of this article. However, here are a few that need to be understood from the outset:

"Drawee": A person ordered in a draft to make payment. (The institution on which the draft is drawn.)

"Drawer": A person who signs or is identified in a draft as a person ordering payment.

"Good Faith" is "honesty and fact in the observance of reasonable commercial standards of fair dealing."

"Ordinary Care": Ordinary care is, "in the case of a person engaged in business means observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged. In the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general banking usage not disapproved of… (elsewhere in the code)." See Commercial Code § 3103.

Other definitions appear in Article IV at Section 4104:

"Customer": "A person having an account with a bank or for whom a bank has agreed to collect items…"

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[1] For purposes of this article, this article will use the term check to signify both checks and share drafts. With a few exceptions not significant to this article, the Commercial Code treats such instruments and the related accounts the same. Additionally, because the Commercial The Code uses the term "bank" interchangeably with the term "credit union" this article will do likewise. See, Commercial Code Section 4105(1).

"Draft": A draft as defined in Section 3104 or an item, other than an instrument, that is an order.

"Drawee": Person ordered in a draft to make payment.

"Item": An instrument or promise or order to pay money handled by a bank for collection or payment. The term does not include a payment order governed by Division 11 (funds transfers) or a credit card or debit card slip.

Commercial Code § 4105.

"Bank": "… a person engaged in the business of banking, including a savings bank, savings and loan association, credit union, or trust company."

"Depositary Bank": "The first bank to take an item even though it is also the payroll bank, unless the item is presented for immediate payment over-the-counter."

"Payor Bank": A bank that is the drawee of a draft.

"Collecting Bank": A bank handling an item for collection except the payor bank.

Our discussions herein will focus on the rights and responsibilities of the four parties most commonly involved in a check transaction or withdrawal: The drawee, the payor or customer of the drawee bank, the payee, and the depositary bank. The nature of the claims allowed and the liberties and defenses available vary depending upon what role the particular party plays in the transaction. It will not analyze in detail the relationship between banks.

II. **<u>CLAIMS AGAINST THE DRAWEE BANK.</u>**

A. **<u>Nature of Relationship Between a Depositor and His Bank.</u>**

In the holiday classic, *It's a Wonderful Life*, Jimmy Stewart played the long-suffering George Bailey, President of the Bailey Building and Loan. His arch nemesis, Mr. Potter, started an unfounded rumor that the Building and Loan was in danger of failing. This precipitated a run on the institution by its customers. George Bailey, blessed with the charm of Jimmy Stewart and a thorough understanding of banking law, is able to stem the tide of this run. He does so by explaining that the customers' funds have actually been loaned by them to the Building and Loan which has in turn lent it out to community members.

Regrettably, a common misperception exists that the relationship is more akin to that of Harry Potter and the goblin run bank Gringotts. Those who are fans of the series or are related to fans of the series will recall the scene in which Harry visits the bank to check the balance of his inheritance. He is shown a vault that has actual piles of gold stacked one upon another. Many share this misunderstanding.

It has long-been regarded that as axiomatic in California that "the relationship between a bank and its depositor arising out of a general deposit is that of a debtor and creditor." See, e.g., *Price v. Wells Fargo Bank* (1989) 213 Cal.App.3d 465, 476. A debt is not a trust and there is not a fiduciary relationship between the debtor and the creditor as such. Accordingly, banks are not fiduciaries of their depositors. *Copesky v. Superior Court* (1991) 229 Cal.App.3d 678, 694.

The relationship of bank and depositor is founded in contract. *Barclay Kitchen, Inc. v. California Bank* (1962) 208 Cal.App.2d 347, 353; *Espresso Roma v. Bank of America* (2002) 100 Cal. App.4th 525. This contractual relationship does not involve any applied duty to supervise activity or to inquire into the purpose for which the funds are being used. See, *Blackmon v. Hale* (1970) 1 Cal.3d 548, *Software Design and Application Limited v. Hoefer and Arnett* (1996) 49 Cal.App.4th 472, 481; *Dodd v. Citizens Bank of Costa Mesa* (1990) 222 Cal.App.3d 624, 628. This is true even where the account at issue is a fiduciary account, see, *Blackmon v. Hale*, *supra*, 1 Cal.3d 548; *Chazen v. Centennial Bank* (1998) 61 Cal.App. 4th 532, or where it is an IRA account. See, *Brown v. California Pension Administrators Consultants, Inc.* (1996) 45 Cal.App.4th 333, 347.

