1991

Bank Liability for Fiduciary Fraud

Marion W. Benfield Jr.

Peter A. Alces
*William & Mary Law School, paalce@wm.edu*

Repository Citation
https://scholarship.law.wm.edu/facpubs/294

Copyright c 1991 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository. 
https://scholarship.law.wm.edu/facpubs
BANK LIABILITY FOR FIDUCIARY FRAUD*

Marion W Benfield, Jr.,** & Peter A. Alces***

Table of Contents

I. Introduction 476

II. Transactional Contexts and "The Risk Reasonably to Be Perceived" 479
   A. Payments to Fiduciaries 480
   B. Fiduciary's Transfer of Negotiable Instruments 481
      1. Instruments Payable to Third Parties 483
      2. Instruments Payable to "Fiduciary as Such" 483
   C. Deposits by Fiduciary 485
      1. Deposit to Account of "Fiduciary as Such" 485
      2. Deposit to Account of Beneficiary 486
      3. Deposit to Personal Account of Fiduciary 487

III. Statutory Treatment of Bank's Liability for Fiduciary Fraud 488
   A. Uniform Fiduciaries Act 488
      1. Section 2: "Application of Payments Made to Fiduciaries" 489
      2. Section 4: "Transfer of Negotiable Instrument by Fiduciary" 489
      3. Section 5: "Check Drawn by Fiduciary Payable to Third Person" 490
      4. Section 6: "Check Drawn by and Payable to Fiduciary" 490
      5. Section 7: "Deposit in Name of 'Fiduciary as Such'" 491
      6. Section 8: "Deposit in Name of Principal" 491

* o Copyright 1991 Marion W. Benfield, Jr., and Peter A. Alces. All Rights Reserved.
** University Distinguished Chair in Law, Wake Forest University School of Law.
*** Professor of Law, Marshall-Wythe School of Law, College of William and Mary.
7. Section 9: “Deposit in Fiduciary’s Personal Account” 492
8. Purpose of the Uniform Fiduciaries Act 492

B. Former U.C.C. Article 3 494
1. Former U.C.C. Section 3-117 494
2. Former U.C.C. Section 3-206 501
3. Former U.C.C. Section 3-304 507

C. Revised U.C.C. Article 3 513
1. Revised U.C.C. Section 3-110 513
2. Revised U.C.C. Section 3-206 515
3. Revised U.C.C. Section 3-307 517
   a. Credit of Check to Fiduciary’s Personal Account 519
   b. Paying Cash to a Fiduciary 526
   c. Who Is a Fiduciary Under Revised U.C.C. Section 3-307? 529
   d. When Does a Transferee Have Knowledge of Fiduciary Status? 530


5. Revised U.C.C. Section 3-405 535
6. Revised U.C.C. Sections 3-404 and 3-406 540

D. Summary of Revised Article 3 Rules as to Bank Liability for Fiduciary Fraud 542

IV Conclusion 546

I. Introduction

Fraud happens;¹ and the challenge for the drafters of commercial and bank collections law is to provide a means to allocate

¹. See Sleicher v. Sleicher, 251 N.Y. 366, 371, 167 N.E. 501, 503 (1929) (Cardozo, C.J., writing for the majority, stated that “[t]he phases of fraud are manifold.”). Another prominent American jurist has also noted that:

“As to relief against frauds, no invariable rules can be established. Fraud is infinite; and were a court of equity once to lay down rules, how far they would go, and no farther, in extending their relief against it, or to define strictly the species or evidence of it, the jurisdiction would be cramped, and perpetually eluded by new schemes, which the fertility of man’s invention would contrive.”

J. Story, Commentaries on Equity Jurisprudence, As Administered in England and America § 186, at 198 n.5 (11th ed. 1873) (quoting letter from Lord Hardwicke to Lord Kames (June 30, 1759)).
fraud losses in a manner that is both economically rational and responsive to conceptions of immanent justice. The contours of that allocation, when finally formulated, will likely be affected by political considerations. In payments law, the interests of financial institutions are juxta­pos­ed against those of their customers, often consumers.

This Article examines the accommodation of these often competing interests that has shaped the commercial paper and bank collections treatment of bank liability that accrues when a fiduciary with the power to sign and indorse checks fraudulently diverts such check proceeds to unauthorized uses. This is not an area of payments law that has been subject to exhaustive treatment in the commentaries. In this Article, we will trace the development of fiduciary fraud principles as promulgated in Article 3 of the Uniform Commercial Code (“U.C.C.”) and in the Uniform Fiduciaries Act (“U.F.A.”). We will then examine the fiduciary fraud rules of revised Article 3 of the U.C.C., promulgated in 1990 by the Ameri-

---


4. See U.C.C. § 4-104(a)(5) (1990) (“Customer’ means a person having an account with a bank or for whom a bank has agreed to collect items and includes a bank maintaining an account at another bank ”).


6. The issues treated here are to be distinguished from the issues presented when a bank customer attempts to impose fiduciary liability on her bank. For a recent treatment of that setting, see Note, The Fiduciary Controversy: Injec­tion of Fiduciary Principles into the Bank-Depositor and Bank-Borrower Relationships, 20 Loy. L.A.L. Rev. 796 (1987).


can Law Institute\textsuperscript{10} ("ALI") and the National Conference of Commissioners on Uniform State Laws\textsuperscript{11} ("NCCUSL").

Part II of this Article introduces various fiduciary fraud problems and the transactional contexts in which they arise. We also offer our general observations about the concepts of duty and breach of duty that most often attend resolution of "troublesome cases."\textsuperscript{12} Part III of this Article reviews the provisions of the U.F.A. and former U.C.C. Article 3, as well as the relevant case law, concerning fiduciary fraud. That review will demonstrate that courts have not uniformly adhered to statutory policy, but rather have sometimes imposed greater liability on banks dealing with a fiduciary than appears to have been intended by the drafters. We then consider the fiduciary fraud provisions of revised Article 3 and note that some provisions of revised Article 3 change previous law by shifting the risk of employee fraud from third parties who deal with employees to the employer.\textsuperscript{13} In contrast, other provisions of revised Article 3 impose greater liability than did prior law on third parties who deal with fiduciaries, including employees.\textsuperscript{14} Therefore, the new provisions may be contradictory in some instances. The Article will conclude in Part IV by reviewing these apparent contradictions and suggesting alternative interpretations of the various U.C.C. sections that should produce reasonable and consistent results. We also suggest that it might have been more appropriate to abandon some of the rigid, specific statutory rules incorporated into revised section 3-307\textsuperscript{15} regarding fiduciary fraud.

\textsuperscript{10} The American Law Institute began in 1921 as a project proposed by the Association of American Law Schools. The ALI was envisioned as a "juristic centre for the betterment of the law," and "its first major undertaking should be to prepare a 'Restatement of the Law.'" W Twining, Karl Llewellyn and the Realist Movement 273-74 (1973).

\textsuperscript{11} The NCCUSL was formed in 1892 and is composed of unpaid commissioners appointed by state governors. It prepares primarily in commercial law acts for possible adoption by state legislatures. W Twining, supra note 10, at 272.

\textsuperscript{12} See W Twining, supra note 10, at 160:
The "trouble case method" consists of examining in detail the processes involved in settling actual disputes. What happened, what each participant did in relation to the dispute, what steps were taken by what other persons, the final outcome, the reasoning of the deciders, the effects of the decision on the parties themselves, on future trouble cases and on the general life of the group are to be considered in depth.

\textit{Id.}

\textsuperscript{13} See infra notes 363-82 and accompanying text.

\textsuperscript{14} See infra notes 279-316 and accompanying text.

\textsuperscript{15} U.C.C. § 3-307 (1990).
leaving the matter instead entirely to the more flexible approach under the "good faith" provisions of revised sections 3-404, 3-405 and 3-406.16

II. TRANSACTIONAL CONTEXTS AND "THE RISK REASONABLY TO BE PERCEIVED"17

This part of the Article describes several contexts in which a payment transaction involving a fiduciary's handling of her beneficiary's negotiable instrument presents fraud risks. The situations generally involve the fiduciary's transfer of a negotiable instrument either to a third party (including a bank) or to herself and a fiduciary's deposit of an item in a bank for collection. As the following discussion will demonstrate, the various permutations of the basic payment and collection scenarios present various fraud opportunities as well as a concomitantly broad range of factual variations that may, depending on the impressions of a trier of fact, yield diametrically opposed legal conclusions.

The Uniform Fiduciaries Act defines a "fiduciary" as follows:

[A] trustee under any trust, expressed, implied, resulting or constructive, executor, administrator, guardian, conservator, curator, receiver, trustee in bankruptcy, assignee for the benefit of creditors, partner, agent, officer of a corporation, public or private, public of-

16. Id. §§ 3-404, 3-405 & 3-406. See also id. § 3-103(a)(4) ("'Good faith' means honesty in fact and the observance of reasonable commercial standards of fair dealing."). U.C.C. section 1-102 provides as follows:
(1) This Act shall be liberally construed and applied to promote its underlying purposes and policies.
(2) Underlying purposes and policies of this Act are
(a) to simplify, clarify and modernize the law governing commercial transactions;
(b) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties;
(c) to make uniform the law among the various jurisdictions.
U.C.C. § 1-102(1) & (2) (1989). See also Hawkland, Uniform Commercial "Code" Methodology, 1962 U. ILL. L.F. 291, 296 & 320 ("[T]he commercial law grew along lines which produced gaps and uncertainties in spite of volumes of cases. Indeed, gaps and uncertainties seem to have been generated in direct proportion to the number of published opinions As a result, "[t]he commercial community has made a modest demand on the law to give it right rules which will operate evenly and with a fair degree of predictability.").


18. In this Article, the term "beneficiary" is used to describe persons for whom a fiduciary is acting, including beneficiaries of trusts, partners, employers, or similarly situated principals.
ficer, or any other person acting in a fiduciary capacity for any person, trust or estate. 19

The revised Article 3 definition is similar; both definitions seem to encompass anyone acting on behalf of another. 20 In the normal course fiduciaries often handle payment transactions involving checks for their beneficiaries. Unfortunately, such a normal course of handling checks provides ample opportunity for fiduciaries to embezzle funds of their beneficiaries. In the next portion of this Article, we examine the fact patterns of fiduciary fraud with which this Article deals.

A. Payments to Fiduciaries

The rule at common law 21 imposed a duty on those who dealt with fiduciaries to assure that payments made to the fiduciary were applied in a manner consistent with the beneficiary's interest. 22 So, if a fiduciary applied a payment inconsistent with the beneficiary's interest, the party making the payment to the fiduciary would remain liable to the beneficiary. 23

Arguably, the early common law rule made sense when businesses were small, usually owned by individuals who handled business matters themselves, and most fiduciaries represented trusts or estates. However, such a rule long ago ceased to make sense in a business world dominated by large enterprises operating through fiduciaries in far-flung activities. In fact, the old common

---

20. U.C.C. § 3-307(a)(1) (1990) ("Fiduciary" means an agent, trustee, partner, corporate officer or director, or other representative owing a fiduciary duty with respect to an instrument"). Compare also UNIF. FRAUDULENT TRANSFER ACT § 1(6), 7A U.L.A. 395-96 (1985) with BANKRUPTCY CODE, 11 U.S.C. § 101(30) (1988) (definition of "insider"). See infra notes 329-34. However, the precise reach of the definitions are unclear and it may be more appropriate, in the context of revised Article 3, to read the definition restrictively so as not, for example, to include a constructive trustee.
23. Note that the question of the fiduciary's authority is a separate issue. See UNIF. FIDUCIARIES ACT § 2 comment, 7A U.L.A. 401 (1985).
law rule largely became a dead letter even in ordinary trust cases since the usual trust document specifically provided that a person dealing with the trustee had no obligation to ensure that money paid was properly applied by the trustee.\textsuperscript{24}

The old common law rule was severely criticized,\textsuperscript{25} and was rejected by the Uniform Fiduciaries Act.\textsuperscript{26} The U.F.A. provides that a third party making payment to a fiduciary has not obligated itself to ensure the proper application of such funds, and has no liability absent bad faith.\textsuperscript{27} Similarly, comment 5 to former U.C.C. section 3-304\textsuperscript{28} states that the purchaser of an instrument may pay cash to a fiduciary without becoming liable, unless the purchaser has notice of a breach of fiduciary duty.\textsuperscript{29} Of course, under certain circumstances, a payment to a fiduciary by cash or check is so likely to lead to fraudulent misapplication, or the circumstances are so unusual, that a court will infer bad faith negligence and hold the payor liable for the resulting breach of trust.\textsuperscript{30}

**B. Fiduciary’s Transfer of Negotiable Instruments**

If a fiduciary is authorized to draw or indorse a negotiable instrument, and therefore is not guilty of forgery, transferees of the instrument can become holders in due course.\textsuperscript{31} Holders in due course take free of defenses and claims of prior parties, including

\textsuperscript{25} See, e.g., Scott, Participation in a Breach of Trust, 34 Harv. L. Rev. 454, 480-82 (1921).
\textsuperscript{26} See Unif. Fiduciaries Act § 2, 7A U.L.A. 401 (1985); see also infra notes 60-64 and accompanying text.
\textsuperscript{27} Unif. Fiduciaries Act § 2, 7A U.L.A. 401 (1985). See also infra notes 60-64 and accompanying text.
\textsuperscript{28} U.C.C. § 3-304 comment 5 (1989).
\textsuperscript{29} Comment 5 of former section 3-304 stated as follows:
Subsection (2) follows the policy of Section 6 of the Uniform Fiduciaries Act, and specifies the same elements as notice of improper conduct of a fiduciary. Under paragraph (e) of subsection (4) mere notice of the existence of the fiduciary relation is not enough in itself to prevent the holder from taking in due course, and he is free to take the instrument on the assumption that the fiduciary is acting properly. The purchaser may pay cash into the hands of the fiduciary without notice of any breach of the obligation. Section 3-206 should be consulted for the effect of a restrictive indorsement.
\textsuperscript{30} See infra notes 218-35 and accompanying text.
\textsuperscript{31} U.C.C. § 3-302 (1989).
claims that a fiduciary has embezzled the instrument or its proceeds. The question then arises whether the usual holder in due course rules should be modified: should a taker from a fiduciary be held responsible for loss arising from fiduciary fraud even though the taker would otherwise be a holder in due course? We will see that courts have differed as to the appropriate balance of interests. Moreover, the revised Article 3 definition of “good faith” and the addition of revised section 3-307 have substantially changed the statutory rules applicable to banks that take checks from fiduciaries.

There are a number of different fact patterns that involve a greater likelihood of fiduciary wrongdoing than others. It is appropriate to draw distinctions along lines that suggest relative degrees of risk. Useful distinctions include: (a) to whom is the instrument payable: (i) the fiduciary as such, (ii) the fiduciary personally, or (iii) a third party; (b) who is the drawer: (i) the fiduciary, (ii) the beneficiary, or (iii) a third party; and (c) what knowledge, actual or inferred, does a third party who deals with the check have regarding possible fiduciary wrongdoing with respect to the instrument. Moreover, these considerations may ultimately be posited in terms of negligence: would the circumstances surrounding the negotiation of the instrument be sufficient to cause a reasonable person to inquire into the fiduciary’s authority to effect the transfer?

