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U.C.C. Section 3-405: Of Imposters, Fictitious Payees, and Padded Payrolls

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U.C.C. SECTION 3-405: OF IMPOSTORS, FICTITIOUS PAYEES, AND
PADDED PAYROLLS

INTRODUCTION

The widespread use of checks and the commercial need to be secure in their use necessitates that the allocation of losses caused by forged indorsements be clearly defined. The Uniform Commercial Code (Code) attempts to provide uniform and definite rules that establish the relationship between banks and their customers and allocate forgery losses based on the relative responsibilities of the parties. Because the Code is generally very certain in its application, it can often be quickly determined who will sustain the loss caused by a forgery. The contractual relationship between a bank and its customer requires that the bank pay out its depositor's funds only in strict accordance with his instructions. By making a check payable to the order of a named payee, a drawer instructs the drawee bank to pay funds from his account to that payee only upon receiving the payee's authorized indorsement. Because a forged indorsement constitutes an unauthorized signature, the drawee bank cannot rightfully debit its drawer's account, and thus it sustains the initial forgery loss unless it has a defense or the drawer is precluded from asserting the forgery. The loss does not remain with the drawee, however, because the

1. Checks today serve as a virtual cash substitute and are the most common method of transferring funds. It has been estimated that 90% of all business dealings involve payment by check. Note, Forgeries and Material Alterations: Allocation of Risks Under the Commercial Code, 50 B.U. L. Rev. 536, 536 (1970); see Leary, Check Handling Under Article Four of the Uniform Commercial Code, 49 Marq. L. Rev. 331, 333 (1965).
5. U.C.C. § 1-201(4).
6. When a check is drawn to the order of a named payee, that payee's indorsement is essential to make the transferee a holder. Id. § 3-202(1). A forged indorsement is wholly inoperative as the payee's signature, id. § 3-404(1), because it is an unauthorized signature. Id. § 1-201(43). When a check contains a forged indorsement, therefore, the transferee is not a holder. Only a holder or one acting in his behalf can properly present a check and receive payment. Id. § 3-504(1).
Consequently, the bank cannot charge its customer's account for the check because it can do so only for "properly payable" items. Id. § 4-401(1); see J. White & R. Summers, Handbook of the Law Under the Uniform Commercial Code § 17-3, at 559 (1972).
7. See Check Frauds, supra note 3, at 210-11: In certain factual situations, U.C.C. § 3-405 provides that an indorsement by someone other than the payee will nonetheless be effective, and a bank will have a defense to a drawer's attempt to have his account recredited because of the forged indorsement. See pt. II infra. A drawer may also be precluded from asserting a forgery caused by his own negligence, U.C.C. § 3-406, his failure to discover and report unauthorized signatures within prescribed time limits, id. § 4-406(4), or because he ratified the unauthorized

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Code provides that each person who transfers a check warrants that he has good title to it. A forged indorsement is ineffective to pass title, and thus the loss can be passed back in the chain of collection because the transfer of a check containing a forged indorsement constitutes a breach of the statutory warranty of good title to the instrument. U.C.C. §§ 3-417(1)(a), 4-207(1)(a). This warranty is also made whenever there is a transfer of a check for a consideration. Id. §§ 3-417(2)(a), 4-207(2)(a). The warranties under § 3-417 and § 4-207 are virtually identical. The § 3-417 warranties, however, are given by any transferor, while the § 4-207 warranties are given only by bank customers and collecting banks.

8. Any person or collecting bank who obtains payment or acceptance warrants that he has good title to the instrument. U.C.C. §§ 3-417 warranties, however, are given by any transferor, while the § 4-207 warranties are given only by bank customers and collecting banks.


10. The loss shifting can be accomplished by a variety of actions. The Code clearly contemplates an action by the drawer against the drawee bank, see U.C.C. § 4-401, and a subsequent action by the drawee against the collecting bank or presenter for breach of the statutory warranty of good title. Id. §§ 3-417, 4-207; see, e.g., East Gadsden Bank v. First City Nat'l Bank, 50 Ala. App. 576, 578, 281 So. 2d 431, 432 (Civ. App. 1973); Thieme v. Seattle-First Nat'l Bank, 7 Wash. App. 845, 849-50, 502 P.2d 1240, 1243-44 (1972); H. Bailey, Brady on Bank Checks § 15.10 (4th ed. 1969 & Supp. No. 2 1979). The Code makes no provision for a direct suit by the drawer against the collecting bank. Some courts, however, have allowed such an action on the basis that the warranties of the collecting bank extend by implication to the drawer, reasoning that this approach reduces the circuity of actions otherwise necessary. In such cases, the courts have allowed the collecting bank to assert against the drawer all the defenses that the drawee bank would have. See, e.g., Prudential Ins. Co. v. Marine Nat'l Exch. Bank, 315 F. Supp. 520, 522 (E.D. Wis. 1970); Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d 671, 682-83, 582 P.2d 920, 928-29, 148 Cal. Rptr. 329, 337-38 (1978); Insurance Co. of N. America v. Atlas Supply Co., 121 Ga. App. 1, 5, 172 S.E.2d 632, 636 (1970). See generally Comment, Drawer v. Collecting Bank for Payment of Checks on Forged Indorsements—Direct Suit Under the Uniform Commercial Code, 45 Temple L.Q. 102 (1971). Other courts have refused to allow a direct action, holding that the substantive rights of the collecting banks would be impaired because they would be unable to assert all the defenses available to a drawee. See, e.g., Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co., 435 Mass. 1, 10, 108 N.E.2d 358, 363 (1962); Life Ins. Co. v. Snyder, 141 N.J. Super. 539, 544, 358 A.2d 859, 862 (Passaic Dist. Ct. 1976); Titan Air Conditioning Corp. v. Chase Manhattan Bank, N.A., 61 A.D.2d 764, 765, 402 N.Y.S.2d 12, 14 (1978) (mem.).

The Code also provides that paying a check with a forged indorsement constitutes conversion, U.C.C. § 3-419(1)(c), but does not explain who the proper plaintiffs or defendants are. See J. White & R. Summers, supra note 6, § 15-4. The courts have generally recognized that the payee is the proper party to bring the conversion action because he is the "true owner" of the check. See, e.g., Saf-T-Boom Corp. v. Union Nat'l Bank, 236 Ark. 518, 522, 367 S.W.2d 116, 119 (1963); Cooper v. Union Bank, 9 Cal. 3d 371, 377-78, 507 P.2d 609, 614, 107 Cal. Rptr. 1, 6 (1973); T. Quinn, supra note 7, § 3-419[A][4][a]. The payee has been permitted to bring suit against the drawee bank. See, e.g., Barden & Robeson Corp. v. Tompkins County Trust Co., 67 Misc. 2d 587, 588-89, 324 N.Y.S.2d 543, 544 (Sup. Ct. 1971); North Carolina Nat'l Bank v. McCarley & Co., 34 N.C. App. 689, 693, 239 S.E.2d 583, 587 (1977). Courts have also allowed the payee to bring a conversion action against the collecting bank. See, e.g., Cooper v. Union Bank, 9 Cal. 3d 371, 380-82, 507 P.2d 609, 616-17, 107 Cal. Rptr. 1, 9 (1973); Robert A. Sullivan Constr. Co. v. Wilton Manors Nat'l Bank, 290 So. 2d 561, 562 (Fla. Dist. Ct. App. 1974).
warranty.11 The loss will therefore fall on the first person who dealt with the forger or on the forger himself.12

Section 3-405 of the Code provides an exception to these general rules and, in certain factual situations, treats anyone's indorsement in the name of the payee as effective to pass title to the check.13 When an impostor assumes another's

Code limits the liability of a representative, including a collecting bank, in a conversion action to the amount of proceeds in its hands, provided that it dealt with the instrument in good faith and in accordance with reasonable commercial standards. U.C.C. § 3-419(3). Courts, however, have narrowly interpreted the statute to exclude from the definition of representative a collecting bank that cashes a check for the forger, see, e.g., Ervin v. Dauphin Trust Co., 38 Pa. D. & C. 2d 473, 482-83 (Dauphin County Ct. 1965), and to find that a collecting bank that has received a final credit from the drawee bank retains the "proceeds" even though the forger has been paid the amount of the check. Cooper v. Union Bank, 9 Cal. 3d 371, 384-85, 507 P.2d 609, 619-20, 107 Cal. Rptr. 1, 6-7 (1973). For an analysis of the Cooper court's effective elimination of the § 3-419(3) defense in contradiction of the Code's intention, but approving the result as facilitating direct action against collecting banks, see 74 Colum. L. Rev. 104 (1974); 5 Rut.-Cam. L.J. 319 (1974).

Pre-Code law was divided as to whether the drawer was the proper plaintiff in a conversion action. See Annot., 99 A.L.R. 2d 637 (1965). Because the Code does not specify whether the drawer is entitled to bring such an action, state courts may continue to apply their own common law. See Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 4-5, 184 N.E.2d 358, 363 (1962). The courts that have reached this issue under the Code have generally not allowed the drawer to bring a conversion action because he is not the true owner of the check and would not be able to present the check for payment. See, e.g., Central Cadillac, Inc. v. Stern Haskell, Inc., 356 F. Supp. 1280, 1283 (S.D.N.Y. 1972); Allied Concord Financial Corp. v. Bank of America Nat'l Trust & Sav. Ass'n, 275 Cal. App. 2d 1, 7, 80 Cal. Rptr. 622, 626-27 (1969); Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 9-10, 184 N.E.2d 358, 363 (1962); Life Ins. Co. v. Snyder, 141 N.J. Super. 539, 545, 358 A.2d 859, 862 (Passaic Dist. Ct. 1976). A recent case has allowed such an action when the depositary bank cashed a check in disregard of a restrictive indorsement even though the forged indorsement was effective under U.C.C. § 3-405. See pt. II infra. The cause of action was allowed because U.C.C. § 3-206 places liability for disregard of a restrictive indorsement solely on the first bank that takes the check and the cause of action therefore could not be asserted against the drawee. Underpinning & Foundation Constructors, Inc. v. Chase Manhattan Bank, N.A., 46 N.Y.2d 459, 466-67, 386 N.E.2d 1319, 1322, 414 N.Y.S.2d 298, 302-03 (1979).