Commercial Code Section 4401 allows a bank to charge the account of the customer for an item only where that item is properly payable, i.e. authorized. Section 4401(a) expressly states "A bank may charge against the account of a customer an item that is properly payable from that account even though the charge creates an overdraft. An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and bank." Thus the Commercial Code clarifies the well-founded case law in California that the relationship of the customer and his bank is one founded in contract. See, *Grover v. Bay View Bank* (2001) 87 Cal.App.4th 452, 456; *Chazen v. Centennial Bank., supra,* 61 Cal.App.4th 532, 537. Thus, where a withdrawal or check is unauthorized, or it is not paid to the customer's order, the customer's claims against the drawee bank sound in contract generally speaking, and not in tort. The bank that pays on an unauthorized check or other order has done nothing more than part with its own money.[2] As discussed below, the Code modifies this general rule and several important aspects, most of which tend to mitigate the liability of the drawee bank. These issues will be discussed below in connection with defenses.

The principle that the drawee bank is not the fiduciary of its customer is well settled in California case law. For example, in *Blackmon v. Hale*, the California Superior Court held that the drawee bank did not have a duty to other signers on an attorney's client trust account to inform them if one of the signers was withdrawing funds or to inquire as to the intended use of such funds. See *Blackmon v. Hale, supra,* 1 Cal.3d 548. Similarly, in *Lamonte v. Sanwa Bank* (1996) 45 Cal.App.4th 509, the Court of Appeals held that a bank does not have a general duty to monitor a depositor's account and so does not have a duty to notify one joint tenant of an account of withdrawals by the other joint tenant on the account. Related to this, it does not have a duty to

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[2] This can extend to items paid on a forged endorsement in some circumstances.

verify endorsements on checks payable to the one joint tenant that are deposited to the joint account. 45 Cal.App.4th 509, 519. At one time, case law existed which some argued supported the existence of a "quasi-fiduciary" duty between a drawee bank and its customer. See *Commercial Cotton Co. v. United California Bank* (1985) 163 Cal.App.3d 511 . However, such doctrine was repudiated by the same panel that originally issued such decision. See *Copesky v. Superior Court* (1991) 229 Cal.App.3d 678.

B. <u>Common Defenses.</u>

Most common defenses available to the drawee bank against claims by a drawer for allegedly unauthorized withdrawals from his or her account derives from two basic sources. One, passage of time, and two, comparative fault.

1. <u>Defenses Based on the Passage of Time.</u>

(a) General Principles.

The legislature sought to bring uniformity to the decisions of the courts of the state of California and, in a series of statutes enacted in 1905 and 1929, enacted Code of Civil Procedure § 340(3) to provide a one-year statute of limitations for commencement of an action by a depositor against a forged or raised check, and by later amendment, a forged endorsement. *Roy Supply, Inc. v. Wells Fargo Bank* (1995) 39 Cal.App.4th 1051, 1065. Unlike the prior rules, it also barred claims even where the bank was negligent. The legislature and the courts recognized that the key fraud detection and prevention device was the customer's review of the statements and thus the statute began to run from the date that the statement was made available to the customer. *Id.*

As discussed above, the relationship between the depositor and the drawee bank is one of creditor and debtor, the bank being the debtor. Thus, there was traditionally seen as being no limitation upon the time in which the customer could bring an action to recover money deposited with the bank. See *Roy Supply, Inc. v. Wells Fargo Bank, supra*, 39 Cal.App.4th 1051, 1064. This was even codified at Code of Civil Procedure § 348. Early case law softened this rule however in the case of forged or altered checks or other unauthorized withdrawals. From very early on in the commercial life of California, the courts imposed a duty upon customers to discover and report forgeries and alterations to the bank without unreasonable delay. See *Janin v. London & San Francisco Bank* (1891) 92 Cal. 14, 23; *Roy Supply, Inc. v. Wells Fargo Bank, supra*, 39 Cal.App.4th 1051, 1064. The results of this analysis were unpredictable however as the rule was essentially one of laches.

(b) Commercial Code Section 4406(f).

The drafters of the 1992 revisions of the Commercial Code emphasized the importance of customer review of statements and codified this in the enactment of Commercial Code § 4406.

Commercial Code § 4406 provides in pertinent part that:

> "(a) a bank that sends or makes available to a customer a statement of account showing payment of items for the account shall either return or make available to the customer the items paid or provide information in the statement of account sufficient to allow the customer to reasonably identify the items paid. The statement of account provides sufficient information if the item is described by item number, amount and date of payment. If a bank does not return the items, it shall provide in the statement of account the telephone number that the customer can call to request an item, a check or legible copy thereof pursuant to subdivision (b).
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> …
>
> (f) without regard to care or lack of care of either the customer or the bank, a customer who does not within one year after the statement or items are made available to the customer (subdivision (a)) discover and report the customer's unauthorized signature on or any alteration on the item is precluded from asserting against the bank the unauthorized signature or alteration. If there is a preclusion under this subdivision, the payer bank may not recover for breach of warranty under section 4208 with respect to the unauthorized or alteration to which the preclusion applies…."