As a corollary to such “suspicious circumstances,” a major question probative of whether the fiduciary’s transfer of the check was fraudulent is whether the instrument was transferred by the fiduciary in satisfaction of an obligation of the fiduciary, or an obligation of the beneficiary. Of course, this is a matter that would

32. Id. § 3-305.
33. U.C.C. § 3-103(a)(4) (1990) (“Good faith” is defined as “honesty in fact and the observance of reasonable commercial standards of fair dealing.”). See also id. § 3-103 comment 4 (“Although fair dealing is a broad term that cannot be defined with any precision, it is clear that it is concerned with the fairness of conduct rather than the care with which an act is performed.”).
34. Revised U.C.C. section 3-307(b) provides rules applicable where a “taker [for value] has knowledge of the fiduciary status of the fiduciary, and a breach of fiduciary duty [has resulted].” Id. § 3-307(b).
generally require virtually no extrinsic investigation by third party transferees.\footnote{See also infra text accompanying notes 48-52.}

1. \textit{Instruments Payable to Third Parties}.—The first category of cases that we examine involves the fiduciary’s transfer of its beneficiary’s negotiable instrument to a third party to whom the instrument is payable, either in satisfaction of an antecedent debt or in exchange for new value. In such circumstances, two obvious questions arise: (1) If the taker of the instrument knows that the transferor is a fiduciary and also knows that the instrument is being transferred for the fiduciary’s personal benefit, should the taker bear the risk that the fiduciary has made an unauthorized transfer for the fiduciary’s personal benefit; and (2) should the taker be liable to the beneficiary for any fiduciary wrongdoing regarding the unauthorized transfer if the taker did not actually know but should have reasonably known that the transaction did not benefit the beneficiary? We will discover that both the U.F.A. and revised U.C.C. Article 3 answer the first question, “yes,” and the second question, “maybe.” However, under revised Article 3, the taker is more likely to be held liable for what she should reasonably have known.\footnote{As to the U.F.A., see infra text accompanying notes 54-85. As to the result under revised Article 3, see infra text accompanying notes 267-362.}

2. \textit{Instruments Payable to “Fiduciary as Such.”}—An instrument payable to “John Doe, trustee, for the benefit of Mary Jones” is clearly intended to benefit Mary Jones rather than John Doe. The design of the maker or drawer was to transfer value to Mary by using John as a conduit. The instrument, then, is payable to John Doe, as Mary’s fiduciary, since it is payable to the “fiduciary as such.”\footnote{It will often be the case that the item is not clearly made payable to the fiduciary “as such.” A threshold issue may be whether the check was in fact made payable to the fiduciary in the fiduciary’s individual capacity, rather than its fiduciary capacity.}

Instruments must sometimes be made so payable. Corporations must act through agents; similarly, trusts and estates must also act through a trustee or an executor, administrator or personal representative. Even where there is an individual beneficiary who could act for herself, a fiduciary may frequently be authorized to act for her. Therefore, fiduciaries must be able to engage in transactions involving negotiable instruments payable to the “fiduciary as such.”
as such" in a manner similar to that of a beneficiary herself. Nevertheless, liability may be appropriately imposed on a financial institution that takes an instrument from a fiduciary, when the bank thereafter gives the fiduciary value under circumstances that would reasonably suggest that such a remittance compromises the rights of the beneficiary.

Of course, any rule that is promulgated to formulate the contours of a bank's exposure to liability under these circumstances should take into account the instrument itself, as well as the circumstances surrounding the bank's receipt of the item. Again, as in the case of an instrument payable to a third party, so far as the fraud calculus is concerned, when a bank takes an instrument payable to the "fiduciary as such," liability may hinge upon who drew the item, and under what circumstances the item was drawn.

If the beneficiary has drawn the item, there may be less reason for the bank to be suspicious of the fiduciary's transfer of the item than would be the case were the item drawn by the fiduciary. That conclusion naturally flows from the long-standing principles of commercial paper law concerning authorized and unauthorized signatures. But just because an item has been drawn by the fiduciary, rather than the beneficiary, does not compel the conclusion that the check has been drawn to accomplish a fraud on the beneficiary. In many situations, no one but a fiduciary is available to draw a check. Even when the principal can act for herself, she will frequently find it more convenient, if not a business necessity, to allow instruments to be drawn and signed by her fiduciary. Ultimately, the question will be whether, given the various circumstances

40. See, e.g., McAdam v. Dean Witter Reynolds, 896 F.2d 750 (3d Cir. 1990) ("faithless employee" defense did not absolve collecting bank of liability where bank failed to follow "sound stated policies" against cashing third-party checks); Lund v. Chemical Bank, 665 F Supp. 218 (S.D.N.Y. 1987) (party held strictly liable to bank pursuant to former section 3-417(1)(b) for breach of warranty that all signatures are genuine and authorized when checks presented with forged indorsements), rev'd sub nom., Lunds, Inc. v. Chemical Bank, 870 F.2d 840 (2d Cir. 1989) (although a material question of fact precluded granting bank's summary judgment motion below, bank could assert contributory negligence as defense to conversion and payee nevertheless had a right to bring conversion action against bank despite fact that check was never actually delivered to such indorsee); Federal Deposit Ins. Corp. v. Galloway, 856 F.2d 112 (10th Cir. 1988) (company held liable pursuant to former section 3-401 as maker of a note that its president had signed as authorized); Guaranty Bank & Trust Co. v. Federal Reserve Bank, 454 F Supp. 488 (W.D. Okla. 1977) (depositary and collecting banks held liable pursuant to former section 4-207 for breach of presentment warranty).
opportunities for fiduciary fraud, commercial paper law should impose the risk of fiduciary misconduct on the beneficiary or upon the bank that deals with the unfaithful fiduciary. Questions of business expedience, and even necessity, are crucial to the calculus by which such risk of loss will be allocated.

**C. Deposits by Fiduciary**

An issue that frequently arises is allocation of loss in cases of a fiduciary's misappropriation of check proceeds deposited in a financial institution. Again, the way in which the check is drawn, as well as the manner in which the fiduciary deposits the check, will have a bearing upon the allocation of the risk of loss occasioned by fiduciary fraud. The following subsections focus on three ways in which items may be deposited by fiduciaries and demonstrate how distinct factual contexts may affect the fraud analysis.

1. **Deposit to Account of “Fiduciary as Such.”**—In order to accommodate the more expeditious execution of the affairs of its beneficiary, a fiduciary may open a bank account, with the blessing and often at the direction of its beneficiary, into which items, payable to the fiduciary for the benefit of the beneficiary, may be deposited for collection. The fiduciary will likely have signatory authority over the account, and will therefore be able to make disbursements from the account in a manner consistent with the interests of its beneficiary. To facilitate operation of the account, it will likely be opened in the name of the “fiduciary as such” (that is, by actually identifying the fiduciary's representative capacity on the account itself). Thereafter, items for deposit into such an account would be made payable to the “fiduciary as such.”

The factual variables treated in this portion of the Article are necessarily interrelated with considerations surrounding the form in which the check is drawn, the subject of the preceding section. Particularly, the designation of the payee will be a substantial factor in determining the liability exposure of a depositary bank.

---

41. A “depositary bank” is “the first bank to which an item is transferred for collection even though it is also the payor bank.” U.C.C. § 4-105(a) (1989).
42. *Cf. id.* § 3-403 comment 3 (providing illustrations of proper agency signatures).
43. *See supra* text accompanying notes 38-40.
44. U.C.C. § 3-206(3) (1989) (“must pay or apply any value of the instrument consistently with the indorsement and to the extent that he does so he becomes a holder for
the item is made payable to the "fiduciary as such" and deposited in an account with the same designation, it would be difficult to fault the depositary for having accepted the item for deposit to that account; indeed, it is not clear that the beneficiary should be heard to complain of such an action by the depositary. Of course, the beneficiary may have good reason to complain about the ultimate disposition of the funds by the depositary once they are collected. Nevertheless, for present purposes, the depositary's acceptance of the item for deposit into a properly designated fiduciary account must be distinguished from a subsequent disposition of the proceeds from the account. The proper acceptance and deposit of an item should not alter the equitable balance in a manner mimical to the interest of the depositary bank.

2. Deposit to Account of Beneficiary—If the depositary accepts the item payable to either the beneficiary or the "fiduciary as such," and credits the proceeds of the deposit to an account of the beneficiary, the analysis should proceed much as it would in the case described in the preceding section. There is no reason for the depositary to infer that anything unsavory would likely result from crediting an account of the beneficiary with the amount of the item. Under ordinary circumstances, the mere deposit could not, without more, prejudice the beneficiary. Arguably, when deposits are made to the beneficiary's account, the law should be reluctant to infer negligence and, therefore, not be quick to impose

45. Id. §§ 3-206(3) & 3-205(d). See also id. § 3-207(2) (holder in due course vested with enforcement rights (former section 3-301) even in circumstances of a negotiation resulting from a breach of duty—such enforcement rights will therefore overcome "the declaration of a constructive trust or any other remedy permitted by law").

46. See supra text accompanying notes 42-45.

47. However, prejudice may flow in extraordinary circumstances. That is, if there were a deposit into an account over which a fiduciary, or another third party, had signatory authority, injury to the beneficiary's interest would be more likely to occur than if the item had been deposited into an account over which signatory authority was more restricted. Of course, the depositary would likely not be able to anticipate such prejudice, absent notice of the fiduciary's disloyalty at the time of deposit. More importantly, the imposition of liability upon a depositary based merely upon a beneficiary's or fiduciary's choice of account would certainly involve a strained policy consideration.
liability upon a depositary for fiduciary fraud regardless of how the
item had been drawn.

3. Deposit to Personal Account of Fiduciary—But what if
the fiduciary takes an item payable to the beneficiary, or to the
"fiduciary as such," and then deposits the item into the fiduciary's
own personal account? Then the depositary might be applying the
item inconsistently with the interests of the beneficiary. But cer­
tainly, that conclusion would not irrefutably flow simply from the
fact of deposit in the fiduciary's personal account. Conceivably, the
fiduciary may ultimately use the funds represented by the deposit
to discharge an obligation of her beneficiary.

It would seem, however, that the depositary's act of crediting
the personal account of the fiduciary with funds belonging to the
beneficiary would more readily accommodate the fiduciary's possi­
ble embezzlement of the funds. Moreover, commingling
complicates tracing and likely subjects trust funds to the reach of
personal creditors of the fiduciary. Perhaps a greater responsibil­
ity should be appropriately imposed upon a depositary when a
fraudulent diversion of funds is facilitated by the depositary's
crediting of the beneficiary's funds to a fiduciary's personal
account.

48. U.C.C. §§ 3-206(3) & 3-205(d) (1989) (item applied inconsistently with restrictive
endorsement would preclude holder in due course status).

49. Of course, there are common law and ethical prohibitions against a fiduciary's
commingling of funds. P. HASKELL, PREFACE TO WILLS, TRUSTS AND ADMINISTRATION 263 (rev.
ed. 1987) ("It is a breach of trust for the trustee to deposit trust funds in a bank account in
his individual name which contains his individual funds as well."). However, "[t]he prohibi­
tion against commingling has been partially abrogated in almost all jurisdictions to permit a
Corporate fiduciary to hold and invest trust assets in a common trust fund." J. DUKEMINIER
property with attorney's own property). See M. FERSIG & K. KIRWIN, CASES AND MATERIALS
ON PROFESSIONAL RESPONSIBILITY 481 (4th ed. 1984) ("It is not a defense that commingling
of a client's funds was due to careless office supervision or inadequate bookkeeping. Evi­
dence of dishonest motives is unnecessary for discipline." (footnotes omitted)); Adams,
(attorneys liable for retaining lien against client's portion of a $300,000 judgment).

50. P. HASKELL, supra note 49, at 263.


52. See supra text accompanying notes 48-52.
III. Statutory Treatment of Bank’s Liability for Fiduciary Fraud

This part of the Article builds upon the foregoing survey of the recurring opportunities for fiduciary fraud. The first section describes both statutory and common law responses to the issues presented when a beneficiary tries to impose liability upon a bank for a fiduciary’s malfeasance. Throughout this discussion, a major policy question is whether there should be relatively rigid rules that produce greater certainty, or whether courts should be permitted substantial flexibility to reach “fair results” on a case by case basis.53

A. Uniform Fiduciaries Act

The Uniform Fiduciaries Act, promulgated by the NCCUSL in 1922,54 and adopted by twenty-four states and the District of Columbia,55 protects certain third parties dealing with unfaithful fiduciaries.56 The Act broadly defines “fiduciary” to include, among others, trustees, personal representatives, agents, partners, officers of corporations, and “any other person acting in a fiduciary capacity for any person, trust or estate.”57

The Act is comprised of nine substantive sections. Of those sections, section 3 deals with registration and transfer of securities

56. Cf. Unif. Fiduciaries Act prefatory note, 7A U.L.A. 391-92 (1985) (“The liabilities of the fiduciary himself are not dealt with, but only the liabilities of the person dealing with the fiduciary. The general purpose of the Act is to establish uniform and definite rules as to ‘constructive notice’ of breaches of fiduciary obligations.”).
57. Unif. Fiduciaries Act § 1(1), 7A U.L.A. 395-96 (1985). The complete definition is: “Fiduciary” includes a trustee under any trust, expressed, implied, resulting or constructive, executor, administrator, guardian, conservator, curator, receiver, trustee in bankruptcy, assignee for the benefit of creditors, partner, agent, officer of a corporation, public or private, public officer, or any other person acting in a fiduciary capacity for any person, trust or estate.

Id.
held by a fiduciary, and section 10 deals with deposits in the names of two or more fiduciaries. Because these two sections are not directly pertinent to the inquiry of this Article, they will not be considered further. The other sections, however, are relevant to our subject, and are therefore discussed briefly below.

1. **Section 2: “Application of Payments Made to Fiduciaries.”**—Section 2 of the Act provides that one who in good faith transfers or pays money or property to a fiduciary is not responsible for the proper application by the fiduciary of the money or property, provided that the fiduciary is authorized to receive it. Protected by this provision, a bank may dispense funds to a fiduciary from a fiduciary account, or cash a check payable to the principal or the “fiduciary as such,” without becoming liable for fiduciary misappropriation of the cash, provided the bank made the payment in good faith and the fiduciary had the requisite signatory authority.

2. **Section 4: “Transfer of Negotiable Instrument by Fiduciary.”**—Section 4 of the U.F.A. provides that if a fiduciary, with power to do so, indorses a negotiable instrument payable or endorsed to him or to his beneficiary, the indorsee has no duty to inquire whether the fiduciary is committing a breach of trust. The

---

59. See **Unif. Fiduciaries Act § 10, 7A U.L.A. 423 (1985).** Section 10 provides that in cases of deposit in the names of two or more trustees and with authorization of multiple trustees to draw checks on the trust account, neither a payee, nor other holder, nor the bank is required to investigate whether such authorization is a breach of trust.
60. **Unif. Fiduciaries Act § 2, 7A U.L.A. 401 (1985).** Section 2 provides as follows: A person who in good faith pays or transfers to a fiduciary any money or other property which the fiduciary as such is authorized to receive, is not responsible for the proper application thereof by the fiduciary; and any right or title acquired from the fiduciary in consideration of such payment or transfer is not invalid in consequence of a misapplication by the fiduciary.

*Id.*

63. **Unif. Fiduciaries Act § 1(2), 7A U.L.A. 396 (1985).** ("Good faith" is a thing "in fact done honestly, whether it be done negligently or not."); see also **Ala. Code § 35-4-254 (1975)** (payor of payment made to a trustee is not liable for the misapplication of payment "unless it be made to appear that the person making such payment colluded with the trustee, or knew of [the trustee’s] intention to waste or mismanage the funds.").
64. **Unif. Fiduciaries Act § 2, 7A U.L.A. 401 (1985).**
Indorsee is not charged with notice that a breach of trust is being committed, unless the indorsee actually knows of the breach, has knowledge of such facts that taking the instrument is evidence of bad faith, or knows that the transaction is for the personal benefit of the fiduciary. Section 4, therefore, protects a transferee from a claim by the beneficiary that the transferee participated in a wrongful transfer of a negotiable instrument, so long as the transferee neither acted in bad faith nor knew that the transaction was for the benefit of the fiduciary. Although the Act does not define “bad faith,” the term has been construed to mean dishonesty, not mere negligence or failure to act reasonably.