11. See, e.g., Kelton Motors, Inc. v. Phoenix of Hartford Ins. Cos., 522 F.2d 728, 729 (2d Cir. 1975) (per curiam); Maddox v. First Westroads Bank, 199 Neb. 81, 89, 256 N.W.2d 647, 653 (1977); Myers v. First Nat'l Bank, 42 A.D.2d 657, 658, 345 N.Y.S.2d 204, 206 (1973) (mem.). Because each presenter warrants his own good title and that of any prior transferor, each subsequent party in the collection chain has a cause of action for breach of warranty against all prior parties. U.C.C. §§ 3-417[1][a], 4-207[1][a]; see T. Quinn, supra note 7, ¶¶ 3-417[A][1][2], 4-207[A][2]-[3].

12. The forger is liable on the instrument because the forgery operates as his signature in favor of any person who in good faith pays the instrument or takes it for value. U.C.C. § 3-404(1). Even when the forged indorsement is deemed effective under § 3-405 and is no longer treated as a forgery, see pt. II infra, the forger still remains liable on the instrument. U.C.C. § 3-405(2) & Comment 5. As a practical matter, however, the forger has typically absconded with the funds before the forgeries are discovered. Even if he can be located, it may be impossible to recover payment from him because he is frequently insolvent. See Liability Variations, supra note 7, at 417; Comment, Allocation of Losses from Check Forgeries Under the Law of Negotiable Instruments and the Uniform Commercial Code, 62 Yale L.J. 417, 417 (1953) [hereinafter cited as Allocation of Losses].

13. U.C.C. § 3-405 provides that, in these circumstances, the indorsements will be "effective." See T. Quinn, supra note 7, ¶ 3-405[A][1][2].
identity and induces the drawer to issue him a check payable in that assumed name, the Code treats the indorsement in the assumed name as effective and allocates the loss to the drawer because his failure to determine the impostor's true identity is deemed to be the cause of the loss. Similarly, when a drawer or his authorized agent makes a check payable to a payee and intends that the payee not actually receive the proceeds of the check, an indorsement in the payee's name will not be considered a forgery under the "fictitious payee" rule because the drawer's actions have guaranteed that a valid indorsement will not be obtained. Finally, the "padded payroll" rule provides that when an employee supplies the name of a payee to his employer intending that the designated payee have no interest in the check, the drawer's lack of care in supervising his employee is deemed to justify the allocation of the forgery loss to him. Section 3-405 allocates the loss to the drawer in these situations because the responsibility for the payment on the forged indorsement is considered more properly attributable to the drawer's actions than to the failure of the bank to obtain a valid indorsement.

Section 3-405 should be recognized and treated as a risk allocation system because it provides a rule that is certain once the parameters of the section are determined and the factual situations to which it applies are clearly identified. This Note will examine the development of the impostor, fictitious payee, and padded payroll rules and contend that the current judicial interpretations of section 3-405 must be reconsidered in order to achieve uniformity in the section's application. Part I will trace the pre-Code treatment of these rules under the common law and the Negotiable Instruments Law (NIL), identifying the scope of their coverage and the rationales for their use. Part II will examine the current judicial treatment of section 3-405 and argue that the factual situations that have been excluded from the coverage of the section need to be reexamined and a more liberal interpretation of the statutory language adopted in order to allocate the losses in a manner consistent with the Code's policy considerations.

I. PRE-CODE LAW

The impostor and fictitious payee rules were well established at common law as exceptions to the general rule of placing losses caused by forged indorsements on the first party to deal with the forger. These exceptions

14. U.C.C. § 3-405(1)(a); see pt. II(B) infra.
15. U.C.C. § 3-405(1)(b); see pt. II(C) infra.
16. U.C.C. § 3-405(1)(c); see pt. II(D) infra.
17. See U.C.C. § 3-405, Comments 2, 4.
18. "In commercial law, perhaps more than in any other field, Justice Brandeis' famous dictum holds true: '[I]t is more important that the applicable rule of law be settled than that it be settled right.' " Comment, The Fictitious Payee and the UCC—The Demise of a Ghost, 18 U. Chi. L. Rev. 281, 286 (1951) (quoting Burnet v. Coronado Oil & Gas Co., 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting)).
19. See, e.g., Forbes & King v. Espy, Heidelbach & Co., 21 Ohio St. 474, 483 (1871) (fictitious payee rule); J. Brady, The Law of Forged and Altered Checks § 63, at 299 (1925) (impostor rule). The fictitious payee doctrine developed from the holding of the court in Minet v. Gibson, 100 Eng. Rep. 689 (K.B. 1789). Elliot v. Smitherman, 19 N.C. (2 Dev. & Bat.) 338 (1837), seems to have been the earliest application of the impostor rule.
were also recognized under the NIL. By the time the Code was enacted, these rules, originally based on principles of negligence and estoppel, had hardened into fixed rules of liability.

A. Impostors

At common law, when an impostor induced a drawer to issue a check to him in another person's name by impersonating that other person, the impostor's indorsement in the payee's name was not treated as a forgery. The policy basis for this rule was that the drawer was considered to have intended to issue the check to the person he dealt with, and the impostor, even though he had assumed another's name, was the person for whom the proceeds were intended. In refusing to consider his indorsement a forgery, the courts reasoned that they were simply carrying out the drawer's intention. The drawer was also considered negligent in dealing with the impostor and not discovering his true identity. Between the two innocent parties—the defrauded drawer and the bank—it was considered more equitable to place the loss on the party who had a better opportunity to discover the imposture. When the NIL was enacted, it contained no provision that directly addressed the impostor situation. Because the NIL provided that the common law would still apply in the absence of a controlling NIL provision, the courts continued to apply the common law impostor rule.

Although the impostor rule was generally accepted by the courts, application of the doctrine was inconsistent and artificial distinctions were drawn between similar factual situations. The primary cause of this inconsistency was the courts' adherence to the notion that the drawer had a double intent—to pay both the impostor himself and the named payee—and liability rested upon a determination of the drawer's "dominant" intent. When the drawer and the impostor dealt in person, the courts found that the drawer's dominant intent was to make the check payable to the person with whom he

20. See, e.g., Hoge v. First Nat'l Bank, 18 Ill. App. 501, 506 (1886); Robertson v. Coleman, 141 Mass. 231, 233, 4 N.E. 619, 620 (1886); Crippen, Lawrence & Co. v. American Nat'l Bank, 51 Mo. App. 508, 517 (1892); Allocation of Losses, supra note 12, at 427. See generally W. Britton, Handbook of the Law of Bills and Notes § 151 (2d ed. 1961). Because the impostor's signature was treated as a valid indorsement, the drawee could rightfully debit the drawer's account. Rhode Island rejected the impostor doctrine in cases in which the impostor pretended to be an actual person about whom the drawer could inquire, but left open the question of whether the impostor rule would apply to an imposture of a fictitious person. See, e.g., Tolman v. American Nat'l Bank, 22 R.I. 462, 464-65, 48 A. 480, 481-82 (1901). See generally Abel, The Impostor Payee: Or, Rhode Island Was Right (pt. 1), 15 Wis. L. Rev. 161 (1940)


23. N.I.L. § 196.

24. Although some courts held that the rule was encompassed by certain sections of the NIL, it was generally agreed that no provision specifically addressed the impostor situation. See Abel, supra note 20, at 201-17; New York Study, supra note 21, at 1001.
had dealt—the impostor under his assumed name.\textsuperscript{25} This certainty lessened, however, when the impostor utilized the telegraph, telephone, or mails to implement his fraud. Although the majority of courts applied the impostor rule in this situation as well,\textsuperscript{26} some courts held that the drawer's dominant intent was to deal with the named payee and not the impostor, and thus the impostor's indorsement was considered a forgery.\textsuperscript{27} This distinction, however, was a complete fiction that was not based on the facts of the cases. Because the drawer believes the impostor and the named payee to be the same person, determining his dominant intent created a distinction without a factual basis.\textsuperscript{28}

The New York courts further modified the impostor rule to require prior dealings between the drawer and the impostor before they would find that the drawer intended the proceeds to be paid to the impostor. Unless the drawer had dealt with the impostor on a previous occasion, he was held to have intended to make payment to the named payee even though he dealt with the impostor face-to-face.\textsuperscript{29} In other jurisdictions, a finding of prior dealings between the drawer and the named payee precluded the operation of the impostor rule because it was deemed to evidence the drawer's intention to make the checks payable to the person he already knew—the designated payee.\textsuperscript{30}

The courts also refused to apply the impostor rule when the impostor, instead of impersonating another person, pretended to be another's agent or representative. When the drawer issued a check payable to a principal and entrusted it to an impostor, the courts held that his intent was to make payment to the principal. The agent's indorsement in the name of the

\begin{itemize}
  \item \textsuperscript{27} See, e.g., Russell v. Second Nat'l Bank, 136 N.J.L. 270, 276, 55 A.2d 211, 215-16 (1947); Mercantile Bank v. Silverman, 148 A.D. 1, 5-6, 132 N.Y.S. 1017, 1019-20 (1911), aff'd, 210 N.Y. 567, 104 N.E. 1134 (1914). The impostor rule was also held inapplicable when the imposture was made in person, but the check was sent through the mails. See, e.g., District Nat'l Bank v. Washington Loan & Trust Co., 65 F.2d 831, 833 (D.C. Cir. 1933).
  \item \textsuperscript{28} "Perhaps, in truth, both intents are so inseparable that the choice of one intent rather than the other is purely arbitrary—an example of rationalization, perhaps unconscious, to reach a desired result." Cohen v. Lincoln Sav. Bank, 275 N.Y. 399, 407-08, 10 N.E.2d 457, 461 (1937). The Code specifically rejected the dominant intent test. U.C.C. § 3-405, Comment 2; see note 68 infra and accompanying text.
  \item \textsuperscript{29} See, e.g., Mohr v. Lawyers Trust Co., 282 N.Y. 770, 27 N.E.2d 48 (1940) (mem.); Cohen v. Lincoln Nat'l Bank, 275 N.Y. 399, 411, 10 N.E.2d 457, 462-63 (1937); New York Study, supra note 21, at 1006.
  \item \textsuperscript{30} See, e.g., Moore v. Moultrie Banking Co., 39 Ga. App. 687, 687, 148 S.E. 311, 311 (1920); Rossi v. National Bank, 71 Mo. App. 150, 162 (1897); Rivara v. Delaware, L. & W.R.R., 98 N.J.L. 290, 290-91, 119 A. 6, 7 (1922) (per curiam).\end{itemize}
principal was therefore considered a forgery, and the loss caused by the fraud was allocated according to the normal rules governing forged indorsements.\textsuperscript{31}