As the Court of Appeals explained in *Roy Supply, Inc. v. Wells Fargo Bank, supra,* 39 Cal.App.4th 1051, 1065, 1066, "Section 4406 imposes the duty upon the customer to act promptly in discovering and reporting forgeries and alterations. If the customer fails to fulfill this duty, then the payor bank is relieved from absolute liability and for an initial one-year period the loss may be imposed on the bank only if it was negligent in the matter. After one year, the statute bars the customer from asserting a forgery or alteration against the payor bank unless it has been earlier discovered and reported to the bank."

"Section 4406 is not per se a statute of limitations, but instead is an issue preclusion statute. Unlike a statute of limitations, it does not purport to bar an action against a bank; rather, it precludes a customer from asserting a forgery or alteration against the bank if the customer has failed to discover and report the forgery or alteration to the bank. The effect this will have on the customer's claim will depend upon whether proof of the forgery is an essential element of the particular claim asserted. In essence, if the customer must prove a forgery in order to establish a claim, then the customer will not be able to establish a claim because he or she is precluded from proving a forgery…." The Court went on to hold that while one could imagine that such claims might exist in the abstract, as a practical matter they would all have as a necessary component the proof of the forgery or alteration. *Roy Supply, Inc. v. Wells Fargo Bank, supra,* 39 Cal.App.4th 1051, 1066. This is particularly true as the Court went on to conclude that the UCC preempted all claims of common law negligence. This is now the prevailing view. See, *Lee Newman, M.D., Inc. v. Wells Fargo Bank* (2001) 87 Cal.App.4th 73.

The courts have also recognized that the bank or credit union cannot force its customer read his or her statements and cannot guarantee that the customer will actually receive them. It is sufficient that the statement is mailed or otherwise made available to the customer. The customer's failure to detect a forgery from transactions appearing in a statement are not excused by the fact that a faithless bookkeeper, a faithless spouse or other interloper prevented the customer from reviewing the statements. See *Kiernan v. Union Bank* (1976) 55 Cal.App.3d 111.

The custom of sending statements is so entrenched in modern banking practice that it is held to be proper for the court to take judicial notice that statements were indeed sent. See, e.g., *Roy Supply, Inc. v. Wells Fargo Bank, supra*, 39 Cal.App.4th 1051, 1074; *Mac v. Bank of America* (1999) 76 Cal.App.4th 562, 566.

The only, narrow, exception to the preclusive effect of 4406(f) where forged items are drawn on the customer's account prior to his or her death until after the customer's death. Where the unauthorized transactions appear on a statement that was mailed to the deceased customer's address are told until such time as an estate representative is appointed and has a reasonable opportunity to gather and review the estate's records. *Mac v. Bank of America, supra,* 76 Cal.App.4th 562, 568. In reaching this decision, the Court of Appeals declined to follow the case precedent from the states of Michigan and New York on the issue holding that it believed that those courts erred. *Id.* It based its decision upon a reading of 4406 which required that, in order for statements to be made available to the customer, the customer had to be alive. While one may question the wisdom of modifying the regimen established under 4406, and departing from uniformity of decisions with other states, if the basis for the tolling is that the statement needs to be made available to a living customer, it is arguable that tolling ceases one year after the appointment of the estate representative.

(c) Contractual Limitations Periods.

Financial institutions and their customers are allowed to modify the provisions of the UCC by contract. See Commercial Code § 4103. The only exception to this is that the parties cannot disclaim bank's responsibility for its lack of good faith or failure to exercise ordinary care or limit the measure of damages for such lack or failure. An important exception to this is that "The parties may determine by agreement the standards by which the bank's responsibility it to be measured. If those standards are not manifestly unreasonable … "

In the retail banking context, banks and credit unions commonly shorten the notification period under Commercial Code § 4406(f). Such provisions are generally enforceable. *American Airlines Federal Credit Union v. Martin* (Texas 2000) 29 S.W. 3d 86, 99; Commercial Code § 4103.

(d) The Repeater Rule.

A common scenario arises in the retail context where a dishonest bookkeeper or "befriender" makes a series of unauthorized transactions on an account over an extended period of time. Commercial Code § 4406 addresses this situation as well.

It provides in pertinent part that:

> "If a bank sends or makes available a statement of account or items pursuant to subdivision (a), the customer shall exercise reasonable promptness in examining the statement or items to determine whether any payment was not authorized because of an alteration of an item or because a purported signature by or on behalf of the customer was not authorized. If, based on the statement or items provided, the customer should reasonably have discovered the unauthorized payment, the customer shall promptly notify the bank of the relevant facts.
>
> (d) if the bank proves that the customer failed with respect to an item, to comply with the duties imposed on the customer by subdivision (c), the customer is precluded from asserting any of the following against the bank:
>
> (1) the customer's unauthorized signature or any alteration on the item if the bank proves that it suffered a loss by reason of the failure.
>
> (2) The customer's unauthorized signature or alteration by the same wrongdoer on any other item paid in good faith by the bank if the payment was made before the bank received notice from the customer of the unauthorized signature or alteration and after the customer has been afforded a reasonable amount of time, not exceeding 30 days, in which to examine the item or statement of account and notify the bank…."