3. Section 5: “Check Drawn by Fiduciary Payable to Third Person.”—Section 5 of the Act protects payees of checks or other drafts drawn by a “fiduciary as such,” or drawn in the name of the beneficiary. That section applies to payees the same rules applied by section 4 to indorsees.

4. Section 6. “Check Drawn by and Payable to Fiduciary”—Pursuant to section 6 of the Act, transferees of checks drawn by the “fiduciary as such” and payable to the fiduciary personally or checks drawn by the fiduciary as such and payable to third persons who have indorsed the item back to the fiduciary, can take such checks without liability even in transactions known to be for the personal benefit of the fiduciary, so long as the trans-

67. See, eg., Maryland Casualty Co. v. Bank of Charlotte, 340 F.2d 550, 554 (4th Cir. 1965) (bad faith means “dishonesty [but] [t]his abbreviated definition is inaccurate if it is read to emphasize and require a high degree of moral guilt. Neither criminal fraud nor downright corruption is an essential ingredient of legal ‘bad faith’” At some point, obvious circumstances become so cogent that it is ‘bad faith’ to remain passive.” (citations omitted)); Davis v. Pennsylvania Co. for Ins. on Lives & Granting Annuities, 337 Pa. 456, 459, 12 A.2d 66, 68 (1940) (bad faith means “only when [the act] is done dishonestly and not merely negligently”); Guild v. First Nat’l Bank, 92 Nev. 478, 483, 553 P.2d 955, 958 (1976) (Mere “lack of due care, or negligence,” does not establish bad faith. “In the absence of conscious purposeful misconduct, banks may not be held liable.”). See also infra note 83.
68. Unif. Fiduciaries Act § 5, 7A U.L.A. 406-07 (1985) (payee not liable to beneficiary for resulting fiduciary fraud if payee has no knowledge of any misappropriation or has not acted in bad faith).
69. Id. § 5.
feree had neither actual knowledge of the breach of trust nor acted in bad faith. The underlying assumption of the section is that fiduciaries will often be entitled to receive payment from the fiduciary account as payment for services rendered or reimbursement for expenditures made on behalf of the beneficiary. In such cases, it would be very cumbersome if the checks had to be signed by someone other than the fiduciary.

5. Section 7: "Deposit in Name of 'Fiduciary as Such.'"—Sections 7 through 9 of the U.F.A. cover depositories that deal with fiduciaries. Section 7 provides that if a bank deposit is made to the credit of a "fiduciary as such," the bank has no duty to determine whether the fiduciary has drawn checks thereon consistently with the beneficiary's interest, and is therefore not liable to the beneficiary for a breach of trust by the fiduciary, unless the bank has knowledge of either a breach of an obligation by the fiduciary or of such facts that paying the item amounts to bad faith by the bank. If, however, the fiduciary draws a check on the account payable to the bank and the bank knows that the check is intended to satisfy or is security for a personal obligation of the fiduciary, then the bank is liable for any resulting loss to the beneficiary if the fiduciary has in fact breached her fiduciary obligation.

6. Section 8: "Deposit in Name of Principal."—Section 8 protects a bank as payor to the same extent that a depository is protected under section 7, if a fiduciary is authorized to draw checks on an account of the beneficiary. The bank may, in such a case, pay the check signed by the fiduciary without liability to the beneficiary unless the bank knows that the fiduciary is breaching her trust or has knowledge of facts that indicate paying the check constitutes bad faith. However, as in the case of an account in the name of a "fiduciary as such," if the check is payable to a drawee bank and is taken by that bank in payment, or as security,

---

70. Id. § 6, at 410.
71. Id. § 6 comment, at 411. ("[H]owever it may very well be that the fiduciary was entitled to receive payment out of his principal's funds, as where the principal is indebted to him for salary, commissions, reimbursements for expenses, dividends, or the like.").
72. Id. § 7, at 413.
73. Id. (applies to accounts in the name of the "fiduciary as such").
74. UNIF. FIDUCIARIES ACT § 8, 7A U.L.A. 415 (1985) (applies to accounts in the name of the principal).
75. Id. § 8.
for a personal debt of the fiduciary, then the bank is liable if the fiduciary is, in fact, breaching her fiduciary obligation. 76

7 Section 9: “Deposit in Fiduciary’s Personal Account.”—Section 9 goes further than the sections described above, and protects the bank even where the fiduciary deposits in her personal account checks that were payable to her principal or payable to her as fiduciary, or checks drawn by her on the beneficiary’s account, or other fiduciary funds. 77 In that case, the bank may permit withdrawal of the proceeds by personal check of the fiduciary without a duty of inquiry 78 and, furthermore, without being liable for any breach of obligation by the fiduciary, unless the bank had actual knowledge of the breach or knowledge of such facts that its payment would be deemed bad faith. 79

8. Purpose of the Uniform Fiduciaries Act.—As the above discussion indicates, the U.F.A. generally imposes upon the beneficiary the risk of fiduciary misappropriation of checks or funds belonging to the beneficiary, in the bank’s absence of actual knowledge of wrongdoing or knowledge of such facts that completing the transaction shows dishonesty 80 The only situation in which liability is imposed upon a bank, without actual knowledge of wrongdoing or bad faith, 81 is the case in which a bank takes an

76. Id.
77. Id. § 9.
78. UNIF. FIDUCIARIES ACT § 9, 7A U.L.A. 417 (1985). Contra U.C.C. § 3-307 (1990); see infra notes 253-312 and accompanying text. Since revised Article 3 departs from the rule stated in U.F.A. section 9, section 9 is here set out in its entirety:

If a fiduciary makes a deposit in a bank to his personal credit of checks drawn by him upon an account in his own name as fiduciary, or of checks drawn to him as fiduciary, or of checks drawn by him upon an account in the name of his principal if he is empowered to draw checks thereon, or of checks payable to his principal and indorsed by him, if he is empowered to indorse such checks, or if he otherwise makes a deposit of funds held by him as fiduciary, the bank receiving such deposit is not bound to inquire whether the fiduciary is committing thereby a breach of his obligation as fiduciary; and the bank is authorized to pay the amount of the deposit or any part thereof upon the personal check of the fiduciary without being liable to the principal, unless the bank receives the deposit or pays the check with actual knowledge that the fiduciary is committing a breach of his obligation as fiduciary in making such deposit or in drawing such check, or with knowledge of such facts that its action in receiving the deposit or paying the check amounts to bad faith.

79. Id. § 9, at 417. See supra, note 47.
80. See supra notes 61-79 and accompanying text.
81. This assumes, of course, that “the fiduciary as such is authorized to receive” the money or property paid or transferred. UNIF. FIDUCIARIES ACT § 2, 7A U.L.A. 401 (1985). See
item in satisfaction of, or as security for, a debt of the fiduciary, or in a transaction otherwise known to be for the benefit of the fiduciary.  

Significantly, the U.F.A. specifically rejects the idea that negligence on the part of a third person dealing with the fiduciary is sufficient to shift the risk of fiduciary misconduct from the beneficiary to the third party.  

Such a policy choice is of particular importance because several courts in both U.F.A. and non-U.F.A. states have imposed negligence-based liability upon banks dealing with disloyal fiduciaries.  

Furthermore, revised Article 3 defines "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing," which suggests that ignoring suspicious circumstances would be sufficient to impose the loss on transactors dealing with unfaithful fiduciaries.

---

Seago, Patrick, Carmichael & Miller v. State Farm Mut. Auto Ins. Co., 521 So. 2d 674 (La. Ct. App. 1988) (bank held not liable for fiduciary misappropriations when bank required corporate resolution authorizing such fiduciary to write unlimited number of checks on the corporation's account, but such authorization did not give the fiduciary the authority to pay her personal obligations with corporate funds).

82. See supra notes 61-79 and accompanying text.

83. Unif. Fiduciaries Act § 1(2), 7A U.L.A. 396 (1985) ("A thing is done 'in good faith' within the meaning of th[e] act, when it is in fact done honestly, whether it be done negligently or not."). See Edwards v. Northwestern Bank, 39 N.C. App. 261, 268, 250 S.E.2d 651, 656 (1979) ("A showing of mere negligence is clearly not sufficient to establish liability."); aff'd, 53 N.C. App. 492, 281 S.E.2d 86 (1981) (bank's failure to inquire not sufficient to establish "bad faith" in alleged misappropriation of corporate assets); Davis v. Pennsylvania Co. for Ins. on Lives and Granting Annuities, 337 Pa. 456, 459, 12 A.2d 66, 69 (1940) (In deciding the question: "At what point does negligence cease and bad faith begin?" the court noted that: "The distinction between them is that bad faith, or dishonesty, is, unlike negligence, wilful." The bank was found not liable for accepting a trustee's deposit into his personal account that consisted of checks the trustee had signed as fiduciary and for paying checks drawn on that account.). See also New Amsterdam Casualty Co. v. National Newark & Essex Banking Co., 117 N.J. Eq. 264, 271, 175 A. 609, 613 (1934) ("The standard of due care or negligence and the doctrine of constructive notice in respect of bank deposits of fiduciary funds find no recognition in the [Uniform] Fiduciaries Act."); aff'd, 119 N.J. Eq. 540, 182 A. 824 (1936). The bank was found not liable in a receiver's elaborate scheme of transferring receivership funds to his personal account. New Amsterdam Casualty, 117 N.J. at 271, 175 A. at 613.

84. See infra notes 283-97 and accompanying text.

85. U.C.C. § 3-103(a)(4) (1990); see infra notes 341-46, 350 & 352 and accompanying text (extent to which the new "good faith" definition imposes a freedom from negligence standard).
B. Former U.C.C. Article 3

At three separate junctures, former Article 3 of the U.C.C. provided rules to guide the courts’ allocation of risk for fiduciary fraud between banks and their customers: section 3-117,\(^{86}\) proper form of indorsement; section 3-206,\(^{87}\) application of the proceeds of a restrictively indorsed item; and, most significantly, section 3-304,\(^{88}\) fiduciary fraud rules in the context of notice of claims or defenses of prior parties, one of the essential elements of the “holder-in-due-course” doctrine. The discussion that follows treats the scope of each of these provisions, their application in decided cases and their interrelation.

1. Former U.C.C. Section 3-117—Discussion of U.C.C. provisions that have an impact on bank liability for fiduciary fraud begins appropriately with a former Article 3 section that provided a rule of construction. Section 3-117 determined the party to whom an instrument was properly payable.\(^{89}\) This was of consequence because the bank that paid the wrong party might have been liable in conversion to the true owner of the item.\(^{90}\) Conversely, the bank that paid in a manner consistent with the payee/indorsee line might have properly argued, pursuant to former section 3-117, that it had done all it should have done to ensure that the fiduciary was not provided, by the bank’s actions, the opportunity to defraud the beneficiary.\(^{91}\) Instruments payable to a named individual (for present purposes, a fiduciary) as the agent of a specified person\(^{92}\) were payable to the specified person, but the agent nevertheless “could act as if he were the holder.”\(^{93}\) The accompanying comment to former subsection 3-117(a) offered four examples of such payee or indorsee lines:

“John Doe, Treasurer of Town of Framingham,”
“John Doe, President Home Telephone Co.,”
“John Doe, Secretary of City Club,” or

\(^{86}\) U.C.C. § 3-117 (1989).
\(^{87}\) Id. § 3-206.
\(^{88}\) Id. § 3-304.
\(^{89}\) See id. § 3-117.
\(^{90}\) See id. § 3-419(1)(c).
\(^{91}\) Id. § 3-419(3).
\(^{92}\) Id. § 1-201(30) (“‘Person’ includes an individual or an organization ”).
\(^{93}\) Id. § 3-117(a).
The 3-117 rule was designed to effectuate general commercial expectations that a party so drawing or indorsing a check intended to make the instrument payable to the beneficiary, but yet also authorized the fiduciary to deal with the instrument on behalf of the beneficiary. Note that the principal/agent relationship addressed by former subsection 3-117(a) described only one form of fiduciary relationship within the scope of the U.F.A.

Subsection (b) of former section 3-117 encompassed all of the other fiduciary relationships not contemplated by subsection (a), and provided that an item made payable in a form such as the following:

"John Doe, Trustee of Smithers Trust,"
"John Doe, Administrator of the Estate of Richard Roe, or
"John Doe, Executor under Will of Richard Roe,"

was payable to the named fiduciary, John Doe, who, as personal representative, would be liable to the beneficiary for any breach of fiduciary duty. The comment accompanying subsection (b) tied section 3-117 into the general "notice to purchaser" provision of former section 3-304 by explaining that

[any subsequent holder of the instrument is put on notice of the fiduciary position, and is not a holder in due course if he takes with notice that John Doe has negotiated the instrument in payment of or as security for his own debt or in any transaction for his own benefit, or otherwise in breach of duty.

While the comment to subsection 3-117(b) did not specifically refer to an instrument made payable in the form contemplated by subsection (a), there was no reason to treat the two cases differ-
ently. Therefore, former section 3-304\textsuperscript{104} should have applied to the subsection 3-117(a)\textsuperscript{105} context just as it applied to the subsection 3-117(b)\textsuperscript{106} context.

Finally, former subsection (c)\textsuperscript{107} provided a "catch-all" rule; in the case of an instrument made payable, with additional words of description not within the scope of subsections (a)\textsuperscript{108} and (b)\textsuperscript{109} and therefore not in a manner that suggested the payee is acting in a representative capacity for another party, the instrument is payable to the payee absolutely, and subsequent parties can therefore ignore such additional words of description\textsuperscript{110} with impunity. The rule of former subsection 3-117(c)\textsuperscript{111} extends to cases in which the representative capacity of the payee, but not the identity of the party represented, is designated.\textsuperscript{112} While the language of the former subsection (c) and comment 3 makes clear that words of description alone\textsuperscript{113} are not sufficient to impart notice that would compromise a subsequent taker's holder in due course status,\textsuperscript{114} it remains the case that such notice can be established by reference to other circumstances surrounding the fiduciary's negotiation of the instrument.\textsuperscript{115}

The cases construing former section 3-117\textsuperscript{116} are not legion. Four decisions,\textsuperscript{117} however, are pertinent so far as fiduciary fraud issues are concerned. In \textit{Feinstein v. Chemical Bank},\textsuperscript{118} a New

\begin{itemize}
\item[104.] \textit{Id.} § 3-304.
\item[105.] \textit{Id.} § 3-117(a).
\item[106.] \textit{Id.} § 3-117(b).
\item[107.] \textit{Id.} § 3-117(c).
\item[108.] \textit{Id.} § 3-117(a).
\item[109.] \textit{Id.} § 3-117(b).
\item[110.] \textit{Id.} § 3-117 comment 3 (offers examples of subsection (c) payee lines: "John Doe, 1121 Main Street," "John Doe, Attorney," or "Jane Doe, unmarried widow").
\item[111.] \textit{Id.} § 3-117(c).
\item[112.] \textit{Id.} § 3-117 comment 3. Thus, former section 3-117(c) applied to "any description of the payee as 'Treasurer, 'President, 'Agent, 'Trustee, 'Executor, or 'Administrator, which does not name the principal or beneficiary." \textit{Id.}
\item[113.] U.C.C. § 3-117 comment 3 (1989) ("words of description are to be treated as mere identification").
\item[114.] \textit{Id.} § 3-117 comment 3 ("Any subsequent party dealing with the instrument may disregard the description and treat the paper as payable unconditionally ").
\item[115.] \textit{Id.} § 3-117 comment 3 ("fully protected [only] in the absence of independent notice of other facts sufficient to affect his position").
\item[116.] \textit{Id.} § 3-117.
\item[117.] \textit{See infra} notes 118-65 and accompanying text.
\end{itemize}
York state appellate court considered an attorney's negotiation of an instrument, issued pursuant to a divorce settlement, that was payable to "Herbert Mildner, Att., Selma Goldin." The court applied former subsection 3-117(b) to support its conclusion that the instrument was payable to the attorney, and that his indorsement alone was therefore sufficient to negotiate the check. So the bank that had taken the item was a holder, notwithstanding the absence of Ms. Goldin's indorsement on the check. Since the necessary indorsement was provided by the attorney, as fiduciary, the bank took a properly payable item even though the beneficiary did not indorse. Of course, notwithstanding the bank's lack of culpability, attorney Mildner might still be liable to his client, the beneficiary, for any misuse of the proceeds.