B. Fictitious Payees

When a drawer issued an instrument payable to the order of a fictitious payee, the common law courts treated the item as payable to the bearer of the check.\textsuperscript{32} Because such an instrument did not require an indorsement to be validly negotiated, it could be enforced against the drawer even though the indorsement of the payee was forged.\textsuperscript{33} The fictitious payee rule developed from a principle of estoppel that the drawer who made a check payable to the order of a fictitious payee had "effectively eliminated the possibility of a valid indorsement ever being placed on the check."\textsuperscript{34} Because the only possible indorsement on the check would be a forgery, the drawer was estopped from denying the authenticity of the signature.\textsuperscript{35} In some circumstances, a drawer might draw such a check for a dishonest purpose of his own, such as to cause someone to rely on the credit of the fictitious person.\textsuperscript{36} The most common application of the rule, however, was when an agent authorized to sign checks on behalf of the drawer embezzled funds by drawing checks payable to fictitious payees and negotiating them on his own behalf.\textsuperscript{37} The drawer sustained the forgery loss in this situation because payment was deemed to be in accordance with the instructions to pay the bearer.\textsuperscript{38}

The fictitious payee rule was codified in the NIL, which provided that an instrument was payable to bearer "[w]hen it is payable to the order of a fictitious or non-existing person and such fact was known to the person making it so payable."\textsuperscript{39} The rule clearly applied when the check was made payable to a non-existing payee. Although the courts debated the question of

\begin{footnotes}
\footnotetext{31}{See, e.g., Bank of Fort Mill v. Lawyers Title Ins. Corp., 268 F.2d 313, 316 (4th Cir. 1959); Russell v. First Nat'l Bank, 2 Ala. App. 342, 351, 56 So. 868, 871 (1911); Strang v. Westchester County Nat'l Bank, 235 N.Y. 68, 72, 138 N.E. 739, 740-41 (1923); Check Frauds, supra note 3, at 225-26.}
\footnotetext{32}{See, e.g., Foster v. Shattuck, 2 N.H. 446, 447-48 (1822); Irving Nat'l Bank v. Alley, 79 N.Y. 536, 540 (1880); Minet v. Gibson, 100 Eng. Rep. 689, 689 (K.B. 1789); W. Britton, supra note 20, § 148.}
\footnotetext{33}{See, e.g., Hortsman v. Henshaw, 52 U.S. (11 How.) 177, 183 (1850); Foster v. Shattuck, 2 N.H. 446, 447-48 (1822); Kulp, The Fictitious Payee, 18 Mich. L. Rev. 296, 301 (1920).}
\footnotetext{34}{Pacific Indemnity Co. v. Security First Nat'l Bank, 248 Cal. App. 2d 75, 88, 56 Cal. Rptr. 142, 150 (1967).}
\footnotetext{35}{See, e.g., Coggill v. American Exch. Bank, 1 N.Y. 113, 117 (1847); Meacher v. Fort, 21 S.C.L. (3 Hill) 227, 229 (1837); Check Frauds, supra note 3, at 215.}
\footnotetext{36}{Kulp, supra note 33, at 301.}
\footnotetext{38}{In the typical situation of the embezzling agent, the loss was placed on the drawer because he was the one who had given the agent the power to draw checks. See, e.g., Goodyear Tire & Rubber Co. v. Wells Fargo Bank & Union Trust Co., 1 Cal. App. 2d 694, 718, 37 P.2d 483, 493-94 (1934).}
\footnotetext{39}{N.I.L. § 9(3).}
\end{footnotes}
whether a "fictitious" payee could be an actual person or company, it was
generally held that the drawer's subjective intent that the payee have no
interest was sufficient to bring the check within the scope of the statute.40

A question that frequently arose under the fictitious payee rule was whether
the knowledge of an employee who supplied his employer with the name of a
fictitious payee, by adding an additional name to the payroll, presenting
forged invoices, or preparing a check for signature, would be deemed to be a
"fact known to the person making [the check] so payable" when the employer
actually signed the check. Most courts excluded this situation from the
coverage of the rule and required that the knowledge had to be that of the
drawer or his agent authorized to sign checks.41 Under this rationale,
an employee's intention would govern for purposes of the statute only when he
actually signed the checks with authority to do so. His indorsement was
otherwise treated as a forgery as long as the checks were actually signed by
the employer. An amendment to the NIL attempted to eliminate the distinc-
tions drawn by the courts between the two types of employee embezzlement
by also shifting liability to the drawer when his agent or employee supplied
the name of a fictitious payee.42 The attempt to achieve uniformity never
succeeded, however, because the amendment was adopted by only half of the
states.43

When a check required two drawers' signatures and only one was an
embezzler, the courts held that the intention of the "dominant party" gov-
erned for purposes of the statute.44 Some courts reasoned that if the embezzler
actually wrote out the check, he was the dominant party and the person
making the check payable.45 Other courts held that the intention of the

40. See, e.g., Norton v. City Bank & Trust Co., 294 F. 839, 844 (4th Cir. 1923); Mueller &
Martin v. Liberty Ins. Bank, 187 Ky. 44, 45-46, 218 S.W. 465, 466-67 (1920); Choctaw Grain Co.
v. First State Bank, 175 Okla. 458, 460, 53 P.2d 579, 581 (1936). Although the common law courts
generally considered the subjective intent of the drawer in determining whether a payee was to be
considered fictitious, a few courts considered it necessary that the payee actually be nonexistent.
Lane v. Kreekle, 22 Iowa 399, 404 (1867) (dictum); Kohn v. Watkins, 26 Kan. 691, 699-700 (1882).
These courts alone adhered to this view. See J Brannan, supra note 25, § 9(3), at 223; Kulp, supra
note 33, at 303 n.30.
41. See, e.g., City of St. Paul v. Merchants Nat'l Bank, 151 Minn. 485, 48-89, 187 N.W. 516,
518 (1922); National Surety Co. v. National City Bank, 184 A.D. 771, 776, 172 N.Y.S. 413, 417
(1918); Liberty Mut. Ins. Co. v. First Nat'l Bank, 151 Tex. 12, 16-17, 245 S.W.2d 237, 239-40
1176, 1181 (Mo. Ct. App.), aff'd, 197 S.W. 115 (Mo. 1917).
42. The amendment added "or known to his employee or other agent who supplies the name
of such payee" to the statute. W. Britton, supra note 20, § 148, at 425.
43. The amendment was adopted in 24 states by 1959. Id. For examples of the amendment's
application, see, e.g., Edgington v. Security-First Nat'l Bank, 78 Cal. App. 2d 849, 853, 179
P.2d 640, 643 (1947); Orton Crane & Shovel Co. v. Federal Reserve Bank, 345 Ill. App. 284,
287-88, 102 N.E.2d 663, 664-65 (1951); Prugh, Combest & Land, Inc. v. Linwood State Bank,
241 S.W.2d 83, 89 (Mo. Ct. App. 1951). For a comparison of the differing results under the
original N.I.L. § 9(3) and the amendment, see Swift & Co. v. Bankers Trust Co., 280 N.Y. 135,
139, 19 N.E.2d 992, 994 (1939).
44. See W. Britton, supra note 20, § 150, at 138.
45. See, e.g., Goodyear Tire & Rubber Co. v. Wells Fargo & Union Trust Co., 1 Cal. App. 2d
694, 709, 37 P.2d 483, 488 (1934); Globe Indemnity Co. v. First Nat'l Bank, 133 S.W.2d 1066,
1071-72 (Mo. Ct. App. 1939); Tri-Bullion Smelting & Dev. Co. v. Corliss, 186 A.D. 613, 620, 174
second cosigner governed when he examined documents supporting the validity of the check instead of relying on the embezzler, and thus the indorsement was a forgery. This distinction as to whether the embezzler was the dominant cosigner was not a realistic one because, as a practical matter, it was the embezzler's intention—that the named payee would have no interest—that was realized. Furthermore, there was no discernible policy basis for allocating the loss to the drawer when the cosigner whose signature was necessary for negotiation relied upon the other signer's drawing of the check, and leaving the loss with the collecting bank when the required signature was placed on the check in reliance upon an employee's supplying the payee's name.

II. APPLICATION OF U.C.C. SECTION 3-405

The Code was designed to provide a uniform statute that would clarify the inconsistent case law that had arisen under the NIL. Section 3-405 expanded the impostor rule and specifically included both the fictitious payee and padded payroll situations within its coverage. The section provides a risk allocation system that operates as an exception to the Code's general forged indorsement rules, and allocates the forgery loss to the drawer in the governed situations because the forgery loss is deemed attributable to the drawer's actions rather than to the bank's paying the check over a forged indorsement. The drafters attempted to ensure uniformity by addressing the pre-Code inconsistencies directly and articulating in the official comments the policy reasons for holding the drawer liable.

A. The Need for an Indorsement

When a factual situation falls within the coverage of section 3-405, "an indorsement . . . in the name of a named payee is effective." The indorsement is not considered a forgery and, because valid title to the check is passed, the drawer will generally be left with the loss. The Code specifically rejects the bearer paper fiction of the NIL and requires an indorsement in N.Y.S. 830, 835 (1919), aff'd, 230 N.Y. 629, 130 N.E. 921 (1921), Dorsey v Houston Nat'l Bank, 338 S.W.2d 540, 543-44 (Tex. Civ. App. 1960).

46. See, e.g., Portland Postal Employees Credit Union v. United States Nat'l Bank, 171 Or 40, 63, 135 P.2d 467, 475-76 (1943); cf. McCann Steel Co. v. Third Nat'l Bank, 47 Tenn. App. 287, 303-04, 337 S.W.2d 886, 893-94 (1960) (defrauded steel company's intention governed when cosigner was subcontractor and not an agent of the company). The nonfraudulent cosigner's intention was considered to govern when he was the dominant party or when the intention of the cosigners was seen as equally controlling. See W. Britton, supra note 20, § 150, at 438.


48. See notes 2-12 supra and accompanying text.

49. In an attempt to facilitate uniform interpretation, the drafters of the Code included official comments following each text section which set forth the purposes of the specific provision. U.C.C. General Comment; see id. § 3-405, Comments 1-4.