Thus, the Code strengthens the duty already imposed under 4406(f) to examine statements by making the customer bear responsibility for failing to exercise reasonable diligence with respect to the review and reporting of items. This preclusion can thus become absolute.

However, as provided in 4406(e), "If subdivision (d) applies and the customer proves that the bank failed to exercise ordinary care in paying the item and that the failure attributed to loss, the loss is allocated between the customer precluded and the bank asserting the preclusion according to the extent to which the failure of the customer to comply with subdivision (c) and the failure of the bank to exercise ordinary care contributed to the loss. If the customer proves that the bank did not pay the item in good faith, the preclusion under subdivision (d) does not apply." If the bank fails to exercise ordinary care, the absolute preclusion of 4406(d) is converted to a comparative fault defense. Thus, a common strategy in defense of such claims is to attempt to set up the so-called "repeater rule" defense to bar claims for transactions after the 30th day after the first statement on which the first unauthorized transaction appears, and the one-year rule to bar such earlier transactions.

As one might expect, the potentially devastating impact of the repeater rule has led to much litigation on the definition of ordinary care. Commercial Code § 3103(7) provides some guidance. It defines "ordinary care" as follows:

> "Ordinary care" in the case of a person engaged in business means observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged. In the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general bank usage not disapproved of [in the UCC].

What is or is not ordinary care is typically established by expert testimony. It is thus generally necessary to employ well-respected experts to testify on the issue. The courts have recognized that different sized institutions and different types of institutions may employ different standards of care. For example, in *Espresso Roma Corp. v. Bank of America* (2002) 100 Cal.App.4th 525, the court held that the trial court properly disregarded the plaintiff's expert's declaration which had opined that Bank of America should have employed further fraud filters or manual review of certain larger items. See *Espresso Roma, supra,* 100 Cal.App.4th 525, 532. The court held that Espresso Roma's expert's declaration did not establish a foundation as to whether his testimony was based upon practices he had observed in banks of comparable size to that of Bank of America. As a result, the court affirmed the grant of summary judgment by the trial court holding that Espresso Roma had failed to create a triable issue of fact as to whether or not Bank of America's automated processing of the subject items had complied with the ordinary standard of care imposed upon large money center banks such as Bank of America. *Id.*

Thus, if a fully automated payment procedure is employed and if the procedure does not have an automatic sort out for items based upon certain criteria, it will generally not be a failure of ordinary care if no manual review is conducted by the drawee bank. Care should be taken however to see that the institutions written policies and procedures conform with practice and that all man's personnel understand this.

Plaintiffs in such cases frequently include all items and transactions in a single cause of action or series of causes of action if different theories are pleaded. However, Code of Civil Procedure § 437c provides that a motion for summary judgment or partial summary judgment must address the entire case or an entire cause of action. Such claimants argue that because one or more of the checks in a particular cause of action would survive the motion, the entire motion must be denied. However, it is settled that each item is a separate actionable primary right and the court has the power to adjudicate each such primary right even where they are grouped under the heading of a single cause of action. See *Edward Fineman Co. v. Superior Court* (1998) 66

Cal.App.4th 1110, 1118. Thus, these time-based defenses can be used to adjudicate particular items, even if they are grouped with other items which would survive.

As shown above, the Commercial Code preempts common law provisions of tort law. However, by statute it establishes a comparative fault type analysis which will be applied as to those transactions where no absolute time bar appears. In the case of a drawee bank that pays an unauthorized item, the drawee bank will want to examine the degree to which the customer reviewed and reconciled his bank accounts. In the case of a commercial customer, it will want to explore whether the customer employed proper segregation of accounting duties and otherwise exercised due diligence with respect to its financial affairs.

(e) Statutes of Limitation.

In California, the Code of Civil Procedure provides that claims by a depositor against a drawee bank for payment of a forged or raised check or for a forged endorsement must be filed within one year. See Code of Civil Procedure § 340(3); *Chatsky & Assoc. v. Superior Court* (2004) 117 Cal.App.4th 873 ; *Hughes Electronics Corp. v. Citibank Delaware* (2004) 120 Cal.App.4th 251.

Within these constructs, the Commercial Code provides for loss allocation rules on statutory principles whose language tracks that of the common law of negligence. This is often misunderstood and, sadly, misapplied, to allow claims to sound in common law tort where they generally should not. Commercial Code § 3406 provides that a person:

> "whose failure to exercise ordinary care contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the authorization or the forgery against a person who, in good faith, pays the instrument or takes it for value for collection.
>
> (B) If the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure contributes to the loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss…"

Commercial Code § 3406(a)(b). The Code equates all unauthorized signatures on items as forged signatures. See Commercial Code § 1201(42). Similar implementations of comparable fault principles appear at Sections 3404, 3405, and 4406. In the context of drawer claims against the drawee bank, common types of negligence involve inadequate segregation of duties, misplaced trust in the use of a signature stamp, inadequate control of check stock and a lack of systems to review disbursements. It will generally be necessary to use expert testimony as to the standard of care of the financial institution and the depositor on such issues.