Similarly, in In re Knox, a bank that paid the proceeds of a check to a fiduciary, the beneficiary's father, was not liable to the child when the father used a portion of the proceeds to benefit not only the child, but also other members of the family. The signature of the father was sufficient to negotiate the check, and there was nothing in former section 3-117 to impose upon the bank, which took the item as indorsed, an obligation to ensure that the proceeds of the check were, in fact, used solely in a manner consistent with the beneficiary's interests.

In two other decisions, the courts were confronted with a payee line that was less than clear regarding the identity of the proper payee. In one of these decisions, West Penn Administration v. Union National Bank, the Pennsylvania court considered an item that had been made payable to the order of "Pittsburgh Na-
tional Bank Carpenters Contribution Account.” 130 The West Penn court found that Pittsburgh National Bank was the payee of the item;131 so the separate indorsement of the contribution account was not necessary 132 Subsection 3-117(c)133 was relied upon in support of the conclusion that the words “Carpenters Contribution Account” were merely descriptive, and had no impact on the title to the paper.134

The California Court of Appeals, in Joffe v. United California Bank,135 considered a payee line somewhat similar to that at issue in the West Penn case.136 The Joffes had obtained a teller’s check from Allstate Savings and Loan Association made payable to “Continental Financial Systems—Wells Fargo Escrow Trust Account.”137 The Joffes then remitted the check to Continental as payment for investment property. Apparently, the land deal was a scam to which the Joffes were victim. Continental had instructed the Joffes how to draw the check, and Continental then took the check and deposited it in an account denominated “Continental Financial Systems,” maintained at Bank of America (“BA”).138 The depositary, BA, credited the check to Continental’s account and forwarded the item to United California Bank (“UCB”), the drawee/payor, for payment.139 The check was paid by UCB and was charged against Allstate’s account.140 The Joffes, as assignees of the rights of the drawer Allstate, brought breach of warranty141 and negligence actions against BA as well as wrongful payment142

130. West Penn, 233 Pa. Super. at 321, 335 A.2d at 729.
131. Id.
132. Id. at 321, 335 A.2d at 730.
133. U.C.C. § 3-117(c) (1989).
137. Joffe, 141 Cal. App. 3d at 548, 190 Cal. Rptr. at 446.
138. Id.
139. Id.
140. Id.
141. Id.
and negligence actions against UCB. The trial court sustained the defendants’ demurrers to all four causes of action, and the Joffes appealed.

The appellate court considered each of the four causes of action and found that three of the four withstood demurrer. Of concern here is the court’s treatment of the breach of presentment warranty claim against BA. The Joffes argued that, because the check had not been properly indorsed, the depositary paid the item over an improper, unauthorized indorsement and therefore did not have good title to the item. The payor responded that the words “Wells Fargo Escrow Trust Account” were merely descriptive of Continental, and therefore, section 3-117 validated the form of indorsement. Under this construction, the depositary did have good title and had not therefore breached a presentment warranty to BA, the drawee/payor.

The court analyzed the application of subsections 3-117(b) and (c) and found that neither applied to validate the indorsement relied upon by the depositary. The court deemed subsection 3-117(b) inapposite “because the payee line does not describe Continental’s fiduciary capacity.” The court then turned to subsection 3-117(c) and held that provision inapplica-

144. Id. at 548, 190 Cal. Rptr. at 446. The three causes of action withstanding demurrer were: (1) that BA had negligently breached its duty of due care by accepting the item for deposit into Continental’s account; (2) that BA had breached its warranty of good title under the California version of U.C.C. section 4-207(1)(a); and (3) that UCB had improperly paid the item over an improper indorsement in breach of UCB’s agreement with drawer Allstate to honor only properly payable items. Id.
145. Id. at 548-57, 190 Cal. Rptr. at 446-52.
146. Id. at 548, 190 Cal. Rptr. at 446.
149. Joffe, 141 Cal. App. 3d at 550, 190 Cal. Rptr. at 447. Also, in Sun ‘N Sand, Inc. v. United Cal. Bank, 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978), the California Supreme Court also recognized that a drawer could have standing to bring a breach of presentment warranty action by characterizing the drawer as an “other payor.” Sun ‘N Sand, Inc., 21 Cal. 3d at 682, 582 P.2d at 928, 148 Cal. Rptr. at 337.
150. U.C.C. § 3-117(b) & (c) (1989).
152. U.C.C. § 3-117(b) (1989).
154. U.C.C. § 3-117(c) (1989).
ble “because the words ‘Wells Fargo Escrow Trust Account’ do not patently identify or describe Continental, but appear rather to identify an escrow or trust at Wells Fargo Bank.” The depository nonetheless urged that on the basis of the West Penn decision, the form of indorsement and therefore BA’s good title to the instrument should be upheld.

But the appellate court was not convinced, and distinguished West Penn. In West Penn, the Pennsylvania Superior Court concluded that the indorsement of Pittsburgh National Bank alone in that case was sufficient because agreements established the Carpenters Contribution Account and authorized Pittsburgh National Bank to act as depository of funds for the contribution account; and the parties had also authorized the bank to make payments out of the account on behalf of the beneficiaries of the account. Insofar as BA had no such agreement or authority on the Joffe facts, the bank could not rely upon the form of indorsement provided by Continental to absolve it from liability.

More interesting is the court’s recognition that the plaintiffs, the Joffes, could bring a negligence action against the depository for having taken an item payable to Continental as fiduciary for deposit to Continental’s individual account. The court concluded, in fact, that once former section 3-117 was found inapplicable, the depository and all who claimed through the depository would be potentially liable for their negligent handling of

155. Joffe, 141 Cal. App. 3d at 551, 190 Cal. Rptr. at 448.
158. Joffe, 141 Cal. App. 3d at 551, 190 Cal. Rptr. at 448.
159. West Penn, 233 Pa. Super. at 325, 335 A.2d at 731.
160. See Joffe, 141 Cal. App. 3d at 551, 190 Cal. Rptr. at 448.
161. See id. at 551-52, 190 Cal Rptr. at 448.
162. Joffe, at 552-53, 190 Cal. Rptr. at 449 (citing WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY 1114 (1981)). The court addressed the issue of whether Continental Financial Systems and Wells Fargo Escrow Trust Account were “joint payees.” The court used a dictionary definition of the word “hyphen” to determine that a hyphen between two names indicates just one payee. Id. Section 3-110 of former Article 3 could therefore be used to determine the liability of the parties that accommodate perpetration of a fraud by enforcing the “conspicuously designated on its face” language of the section. See U.C.C. § 3-110(1) (1989).
the item.\textsuperscript{164} The court then remanded on the grounds that there was an issue of fact concerning the bank’s negligence.\textsuperscript{165} Such a finding would support the imposition of liability upon the depositary in favor of the Joffes, as beneficiaries, for the fraud of their fiduciary Continental.\textsuperscript{2}

2. \textit{Former U.C.C. Section 3-206}.—Fiduciary fraud considerations may be directly presented in the context of instruments bearing certain restrictive indorsements. Former section 3-205\textsuperscript{166} described an indorsement that “states that it is for the benefit or use of the indorser or of another person” as a restrictive indorsement,\textsuperscript{167} and former section 3-206\textsuperscript{168} described the consequences that attend negotiation of an instrument restrictively indorsed.\textsuperscript{169} The effect of former subsection 3-206(4)\textsuperscript{170} is twofold: (1) to impose on the first taker of a restrictively indorsed instrument the duty to pay, or apply value, consistently with the restrictive indorsement; and (2) to make clear that no subsequent transferee is encumbered by the duty to assure that value was in fact properly credited.\textsuperscript{171}

If, therefore, a check is indorsed “Pay to B, as trustee for A” and depositary bank allows B to deposit the check in his personal account, bank has no duty to see that the funds are properly applied. If the fiduciary subsequently breaches the trust by withdrawing the funds for non-trust purposes, the bank has no liability to the beneficiary unless the bank acts in bad faith or is on

\begin{itemize}
  \item \textsuperscript{165} \textit{Joffe} 141 Cal. App. 3d at 558, 190 Cal. Rptr. 452-53 (lower court’s dismissal of plaintiff’s cause of action was reversed).
  \item \textsuperscript{166} U.C.C. § 3-205 (1989).
  \item \textsuperscript{167} U.C.C. § 3-205(d) (1989).
  \item \textsuperscript{168} \textit{Id.} § 3-206.
  \item \textsuperscript{169} \textit{Id.} § 3-206(4). Former subsection 3-206(4) provided:
  
  The first taker under an indorsement for the benefit of the indorser or another person (subparagraph (d) of Section 3-205) must pay or apply any value given by him for or on the security of the instrument consistently with the indorsement and to the extent that he does so he becomes a holder for value. In addition such taker is a holder in due course if he otherwise complies with the requirements of Section 3-302 on what constitutes a holder in due course. A later holder for value is neither given notice nor otherwise affected by such restrictive indorsement unless he has knowledge that a fiduciary or other person has negotiated the instrument in any transaction for his own benefit or otherwise in breach of duty (subsection (2) of Section 3-304).
  
  \item \textsuperscript{170} \textit{Id.} § 3-206(4).
  \item \textsuperscript{171} \textit{Id.}
notice of the breach of fiduciary duty. Mere knowledge that the check is being deposited in the trustee’s personal account is neither evidence of bad faith nor notice of a breach of fiduciary duty.\(^{172}\)

The comment to former section 3-206\(^{173}\) explained the limited scope of the protection of subsection 3-206(4): “Whether transferees from [the fiduciary] have notice of a breach of trust such as to deny them the status of holders in due course is governed by the section on notice to purchasers (Section 3-304); the trust indorsement does not of itself give such notice.”\(^{174}\) This comment clarified the operation of subsection (4)\(^{176}\) in the fiduciary fraud case. So far as the first taker, e.g., a depositary bank, of a restrictively indorsed instrument for the benefit of a beneficiary is concerned, value given for the item must be given in a manner consistent with the indorsement.\(^{176}\) Therefore, in terms of the restrictive indorsement analysis, the fiduciary’s transferees, such as the depositary give value for holder in due course purposes by giving value to the fiduciary\(^{177}\) whether or not the fiduciary absconds with the proceeds of the item. What does matter is whether the depositary bank had notice of the fiduciary’s defalcation, and that was a matter within the purview of former section 3-304,\(^{178}\) not a matter of value under former section 3-303.\(^{178}\)

The former section 3-206\(^{180}\) issues of concern, for the purposes of this portion of the Article, involve cases in which courts have been called upon to consider whether the depositary did in fact apply value in a manner consistent with a restrictive indorsement and the interests of the trust. Allegations of misapplication are premised on the tort of conversion because the defendant would have taken an action inconsistent with the right, title, or claim of another.\(^{181}\) Section 3-419\(^{182}\) of Article 3 concerned the conversion

---

172. See id. § 3-206 comment 6; infra text accompanying notes 256-66.
174. Id. § 3-206 comment 6.
175. Id. § 3-206(4).
177. U.C.C. § 3-303(a) (1989).
178. Id. § 3-304.
179. Id. § 3-303.
180. Id. § 3-206.
of commercial paper, but did not specify the scope of conversion theory applicable to commercial paper. However, by negative inference from former subsection 3-419(3)\(^{183}\) and from supplementary common law principles\(^{184}\) incorporated by operation of section 1-103,\(^{185}\) a conversion action would lie against a depositary that paid in a manner inconsistent with a restrictive indorsement.\(^{186}\)

Three cases, in particular, are noteworthy for their treatment of the conversion issues raised when a depositary fails to apply value consistently with a restrictive indorsement and thereby accommodates the fiduciary's fraud on her beneficiary First, In re Quantum Development Corp.\(^{187}\) dealt with the liability of a depositary bank that improperly applied the proceeds of a restrictively indorsed item. Although the court could find no specific U.C.C. section that it believed established the liability of a depositary for such an erroneous action, it construed the pervasive statutory scheme of Article 3 to accommodate the imposition of liability on the depositary.\(^{188}\) From those premises the court distilled its holding:

183. Former subsection 3-419(3) provided:
Subject to the provisions of this Act concerning restrictive indorsements a representative, including a depositary or collecting bank, who has in good faith and in accordance with the reasonable commercial standards applicable to the business of such representative dealt with an instrument or its proceeds on behalf of one who was not the true owner is not liable in conversion or otherwise to the true owner beyond the amount of any proceeds remaining in his hands.

Id. § 3-419(3).

184. See infra notes 187-89.


188. In re Quantum Dev., 397 F Supp. at 336-37. The court noted, first, that former section 3-206(2) did not apply to depositary banks and that here BNS was a depositary. Second, by negative implication, former section 3-419(4) provided a remedy in conversion against a depositary bank that failed to pay according to a restrictive indorsement. Third, former section 3-419(3) imposed conversion liability on the depositary if it failed to act in accordance with "reasonable commercial standards." Fourth, former section 3-603 made an explicit exception to its general rule not requiring payor banks to obey a stop order issued
The common law rule, sifted from both case precedent and the respected treatises in the field, suggest [sic] that if a bank receives a deposit with instructions to place it to the credit of a fiduciary in his representative capacity, and instead credits it to the individual account of the fiduciary, the bank is liable in conversion if the deposit is later disbursed by the trustee for nontrust purposes. 189

Because the depositary had issued certificates of deposit to the fiduciary personally, the court found that the beneficiary would be able to recover the amount of the CDs from the depositary 190. The depositary argued that the beneficiary could not recover because the depositary was a holder in due course. 191 The court concluded that former section 3-306 192 only provided that a depositary was not "ipso facto" given notice by a restrictive trust indorsement. 193 Because the depositary had not applied the funds represented by the check in a manner consistent with the indorsement, former subsection 3-206(2) "immunity" was not available to the depositary 194. In that case, the beneficiary would have a viable conversion action.

The New York Court of Appeals, in Underpinning & Foundation Constructors v. Chase Manhattan Bank, N.A., 195 recognized that "the prime function of [fiduciary fraud loss allocation] rules is to impose liability on the party which could most readily have prevented the fraud." 196 An employee had company checks issued to named payees intending them to have no interest; the employee restrictively indorsed the checks "for deposit" over the forged signatures of the named payees, but deposited the checks

by an indorser in the case of a depositary that satisfies the holder of an item that has been indorsed inconsistently with a restrictive indorsement. Finally, the court stated that section 1-103 was provided by the drafters of the Code to demonstrate that particular U.C.C. provisions are not exclusive; thus, common law principles remain in force.