50. U.C.C. § 3-405(1).


52. See note 39 supra and accompanying text.
order for the forgery loss to be allocated to the drawer. The statute is silent, however, as to whether the payee's name and the indorsement must be identical. Although the provision that the indorsement be "in the name of a named payee" might be construed to require a match between the name designated on the check and the indorsement, the comments to the section indicate that what is required is that the check have "what purports to be a regular chain of indorsements." Under normal circumstances, a check made payable to order is "negotiated by delivery with any necessary indorsement." A necessary indorsement, however, need not match the payee's name exactly and any symbol or mark intended as an indorsement will generally be sufficient. When a payee's name is misspelled or incorrectly designated on a check, his signature in his true name, the incorrect name, or both is a sufficient indorsement. In addition, a bank that takes an item for collection generally "may supply any indorsement of the customer which is necessary to title." Although it requires a normal chain of indorsements, the section 3-405 standard differs somewhat from what is necessary when an authorized check is processed. A depositary bank's stamp would not be a sufficient indorsement in a section 3-405 situation because the Code requires some indorsement for the section to be applicable. An indorsement in a name completely different from that of the designated payee would preclude the section's operation, although it normally would be sufficient when the check was made payable to...

53. "The instrument is not made payable to bearer and indorsements are still necessary to negotiation." U.C.C. § 3-405, Comment 1; see Wright v. Bank of Cal., Nat'l Ass'n, 276 Cal. App. 2d 485, 489-90, 81 Cal. Rptr. 11, 14 (1969); New York Study, supra note 21, at 1007.
54. U.C.C. § 3-405, Comment 1.
55. Id. § 3-201(1).
56. See id. §§ 1-201(39) & Comment 39, 3-401(2), -402.
57. Id. § 3-203. For example, a maker who incorrectly designated "Greenlaw & Sons Roofing & Siding Co." as payee on a note was not allowed to challenge the indorsement "Greenlaw & Sons by George M. Greenlaw." Watertown Fed. Sav. & Loan Ass'n v. Spanks, 346 Mass. 398, 399-400, 193 N.E.2d 333, 334 (1963).
58. U.C.C. § 4-205(1). The depositary bank's stamp to the effect that the item was deposited by the customer or credited to his account is as effective as the customer's own indorsement, unless the item specifically requires the payee's own indorsement. Id. See generally Bell, The Payor Bank and Its Customer: An Analysis of Recent Cases, 6 U. Tol. L. Rev. 110, 163-70 (1974).
59. See note 53 supra and accompanying text. There is a common law rule, however, that the drawer cannot assert the forgery if he has not suffered a loss because of it. He is therefore precluded from asserting a forged indorsement when the proceeds of the check actually reach the intended party. See, e.g., Commercial Credit Corp. v. Empire Trust Co., 260 F.2d 132, 134 (8th Cir. 1958); Florida Nat'l Bank v. Geer, 96 So. 2d 409, 412 (Fla. 1957); Blomquist v. Zions First Nat'l Bank, 18 Utah 2d 65, 68-69, 415 P. 2d 213, 215-16 (1966). This doctrine has also been applied under the Code. See, e.g., Perini Corp. v. First Nat'l Bank, 553 F.2d 398, 412-14 (5th Cir. 1977) (applied in a double forgery situation where the indorsements were not in the name of the payee as required by § 3-405); Gordon v. State Street Bank & Trust Co., 361 Mass. 258, 261-62, 280 N.E.2d 152, 154-55 (1972) (applied as an alternative rationale to § 3-405 when check was made payable to joint payees but only one was intended to receive the proceeds); Gotham-Vladimir Advertising Inc. v. First Nat'l City Bank, 27 A.D.2d 190, 192-93, 277 N.Y.S.2d 719, 722 (1967) (applied as an exception to § 3-404, which provides that an unauthorized indorsement is inoperative as the payee's signature).
a payee under an incorrectly designated name. For example, a check made payable to a business entity that is indorsed in a personal capacity does not comply with the statutory requirement because, in that instance, the indorsement is in a name other than that of the payee.

Although most decisions have held section 3-405 inapplicable only when the indorsement was in a different name than that of the payee or when no indorsement at all appeared, one recent case has held that an "exact match" between the payee's name and the indorsement was necessary. In Seattle-First National Bank v. Pacific National Bank, the court held that an indorsement in the name of "Sumner Motors" did not satisfy the requirement of section 3-405 when the checks were made payable to "Sumner Motors, Inc." and "Sumner Ford." By requiring an exact correlation between the two names, however, the court failed to recognize that the purpose of the indorsement requirement is to ensure that the check presents a normal appearance. A misspelling or omission of a word, such as "Inc.", that is not essential for identification and would not bar the negotiation of a check with an authorized indorsement should not bar the statute's application. A requirement of an exact match is also inappropriate when section 3-405 is viewed as an equitable loss allocation system. If a check is issued under one of the three applicable circumstances, the statute should operate to allocate the forgery loss to the drawer as long as the bank has obtained a signature that gives no notice of the irregularity.

B. Impostor Rule

Section 3-405(1)(a) codifies the impostor rule and provides that an indorsement is effective if "an impostor by use of the mails or otherwise has induced the maker or drawer to issue the instrument to him or his confederate in the name of the payee." The Code attempts to eliminate the inconsistent common law applications of the doctrine by rejecting the dominant intent fiction and the requirement of face-to-face dealing or prior negotiations between the parties. The policy behind the Code provision is that the drawer is in a better position to identify the impostor as such and, if he fails to do so, the bank that cashes the check for the forger should not be required to ascertain the impostor's true identity.

60. See note 57 supra and accompanying text.
63. Id. at 54, 587 P.2d at 623. The court relied on language in Twewman v. Lindell Trust Co., 534 S.W.2d 83, 92-93 (Mo. Ct. App. 1976), that an "exact match" was required. 22 Wash. App. at 54, 587 P.2d at 623.
64. See note 54 supra and accompanying text.
65. Courts have generally held that the negligence of a depositary bank cannot serve to defeat the operation of § 3-405. See notes 168-76 infra and accompanying text.
66. U.C.C. § 3-405(1)(a).
67. See notes 25-30 supra and accompanying text.
68. U.C.C. § 3-405(1)(a) & Comment 2; see H. Bailey, supra note 10, § 15.17, at 514; J. White & R. Summers, supra note 6, § 16-8, at 543; Allocation of Losses, supra note 12, at 465-66.
69. U.C.C. § 3-405, Comment 2; see Covington v. Penn Square Nat'l Bank, 545 P.2d 824,
Because the technical distinctions that resulted from determinations of the drawer's dominant intent are eliminated, the loss will be allocated to the drawer whether he was induced to draw a check to the impostor because of face-to-face dealings\textsuperscript{70} or through the mails.\textsuperscript{71} Indeed, it has been held that the impersonation need not be made directly to the drawer. In \textit{Philadelphia Title Insurance Co. v. Fidelity-Philadelphia Trust Co.},\textsuperscript{72} a woman, in order to obtain a mortgage loan on property belonging to her husband, attended a meeting with the attorney and real estate broker who were handling the transaction accompanied by a man who impersonated her husband. The court held that the man was an impostor within the meaning of section 3-405 even though the title insurance company, the drawer of the check, had not seen him.\textsuperscript{73} The court recognized that when the drawer relied upon third party representations—those of the attorney and the real estate broker—the imposture had been carried out “by use of the mails or otherwise.”\textsuperscript{74}

In \textit{Fair Park National Bank v. Southwestern Investment Co.},\textsuperscript{75} the court was faced with two questions arising under the impostor rule: first, whether a check made payable to joint payees is within the scope of section 3-405(1)(a) when an impostor impersonates only one of the payees; and second, whether a forged signature on a document presented to obtain payment from a drawer qualifies as an impersonation. In \textit{Fair Park}, a borrower had requested a loan from an investment company in order to purchase machinery from two nonexistent sellers. Someone appeared at the company's offices pretending to be one of the sellers and presented a bill of sale containing purported signatures of both sellers. As a result, the company issued a check in the name of the two sellers. The signature in the name of the seller whom the impostor had pretended to be was clearly effective and thus not a forgery.\textsuperscript{76} The court also held that the indorsement in the name of the other payee was effective, offering two rationales for this decision. First, the court reasoned that an imposture by one of the joint payees was sufficient for the rule to apply because of the Code's policy of allocating the loss to the drawer who had dealt with the impostor and had the better opportunity to discover the fraud.\textsuperscript{77} The court perceived no difference in the ability of the drawer to discover the imposture in this situation than when he dealt with a single payee.\textsuperscript{78} This well-reasoned holding of the court is consistent with the Code provision that its sections be liberally construed to carry out their underlying policies.\textsuperscript{79}


\textsuperscript{72} 419 Pa. 78, 212 A.2d 222 (1965).

\textsuperscript{73} \textit{Id.} at 85, 212 A.2d at 225.

\textsuperscript{74} \textit{Id.} at 84, 212 A.2d at 225.

\textsuperscript{75} 541 S.W.2d 266 (Tex. Civ. App. 1976).

\textsuperscript{76} \textit{Id.} at 268-69.

\textsuperscript{77} \textit{Id.} at 269-70.

\textsuperscript{78} \textit{Id.} at 270.

\textsuperscript{79} U.C.C. § 1-102(1).
Second, the court held that whoever had signed the name of the second payee on the bill of sale was also an impostor.\textsuperscript{80} In support of this position, the court noted that the statute covers impersonations conducted through "the mails or otherwise," and that delivery of the check can be made to a confederate of the impostor.\textsuperscript{81} The forged signature on the bill of sale presented by the confederate was therefore held to be sufficient to constitute an impersonation.\textsuperscript{82} This position is justifiable because the impostor carried out his impersonation through a confederate's representations.

The court in \textit{Fidelity & Deposit Co. v. Manufacturers Hanover Trust Co.} \textsuperscript{83} faced the similar question of whether a husband who presented a withdrawal slip with the forged signature of his wife to her bank could be considered an impostor.\textsuperscript{84} The court acknowledged that a man presenting a document with a woman's name would not be pretending to be the woman, but rather her authorized agent. In distinguishing this situation from a misrepresentation of agency\textsuperscript{85} and concluding that the man was an impostor, the court identified as a key factor whether the drawer was given anything to ascertain the identity of the principal. Because the bank, in this instance, was given the signature on the withdrawal order to be compared with the signature card it had in its files, the court concluded that the man was an impostor.\textsuperscript{86}

If this holding was correct, then presenting a forged signature on a supporting document would be sufficient to constitute an imposture. The court failed to recognize, however, that in order to be an impostor within the meaning of section 3-405, the defrauder, in addition to utilizing an assumed name, must impersonate another person and induce the drawer to believe that he is in fact dealing with that person.\textsuperscript{87} Because it is the impersonation that is the essential element, the use of an assumed name alone is insufficient to constitute an imposture.\textsuperscript{88} The \textit{Fidelity} decision is unfounded because it necessitates a finding that an impersonation occurs when someone appears before the drawer and does not pretend to be anyone other than himself. Although a person may be impersonating someone else when he signs that name on a document, he cannot be considered an impostor when he does not

\textsuperscript{80} 541 S.W.2d at 269.