C. Damages and Attorneys Fees.

If there are transactions which survive these defenses, what then is the measure of damages? The starting point will be amount of the unauthorized transaction, to the extent that such amounts are unauthorized. For example, if an item is raised, but is paid to the party, it is only the amount of the raise which will be included in the measure of damages. See Commercial Code § 3407. However, unless the bank has acted in "bad faith," "the measure of damages for failure to exercise ordinary care in handling an item is the amount of the item reduced by an amount that could not have been realized by the exercise of ordinary care." Commercial Code § 4103(e). Thus, generally speaking, emotional distress or punitive damages or other damages beyond the amount of the item are not recoverable. Commercial Code § 1106(i); *Gil v. Bank of America N.A.* (2006) 138 Cal.App.4th 1371; *Stenseth v. Wells Fargo Bank* (1995) 41 Cal.App.4th 457; Commercial Code § 3420.

Attorneys fees are generally not recoverable in actions under the Commercial Code. See *Grasso v. Crow* (1997) 57 Cal.App.4th 847, 849, 850. However, care should be taken to review account documentation to determine if they contain fees shifting clauses. If such a clause is found, it needs to be analyzed to determine the potential impact of Civ. Code Section 1717.

D. Doctrine of Superior Equities.

In the litigation context, discovery should be taken early on to determine if the plaintiff has insurance for all or part of its loss. If so, the doctrine of superior equities may operate to bar those claims for which the plaintiff has been compensated by insurance. See *Meyers v. Bank of America* (1938) 11 Cal.2d 92.

III. CLAIMS AGAINST THE DEPOSITARY BANK.

A. Claims By the Drawer against the Depositary Bank.

1. General Principles

Claims by the drawer against the bank of first deposit present an entirely different set of problems. The drawee bank has the protections afforded to it by Commercial Code § 4406 and its contract with its customer. As will be shown below, a different set of rules apply where the claim is against the depositary bank.

Claimants will frequently attempt to take advantage of this to shift a loss from themselves to the depositary bank. In addition to the potentially greater legal remedies, they are also often naturally loathe to bring a complaint against their own bank. A common situation in which this arises is where a fraudulent scam is developed by a bookkeeper or "friend" and funds are stolen by means of a fraudulent payables scam.

Drawers of checks can, in limited circumstances, state the claims against depositary banks. These claims sound in negligence principles as codified in the commercial code and most typically arise where the depositary institution accepts items drawn on another institution, usually with the connivance of a defalcating bookkeeper or friend or relative of the victim, and then deposited into an account of the fraudster at the depositary bank. See *Lee Newman, M.D. v. Wells Fargo Bank, supra,* 87 Cal.App.4th 73.

One common scheme involves the use of fraudulent invoices or payroll checks. Commercial Code § 3404 addresses one such set of activities as follows, providing in pertinent part that :

> "(a) If an imposter, by use of the mails or otherwise, induces the issuer of an instrument to issue the instrument to the imposter, or to a person acting in concert with the imposter, by impersonating the payee of the instrument or a person authorized to act for the payee, an endorsement of the instrument by any person in the name of the payee is effective as the endorsement of the payee in favor of a person who in good faith pays the instrument or takes it for value or collection.
>
> (b) If (i) a person whose intent determines to whom an instrument is payable … does not attend the person identified as the payee to have any interest in the instrument, or (ii) the person identified as payee of an instrument is a fictitious person, the following rules apply until the instrument is negotiated by special endorsement:
>
> (1) Any person in possession of the instrument is its holder.
>
> (2) An endorsement by any person in the name of the payee stated in the instrument is effective as the endorsement of the payee in favor of a person who, in good faith, pays the instrument or takes it for value or collection."

2. <u>Common Fact Patterns and Comparative Fault Issues.</u>

If a fraudster induces his employer to issue a check payable in the name of a genuine entity or person but does not intend the payee to have an instrument in that instrument, an endorsement in the name of the purported payee will still be effective even if the actual purported payee does not make than endorsement. This statute relies in part upon the doctrine codified at Commercial Code § 3110 and bearing the oddly metaphysical name of "doctrine of transferred intent." This doctrine provides generally that the intent of the person preparing the instrument controls as to the actual payee, even if that that person is not the named payee and even if the person preparing the instrument is not the person who signs it. This doctrine is particularly strong in the area of checks prepared by automated means. See Commercial Code § 3110.

Commercial Code § 3404(d) imports comparative fault principles to the Commercial Code's loss allocation schemes. It provides in pertinent part that:

> "With respect to an instrument to which subdivision (a) or (b) applies, the person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure contributes to loss resulting from payment of the instrument, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.