194. Id.


196. Underpinning, 46 N.Y.2d at 469, 386 N.E.2d at 1324, 414 N.Y.S.2d at 303.
into his personal account or the accounts of confederates. The court acknowledged that had the check bearing the forged indorsement in the case not been restrictively indorsed, the loss would have properly been borne by the drawer of the check by operation of former section 3-405.\textsuperscript{197} The court determined, however, that the existence of the restrictive indorsement changed matters profoundly: “By disregarding the restriction, [the depositary] not only subjects itself to liability for any losses resulting from its actions, but it also passes up what may well be the best opportunity to prevent the fraud.”\textsuperscript{198} The court deemed deposit into the account of someone other than the restrictive indorser “an obvious warning sign.”\textsuperscript{199}

In \textit{Brite Lite Lamps Corp. v. Manufacturers Hanover Trust Co.},\textsuperscript{200} another New York court reached the same conclusion as the Quantum Development court and relied on much of the Underpinning analysis to support the conversion action against the depositary that made a payment inconsistent with a restrictive indorsement. \textit{Brite Lite}, an employee defalcation case, involved an employee’s theft of checks already indorsed “for deposit only” from her employer.\textsuperscript{201} The court recognized the viability of four potential causes of action brought by the employer-payee of the restrictively indorsed checks: \textsuperscript{202} “(1) money had and received;[\textsuperscript{203}]

\begin{itemize}
  \item \textsuperscript{197} \textit{Id.} at 462-63, 385 N.E.2d at 1320, 414 N.Y.S.2d at 299. In this case, the employee, Walker, was an agent for Underpinning & Foundation Constructors ("Underpinning") and was supplying the drawer Underpinning with the name of the payee for the checks, intending that the payee have no interest in the instruments. This is the type of fact situation contemplated by former section 3-405(1)(c). See U.C.C. § 3-405 comment 3 (1989). Therefore, but for the restrictive indorsement that shifted liability to the depositary bank, the drawer would have borne the loss. See U.C.C. § 3-419(3) (1989) (conversion action may lie where depositary fails to honor restrictive indorsement).
  \item \textsuperscript{198} \textit{Underpinning}, 46 N.Y.2d at 469, 386 N.E.2d at 1324, 414 N.Y.S.2d at 303.
  \item \textsuperscript{199} \textit{Id.}
  \item \textsuperscript{200} 34 U.C.C. Rep. Serv. (Callaghan) 1221 (N.Y. Sup. Ct. 1982).
  \item \textsuperscript{202} \textit{See} Underpinning & Found. Constructors v. Chase Manhattan Bank, N.A., 46 N.Y.2d 459, 464, 385 N.E.2d 1319, 1320-21, 414 N.Y.S.2d 298, 300 (1979) (cited in Brite Lite, 34 U.C.C. Rep. Serv. (Callaghan) at 1223). The plaintiff was the drawer of the check. The court found that the drawer was a proper plaintiff and that a cause of action could lie against the depositary, thereby rejecting the holdings in Stone & Webster Eng’g Corp. v. First Nat’l Bank & Trust Co., 345 Mass. 1, 184 N.E.2d 358 (1962); and Life Ins. Co. v. Snyder, 141 N.J. Super. 539, 358 A.2d 859 (1976); and instead, adopting the conclusion
\end{itemize}
(2) negligence; (3) conversion; and (4) breach of contract.” 204 The same facts that would support the conversion and negligence theories were also deemed sufficient by the Brite Lite court to support a breach of contract action against the depositary 205 The fact that the plaintiff was a depositor at the defendant-depository bank gave rise to a contractual relation between the plaintiff and the defendant and the payment inconsistent with the restrictive indorsement constituted a breach of that contract.206

From the plaintiff's perspective, there is both a good and a bad side to the court's recognition of the bank's liability based upon breach of contract theory. First, since the court found that the plaintiff's action sounded in contract, punitive damages would not be available. That would matter little to the plaintiff in cases such as Brite Lite and Underpinning because recovery of punitive damages would be possible only if a successful plaintiff demonstrated a willful, malicious, and intentional wrongdoing on the part of the defendant.207 Therefore, an award of punitive damages would have been highly improbable since the depositary would almost have to have been a joint tortfeasor with the fraudulent employee to support exemplary recovery. Nevertheless, because the court recognized the availability of a coincident negligence ac-

[203. See Coast Trading Co. v. Parmac, Inc., 21 Wash. App. 896, 902, 587 P.2d 1071, 1075 (1978) (holding that “money had and received” is an ancient common-law remedy, based on quasi-contract or contract implied-in-law, with equitable overtones); Weiss v. Marcus, 51 Cal. App. 3d 590, 598, 124 Cal. Rptr. 297, 303 (1975) (“An action for money had and received lies wherever one person has received money which belongs to another, and which in equity and good conscience should be paid over to the latter.”).]

204. Brite Lite, 34 U.C.C. Rep. Serv. (Callaghan) at 1222.
205. Id. at 1223.
206. Id.
tion, an intentional tort action would lie, in any event,\(^ {208} \) in appropriate circumstances.

Second, and even more importantly from the plaintiff's perspective, because the *Brite Lite* court concluded that the action against the depositary sounded in contract, affirmative negligence defenses would be inapposite.\(^ {209} \) While this conclusion may be questionable,\(^ {210} \) the possible loss of such defenses adds an interesting wrinkle to the issue of bank liability for fiduciary fraud.

In stark contrast to the contract theory posited in the *Brite Lite* decision, as well as the conversion and strict liability theory otherwise available in former section 3-206 situations, the negligence analysis pursued by the cases just discussed, has introduced a substantial degree of uncertainty. As the discussion in the next section of the Article demonstrates, reliable rules are elusive in the negligence jurisprudence.

3. *Former U.C.C. Section 3-304.*—Perhaps the central Article 3 provision in the fiduciary fraud matrix was former section 3-304, the U.C.C.'s statement of notice rules, for purposes of determining of holder in due course status.\(^ {211} \) The Article 3 notice concept gen-

\(^{208}\) *Brite Lite*, 34 U.C.C. Rep. Serv. (Callaghan) at 1225 ("Even considering the plaintiff's tort theories, the defendant's conduct in this matter does not rise to a claim for punitive damages.").

\(^{209}\) *Id.* ("Moreover, the defenses of the plaintiff's alleged negligence would not obviate or mitigate the defendant's damages herein since these defenses are available only in tort actions and do not apply to a breach of contract claim (see Luppes v. Atlantic Bank, [69 A.D.2d 127, 141, 419 N.Y.S.2d 505, 513 (1979)], which is the basis of the court's decision herein.").


\(^{211}\) See U.C.C. § 3-302 (1989) (providing that a "holder in due course" is a holder who takes for value, and in good faith, and without notice of defenses). See also U.C.C. § 1-201(25) (1989), providing that a person has "notice" of a fact if:

(a) he has actual knowledge of it;

(b) he has received a notice or notification of it;

(c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists.

*Id.* § 1-201(25).
erally contemplated application of an objective standard; a party is
deemed to have notice of that which she should reasonably have
known.212 The treatment of notice of fiduciary fraud under former
subsection 3-304(2), however, cast the inquiry in subjective terms
by incorporating actual knowledge: "The purchaser[213] has notice
of a claim against the instrument when he has knowledge that a
fiduciary has negotiated the instrument in payment of or as security
for his own debt or in any transaction for his own benefit or
otherwise in breach of duty."214 So, apparently, ignorance, even in-
excusable ignorance, was an excuse so far as former subsection 3-
304(2) notice of fiduciary fraud was concerned.215 However, it
should be noted that when an instrument is transferred by the fi-
duciary in payment of her own debt, or otherwise for her own
benefit, such transfer is not necessarily a breach of duty. There-
fore, except to the extent that former subsection 3-304(2)216
applied to transfers known to be in breach of duty, former section
3-304 actually stated a "notice" rule; in other words, the taker's
knowledge that the fiduciary had transferred the instrument for
her own benefit, was "notice" that she might have been transffer-
ing in breach of duty.217

Former section 3-304 cases often presented the type of factual
scenarios that have been criticized as making bad law.218 Generally,
the beneficiary has been victimized by her fiduciary, and the finan-

court's power to find notice when the holder 'has reason to know' that something exists on
the basis of the 'facts and circumstances known to him' introduces at least the flavor of the
objective-subjective fight. It is a short step from that definition to say that one 'knows what
a reasonably prudent man in his circumstances 'knows'."

213. See U.C.C. § 1-201(32) & (33) (1989) ("purchaser" is "one who takes by
purchase," which "includes taking by sale, discount, negotiation, mortgage, pledge, lien, is-
ssue or re-issue, gift or any other voluntary transaction creating an interest in property"

214. Id. § 3-304(2).

215. Id. § 3-304(4)(e) (which supports strong actual knowledge requirement of former
section 3-304(2) by providing that knowledge "that any person negotiating the instrument is
or was a fiduciary" is not enough to impart notice of a defense to the purchaser).

216. See id. § 3-304(2) & comment 5.

217. See, e.g., Waukon Auto Supply v. Farmers & Merchants Sav. Bank, 440 N.W.2d
844 (Iowa 1989); First Federal Sav. & Loan Ass'n v. Gump & Ayers Real Estate, Inc., 771

(quoting Ex parte Long, 3 W.R. 19 (1854) (Lord Campbell: "Hard cases, it is said, make bad
laws.").
cial institution attempting to invoke former subsection 3-304(2) protection appears, at least after the fact, to have been in the best position to have prevented the fraud. While the former subsection 3-304(2) knowledge criterion apparently preempted many actions against financial institutions, the cases in which courts have imposed liability upon banks by playing somewhat fast and loose with former subsection 3-304(2) in order to apparently accommodate their personal preferences are more pertinent for the purposes of this essay. Several cases, in particular, warrant mention.

One of the more provocative decisions construing commercial paper and bank deposits law is Sun 'N Sand, Inc. v. United California Bank. In the course of deciding myriad issues of concern to banking institutions, the California Supreme Court determined the liability of a depositary for handling items that had been manipulated by a faithless employee (a fiduciary) embezzling funds of her employer (the beneficiary). The faithless employee had fraudulently prepared checks, payable to United California Bank, for her employer's signature. She deposited each of the checks into her personal account at UCB. Despite UCB's claim of holder in due course status, the court cited former section 3-304(2) to support the decision that UCB was not a holder in due

219. See Schwegmann Bank & Trust Co. v. Simmons, 880 F.2d 838, 843 (5th Cir. 1989) (mere knowledge of the poor financial condition of debtor does not constitute notice of defense); Lawton v. Walder, 231 Va. 247, 252-53, 343 S.E.2d 335, 338 (1988) (in action involving non-bank parties, fact that purchaser may have acted negligently or had notice of suspicious circumstances is insufficient to deny holder in due course status under former section 3-304); see also Soloff v. Dollahite, 779 S.W.2d 57, 60 (Tenn. Ct. App. 1989) (in action against non-bank party without actual knowledge that corporate fiduciary had breached his duty, the form of the transaction, here corporate notes, did not affect holder in due course status of transferee); Favors v. Yaffe, 605 S.W.2d 342, 345 (Tex. Civ. App. 1980) (even if a party proved that purchaser had knowledge of fact that the note was signed and returned for executory promise, or was accompanied by a separate agreement, unless that party could show that purchaser had notice of a claim or defense, such knowledge by purchaser would not constitute notice); Fireman's Fund Ins. Co. v. Security Pac. Nat'l Bank, 85 Cal. App. 3d 797, 824-25, 149 Cal. Rptr. 883, 901-02 (1978) (defendant bank not put on notice of inquiry as to any claim or defense because of ambiguity as to party to be paid; payee line was not so irregular as to call into question instrument's validity).


221. Sun 'N Sand, 21 Cal. 3d at 678-79, 582 P.2d at 926, 148 Cal. Rptr. at 335. The employee, over a three year period, drew nine checks for small amounts. Then, after obtaining the authorized signatures, the employee altered the amounts on the checks, increasing them to several thousand dollars each. She further concealed her actions by destroying some company records and altering others.
course because UCB had taken with notice. The court thought that the bank had notice of possible wrongdoing where an employee was depositing into her account checks of her employer payable to the bank.

The court construed the notice provision of former subsection 3-304(2) in objective terms, pursuant to subsection 1-201(25)(c):

[The facts in evidence] suggest an irregularity in the negotiation of the checks which at the very least creates an ambiguity as to the proper disbursement of the funds represented by the checks; indeed, the facts present the situation described in subdivision (2), which seems to contemplate that notice derives not from a mere ambiguity as to the person to be paid, but from affirmative indications that an improper party is attempting to procure payment.

The footnote accompanying that portion of the opinion was particularly enlightening; the court assumed a fundamental affinity between the subsection 3-304(2) analysis and the viability of the employer’s common law negligence action against UCB. In an elaboration of that affinity, the court sidestepped the consequences of its conclusion to some extent, but specifically equated “notice” under the Code to negligence liability. The facts which impart notice herein are precisely those facts which form the basis of UCB’s breach of duty: [I]ts negligence derives from its failure to respond reasonably to the ‘notice’ conveyed by such suspicious circumstances.

Other courts have recognized the availability of negligence theories that parallel the former subsection 3-304(2) notice inquiry. In Pargas, Inc. v. Estate of Taylor, a Louisiana appellate court expressly found that “inquiry” notice would be sufficient under former subsection 3-304(4)(e); the plaintiff was not required to establish that the bank had actual knowledge of the employee’s

222. Id. at 690, 582 P.2d at 933, 148 Cal. Rptr. at 342.
223. Id. (citing Dayton, Price & Co. v. First Nat’l City Bank, 64 A.D.2d 563, 565, 406 N.Y.S.2d 823, 825 (1978)).
224. Id. at 690 n.16, 582 P.2d at 933 n.16, 148 Cal. Rptr. at 342 n.16 (“The duty of a bank presented with a check drawn to its order is more fully discussed in the analysis of Sun ‘N Sand’s negligence cause of action [later in] this opinion.”).
225. See id. at 698 n.21, 582 P.2d at 938 n.21, 148 Cal. Rptr. at 347 n.21 (the court effectively “writes” the subjective knowledge standard out of section 3-304 and replaces it with an objective notice standard).
226. Id.
breach of fiduciary duty. Sufficient notice was inferred from the circumstances to deny the depositary holder in due course status. The court recognized that the employee fraud provisions of former section 3-405 were inapplicable to the facts as presented, and then noted that under the U.F.A. the bank would have been absolved of liability to the employer, absent actual knowledge. Nevertheless, the court imposed liability on the depositary for its failure to inquire. The court deemed dispositive the fact that the defendant-bank had not only failed to act reasonably with regard to the checks in question, but, more importantly, had failed to follow its own internal procedures in connection with such items. Arguably, the court's action misapplied 3-304(2), since former 3-304(2) requires actual knowledge that a fiduciary is transferring the instrument for his own benefit or otherwise in breach of fiduciary duty, but the court nevertheless imposed liability on the basis of an objective duty to inquire.

Notwithstanding the language of 3-304(2), other courts also have construed that provision to impose upon the financial institution a burden to take steps to inquire once the hint of fiduciary fraud is "in the air." At least one court has even gone so far as to engraft pre-U.C.C. duties of inquiry notice on banks that deal with fiduciaries.

The uneasy tension between subjective knowledge and objective notice standards is illustrated by a decision applying New
York's non-uniform version of 3-304(7). Chemical Bank v. Haskell234 reversed a lower court squarely on this issue of subjective knowledge versus reasonable inquiry notice. The New York Commercial Code version of former subsection 3-304(7) provided that for a purchaser to have the type of notice that would vitiate holder in due course status, "the purchaser must have [had] knowledge of the claim or defense or had knowledge of such facts that his action in taking the instrument amounts to bad faith."235 That subsection was added to the New York Code to make clear that former subsection 3-304(2) mandated a subjective standard. The court elaborated by distinguishing the duty imposed by New York law from the duty contemplated in the lower court's opinion: "[T]he inquiry is not whether a reasonable banker in Chemical's position would have known, or would have inquired concerning the alleged breach by Stanndco of its partnership duties, but rather, the inquiry is what Chemical itself actually knew."236

Observe, however, that there are situations other than those encompassed by former subsection 3-304(2) in which a taker of an instrument from a fiduciary might be held to have notice of a claim or defense that would prevent the transferee from being a holder in due course.237 Therefore, even though a bank takes an instrument and has no knowledge that the fiduciary has benefited personally from the transaction, it is still possible that the circumstances are so unusual that the bank, "from all the facts and circumstances known to [it],"238 may have notice of a claim or defense of the beneficiary. In fact, the deposit of a check, payable to a business, into the personal account of an employee might be just such a case.239

---

235. Chemical Bank, 51 N.Y.2d at 92, 411 N.E.2d at 1341, 432 N.Y.S.2d at 481 (citing New York version of former section 3-304(7)).
236. Id. at 92, 411 N.E.2d at 1341, 432 N.Y.S.2d at 480.
237. See Gross v. Appelgren, 171 Colo. 7, 18, 467 P.2d 789, 794 (1970). (bank "was so closely connected with entire transaction" that it was precluded from asserting holder in due course status as defense against fraudulent indorsement cause of action).
238. Section 1-201 provides: "A person has 'notice' of a fact when (a) he has actual knowledge of it; or (b) he has received a notice or notification of it; or (c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists." U.C.C. § 1-201(25) (1989).
A number of sections of revised Article 3 affect bank liability for fiduciary fraud. The most important of these new provisions are revised section 3-307, "Notice of Breach of Fiduciary Duty,"240 and revised section 3-405, "Employer’s Responsibility for Fraudulent Indorsement by Employee."241 Also, the change in the definition of “good faith” from “honesty in fact”242 to “honesty in fact and the observance of reasonable commercial standards of fair dealing”243 will have a substantial impact on a bank’s ability to achieve holder in due course status and the resulting protection from beneficiaries’ fiduciary fraud claims. Several other sections of revised Article 3 have a less significant impact on bank liability for fiduciary fraud. They include revised section 3-110, “Identification of Person to Whom Instrument Is Payable,”244 and revised section 3-206, "Restrictive Indorsement."245 First, revised subsections 3-110 and 3-206 will be discussed briefly Then, revised sections 3-307, 3-404, 3-405 and 3-406 and the new “good faith” rules will be discussed in detail.