\textsuperscript{81} \textit{Id.; see note 66 supra and accompanying text.}

\textsuperscript{82} 541 S.W.2d at 269.


\textsuperscript{84} Because the facts did not clearly indicate whether the slip was presented by the husband himself or by a woman impersonating his wife, the court examined both possibilities. If a woman had presented the slip and pretended to be the depositor, the factual situation would have been included within the impostor rule. \textit{Id.} at 963-64, 313 N.Y.S.2d at 826.

\textsuperscript{85} If the impostor misrepresents that he is another's agent, the situation is generally excluded from the impostor rule and his signature on the check remains a forgery. \textit{See} notes 92-100 \textit{infra} and accompanying text.

\textsuperscript{86} 63 Misc. 2d at 964, 313 N.Y.S.2d at 826.


\textsuperscript{88} \textit{See}, \textit{e.g.}, W.R. Grimshaw Co. \textit{v.} First Nat'l Bank & Trust Co., 563 P.2d 117, 122 (Okla. 1977) (impostor rule held not applicable when defrauder assumed another name throughout his dealings but always truthfully asserted his true identity as the son of the business owner).
pretend to be the person whose name is forged to the document. To hold otherwise would mandate a finding that every forged document presented personally or through the mails is the equivalent of an impersonation.

The Fidelity holding was properly rejected by the court in *East Gadsden Bank v. First City National Bank*. The court correctly distinguished between an impersonation and a misrepresentation accompanied by a forged supporting document. A loan applicant who presented a forged buyer's order for an automobile did not thereby impersonate the dealer whose signature was forged, but merely misrepresented that he was purchasing an automobile and used the forged buyer's order to convince the bank. He did not pretend to be the dealer or anyone other than himself and, consequently, the forged dealer's signature on the joint check was not effective.

The pre-Code exclusion of misrepresentations of agency from the impostor rule is continued on the theory that when a drawer takes the precaution of making the check payable to a principal, he is entitled to the principal's indorsement. If the drawer makes the check payable to the agent personally, however, the misrepresentation of agency is not a basis for exclusion from section 3-405 coverage because the drawer is dealing directly with the impostor in his personal capacity and not as an agent on behalf of his principal. For example, in *Covington v. Penn Square National Bank*, a James Beaird misrepresented to the drawer that he was an employee of a certain company. The drawer contacted the company and learned that a James Baird was employed there and made out a check in that name. James Beaird's indorsement in the name of James Baird was held to be effective notwithstanding the fact that the misrepresentation of agency had induced the drawer to deal with him. The court held that by issuing a check to the impostor in the name of James Baird, the drawer indicated that he intended to deal with the impostor.

The exclusion of misrepresentations of agency from the impostor rule has

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90. *Id.* at 580-81, 281 So. 2d at 434. The court reasoned that the loan applicant had strengthened his misrepresentation with the forged buyer's order, but had never led the drawer to believe he could negotiate the check on behalf of the dealer. *Id.* If in fact he had attempted to act as the dealer, he would have misrepresented his authority and it probably would have been a misrepresentation of agency as opposed to imposture. See notes 92-100 infra and accompanying text.
91. See note 31 supra and accompanying text.
92. See note 31 supra and accompanying text.
93. U.C.C. § 3-405, Comment 2; see, e.g., Maddox v. First Westroads Bank, 199 Neb. 81, 90, 256 N.W.2d 647, 653 (1977); Fidelity & Deposit Co. v. Chemical Bank N.Y. Trust Co., 62 Misc. 2d 509, 513-14, 309 N.Y.S.2d 266, 272-73 (N.Y.Civ. Ct.), rev'd on other grounds, 65 Misc. 2d 619, 318 N.Y.S.2d 957 (App. T. 1970) (per curiam), aff'd mem., 39 A.D.2d 1019, 333 N.Y.S.2d 762 (1972); Thieme v. Seattle-First Nat'l Bank, 7 Wash. App. 845, 849-50, 502 P.2d 1240, 1243-44 (1972). It has been suggested that Comment 2 to § 3-405 is in conflict with the statutory language, which does not exclude misrepresentations of agency and would cover an impostor who appeared on behalf of a third person who was also an impostor. See New York Study, supra note 21, at 1007; J. White & R. Summers, supra note 6, § 16-8, at 548.
95. *Id.* at 826-27.
been criticized on the basis that the drawer is better able to discover the fraud in this instance as well and should not be allowed to rely on the depositary bank to discover the forged indorsement.\textsuperscript{96} There is little logic to the exclusion if the defrauder pretends to be the agent of a nonexistent corporation\textsuperscript{97} because there is no actual principal that the drawer can be said to be relying on, and there is little difference between this situation and the normal imposture situation where the impostor impersonates another person.\textsuperscript{98} When the principal is existing and the agency can be verified by the drawer, however, the distinction is sound. When the drawer takes the precaution of making the check payable to an existing principal, there is no basis for allocating the loss to him. The impostor rule developed from the principle that the drawer was negligent in dealing with the impostor and not ascertaining his true identity.\textsuperscript{99} It is not always negligent, however, to deliver a principal's check to an apparent agent, and thus it would be inappropriate to include this situation under section 3-405 and automatically allocate the loss to the drawer. Excluding this situation would not necessarily mean that the drawer will be able to pass the loss back to his drawee bank. If the drawer's issuance of the check to the agent "substantially contributes" to the forgery, the drawer will be precluded from asserting the forgery against the drawee and thus sustain the forgery loss himself.\textsuperscript{100}

C. Fictitious Payee Rule

Section 3-405(1)(b) continues the fictitious payee rule of the NIF\textsuperscript{101} and provides that an indorsement will be effective when "a person signing as or on behalf of a . . . drawer intends the payee to have no interest in the instrument."\textsuperscript{102} The Code clearly dispenses with the pre-Code minority view that the payee need actually be fictitious\textsuperscript{103} by requiring only that the drawer intend him not to receive the proceeds of the check.\textsuperscript{104} The Code also resolves


\textsuperscript{97} An impostor situation may be impossible when the payee is a corporation because, by necessity, what will have occurred is a misrepresentation of agency. B. Clark, The Law of Bank Deposits, Collections and Credit Cards 212 (Supp. No. 2 1978).

\textsuperscript{98} When a drawer makes a check payable to a nonexistent principal, he "acts in an excessively gullible manner" and should bear the loss. J. White & R. Summers, supra note 6, § 16-8, at 548; see B. Clark, supra note 97, at 212-13.

\textsuperscript{99} See note 22 supra and accompanying text.


\textsuperscript{101} See note 39 supra and accompanying text.

\textsuperscript{102} U.C.C. § 3-405(1)(b).

\textsuperscript{103} See note 40 supra.

\textsuperscript{104} U.C.C. § 3-405, Comment 3a-e.
the inconsistent pre-Code determinations of intent that occurred when a check contained joint drawer signatures. Under the Code, if cosigners are necessary for negotiation, it is sufficient that one possesses the requisite intent for the section to apply.

The loss allocation in the governed situations is certain once it is determined that an authorized signer of the check intended the payee to have no interest. The official comments accompanying section 3-405 illustrate the embezzlement situations covered by the statute. In the typical situation, the drawer or his authorized agent draws a check payable to a payee knowing or believing that the payee does not exist, or knowing that the payee exists but intending to receive the proceeds for himself. The drawer's intention that the payee have no interest in the check is clearly demonstrated when the person who draws the check negotiates it on his own behalf. The requisite intent has also been found when an authorized agent drew checks payable to a nonexistent company and then had a confederate deposit them in an account established in the fictitious name. Even if the payee is an actual person with whom the drawer has had business dealings, the section has been found applicable when the check was negotiated on behalf of the check's drawer rather than the payee.

The certainty of the fictitious payee rules fades, however, when a factual situation is presented that departs from the scope of the Code's illustrations. The intent that the payee have no interest is apparent when the drawer or his authorized agent embezzles by drawing a check and negotiating it on his own behalf. The determination of the drawer's or agent's intent becomes more difficult, however, when a check is made payable to joint payees and negotiated over the authorized indorsement of one and the forged indorsement of the other. In this situation, it must be determined whether one or both of the payees was intended to receive the proceeds of the check.

In two instances, the courts have been called upon to decide whether a drawer who had issued a check jointly payable to a husband and wife in exchange for a promissory note purportedly signed by both intended the

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105. See notes 44-46 supra and accompanying text.
107. U.C.C. § 3-405, Comment 3.
108. Id. § 3-405, Comment 3a-b, d.
109. Id. § 3-405, Comment 3c, e.
111. See, e.g., Kansas Bankers Surety Co. v. Bank of Odessa, 386 F. Supp. 555, 559 (W.D. Mo. 1974); General Accident Fire & Life Assurance Corp. v. Citizens Fidelity Bank & Trust Co., 519 S.W.2d 817, 818-19 (Ky. 1975); McConnico v. Third Nat'l Bank, 499 S.W.2d 874, 885 (Tenn. 1973). In McConnico, although the court held that the forged indorsements were effective to pass title, it found that notice of the forgery on the face of the instrument precluded holder in due course status. Id. at 886; see pt. II(E) infra.
112. If a check is made payable to the order of joint payees in the alternative, either may provide the necessary indorsement. Otherwise, it must be indorsed by all of them. U.C.C. § 3-116(b).
proceeds solely for the party with whom he had dealt. In *Perley v. Glastonbury Bank & Trust Co.*, the wife's forgery of her husband's signature on a loan check was held to be ineffective because the drawer believed that the business venture for which the loan was intended was to be pursued as a joint venture and that the loan proceeds would be combined with joint funds of the payees. In *Gordon v. State Street Bank & Trust Co.*, the opposite result was reached because the drawer testified that he intended the proceeds for the husband's sole use even though he required the wife's name on the note for additional security. *Montgomery v. First National Bank* involved the issuance of a fire insurance claim check payable to both the vendor and the purchaser of a burned building. The court held that the purchaser's testimony that he had conspired with the drawer to issue the check solely for his own benefit was insufficient by itself to prove that the drawer intended the proceeds for himself alone. The underlying basis of these decisions is that the act of drawing a check payable to joint payees objectively manifests an intention that both parties receive the proceeds. The bank therefore will sustain the forgery loss unless it can clearly demonstrate (or the drawer admits) that the drawer's intention was that only one of the payees receive the proceeds of the check.