Commercial Code §§ 3404(a) and 3404(b) will frequently insulate the drawee bank from liability in such cases and can, under the right circumstances, provide protection to the depositary bank. If however the institution, most commonly the depositary bank, fails to exercise ordinary care in the taking of the instrument, the loss will be allocated according to comparative fault principles. See Commercial Code § 3404(d), official comment 3. Such rules will apply to fault allocation as to the drawee bank as well. However, as a practical matter, ordinary care standards do not require a drawee bank to examine endorsements and determine their genuineness and thus the drawee bank will have greater protection under 3404 than the depositary bank. See, *Espresso Roma v. Bank of America, supra,* 100 Cal.App.4th 525, 534.

Another common scheme involves the defalcating of employee's negotiation of an instrument by way of a fraudulent endorsement. Commercial Code § 3405(b) provides in pertinent part that:

> "For the purpose of determining the rights and liabilities of a person who in good faith pays an instrument or takes it for value or collection, if an employer entrusted an employee with responsibility with respect to the instrument and the employee or a person acting in concert with the employee makes a fraudulent endorsement of the instrument, the endorsement is effective as the endorsement of the person to whom the instrument is payable if it is made in the name of that person. If the person paying the instrument or taking it for value or collection fails to exercise ordinary care in paying of taking the instrument and that failure contributes to loss resulting from the fraud, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss…."

Commercial Code § 3405 goes on to provide at subsection (c) that:

> "(c) Under subdivision (b), an endorsement is made in the name of the person to whom an instrument is payable if (1) it is made in a name substantially similar to the name of that person or (2) the

> instrument, whether or not endorsed, is deposited in a depositary bank to an account in a substantially similar to the name of that person."

Section 3405 addresses fraudulent endorsements by an employee on instruments for which the employee has been given responsibility. It covers two general categories of fraudulent endorsements: endorsements made in the name of the employer, on instruments payable to the employer, and endorsements made in the name of payees on checks issued by the employer. Generally speaking, § 3405 codifies existing law that the risk of loss for fraudulent endorsements by employees who are entrusted with the responsibility for the instrument should fall on the employer rather than the bank that takes the check or pays it, if the bank was not negligent in the transaction. It is based upon the belief that the employer is in the position to supervise the employee and prevent fraud. However, if the bank failed to exercise ordinary care with respect to the paying or taking of the instrument, 3405(b) shifts the loss to the bank or credit union under principles of the comparative fault to the extent that its lack of ordinary care contributed to the loss.

Official comment case no. 3 provides an illustration of a common fact pattern. In this hypothetical, the duties of the employee, a bookkeeper, include posting the amounts of checks payable to the employer to accounts of drawers of the checks. The employee steals a check payable to the employer which was entrusted to the employee and the employee forges the employer's endorsement to the check. He then deposits the check to an account at the depositary bank which he had opened in the name of his employer and that check is then honored by the drawee bank. Under Official comment case no. 3, the endorsement is effective as to the employer's endorsement because the employee has responsibility for the check under the code. Neither the depositary bank nor the drawee bank is liable to the employer for conversion of the check.

A common issue litigated in such situations is whether or not the depositary bank was negligent in the establishment of the account. Official comment 4 leaves open the possibility that if the depositary bank is in some fashion negligent with the opening of the account to which the checks are deposited, the negligence and the opening of the account can operate to create liability for that institution under Commercial Code § 3405(b). It should be noted however, that the example given in comment 4 is that of a situation in which the account is opened in the name of the hypothetical well-known national corporation without receipt of any of the normal corporate formalities for the opening of such an account. The section should not be read to require such full formalities in all such situations, but only such procedures as are consistent with the duty of ordinary care as described above.

The Court of Appeals described the impact of §§ 3404 and 3405 in the case of *Lee Newman, M.D., Inc. v. Wells Fargo Bank* (2001) 87 Cal.App.4th 73. Dr. Newman hired Naomi Zamano to act as his bookkeeper and office manager. Her responsibilities included responsibility for accounts receivable, accounts payable, issuance of checks, bank deposits and related financial matters. Zamano and her cohorts stole checks payable to Newman received at his office and fraudulently endorsed them. They also stole checks drawn on Newman's accounts to patients and endorsed the name of the payee and deposited those checks to their personal bank accounts. Newman sued Wells Fargo, the collecting bank. 87 Cal.App.4th 73, 75, 76. Wells Fargo filed a demurrer, which the trial court sustained without leave. It provides that Commercial Code § 3405 adopted a comparative fault allocation ruling that:

> "Because the first amended complaint alleges that Newman's bookkeeper and office assistant were responsible for billing, accounts payable, accounts receivable, bank deposits and related financial matters, they are employees entrusted with responsibility for checks within the meaning of section 3405. The comprehensive loss allocation function of section 3405, therefore, is applicable to the factual circumstances presented. If Wells Fargo, the depositary or collecting bank taking the checks, acted in good faith and with ordinary care, the entire loss falls on Newman regardless of whether Newman was negligent. To the extent Newman can prove that Wells Fargo failed to exercise ordinary care and can further prove that such a lack of care contributed to the loss, Newman may recover from Wells Fargo pursuant to section 3405 to the extent that bank's failure contributed to the loss…."