1. Revised U.C.C. Section 3-110.—Revised section 3-110, entitled “Identification of Person to Whom Instrument Is Payable,” contains, in subsection (c)(2), rules equivalent to those of former section 3-117 regarding checks payable to agents or other fiduciaries.246 Revised subsection 3-110(c)(2)(iii) provides that “an

241. Id. § 3-405.
244. Id. § 3-110.
245. Id. § 3-206.
246. Id. § 3-110 comment 3. Revised subsection 3-110(c)(2) provides:

If an instrument is payable to:

(i) a trust, an estate, or a person described as trustee or representative of a trust or estate, the instrument is payable to the trustee, the representative, or a successor of either, whether or not the beneficiary or estate is also named;

(ii) a person described as agent or similar representative of a named or identified person, the instrument is payable to the represented person, the representative, or a successor of the representative;

(iii) a fund or organization that is not a legal entity, the instrument is payable to a representative of the members of the fund or organization; or

(iv) an office or to a person described as holding an office, the instrument is payable to the named person, the incumbent of the office, or a successor to the incumbent.

Id. § 3-110(c)(2).
instrument payable to a fund or organization that is not a legal entity is payable to a representative of the members of the fund or organization.247 In the case of instruments payable to an agent of a named or identified person, former section 3-117 stated that the instrument is payable to the principal, but that the agent can act as if he were the holder.248 Revised section 3-110, however, merely says that the instrument is payable to either the principal or the agent.249 There seems to be no difference in legal effect between the two statements regarding the rights of the agent. Similarly, former subsection 3-110(1)(f) stated that an instrument payable to "an office, or an officer by his title as such is payable to the principal but the incumbent of the office may act as if he were the holder,"250 while revised subsection 3-110(c)(2)(iv) says that in such a case "the instrument is payable to the named person, the incumbent of the office, or a successor to the incumbent."251 As to this case, under former subsection 3-110(1)(f), a check payable to "Smith, County Treasurer" probably could not be negotiated by Smith after he left office,252 while revised subsection 3-110(c)(2)(iv), since it makes the check payable to Smith, possibly gives Smith power to transfer even after he has left office.253 The change will only affect transferees who take instruments from wrongdoing former office holders that managed to gain possession of checks payable to them as officers, and in that

247. Id. § 3-110(c)(2)(iii). Former subsection 3-110(1)(g) stated similarly that an instrument payable to "a partnership or unincorporated association is payable to the partnership or association and may be endorsed or transferred by any person thereto authorized." U.C.C. § 3-110(1)(g) (1989). The change in statement of the rule probably does not change the substance of the rule; under either formulation representatives have power to transfer or collect the instrument.


249. Compare U.C.C. § 3-110(c)(2) (1990) ("If an instrument is payable to a person described as agent or similar representative of a named or identified person, the instrument is payable to the represented person, the representative, or a successor of the representative") with U.C.C. § 3-117(a) (1989) ("An instrument made payable to a named person with the addition of words describing him as agent or officer of a specified person is payable to his principal but the agent or officer may act as if he were the holder" (emphasis added)).


252. U.C.C. § 3-110(1)(f) (1989) ("[The instrument] is payable to the principal but the incumbent of the office or his successors may act as if he or they were the holder.").

253. U.C.C. § 3-110(c)(2)(iv) (1990) (the instrument on the facts stated is "payable to the named person, the incumbent of the office, or a successor to the incumbent.").
case arguably protects transferees who would otherwise take under a forged indorsement. Nevertheless, the only probable taker of such an instrument will be a depositary bank and, under revised section 3-307, a bank that accepts such an instrument for any purpose other than as a deposit to the account of the beneficiary is likely to be liable to the beneficiary if the former office holder embez zes the funds.

2. Revised U.C.C. Section 3-206.—Revised section 3-206 replaces former sections 3-205 and 3-206 and continues the rules of those sections as they relate to the responsibilities of

---

254. If a former office holder is no longer a person to whom an instrument is payable, then presumably his indorsement of the instrument is a forgery.

255. See infra notes 279-316 and accompanying text.

256. Revised section 3-206 reads as follows:

Restrictive Indorsement.

(a) An indorsement limiting payment to a particular person or otherwise prohibiting further transfer or negotiation of the instrument is not effective to prevent further transfer or negotiation of the instrument.

(b) An indorsement stating a condition to the right of the indorsee to receive payment does not affect the right of the indorsee to enforce the instrument. A person paying the instrument or taking it for value or collection may disregard the condition, and the rights and liabilities of that person are not affected by whether the condition has been fulfilled.

(c) If an instrument bears an indorsement (i) described in Section 4-201(b), or (ii) in blank or to a particular bank using the words “for deposit,” “for collection,” or other words indicating a purpose of having the instrument collected by a bank for the indorser or for a particular account, the following rules apply:

(1) A person, other than a bank, who purchases the instrument when so indorsed converts the instrument unless the amount paid for the instrument is received by the indorser or applied consistently with the indorsement.

(2) A depositary bank that purchases the instrument or that takes it for collection when so indorsed converts the instrument unless the amount paid by the bank with respect to the instrument is received by the indorser or applied consistently with the indorsement.

(3) A payor bank that is also the depositary bank or that takes the instrument for immediate payment over the counter from a person other than a collecting bank converts the instrument unless the proceeds of the instrument are received by the indorser or applied consistently with the indorsement.

(4) Except as otherwise provided in paragraph (3), a payor bank or intermediary bank may disregard the indorsement and is not liable if the proceeds of the instrument are not received by the indorser or applied consistently with the indorsement.

(d) Except for an indorsement covered by subsection (c), if an instrument bears an indorsement using words to the effect that payment is to be made to the indorsee as agent, trustee, or other fiduciary for the benefit of the indorser or another person the following rules apply:

(1) Unless there is notice of breach of fiduciary duty as provided in subsection 3-307, a person who purchases the instrument from the indorsee or takes
banks dealing with fiduciaries. Revised subsection 3-206(c) continues the old rule that a depositary bank is liable for conversion if it accepts an instrument indorsed “for deposit” or “for collection,” and the amount paid by the bank for the check is neither received by the indorser nor applied consistently with the indorsement. Therefore, as was the case under former sections 3-205 and 3-206, a depositary bank will be liable if it permits a check, payable to an employer and indorsed “for deposit” or “for collection” by the employer, to be deposited in the account of, or cashed by, an embezzling employee.

Revised subsection 3-206(d) provides that if an indorsement indicates that payment is to be made to the indorsee as a fiduciary for the benefit of another person, a transferee for value or for collection may pay the fiduciary-indorsee without liability to the beneficiary, unless there is notice of a breach of fiduciary duty under revised section 3-307. The section, therefore, permits payment of cash to the in-trust indorsee, unless there is notice of breach of the fiduciary’s duty. Under revised section 3-307, there

the instrument from the indorsee for collection or payment may pay the proceeds of payment or the value given for the instrument to the indorsee without regard to whether the indorsee violates a fiduciary duty to the indorser.

(2) A subsequent transferee of the instrument or person who pays the instrument is neither given notice nor otherwise affected by the restriction in the indorsement unless the transferee or payor knows that the fiduciary dealt with the instrument or its proceeds in breach of fiduciary duty.

(e) The presence on an instrument of an indorsement to which this section applies does not prevent a purchaser of the instrument from becoming a holder in due course of the instrument unless the purchaser is a converter under subsection (c) or has notice or knowledge of breach of fiduciary duty as stated in subsection (d).

(f) In an action to enforce the obligation of a party to pay the instrument, the obligor has a defense if payment would violate an indorsement to which this section applies and the payment is not permitted by this section.

258. Id. § 3-206.
259. U.C.C. § 3-206 comments 1 & 3 (1990). One of the major contributions of revised Article 3 is the clear restatement, contained in revised section 3-206, of the rules applicable to “for deposit” or “for collection” and trust indorsements. It was nearly impossible for the uninstructed to glean the meaning of former section 3-206 from the language. See id. § 3-206 comments 3 & 4.
260. Id. § 3-206(c).
261. Id. § 3-206(2) & (3); see also B. Clark, The Law of Bank Deposits, Collections, and Credit Cards 4-30 to 4-35 (rev. ed. 1981).
262. See U.C.C. § 3-206(d)(1) (1990). See also supra notes 213-16 and accompanying text.
would be notice of breach of fiduciary duty if the transferee of the instrument knew that the indorsee intended to use the funds for her own benefit.\textsuperscript{263} Similarly, revised subsection 3-206(d) might seem to permit deposit to the account of the indorsee-fiduciary since it would seem that payment to the fiduciary might be made either in cash or by credit to her account; however, revised section 3-307\textsuperscript{264} provides that a bank has notice of a breach of fiduciary duty if a fiduciary deposits a check, indorsed to the fiduciary as such, into the personal account of the fiduciary\textsuperscript{265}

In-trust indorsements are not likely to be common and, therefore, any inconsistency between the liability of a transferee that pays cash to the in-trust indorsee and a bank that allows the in-trust indorsee to deposit the check into her personal account is not likely to be of great consequence. The fact that the transferee can pay cash to the in-trust indorsee under revised subsection 3-206(c)(1) is likely to have greater importance in relation to the question of whether, under revised section 3-307, a bank can pay cash to a fiduciary in cases in which a check is drawn payable to the fiduciary in trust, rather than indorsed in trust.\textsuperscript{266}

3. \textit{Revised U.C.C. Section 3-307}—Revised section 3-307\textsuperscript{267} is an elaborate statement of the circumstances under which a taker from a fiduciary is deemed “on notice” and, therefore, subject to

\begin{footnotes}
\footnoteref{263}{See U.C.C. \textsection\textsuperscript{3-307}(b)(2) (1990). See also infra note 323.}
\footnoteref{264}{U.C.C. \textsection\textsuperscript{3-307} (1990). See infra notes 270-320 and accompanying text.}
\footnoteref{265}{U.C.C. \textsection\textsuperscript{3-307}(b)(2) (1990) ("In the case of an instrument payable to the fiduciary as such, the taker has notice of the breach of fiduciary duty if the instrument is (iii) deposited to an account other than an account of the fiduciary as such, or an account of the represented person."). No case has been found involving an “in trust” indorsement and deposit into a fiduciary’s personal account under former Article 3.}
\footnoteref{266}{If the check as drawn is payable to “A, trustee for B,” no trust indorsement is involved and, therefore, revised subsection 3-206(c)(1), by its terms, does not apply. However, it would seem inconsistent to apply a different rule of transferee liability in that case. See U.C.C. \textsection\textsuperscript{3-206}(c)(1) (1990). See also supra notes 112-23 and accompanying text.}
\footnoteref{267}{Revised section 3-307 provides as follows:
Notice of Breach of Fiduciary Duty.
(a) In this section:
(1) “Fiduciary” means an agent, trustee, partner, corporate officer or director, or other representative owing a fiduciary duty with respect to an instrument.
(2) “Represented person” means the principal, beneficiary, partnership, corporation, or other person to whom the duty stated in paragraph (1) is owed.
(b) If (i) an instrument is taken from a fiduciary for payment or collection or for value, (ii) the taker has knowledge of the fiduciary status of the fiduciary, and (iii) the represented person makes a claim to the instrument or its proceeds on the basis

claims of a beneficiary that her fiduciary has misappropriated funds. The section, to a large extent, is based upon the provisions of the Uniform Fiduciaries Act that have been previously discussed. Former Article 3 dealt with the issue of notice to persons dealing with fiduciaries only superficially in former section 3-304.

Revised section 3-307 applies if (1) an instrument is taken from a fiduciary for payment or collection, or for value, (2) the taker has knowledge of the fiduciary status of the fiduciary, and (3) the beneficiary makes a claim against the transferee for the instrument or its proceeds on the ground that her fiduciary breached his duty. In those circumstances, if the taker has notice of a possible breach of fiduciary duty, the taker becomes liable to the beneficiary if there is in fact a misappropriation of the proceeds of the instrument.

that the transaction of the fiduciary is a breach of fiduciary duty, the following rules apply:

(1) Notice of breach of fiduciary duty by the fiduciary is notice of the claim of the represented person.

(2) In the case of an instrument payable to the represented person or the fiduciary as such, the taker has notice of the breach of fiduciary duty if the instrument is (i) taken in payment of or as security for a debt known by the taker to be the personal debt of the fiduciary, (ii) taken in a transaction known by the taker to be for the personal benefit of the fiduciary, or (iii) deposited to an account other than an account of the fiduciary, as such, or an account of the represented person.

(3) If an instrument is issued by the represented person or the fiduciary as such, and made payable to the fiduciary personally, the taker does not have notice of the breach of fiduciary duty unless the taker knows of the breach of fiduciary duty.

(4) If an instrument is issued by the represented person or the fiduciary as such, to the taker as payee, the taker has notice of the breach of fiduciary duty if the instrument is (i) taken in payment of or as security for a debt known by the taker to be the personal debt of the fiduciary, (ii) taken in a transaction known by the taker to be for the personal benefit of the fiduciary, or (iii) deposited to an account other than an account of the fiduciary, as such, or an account of the represented person.


269. See U.C.C. § 3-304 (1989); see also supra notes 211-39 and accompanying text.


271. Id. § 3-307(b)(1). In that case, a transferee for value could not be a holder in due course since it has notice of the claim of the beneficiary. Id. §§ 3-302(a)(2) & 3-306. Such
Mirroring sections 4 and 5 of the U.F.A., revised section 3-307 imposes liability for any fraud of the fiduciary on the taker of the instrument if it (1) knowing that it is dealing with a fiduciary, (2) takes an instrument payable to the beneficiary or to the fiduciary as such, or an instrument drawn by the beneficiary or by the fiduciary, and (3) accepts the instrument: (a) in payment of or as security for a debt known by the taker to be the personal debt of the fiduciary, or (b) in any transaction known by the taker to be for the personal benefit of the fiduciary. Also, like the U.F.A., revised section 3-307 provides that a transferee may take an instrument drawn by the fiduciary as such or by the beneficiary and payable to the fiduciary personally, without being put on notice of a breach of fiduciary duty.