A second determination that the courts have had to make is whose intention controls to make the indorsements effective. When the drawer or his authorized agent actually signs the check on which the forged indorsement appears, the statute clearly provides that the applicability of section 3-405 is governed by a determination of the signer's intent. In the case of a cashier's check, however, where the drawer of the check is the issuing bank, the governing intent for the purposes of section 3-405 will vary. If a person purchases a cashier's check in lieu of issuing a personal check, the court will examine the purchaser's intent to decide if section 3-405 is applicable. Similarly, when a defrauder induces a drawer to issue him a check and then exchanges it for a cashier's check, the governing intention is that of the defrauder. When a defrauder forges a depositor's signature on a withdrawal slip, however, and receives the proceeds of the bank account in the form of a cashier's check, it is the bank's intention, and not the defrauder's

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113. 170 Conn. 691, 368 A.2d 149 (1976).
114. *Id.* at 696-97, 368 A.2d at 152.
116. *Id.* at 261-62, 280 N.E.2d at 154-55.
118. *Id.* at 61-62, 508 P.2d at 431.
119. The analysis that the courts have employed in this situation is comparable to the common law rule that the drawer could not assert a forgery if the proceeds actually reach the intended party. See note 59 *supra*.
120. U.C.C. § 3-405, Comment 3.
intention to receive the proceeds for himself, that is controlling.\textsuperscript{123} The distinction is that, in the latter instance, the bank is issuing the check on its own behalf, intending to make payment to its depositor, and therefore that intention governs.\textsuperscript{124}

The need to determine whether a forger can supply the necessary intent under section 3-405 arises in the case of a "double forgery," in which both the drawer's and payee's signatures are forged.\textsuperscript{125} Section 3-405 is silent as to whether a forger can sign "as or on behalf of a . . . drawer." This determination is crucial because the Code allocates losses caused by checks with forged drawer's signatures (forged checks) in a different manner than forged indorsement losses. Unless the drawer is precluded from asserting the forgery of his signature,\textsuperscript{126} the drawee bank cannot charge his account for the amount of the check.\textsuperscript{127} If the drawee bank has made final payment on the check, it will be unable to shift its loss to innocent prior parties in the collection chain,\textsuperscript{128} and thus will be left with the loss. The rationale for allocating the loss in this manner is the recognition of the commercial need for an ascertainable point at which transactions on a check are completed.\textsuperscript{129} In the double forgery situation, if the forger's intent is operative to make the indorsement effective, then the only forgery will be that of the drawer's signature and the loss will be allocated according to the rules governing forged checks. If the forger's intent is not sufficient for section 3-405 to apply, then

\begin{verbatim}
124. Id. at 90, 256 N.W.2d at 654.
125. A double forgery would occur when an employee, without authority to sign checks, steals one of his employer's checks, makes it payable to a fictitious payee, and then indorses the check in the payee's name. The term "double forgery" is actually a misnomer. Although it is theoretically possible that a forger would draw a check intending that someone else actually receive the proceeds, all the double forgery cases have involved checks made payable to persons not intended to have an interest in them. See cases cited note 131 infra; O'Malley, The Code and Double Forgeries, 19 Syracuse L. Rev. 36, 41-42 (1967) [hereinafter cited as Double Forgeries].
126. See, e.g., Perini Corp. v. First Nat'l Bank, 553 F.2d 398, 403 (5th Cir. 1977) (drawer precluded from asserting the forgery because it had passed a corporate resolution authorizing the drawee to honor all checks bearing facsimile signatures); Wilmington Trust Co. v. Phoenix Steel Corp., 273 A.2d 266, 268 (Del. 1971) (same); Wall v. Hamilton County Bank, 276 So. 2d 182, 183 (Fla. Dist. Ct. App. 1973) (same).
127. The contractual relationship between the drawee and depositor requires that it charge his account only for items that are properly payable. U.C.C. § 4-401(1). Because a forgery is an unauthorized signature, id. § 1-201(43), it is inoperative as the drawer's signature. Id. § 3-404(1). A drawer cannot be liable on a check unless his signature appears on it, id. § 3-401(1), he has ratified the forgery, id. § 3-404(2), or the check has been signed by his authorized agent. Id. § 3-403.
128. Id. § 3-418 provides that "payment or acceptance of any instrument is final in favor of a holder in due course, or a person who has in good faith changed his position in reliance on the payment." A bank makes final payment by paying the item in cash, settling the item without reserving the right to revoke the settlement, posting the item to the drawer's account, or making a provisional settlement and not revoking within the applicable time limitations. Id. § 4-213(1). If, however, the forgery is discovered prior to final payment or acceptance, the drawee can avoid the loss by returning the item or sending notice of its intention not to make final payment. Id. § 4-301(1); see id. § 3-409.
129. Id. § 3-418, Comment 1.
\end{verbatim}
the rules governing forged indorsements\textsuperscript{130} will apply. The few courts that have examined this question have concluded that the forger's intention governs for the purposes of section 3-405, resulting in the treatment of double forgeries simply as forged checks.\textsuperscript{131} This approach is consistent with the pre-Code majority rule\textsuperscript{132} and is preferable.\textsuperscript{133} The rationale behind these decisions is that there is little possibility that a genuine indorsement will be obtained on a check drawn by a forger,\textsuperscript{134} and the forgery loss can properly be said to be caused by the forger's actions. It is thus appropriate to find the forger's indorsement effective under section 3-405.

D. Padded Payroll Rule

Section 3-405(1)(c) resolves the split in authority under the NIL\textsuperscript{135} by making an indorsement in the name of the payee effective when "an agent or employee of the maker or drawer has supplied him with the name of the payee intending the latter to have no such interest."\textsuperscript{136} In a typical situation, an embezzling employee prepares a check or otherwise furnishes the name of a payee on a fraudulent invoice or payroll slip to an innocent drawer who actually signs the check.\textsuperscript{137} The determination of intent is basically the same as under the fictitious payee rule.\textsuperscript{138} If the employee supplies the name intending that the payee have no interest in the check, any indorsement in the name of the payee will be effective.\textsuperscript{139} Conversely, if the employee actually intends the payee to receive the proceeds of the check, such as when the payee is a creditor of the employee, the embezzlement is not within the section's scope.\textsuperscript{140} The policy behind the Code's decision to allocate to the drawer the

\textsuperscript{130} See notes 2-12 supra and accompanying text.

\textsuperscript{131} See Perini Corp. v. First Nat'l Bank, 553 F.2d 398, 414-15 (5th Cir. 1977); Aetna Life & Cas. Co. v. Hampton State Bank, 497 S.W.2d 80, 84 (Tex. Civ. App. 1973); Mortimer Agency, Inc. v. Underwriters Trust Co., 73 Misc. 2d 970, 973, 341 N.Y.S.2d 75, 79-80 (N.Y.C. Civ. Ct. 1973). But see Bank of Thomas County v. Dekle, 119 Ga. App. 753, 757, 168 S.E.2d 834, 837 (1969) (court applied longer statute of limitations for forged indorsements, see U.C.C. § 4-405(4), to a drawer's action against a drawee based on a check with both a forged drawer's signature and a forged indorsement). In Perini, § 3-405 was held to be inapplicable because the indorsements were not made in the name of the payee. Perini Corp. v. First Nat'l Bank, 553 F.2d at 415; see note 61 supra and accompanying text. The court held, however, that the collecting bank's liability in paying a forged check in a double forgery situation was limited to the claims of the true payee. Id. at 414-16. For a criticism of the Perini decision, see 46 Fordham L. Rev. 1273, 1286 (1978).

\textsuperscript{132} See, e.g., United States v. Chase Nat'l Bank, 252 U.S. 485, 495-96 (1920); Fidelity & Deposit Co. v. Peoples Exch. Bank, 270 Wis. 415, 419, 71 N.W.2d 290, 293 (1955); W. Britton, supra note 20, § 149, at 432 & n.4.

\textsuperscript{133} "[T]he common-law position on double forgeries . . . is clearly desirable since it places the risk of forgery on the proper party—the drawee." Whaley, supra note 9, at 71; Double Forgeries, supra note 125, at 41. But see Graybill, Reconsidering an Old Conundrum: The Case for Indorsement Liability on Double Forgeries, 83 Com. L.J. 61, 73-77 (1978).

\textsuperscript{134} It is unlikely that a forger would risk easy detection by making a check payable to himself and then indorsing his own name.

\textsuperscript{135} See notes 41-43 supra and accompanying text.

\textsuperscript{136} U.C.C. § 3-405(1)(c).

\textsuperscript{137} See T. Quinn, supra note 7, ¶ 3-405[A][4].

\textsuperscript{138} See note 104 supra and accompanying text.

\textsuperscript{139} U.C.C. § 3-405, Comment 4a-b.

\textsuperscript{140} Hobart Mfg. Co. v. Fidelity & Deposit Co., 360 F.2d 453, 457 (6th Cir. 1966).
loss caused by this type of employee embezzlement is that the loss is more properly a risk of doing business than a banking risk. The employer is in a better position to prevent such frauds through careful selection and supervision of his employees and should bear the resulting losses or the costs of insuring against their occurrence.\textsuperscript{141}

In order to apply section 3-405, the courts have first had to determine who is an “employee” or “agent” within the meaning of the statute. The Code offers some illustrations in the official comments,\textsuperscript{142} but provides no definition of these terms and thus the ordinary rules of agency apply.\textsuperscript{143} Although the Code illustrations describe only employees with check preparation duties,\textsuperscript{144} the section has been interpreted to include any employee who, incident to his employment, conveys information to his employer resulting in the issuance of a check.\textsuperscript{145} The policy behind section 3-405—to allocate the loss to the drawer when he is in a better position to prevent the forgery through careful supervision of his employees\textsuperscript{146}—supports an interpretation that does not restrict its scope. The term “agent,” however, requires a strict interpretation because the drawer can prevent frauds by proper supervision only when the defrauder’s work is subject to his control. Unless the defrauder is subject to the drawer’s control, he is not deemed to be an agent within the meaning of section 3-405, and his intention regarding the issued checks is not binding on the drawer.\textsuperscript{147}

A second judicial determination required by the statute, which has been the source of some confusion, is whether the employee or agent “supplied” the drawer with the name of the payee. In order to supply the payee’s name, the

\textsuperscript{141} “The principle followed is that the loss should fall upon the employer as a risk of his business enterprise rather than upon the subsequent holder or drawee. The reasons are that the employer is normally in a better position to prevent such forgeries by reasonable care in the selection or supervision of his employees, or, if he is not, is at least in a better position to cover the loss by fidelity insurance; and that the cost of such insurance is properly an expense of his business rather than of the business of the holder or drawee.” U.C.C. § 3-405, Comment 4.