Lee Newman, M.D. v. Wells Fargo Bank, supra, 87 Cal.App.4th 73.

The Court of Appeals noted that the current version of Commercial Code § 3405 displaced Dr. Newman's claim for common law negligence under *Sun 'n Sand, Inc. v. United California Bank*, (1978) 21 Cal.3d 671. See *Lee Newman, M.D. v. Wells Fargo Bank, supra,* Cal.App.4th 73, 80. It appeared however to also hold that *Sun 'n Sand's* core holding, that a depositary bank fails to exercise ordinary care where it accepts checks payable to it for deposit to an individual's account where the drawer of the check does no business with the depositary bank is codified under 3405 of the Code.

These cases are tempered by a judicial climate in which there is a large body of case law holding that the depositary bank, outside of extraordinary circumstances such as those addressed by *Sun 'n Sand*, does not owe a duty to the drawer of a check that is not its customer. See e.g., *Karen Kane, Inc. v. Bank of America* (1998) 67 Cal.App.4th, 1192; *Chazen v. Centennial Bank, supra,* 61 Cal.App.4th 532, 537.

Moreover, there is good authority to support the proposition that policies and procedures of a depositary bank designed to prevent and detect fraud are designed to protect the depositary institution only and do not give rise to a duty to a third party. See *Software Design & Application, Inc., Ltd., v. Hoefer & Arnett, Inc.* (1996) 49 Cal.App.4th 472. As in the case of a claim against a drawee bank, the claims under these statutes should be limited to the amount of the instrument, less an offset for the comparative fault of the drawer of the check. *Stenseth v. Wells Fargo Bank* (1995) 41 Cal.App.4th 457.

3. **Damages.**

Commercial Code § 3420(b) specifically limits the liability of the collecting institution to, at the most, the amount of the instrument. See, *Gil v. Bank of America, supra,* 138 Cal.App.4th 1371; *Stenseth v. Wells Fargo Bank, supra,* 41 Cal.App.4th 457. Emotional distress damages, punitive damages and consequential damages are typically not recoverable. See, Commercial Code §§ 1106, 3420(b). This, read together with Commercial Code § 3405's comparative fault defenses, provides significant protection to a forged endorsement should give rise to a comparative fault defense under Commercial Code § 3406.

Punitive damages are typically not allowed in such claims. See, Commercial Code § 1106(i). Additionally, attorneys fees are typically not recoverable. See, *Stenseth v. Wells Fargo Bank, supra,* 41 Cal.App.4th 457; *Gil v. Bank of America, supra,* 138 Cal.App.4th 1371; Code of Civil Procedure § 1021; *Grasso v. Crow* (1997) 57 Cal.App.4th 847, 849, 850.

4. **Time Based Defenses.**

Claims in this category are likely subject to the three year limitations period of Code of Civil Procedure § 338 and Commercial Code § 3118, without regard to tolling except where the institution engaged in fraudulent concealment of the acts. See, e.g., *Rodrigue v. Olin Employees Credit Union* (7th Cir. 2005) 406 F.3d 434, 445; *Menichini v. Grant* (3rd Cir. 1993) 995 F.2d 1224, 1230; *Amerus Life Insurance Company v. Bank of America, N.A.* 2006 Westlaw 2781059, (2006) 143 Cal.App.4th 631.

There is some authority to support the proposition that the collecting bank should be allowed to assert the defenses available to the drawee bank, most notably those based upon the passage of time. See *Allied Concord v. Bank of America* (1969) 275 Cal.App.2d 1. However, at least one decision has limited such to claims sounding in breach of warranty. See *Sun 'n Sand v. United California Bank* (1978) 21 Cal.3d 671, 698.

5. **Doctrine of Superior Equities.**

As in the context of payor claims against the drawee bank, discovery should be taken early on to determine if the plaintiff has insurance for all or part of its loss. If so, the doctrine of superior equities may operate to bar those claims for which the plaintiff has been compensated by insurance. See *Meyers v. Bank of America, supra,* 11 Cal.2d 92.

B. **Claims By the Payee against the Depository Bank.**

1. **General Principles and Comparative Fault Issues.**

The final, common area of consumer claims raised against banks or credit unions relating to the negotiation of checks are those brought by a payee against the depository bank for accepting an instrument on the strength of an allegedly forged endorsement. Under Commercial Code § 3420(a) "The law applicable to conversion of personal property applies to instruments.