Under U.F.A. sections 4 and 5, a transferee or drawee is also liable to the beneficiary if it takes from the fiduciary with knowledge of such facts that its taking amounts to bad faith. Revised section 3-307 does not state the bad faith rule, but as to transferees for value or for collection the general holder in due course rules of revised section 3-302 will produce the same result. Also, a drawee who in bad faith pays the instrument to the fiduciary will be guilty of conversion.

a. Credit of Check to Fiduciary's Personal Account.—Revised section 3-307 makes one major change from the rules under the U.F.A. Under the U.F.A., a bank can permit a fiduciary to deposit fiduciary funds to the personal account of the fiduciary and then allow the fiduciary to withdraw the funds without incurring liability to the beneficiary, unless the transferee is

---

272. See supra notes 65-69 and accompanying text.
276. See supra notes 65-69 and accompanying text.
278. See supra note 271.
acting in bad faith. However, under revised section 3-307, a depositary is on notice of breach of fiduciary duty if the depositary allows the fiduciary to deposit to an account other than one for the benefit of the beneficiary: (a) an instrument payable to the beneficiary or the fiduciary as such, or (b) an instrument drawn by the beneficiary or the fiduciary and payable to the depositary. There is, therefore, automatic liability if a bank allows a fiduciary to deposit items of the types just described in the fiduciary's personal account and the fiduciary then uses the funds for non-fiduciary purposes.

The U.F.A. rule is based upon the assumption that a fiduciary will properly apply fiduciary funds and that knowledge by a depositary bank that a fiduciary has deposited fiduciary funds in her personal checking account is not knowledge or notice of a present or intended future misappropriation. On the other hand, revised Article 3 treats a deposit by a fiduciary in her personal account as, in effect, a suspicious circumstance imposing on the depositary bank the risk that the deposit is part of a scheme to misappropriate funds.

While revised section 3-307 departs from the U.F.A. regarding the liability of banks that accept deposits from fiduciaries for the personal account of the fiduciary, the revised Article 3 provisions are consistent with many, but not all, recent cases. The comments to revised section 3-307 accurately state that the matter is one on which the courts are divided. Nearly all the recent cases

279. **Unif. Fiduciaries Act** § 9, 7A U.L.A. 417 (1985). Section 9 provides that a bank is not liable to the beneficiary for allowing a fiduciary to deposit fiduciary funds (either checks payable to the beneficiary or fiduciary or drawn by the fiduciary) into the fiduciary's personal account, nor is it liable for allowing the fiduciary to subsequently withdraw such funds, unless it has knowledge of the misappropriation or knows such facts that its allowance of the withdrawal is bad faith. Section 9 does not specifically refer to checks made payable to the depositary bank, but its language is sufficiently broad to cover checks payable to the beneficiary, to the fiduciary, and to the bank. See Sugarhouse Fin. Co. v. Zions First Nat'l Bank, 21 Utah 2d 68, 440 P.2d 869 (1968).


281. Id. § 3-307(b)(2) & (4).

282. Id. § 3-307 comment 3 ("It is not normal for an instrument payable to the fiduciary, as such, to be used for the personal benefit of the fiduciary.").

283. Id.

284. See infra notes 292-312 and accompanying text.

285. U.C.C. § 3-307 comment 3 (1990) ("there is a split of authority").
involve disloyal employees rather than trustees of trusts or estates.286

A common form of employee misconduct involves taking a check payable to the employer, placing the indorsement of the employer thereon, and depositing the check in the employee's personal account. Under former Article 3, if the employee has no real or apparent authority to indorse the check, the indorsement is a forgery 287 Subject to the possible limitation imposed by former subsection 3-419(3),288 and to possible liability of the employer under former section 3-406,289 the bank that takes the check from the employee is liable in conversion to the employer for interfering with the employer's rights in the check.290 On the other hand, if the employee had authority to indorse the check, no forgery is involved and the depositary bank will take free of the claim of the employer if the bank is a holder in due course.291

286. See id. § 3-404 comment 3.
287. See U.C.C. § 3-405(1)(b) ("a person signing as or on behalf of a maker or drawer" will provide the transferee with an effective indorsement) & comment 3 (1989).
288. Under former subsection 3-419(3), a representative, including a depositary bank who dealt in good faith with an item on behalf of a person who was not the true owner, would not be liable to the true owner beyond the amount of the proceeds of the item still in the hands of the representative when it learned of the true owner's interest. See U.C.C. § 3-419(3) (1989). However, since, in the case posited, the depositary bank would be liable to subsequent parties, including the payee bank, for breach of the warranty of title, many courts have refused to give effect to former section 3-419(3), and have instead held that depositary banks may be liable to the true owners even though the banks permitted complete withdrawal of all the account funds by wrongdoers. See J. White & R. Summers, Uniform Commercial Code 688 (3d ed. 1983). Revised Article 3 does not provide the protection that former subsection 3-419(3) furnished depositary banks. See U.C.C. § 3-420(c) (1990) ("A representative, other than a depositary bank, that has in good faith dealt with an instrument or its proceeds on behalf of one who was not the person entitled to enforce the instrument is not liable in conversion to that person beyond the amount of any proceeds that it has not paid out." (emphasis added)).
289. Under former section 3-406, a person whose negligence substantially contributed to the making of an unauthorized signature was precluded from asserting the forgery against a holder in due course or a drawee or other payor who had paid the instrument in good faith and in accordance with the reasonable commercial standards of the drawee's or payor's business. U.C.C. § 3-406 (1989). An employer that was itself negligent, as in failing to discover that an employee had been previously guilty of embezzlement, would be barred from asserting the forgery. See Commercial Credit Eqmp. Corp. v. First Ala. Bank, 636 F.2d 1051 (5th Cir. Unit B 1981) (where the employee was a known embezzler).
290. As to payor banks, see U.C.C. § 3-419(1)(c) (1989) ("An instrument is converted when it is paid on a forged indorsement."); see also B. Clark, The Law of Bank Deposits, Collections and Credit Cards § 8.04[5][b] (3d ed. 1990).
In recent years, however, courts have generally found that banks were not holders in due course when they accepted for deposit into an employee’s personal account checks payable to an employer.\(^{292}\) In spite of the fact that the official comment to former subsection 3-304(2) stated that “the purchaser may pay cash into the hands of the fiduciary without notice of any breach of the obligation [to the beneficiary],”\(^{293}\) several courts have held that depositing the check into the account of the employee was a transaction for the benefit of the employee-fiduciary under former subsection 3-304(2); therefore, the depositary bank had notice of the claim of the employer.\(^{294}\) One court even went so far as to allow the trustee in bankruptcy to recover against a bank that allowed the sole owner-president of the corporation to deposit into his personal account, or take cash for, checks payable to the corporation.\(^{295}\)

\(^{292}\) See, e.g., infra notes 294-95.

\(^{293}\) U.C.C. § 3-304 comment 5 (1989); see also id. § 3-304(2) (“The purchaser has notice of a claim against the instrument when he has knowledge that a fiduciary has negotiated the instrument in payment of or as security for his own debt or in any transaction for his own benefit or otherwise in breach of duty.”).

\(^{294}\) See, e.g., Waukon Auto Supply v. Farmers & Merchants Sav. Bank, 440 N.W.2d 844 (Iowa 1989); Mott Gram Co. v. First Nat’l Bank & Trust, 259 N.W.2d 667 (N.D. 1977); Pargas, Inc. v. Estate of Taylor, 416 So. 2d 1358 (La. Ct. App. 1982); Von Gohren v. Pacific Nat’l Bank, 8 Wash. App. 245, 505 P.2d 467 (1973). In Mott, the court also found that the indorsement was a forgery since the wrongdoer only had authority to indorse for deposit into the account of the company, even though the wrongdoer did have authority to draw checks on the account. Mott, 259 N.W.2d at 669-70. In Pargas, the court held that an employee who has authority to indorse checks only for deposit to the account of his employer commits forgery when the employee indorses and deposits in his personal account. Pargas, 416 So. 2d at 1363.

\(^{295}\) See Maley v. East Side Bank, 361 F.2d 393 (7th Cir. 1966). In Maley, the bank was held liable when it permitted the sole shareholder to cash or receive credit for proceeds of instruments payable to his corporation. Shortly after the shareholder acquired the corporation, the bank received about 100 credit inquiries about the corporation, and a prospective seller to the corporation, from outside the geographic area, called the bank to ask why the corporation might be buying out of its trade area. At the close of the conversation, the prospective seller stated his belief that something fishy was happening, and that he would not be selling to the corporation. Nevertheless, the bank continued to allow the president to receive cash or credit to his personal account for checks payable to the corporation. The owner-president defrauded many sellers by purchasing on credit, selling the purchased merchandise for cash, misappropriating the sales proceeds, and leaving credit sellers unpaid. In addition to noting the negligence of the bank, the court also relied on the fact that the only corporate resolution on file with the bank required cosignatures for withdrawals from the corporate account, although in fact, the other cosignatory no longer had any interest in the corporation, and the president could have, at any time, instructed the bank to accept his signature alone.
In states, however, that have adopted section 9 of the U.F.A., the courts should hold that, unless a bank is guilty of bad faith or has knowledge of a misappropriation, a bank does not become liable to the beneficiary merely by allowing the fiduciary to deposit a check payable to the principal or the fiduciary as such into the personal account of the fiduciary. A case so holding is Johnson v. Citizens National Bank, decided by the Illinois Court of Appeals in 1975.

Many fiduciaries are not employees. As to nonemployee fiduciaries, two recent cases took opposing positions concerning the question whether a bank that accepts a check payable to the fiduciary as such for deposit into the fiduciary's personal account is liable if the fiduciary subsequently misappropriates the funds. The first involved a father who deposited in his personal account a check payable to him as trustee for his minor son. The New York Court of Appeals held the depositary not liable. In contrast, the Washington Supreme Court held in a case involving a father-guardian who deposited guardianship funds in his personal account that the bank was liable. In the New York case, the court said that there is no requirement that a check payable to a fiduciary be deposited to a fiduciary account and that, in general, a bank may assume that a person acting as fiduciary will apply trust funds for trust purposes. In the Washington decision, the court followed an earlier Washington case involving an embezzling employee and held that a bank that allowed a check payable to a father as guardian of his minor son to be deposited to the father's personal account was on notice that the father was breaching his fiduciary duty.

Another common situation in the reported cases is that of a bank which takes a check payable to the bank from a person other than the drawer, and credits the check to the account of the person presenting the check or otherwise allows the presenter to control the disposition of the proceeds of the check. The presenter may or may not be an employee of the drawer and may or may not be a

300. In re Knox, 64 N.Y.2d at 436, 477 N.E.2d at 449, 64 N.Y.S.2d at 44.
301. Smith, 103 Wash. 2d at 420, 693 P.2d at 94.
fiduciary of the drawer. Here, too, the cases have split, some imposing liability if the presenter is acting inconsistently with the intent of the drawer\(^{302}\) and others holding that a bank can be a holder in due course of a check so deposited if it takes in good faith and without notice of claims or defenses.\(^{303}\) (As a holder in due course the bank takes free of the claim by the beneficiary that the fiduciary wrongfully deposited the check.\(^{304}\)) Of course, it is implicit in the second line of cases that the mere fact that a check is payable to the bank and presented by one other than the drawer is not sufficient to put the bank on notice of a claim or defense of the drawer. The decisions usually make that point expressly \(^{305}\)

Most of the cases that impose liability on a bank if the presenter of the check had no authority from the drawer to negotiate the check do not focus upon whether the presenter was an employee or fiduciary of the drawer. Rather, the result is based on a categorical rule that a bank which takes a check payable to the bank, itself, from one other than the drawer is bound to apply the check according to the wishes of the drawer. For example, in \textit{Douglass v. Wones},\(^ {306}\) the court first noted that prior Illinois cases had held that the payee of a check, who took the item in payment of the debt of a presenter other than the drawer, could be a holder in due course. Therefore, the payee could take free of a claim by the drawer that the presenter had misappropriated the check.\(^ {307}\)

\begin{thebibliography}{9}
\bibitem{302} See, \textit{e.g.}, Bank of S. Md. v. Robertson's Crab House, 39 Md. App. 707, 389 A.2d 388 (1978). In \textit{Robertson's Crab House}, the bank was held liable for applying proceeds of the corporation's checks to an employee's account without using ordinary care to establish the employee's authorization. The court held that the bank was negligent as a matter of law where the bookkeeper of plaintiff Robertson deposited checks into the tax escrow account of plaintiff at defendant bank, but also deposited portions of some of these checks, and all of others, into his own account or the tax accounts of other business for which he was also bookkeeper. See also PWA Farms v. North Platte State Bank, 220 Neb. 516, 371 N.W.2d 102 (1985); Douglass v. Wones, 120 Ill. App. 3d 36, 458 N.E.2d 514 (1983). See \textit{generally} Spaulding & Sherwood, \textit{The Wayward Corporate Check: Notice of Disavowal under the U.C.C.}, 18 Cath. U.L. Rev. 127, 145-47 (1968).
\bibitem{304} U.C.C. 3-305 (1989).
\bibitem{305} See, \textit{e.g.}, St. Stephen's Evangelical Lutheran Church v. Seaway Nat'l Bank, 38 Ill. App. 3d 1021, 350 N.E.2d 128 (1976); Richardson Co. v. First Nat'l Bank, 504 S.W.2d 812 (Tex. Civ. App. 1974).
\bibitem{306} 120 Ill. App. 3d 36, 458 N.E.2d 514 (1983).
\bibitem{307} \textit{Douglass}, 120 Ill. App. 3d at 45, 458 N.E.2d at 522.
\end{thebibliography}
Douglass then held that a different rule applies to a bank. The Douglass court reasoned that:

"[W]hen [a bank] is named as the payee of a check by a party not indebted to the bank, such bank will be presumed to have accepted the same subject to the directions of the drawer, and not to the directions of a stranger to the paper who happens to present it."

Other courts have expressed the same idea by saying that a bank cannot treat a check payable to itself as a bearer instrument; that is, the bank cannot assume that the person presenting the item is the owner or is authorized to control disposition of the item. As noted above, the rule, as stated in Douglass and similar cases, is not limited to fiduciaries. In fact, in the case of fiduciaries, if the particular state has adopted the U.F.A., a different result is mandated if the fiduciary deposits, into the fiduciary's personal account, a check drawn by the beneficiary and payable to the bank.

As the discussion just concluded shows, there is substantial authority for the position taken in revised section 3-307 that a depositary bank that accepts for deposit into the personal account of the fiduciary a check payable to the beneficiary or the fiduciary as such, or a check drawn by the beneficiary or the fiduciary as such and payable to the bank, is liable to the beneficiary if the fiduciary

---

308. Id.
311. See infra notes 301-09 and accompanying text.
312. Unif. Fiduciaries Act § 9, 7A U.L.A. 417 (1985) (dealing generally with checks drawn by the fiduciary, checks payable to the fiduciary as such, and checks payable to the beneficiary and indorsed by the fiduciary). Section 9 contains a catch-all provision that covers deposit of checks payable to the bank, viz: "or otherwise makes a deposit of funds held by him as fiduciary." Id. In the described cases, the bank may accept the deposit into the personal account of the fiduciary and pay the funds out on the personal check of the fiduciary without being liable to the beneficiary unless the bank pays with actual knowledge of fiduciary wrongdoing or acts in bad faith. See also Unif. Fiduciaries Act § 8, 7A U.L.A. 415 (1985) (check drawn by the fiduciary and payable to the depositary bank); see generally supra notes 48-52 & 77-79 and accompanying text. Illinois has adopted the U.F.A., but the court in Douglass did not refer to it.
in fact subsequently misappropriates the funds.\textsuperscript{313} Cases so holding ignore the holder in due course rules of former Article 3, adopting instead a rule that automatically imposes upon the bank the risk that the depositor is acting inconsistently with the rights of the drawer or owner of the check.