\textsuperscript{142} Id.

\textsuperscript{143} Id. § 1-103 provides: “Unless displaced by the particular provisions of this Act, the principles of law and equity, including . . . the law relative to . . . principal and agent . . . shall supplement its provisions.”

\textsuperscript{144} Id. § 3-405, Comment 4a-b. These illustrations clearly include the employee who prepares the actual check for his employer’s signature, \textit{see}, \textit{e.g.}, Titan Air Conditioning Corp. v. Chase Manhattan Bank, N.A., 61 A.D.2d 764, 765, 402 N.Y.S.2d 12, 14 (1978) (mem.), and the employee who prepares the payroll, invoices, or other supporting documents for the issuance of checks. \textit{See}, \textit{e.g.}, May Dep’t Stores Co. v. Pittsburgh Nat’l Banks, 374 F.2d 109, 110 (3d Cir. 1967) (per curiam); Delmar Bank v. Fidelity & Deposit Co., 300 F. Supp. 496, 498 (E.D. Mo. 1969) (mem.), \textit{rev’d on other grounds}, 428 F.2d 32 (8th Cir. 1970).

\textsuperscript{145} New Amsterdam Casualty Co. v. First Pa. Banking & Trust Co., 451 F.2d 892, 896 (3d Cir. 1971). Because the actual signer of a check often has no knowledge of or intention regarding the payee, he frequently relies on employees to furnish him with the necessary information. Leary, \textit{Commercial Paper}, in \textit{ABA Uniform Commercial Code Handbook} 87, 115 (1964).

\textsuperscript{146} See note 141 \textit{supra} and accompanying text.

employee's actions must occur before the check is drawn. When an employee's only contact with a check is his act of stealing it after it has been drawn, his indorsement is not covered by section 3-405 and is a simple forgery. The official comments accompanying the section indicate that the loss should be allocated to the drawer when an employee adds a fictitious name to the employer's payroll or authorizes an additional check for an actual employee. Although the comments illustrate only the padded payroll situation, the courts have indicated that the scope of the section is not so limited. This section has been interpreted to include an employee who received and indorsed a check payable to a customer after misrepresenting to his insurance company employer that the customer had applied for a loan. It has also been applied when an employee issued a fraudulent "sell" order to the brokerage firm by which he was employed, even though many intermediary employees were involved in processing the check. This view that the employee need not be closely connected with the preparation of the check is proper because it is the dishonest employee's actions that have caused the issuance of the unauthorized check.

A series of recent cases have held that an employee cannot "supply" the name of any payee who is a bona fide creditor of the drawer, regardless of the intent of the faithless employee who presents the creditor's proper invoice to the drawer for payment. In Snug Harbor Realty Co. v. First National Bank, the employee verified invoices, initialed them for payment, and forged indorsements on the checks that were subsequently drawn and signed by the treasurer. The court held that section 3-405 did not apply and consequently the indorsements were treated as forgeries. The court in Danje Fabrics v. Morgan Guaranty Trust Co. followed the same rationale even though the employee had actually prepared the checks and filled in the name of the payee before submitting them to the president for his signature.

148. See J. White & R. Summers, supra note 6, § 16-8, at 544.
149. U.C.C. § 3-405, Comment 4a-b.
154. Id. at 574, 253 A.2d at 582.
156. Id. at 747, 409 N.Y.S.2d at 566. The court distinguished the prior holding of Board of Higher Educ. v. Bankers Trust Co., 86 Misc. 2d 560, 383 N.Y.S.2d 508 (Sup. Ct. 1976), which had held effective an employee's indorsement on checks issued on the basis of duplicate as well as authorized requisitions supplied by the employee, id. at 562, 383 N.Y.S.2d at 510, because the Board of Higher Education court had noted that the plaintiff did not seriously contest the applicability of § 3-405 to the facts of the case. 96 Misc. 2d at 753, 409 N.Y.S.2d at 569 (citing Board of Higher Educ. v. Bankers Trust Co., 86 Misc. 2d at 562, 383 N.Y.S.2d at 510).

In Board of Higher Education, the plaintiff had argued that a bank's gross negligence precluded the transfer of liability to the drawer, see notes 178-82 infra and accompanying text,
The distinction that the courts have drawn between bona fide and fraudulent transactions is inappropriate. The general rule governing forged indorsements—that the bank cannot charge its customer's account for checks containing unauthorized signatures—is "designed to protect bank customers from financial loss incurred through forgeries of lost or stolen checks." Although it is essential to draw a distinction between the two, the Snug Harbor and Danje decisions erroneously equate an employee involved in the check preparation process who presents a check payable to company creditors and that § 3-405 ought not to apply to a municipal business. The plaintiff apparently attempted to expand the definition of federal commercial paper to include any governmental use of commercial paper because questions of liability on federal commercial paper are resolved under federal common law and not the Code. National Metropolitan Bank v. United States, 323 U.S. 454, 456 (1945); Clearfield Trust Co. v. United States, 318 U.S. 363, 367 (1943); see T. Quinn, supra note 7, § 3-405[A][5][b] ("the Code is technically a body of state law, and, even though operative in all the states, is still only state law"). Even when a factual situation clearly falls within the parameters of § 3-405(1)(c), forged indorsements on federal commercial paper are not necessarily effective. In situations where the name of an existing person has been supplied by a federal employee, the indorsement of the payee's name remains a forgery. See, e.g., United States v. Bank of America Nat'l Trust & Sav. Ass'n, 438 F.2d 1213, 1214 (9th Cir.) (per curiam), cert. denied, 404 U.S. 864 (1971); United States v. City Nat'l Bank & Trust Co., 491 F.2d 851, 854 (8th Cir. 1974). In an impostor situation, however, application of the federal common law achieves a result consistent with the application of § 3-405(1)(a). See, e.g., United States v. Bank of America Nat'l Trust & Sav. Ass'n, 274 F.2d 366, 369 (9th Cir. 1959); Atlantic Nat'l Bank v. United States, 250 F.2d 114, 116 (5th Cir. 1957). Relying on the impostor rule, Justice Clark, writing for the Ninth Circuit, held that when a person forged military pay orders, records, and drafts for nonexistent payees, the indorsements were effective. Bank of America Nat'l Trust & Sav. Ass'n v. United States, 552 F.2d 302, 303 (9th Cir. 1977). This holding includes the fictitious payee rule within the federal impostor rule when a federal employee supplies the name of a nonexistent payee, thereby continuing in the area of federal commercial paper a pre-Code concept long rejected—distinguishing between actual and nonexistent fictitious payees. See notes 103-04 supra and accompanying text. Federal adoption of the Code has frequently been urged to resolve the conflict between the Code and the federal law of contracts, and to generally increase uniform application by the states. See, e.g., Bank of America Nat'l Trust & Sav. Ass'n v. United States, 552 F.2d 302, 303 n.1 (9th Cir. 1977); Fox, Forgery and Government Checks, 27 Drake L. Rev. 458, 470-73 (1977-78); Henson, Current Developments in the Uniform Commercial Code: The Problem of Uniformity, 20 Bus. Law. 689, 695 (1965); Note, Disparate Judicial Construction of the Uniform Commercial Code—The Need for Federal Legislation, 1969 Utah L. Rev. 722, 740-42; Comment, Application of the Uniform Commercial Code to Federal Government Contracts: Doing Business on Business Terms, 16 Wm. & Mary L. Rev. 395 (1974).
while intending to retain the proceeds himself with one who merely steals a completed check. The policy reasons for the section 3-405 risk allocations to the drawer, however, are applicable in this situation as well. The employer has delegated check processing duties to these employees and must use care in supervising and selecting them or bear the loss or expense of insuring against embezzlement as a business expense. The business risk assumed by an employer who allows employees to process supporting documents or prepare checks is just as real whether the invoices presented are forged or authentic and should be recognized as such. Although it is arguably more difficult to discover the employee's intention to embezzle checks payable to bona fide creditors, it is surely of equal difficulty whenever the payee is an actual person with whom the drawer has dealt. As a practical matter, applying section 3-405 may be the only method of deferring such embezzlements because if the loss is allocated to the collecting bank that has paid the instrument in good faith, the incentive for businesses to take the necessary measures to guard against this fraud will be eliminated.

The Code's padded payroll rule developed from the common law fictitious payee rule. The expansion of the rule to include employees without actual authority to sign checks was based on the realization that the actual signer of the checks often relies on other employees who prepare the documents and signs the checks mechanically. By recognizing the employee as possessing the governing intention, he is equated with the actual signer whose intention is governed by the fictitious payee rule. Because an authorized signer who draws a check payable to an actual creditor-intending that he have no interest in the check comes within the risk allocation of the fictitious payee rule, the employee who prepares the check or payroll for such checks should also be included in the padded payroll rule.