An instrument is also converted if it is taken by transfer, other than in negotiation, from a person not entitled to enforce the instrument or a bank makes or takes payment with respect to the instrument not entitled to enforce the instrument or receive payment. An action for conversion of an instrument may not be brought by (1) the issuer or acceptor of the instrument or (2) a payee or endorsee who did not receive delivery of the instrument either directly or through delivery to an agent or co-payee . . ."

Thus, where a check is delivered to a payee or the payee's agent and then negotiated at the depository bank on the strength of a forged endorsement, the payee will have a claim sounding in conversion against the depository bank. Commercial Code §3420(a). See, e.g., *Lewis v. Telephone Employees Credit Union* (9th Cir. 1996) 87 F.3d 1537, 1552; *In Re Bartoni-Corsi Produce, Inc.* (9th Cir. 1997) 130 F.3d 857, 861, 862; *Stenseth v. Wells Fargo Bank, supra,* 41 Cal.App.4th 457, 466.

In analyzing such claims, however, it is important to remember that, as discussed above, the legislature has modified the rule of § 3420 in situations where an employer's responsibility for an instrument is involved in the allegedly fraudulent activity. Under Commercial Code § 3404, if the instrument is issued to a person who is not intended to have any interest in the instrument, but deposited to an account set up in that person's name, ostensibly and done so in compliance with ordinary care standards, the named payee will not have any interest in the instrument and thus not be able to raise a claim sounding in conversion.

Similarly, where a check is received by an employee of payee and then converted by way of a forged endorsement of that payee's name, Commercial Code § 3405 will operate to reduce or eliminate the collecting bank's liability where the employee has responsibility for the item. See, Commercial Code § 3405; *Lee Newman M.D. v. Wells Fargo Bank, supra,* 87 Cal.App.4th 73. Thus, under Commercial Code § 3405, at a minimum, the loss will be allocated under principles of comparative fault. See, Commercial Code § 3405. However, where the institution *does* exercise ordinary care, the endorsement by the employee or one of his cohorts in the name of the person to whom the instrument is made payable or for deposit in an account substantially similar in the name of that person should insulate the institution from liability.

Two important threads can be seen in claims where this section becomes relevant.

The first common area will arise in the context of a so-called third party check. Under such instrument, a check is payable to one party and then endorsed for further payment over to a third party, typically the defalcating employee. As noted in Clark, 90% of institutions accept such items, most without extraordinary review. Clark, <u>The Law of Bank Deposits and Collections</u>, vol. 2, p.12-148.

Another common area giving rise to such claims will be in situations where the payee's employee has set up an account at the institution ostensibly in the name of his or her employer. He or she then brings the instruments for deposit to the account. It is frequently alleged that such accounts were not open with ordinary care standards, supporting claims under § 3405. See, official comment 4 to the Commercial Code § 3405.

2. **Damages.**

Commercial Code § 3420(b) specifically limits the liability of the collecting institution to, at the most, the amount of the instrument. See, *Gil v. Bank of America, supra,* 138 Cal.App.4th 1371; *Stenseth v. Wells Fargo Bank, supra,* 41 Cal.App.4th 457. Emotional distress damages, punitive damages and consequential damages are typically not recoverable. See, Commercial Code §§ 1106, 3420(b). Even outside the context of Commercial Code § 3405, a forged endorsement should give rise to a comparative fault defense under Commercial Code § 3406.

Punitive damages are typically not allowed in such claims. See, Commercial Code § 1106(i). Additionally, attorneys fees are typically not recoverable. See, *Stenseth v. Wells Fargo Bank, supra,* 41 Cal.App.4th 457; *Gil v. Bank of America, supra,* 138 Cal.App.4th 1371; Code of Civil Procedure § 1021; *Grasso v. Crow* (1997) 57 Cal.App.4th 849, 850.

3. **Limitations.**

Claims in this category are likely subject to the three year limitations period of Code of Civil Procedure § 338 and Commercial Code § 3118, without regard to tolling except where the institution engaged in fraudulent concealment of the acts. See, e.g., *Rodrigue v. Olin Employees Credit Union* (7th Cir. 2005) 406 F.3d 434, 445; *Menichini v. Grant* (3rd Cir. 1993) 995 F.2d 1224, 1230; *Amerus Life Insurance Company v. Bank of America, N.A.* 2006 Westlaw 2781059, (2006) 143 Cal.App.4th 631.

4. **Doctrine of Superior Equities.**

The doctrine of superior equities should also be analyzed in this context to determine the extent to which it may operate to bar those claims for which the plaintiff has been compensated by insurance. See *Meyers v. Bank of America* (1938) 11 Cal.2d 92.

IV. **CONCLUSION.**

The U.C.C. establishes a comprehensive framework for the resolution of disputes with depositors and parties to negotiable instruments. It and cases decided under it should be consulted closely in evaluating the rights and responsibilities of the parties.

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