E. The Bank's Standard of Care

The Code is silent as to whether a bank must act without negligence in order to assert the defense of section 3-405, as is required when a bank asserts that the drawer's negligence has contributed to the making of a forgery. Relying on this omission, courts have generally held that the drawer cannot defeat the operation of section 3-405 by proving the ordinary negligence of the bank. The courts have noted, however, that the section does not provide

162. U.C.C. § 3-405, Comment 4.
163. See J. White & R. Summers, supra note 6, § 16-8, at 546.
164. "Good internal organization in a corporation makes it difficult for employees to carry out frauds. If banks, and not employers bear fraud losses, there is no pressure on companies to organize their affairs to minimize these losses." Comment, The Fictitious Payee and the UCC—The Demise of a Ghost, 18 U. Chi. L. Rev. 281, 288 (1951).
165. See pt. I(B) supra.
166. See Leary, supra note 145, at 115.
167. See note 111 supra and accompanying text.
168. U.C.C. § 3-406. The drawer may also be precluded from asserting the forgery if he fails to discover and report the unauthorized signature within the applicable time limitations, id. § 4-406(1), but again the bank must meet a standard of ordinary care. Id. § 4-406(2).
169. "Since [§ 3-405] makes all endorsements in the name of the payee effective, the collecting bank has good title to the draft, and can have no more liability for negligence than for breach of
an absolute defense and are in agreement that the Code's general requirement that "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement"\textsuperscript{170} is applicable to section 3-405 even though the section itself contains no such provision.\textsuperscript{171} There is, however, no standard as to what type of conduct will constitute bad faith. The Code defines good faith as "honesty in fact"\textsuperscript{172} and, therefore, dishonest conduct by the bank would surely seem to breach this standard. The court in Hicks-Costarino Co. v. Pinto,\textsuperscript{173} however, held that a bank teller's acting as an accomplice to an embezzlement scheme did not constitute "bad faith" on the part of the bank, reasoning that the drawer was more responsible for the loss.\textsuperscript{174} Some courts have indicated that subjective dishonesty is not necessary and that proof of gross negligence would suffice to constitute bad faith.\textsuperscript{175} Nevertheless, no court has actually found an absence of good faith and transferred liability in a section 3-405 situation from the drawer to the bank on that basis.\textsuperscript{176}

Some courts have undercut the good faith standard by holding that a collecting bank must satisfy the notice, value, and good faith requirements of a holder in due course\textsuperscript{177} in order to assert section 3-405. In these cases, the warranty." Fair Park Nat'l Bank v. Southwestern Inv. Co., 541 S.W.2d 266, 270 (Tex. Civ. App. 1976); accord, Prudential Ins. Co. of America v. Marine Nat'l Exch. Bank, 371 F. Supp. 1002, 1003 (E.D. Wis. 1974); General Accident Fire & Life Assurance Corp. v. Citizens Fidelity Bank & Trust Co., 519 S.W.2d 817, 818 (Ky. Ct. App. 1975); Hicks-Costarino Co. v. Pinto, 23 U.C.C. Rep. Serv. 680, 681 (N.Y. Sup. Ct. 1978). But see notes 177-93 infra and accompanying text.

\textsuperscript{170} U.C.C. § 1-203.


\textsuperscript{172} U.C.C. § 1-201(19).


\textsuperscript{174} Id. at 684. The plaintiff's employee had supplied the names of fictitious payees and negotiated the checks in collusion with the bank teller. Because the bank had discharged its employee and there was no indication that further inquiry should have been made or that the bank officers acted in bad faith, the court found that there was no bad faith. The basis of this decision seems to be that the drawer was more responsible for the fraud because its employee initiated the scheme and it was receiving bank statements that should have put it on notice of the fraud. See id.


\textsuperscript{176} The closest the courts have come to finding bad faith has been the denial of summary judgment and the ordering of a trial to determine whether the bank breached the good faith standard. See Titan Air Conditioning Corp. v. Chase Manhattan Bank, N.A., 61 A.D.2d 764, 765, 402 N.Y.S.2d 12, 14 (1978) (mem.); Board of Higher Educ. v. Bankers Trust Co., 86 Misc. 2d 560, 563, 383 N.Y.S.2d 508, 510-11 (Sup. Ct. 1976) (good faith standard held applicable to checks for which the drawee also acted as collecting bank).

\textsuperscript{177} "A holder in due course is a holder who takes the instrument (a) for value; and (b) in good faith; and (c) without notice that it is overdue or has been dishonored or of any defense
loss was shifted away from the drawer even though the indorsements were effective under section 3-405. In Board of Higher Education v. Bankers Trust Co., the court held that a collecting bank that took a check from the forger and paid cash for it, rather than accepting it for deposit subject to collection, was not acting as a collecting bank and therefore could not assert that it owed no duty to the drawer. In denying the bank's motion for summary judgment, the court held that a collecting bank that took a check from the forger and paid cash for it, rather than accepting it for deposit subject to collection, was not acting as a collecting bank and therefore could not assert that it owed no duty to the drawer. In denying the bank's motion for summary judgment, the court held that a collecting bank that took a check from the forger and paid cash for it, rather than accepting it for deposit subject to collection, was not acting as a collecting bank and therefore could not assert that it owed no duty to the drawer.

The good faith requirement is a subjective provision comparable to the § 1-203 general standard. Language in the 1952 Code requiring that a holder be "in good faith including observance of the reasonable commercial standards of any business in which the holder may be engaged," U.C.C. § 3-302(1)(b) (1952 Official Draft), was deleted to make clear that an objective standard of a reasonably prudent man was not intended. Permanent Editorial Board for the Uniform Commercial Code, 1956 Recommendations 102 (1956); see J. White & R. Summers, supra note 6, § 14-6. A purchaser who has notice of any claim or defense is not a holder in due course. U.C.C. § 3-302(c). Such notice exists when an instrument evidences a forgery or is so irregular that its validity should be questioned, or the purchaser knows that the obligation is voidable or discharged. Id. § 3-304(1). Notice encompasses a negligence standard because it applies both when there is actual knowledge and "reason to know." Id. § 1-201(25).

179. "Collecting bank" means any bank handling the item for collection except the payor bank. U.C.C. § 4-105(d). The court reasoned that, by paying the forger cash for the check, the collecting bank was in the position of a purchaser because it was not handling the item for the benefit of anyone other than itself. 86 Misc. 2d at 564, 383 N.Y.S.2d at 511. This distinction seems somewhat tenuous because a bank does not automatically lose its status as a collecting bank when it pays cash outright for a check. See U.C.C. §§ 4-201 & Comment 1, -105(d); J. Clarke, H. Bailey, III & R. Young, Jr., Bank Deposits and Collections 46 (4th ed. 1972).

If the collecting bank had acted in bad faith in negotiating the check but the drawer was limited to an action against his drawee bank to have his account recredited, see note 6 supra, § 3-405 would make the indorsements effective and bar recovery. See, e.g., Board of Higher Educ.
judgment, the court held that the bank was entitled to be paid only if it was a holder in due course, and ordered a trial to determine whether the bank had acted without notice of any defenses.\textsuperscript{181} This holding seemed to allow the drawer to assert a negligence action against the collecting bank.\textsuperscript{182} The holder in due course doctrine was also invoked in \textit{Sun 'n Sand Inc. v. United California Bank},\textsuperscript{183} in which an employee had supplied his employer with the name of the bank as payee and persuaded the bank to deposit the funds into his personal account.\textsuperscript{184} Although the indorsements were effective under section 3-405, the court allowed the drawer to proceed against the collecting bank on theories of negligence and mistake of fact, rejecting the argument that the loss allocation scheme of section 3-405 displaces the common law negligence action.\textsuperscript{185}

In \textit{Dayton, Price & Co. v. First National Bank},\textsuperscript{186} the court determined that a collecting bank had notice of an irregularity when its branch manager cashed checks for the forger in violation of the bank's normal procedure and thus could not qualify as a holder in due course.\textsuperscript{187} Although the drawer's action against the collecting bank was dismissed,\textsuperscript{188} the court imputed the
notice to the drawee bank so that neither bank could assert section 3-405 to defeat liability. In *McConnico v. Third National Bank*, a trustee in bankruptcy brought suit against the collecting bank in conversion. The forged indorsements on the checks in question were held to be effective under section 3-405 because the president of the bankrupt company, who had authority to draw checks, had made the checks payable to a corporate creditor intending to receive the proceeds for himself. The court held, however, that despite the effectiveness of the indorsements, the president's actions of indorsing the checks and depositing them into his personal account were so irregular that they gave notice to the bank which precluded holder in due course status, and the bank was therefore not entitled to payment.

Invoking the holder in due course doctrine is inappropriate in a section 3-405 situation. By holding that the bank could not assert section 3-405 as a defense because a check was cashed contrary to normal procedures or because it had notice of an irregularity, the courts have factored a negligence standard into section 3-405. Such a modification of the Code's risk allocation is unwarranted. The Code specifically provides that the indorsements will be effective if section 3-405 is applicable and contains no requirement that a subsequent holder of the check act with due care or in accordance with reasonable commercial standards. The section does require the bank to obtain an indorsement in the name of the payee before the section operates, thus assuring a modicum of regularity, and no duty should be imposed upon the collecting bank to inquire beyond the face of the instrument. The forgery loss in a section 3-405 situation is deemed to be the drawer's responsibility because he is in the better position to prevent it. Egregious conduct on the part of the bank—dishonesty or conduct that could be equated with bad faith, such as gross negligence or willful ignorance—is the only conduct that should justify holding the bank liable. The conduct that the courts have held to preclude holder in due course status need not be disregarded; it should, however, be evaluated in light of the good faith standard and not in terms of negligence.

189. 22 U.C.C. Rep. Serv. at 47. Although there is no apparent basis for imputing the notice of the collecting bank to the drawee, this approach is a practical solution to the problem that arises when the collecting bank's conduct violates a good faith standard and direct suit is not permitted.

190. 499 S.W.2d 874 (Tenn. 1973).

191. Paying a check with a forged indorsement constitutes conversion. U.C.C. § 3-419(1)(c); see note 10 supra.

192. 499 S.W.2d at 885.

193. Id. at 886. This case presents the anomalous situation of a holding that there was a conversion for paying a check with a forged indorsement even though the indorsements were effective and thus not forgeries.

194. See note 187 supra and accompanying text.

195. See note 193 supra and accompanying text.

196. Although the drawer can defeat the bank's defenses to a forgery contained in other Code provisions by showing that the bank did not observe reasonable commercial standards, see, e.g., U.C.C. §§ 3-406, 4-406, such a requirement is conspicuously absent from § 3-405.

197. See pt. II(A) supra.

CONCLUSION

The losses suffered by a drawer as a result of section 3-405’s operation are not accidental or unforeseen. The drafters of the Code clearly intended the risk of loss in certain factual situations to be borne by the drawer, and to impose on him the burden of taking precautions against these losses. In expanding the prior law, the Code attempted to eliminate the technical distinctions that had been made in similar factual situations. The courts must recognize that the purposes underlying section 3-405 mandate a liberal interpretation, and that factual situations not specifically illustrated in the official comments should be included within the scope of the statute when the same policy considerations apply. The risk allocation of the section is definite; it must be recognized as such in order for the statutory intent to be realized.

Vilia Hayes