In summary, the cases are split with regard to a depository bank's duty to make inquiries of the beneficiary when a fiduciary deposits a fiduciary check into the fiduciary's personal account. Some cases impose liability on the bank if the fiduciary is acting inconsistently with the beneficiary's rights. (The courts in those cases reach that result whether or not the depositor is a fiduciary, and therefore extend bank liability beyond the fiduciary disloyalty covered in revised section 3-307).\textsuperscript{314} Other cases have applied former Article 3 holder in due course rules and concluded that a bank may be a holder in due course of fiduciary checks credited by the bank to the personal account of the fiduciary.\textsuperscript{315} Further, in the large number of states that have adopted the U.F.A., a bank is protected in such situations unless the bank either had actual knowledge of a fiduciary-presenter's wrongdoing or acted in bad faith.\textsuperscript{316}

\textbf{b. Paying Cash to a Fiduciary}—Interestingly, neither revised section 3-307 nor the comments thereto address the question of potential liability for paying cash to a fiduciary for fiduciary instruments.\textsuperscript{317} Since under revised 3-307, fiduciary instruments drawn and payable as just described cannot be deposited into the personal account of the fiduciary without liability to the principal for any fiduciary wrongdoing, by analogy it seems logical that a similar rule should be applied where the fiduciary receives cash for such instruments. Therefore, in the absence of a clear statement to the contrary in the statute (or the comments), a court could prop-

\begin{itemize}
  \item \textsuperscript{313} U.C.C. § 3-307 (1990); see supra notes 284-312 and accompanying text.
  \item \textsuperscript{314} U.C.C. § 3-307 (1990); see supra notes 292-95,299 & 302 and accompanying text.
  \item \textsuperscript{315} See supra note 303 and accompanying text.
  \item \textsuperscript{316} See supra note 302 and accompanying text.
  \item \textsuperscript{317} See U.C.C. § 3-307 (1990); cf. Unif. Fiduciaries Act § 2, 7A U.L.A. 401 (1985) (stating that the transferee is not obligated to see that the fiduciary properly applies the proceeds of any money paid to the fiduciary for the principal). In the context of a transferee of a negotiable note, the result is that the transferee may pay cash to the fiduciary without incurring liability, unless there is actual knowledge of an intention to misappropriate or knowledge of such facts that giving the cash to the fiduciary is bad faith. See Unif. Fiduciaries Act § 9, 7A U.F.A. 417 (1985); see also supra note 305 and accompanying text.
\end{itemize}
erly conclude that paying cash to the fiduciary is a transaction for the personal benefit of the fiduciary, if there is in fact a misappropriation, thereby making the bank liable.\textsuperscript{318} However, as noted earlier, revised section 3-206 specifically provides that, in the case of an in-trust indorsement, the transferee bank can “pay the proceeds of payment or the value given for the instrument to the indorsee without regard to whether the indorsee violates a fiduciary duty to the indorser,”\textsuperscript{319} unless the transferee has notice of a breach of fiduciary duty by the indorsee.\textsuperscript{320}

Therefore, it seems that, under revised section 3-206,\textsuperscript{321} receipt of cash by the fiduciary-indorsee is not automatically notice of breach of fiduciary duty that would make the transferee bank liable under revised section 3-307.\textsuperscript{322} But, if the bank is not liable for paying cash to Jones where payee Smith indorses “Jones as trustee for Smith,” it is difficult to justify imposing liability on the bank for paying cash to Jones in the case where Smith or third party Roe draws the check payable to “Jones, trustee for Smith.”\textsuperscript{323} Therefore, it would seem that, by analogy from the rule of 3-206, the bank should be able to pay cash to Jones where the check is payable to “Jones, trustee for Smith.”

However, since revised 3-206 does not apply to payees and since under revised 3-307 a depositary bank would be on notice of a breach of fiduciary duty if it allowed Jones to deposit a check payable to “Jones as trustee for Smith” to his personal account, the analogical extension of 3-307 to the case in which bank pays cash to Jones would impose liability on the bank. Sections 3-206

\textsuperscript{318} See Waukon Auto Supply v. Farmers & Merchants Sav. Bank, 440 N.W.2d 844 (Iowa 1989) (court treated the receipt of cash as a transaction for the benefit of the employee). But see U.C.C. § 3-304(2) comment 5 (1989) (“The purchaser may pay cash into the hands of the fiduciary without notice of any breach of the [fiduciary’s] obligation.”).

\textsuperscript{319} U.C.C. § 3-206(d)(1) (1990).

\textsuperscript{320} See supra notes 256-66 and accompanying text.

\textsuperscript{321} U.C.C. § 3-206 (1990); see also supra notes 256-66 and accompanying text.

\textsuperscript{322} See supra notes 262-63 and accompanying text.

\textsuperscript{323} Of course it might be argued that a transferee of an in-trust indorsee always has notice of a breach of fiduciary duty when it pays cash to the indorsee, since paying cash is the equivalent of crediting the indorsee’s personal account and that crediting the personal account gives notice of a breach of fiduciary duty under revised section 3-307(b)(2). That reading of revised section 3-206, however, would mean that the transferee never in fact would take free of a claim by the beneficiary of fiduciary wrongdoing, in spite of the fact that revised section 3-206 seems to grant protection. Such a reading, which makes revised section 3-206 a trap for the unwary transferee, should be rejected.
and 3-307, therefore, suggest inconsistent results when a bank pays cash to an in-trust payee of an instrument.

The two sections also suggest inconsistent results when a bank allows an in-trust indorsee to deposit the instrument in his personal account. If, under revised section 3-206, a transferee bank can pay cash to an in-trust indorsee, it is difficult to understand why it cannot also allow the in-trust indorsee to deposit the instrument into his personal account. In fact, were the contrary rule not clearly stated in revised subsection 3-307(b)(2), a natural reading of subsection 3-206(d)(1) would be that it applies to credit given to a personal account of an in-trust indorsee as well as to cash payments to the indorsee. If an in-trust indorsee intends to commit fraud when he deposits an in-trust instrument to his personal account, he can commit the same fraud by taking cash at one window and then depositing the cash to his personal account at another.

However, the drafters perhaps concluded that fiduciaries do at times have need for cash and that a bank should not be automatically at risk in paying cash to an in-trust indorsee. Under that rationale, since revised 3-307 does not expressly put the bank on notice of possible fiduciary fraud if it pays cash to the fiduciary, a bank could pay cash to the in-trust payee without being automatically subject to liability under 3-307, just as it can pay cash to an in-trust indorsee without being automatically subject to liability under 3-206. In any event, a transferee bank paying cash to an in-trust payee or indorsee might, on particular facts, be held to have acted in bad faith or to have had notice of a claim or defense and thus be subject to a claim of the beneficiary that the fiduciary misappropriated the funds. If, for example, an administrator of an estate took a $100,000 check payable to the administrator as such

324. Revised subsection 3-307(b)(2) reads in pertinent part: “In the case of an instrument payable to the fiduciary as such, the taker has notice of the breach of fiduciary duty if the instrument is deposited to an account other than an account of the fiduciary, as such, or an account of the represented person.” U.C.C. § 3-307(b)(2)(ii) (1990). Of course, once a check is indorsed to “Jones, trustee for Smith,” it is payable to Jones, who is Smith’s “fiduciary as such.” See id. § 3-205(a). Therefore, revised subsection 3-307(b)(2) applies to the in-trust indorsement.

325. Id. § 3-206(d)(1) (permits the transferee to “pay the proceeds of payment or the value given for the instrument to the indorsee without regard to whether the indorsee violates a fiduciary duty to the indorsee”).

326. See id. § 3-307(b).
to the bank in which she maintains a trust account for the estate and receives cash over the counter for the check, the bank might be liable to the estate if the administrator misappropriates the funds. It could be argued that it is so doubtful that an administrator of an estate would have a need for $100,000 cash for estate purposes that the bank failed to act in good faith in giving the administrator the cash or was on notice of a claim of the estate.

We have reviewed the basic operation of revised section 3-307 which applies to situations in which a bank “knows” that it is dealing with a fiduciary. We have noted that 3-307 generally follows the U.F.A. with one important exception. That exception is that under 3-307 a depositary bank is on notice of a breach of fiduciary duty if it allows a fiduciary to deposit to her personal account an item payable to the beneficiary or to the fiduciary as such, or drawn by the beneficiary or the fiduciary as such and payable to the bank. Under the U.F.A., the bank could have allowed deposit of such instruments to the account of the fiduciary without incurring liability for any subsequent misappropriation by the fiduciary unless the bank actually knew of a breach of trust or acted in bad faith. We have also noted a possible inconsistency between revised 3-307 and revised 3-206. We now examine the following questions: (1) Who is a fiduciary, and (2) What must a bank “know” concerning a fiduciary’s status before the bank is subject to liability under revised section 3-307?

c. **Who Is a Fiduciary Under Revised U.C.C. Section 3-307?**—Revised section 3-307 applies only to transfers from a “fiduciary.” Revised subsection 3-307(a)(1) defines “fiduciary” as “an agent, trustee, partner, corporate officer or director, or other representative owing a fiduciary duty with respect to an instrument.” The definition is broad, but its scope is unclear.

“Representative” suggests a person who has been designated to act for the principal in some matter. However, a person might owe a “fiduciary duty [to another] with respect to an instrument” even though that person had not been given the power to act as a representative. An employee having no responsibility or

327. *Id.* § 3-307(b)(2).
328. *Id.* § 3-307(b)(4).
329. *Id.* § 3-307(b)(1).
330. *Id.* § 3-307(a)(1).
331. *Id.*
authority with respect to his employer’s checks or checking accounts who steals a check drawn by the employer payable to a bank and then has the check deposited in the employee’s personal account at the payee bank might be said to owe a fiduciary duty to his employer. To the extent that revised section 3-307 imposes liability on a depositary bank that accepts from an employee a check payable to the bank for deposit into the employee’s personal checking account, it seems somewhat incongruous to impose automatic liability if the employee is authorized to handle checks but not to do so if the employee has no authority with respect to the checks. Therefore, a court might apply 3-307 to all employee cases.

On the other hand, revised section 3-307 operates so harshly against the bank in the “deposit to the account” cases that it may be appropriate to limit its application to real or apparent authority situations. Several courts have held that the U.F.A. applies only to persons with real or apparent authority, and not to wrongdoers without authority. Probably the same limitation should be applied to revised section 3-307.

d. When Does a Transferee Have Knowledge of Fiduciary Status?—Revised section 3-307 states that it applies only if the taker of the instrument “has knowledge of the fiduciary status of the fiduciary.” The comment points out that if the taker is an organization, the relevant knowledge is that of the “individual conducting that transaction” on behalf of the organization. The comment further provides that

[the requirement that the taker have knowledge rather than notice is meant to limit Section 3-307 to relatively uncommon cases in which the person who deals with the fiduciary knows all the relevant facts: the fiduciary status and that the proceeds of the instrument are being used for the personal debt or benefit of the

332. Id. § 3-307(b)(2).

333. As will be noted in the next section of this Article, the fact that the bank is not liable under revised section 3-307 does not mean that it will take free of a beneficiary’s claim of embezzlement. Particularly, under the new definition of good faith, the bank may be held to lack good faith regarding its involvement in the transaction, and therefore be liable to the beneficiary. See infra text accompanying notes 347-62.


336. Id. § 3-307 comment 2 (quoting U.C.C. § 1-201(27) (1989)).
fiduciary or are being paid to an account that is not an account of
the represented person or of the fiduciary, as such. Mere notice of
these facts is not enough to put the taker on notice of the breach of
fiduciary duty. 337

If, therefore, Mary Smith comes into the bank with a check drawn
by Rapid Spinners, Inc., and payable to the bank, but which Mary
deposits into her personal account, the bank would not be liable
under revised section 3-307 unless the teller taking the check knew
that Mary was a fiduciary of Rapid Spinners, Inc. In view of the
relative harshness of the operation of revised section 3-307 against
the bank, it would be appropriate to limit the scope of the revised
section to cases in which the bank teller involved actually knows
that the person from whom the instrument is taken has fiduciary
responsibilities with respect to the instrument, 338 not merely that
the presenter is an employee of the drawer of the instrument. 339
This is particularly true since holding that revised section 3-307
does not apply will not automatically relieve the bank from liabil-
ity, but merely shifts the inquiry to whether the bank was
negligent or guilty of bad faith in taking the instrument. 340

Generally, it should not be too readily assumed that the trans-
feror of an instrument is known by the taker to be a fiduciary. This
point is illustrated by the case of Eldon’s Super Fresh Stores v.
Merrill Lynch, Pierce, Fenner & Smith, Inc. 341 In that case, Drex-
ler, attorney for, and secretary of, the corporate plaintiff, sent to
Merrill Lynch, as payment for stocks purchased by Drexler, a
check drawn by the corporation and payable to Merrill Lynch. 342
Although the corporation had no account with Merrill Lynch, 343
the court held that Merrill Lynch was a holder in due course since
it could assume that the check had been given to Drexler, whom

338. See U.C.C. § 1-201(27) (1989); U.C.C. § 3-307(b) & comments 2, 3 & 5 (1990).
388 (1978) (court cites a number of authorities that state an absolute rule holding banks
liable for taking checks payable to the banks themselves and not consistently applying the
proceeds according to the wishes of the drawers).
340. See U.C.C. §§ 3-405(b) & 3-406(b) (1990). The bank may be liable to Rapid Spin-
ners, Inc., on negligence principles under revised sections 3-405 and 3-406, or because the
bank may not be a holder in due course because it has acted in bad faith. See also infra
notes 363-82 & 389-90 and accompanying text.
341. 296 Minn. 130, 207 N.W.2d 282 (1973).
342. Eldon’s, 296 Minn. at 132, 207 N.W.2d at 284.
343. Id.
they knew to be an attorney, in payment of a debt to him.\textsuperscript{344} Under revised section 3-307, if Merrill Lynch had known Drexler to be a fiduciary, then Merrill Lynch would automatically be liable to plaintiff because it had taken the instrument in a transaction known to be for the benefit of Drexler. However, the mere fact that Merrill Lynch knew that Drexler was an attorney should not be treated as giving knowledge that he was acting in a fiduciary capacity with respect to the check. In fact, even if Merrill Lynch knew that he was attorney for plaintiff, that would not mean that it knew of the “fiduciary status of the fiduciary.”\textsuperscript{345} Lawyers do not usually serve as financial fiduciaries for their clients, though in a different sense they are certainly fiduciaries. Presumably, if Merrill Lynch had known that Drexler was plaintiff’s secretary-treasurer, it would have known of his fiduciary status,\textsuperscript{346} and would therefore have been liable to the plaintiff if, in fact, Drexler had acted in breach of his fiduciary duty.

4. Impact of Objective “Good Faith” Standard Under Revised U.C.C. Section 3-103(a)(4) The New Definition of “Good Faith.”—The revised definition of “good faith”\textsuperscript{347} will almost certainly increase the number of cases in which a depositary bank is denied holder in due course status because of a lack of good faith. In the context of fiduciary fraud, even though a bank transferee of a fiduciary instrument avoids liability to a beneficiary under revised section 3-307,\textsuperscript{348} the bank may be held liable to the beneficiary in conversion\textsuperscript{349} if the fiduciary-transferor has embezzled the beneficiary’s funds, unless the bank is held to be a holder in due course.\textsuperscript{350}

\textsuperscript{344} Id. at 140, 207 N.W.2d at 289.

\textsuperscript{345} U.C.C. § 3-307(b)(ii) (1990).

\textsuperscript{346} Presumably a secretary-treasurer of a corporation is always an agent of the corporation. However, even here, if the check had been signed by someone other than Drexler, perhaps Merrill Lynch would not “know” of any fiduciary capacity of Drexler in connection with the particular transaction.

\textsuperscript{347} Compare U.C.C. § 3-103(a)(4) (1990) (“‘Good faith’ means honesty in fact and the observance of reasonable commercial standards of fair dealing.”) with U.C.C. § 1-201(19) (1989) (“‘Good faith’ means honesty in fact in the conduct or transaction concerned.”).

\textsuperscript{348} U.C.C. § 3-307 (1990).

\textsuperscript{349} Id. § 3-420(a) (law of conversion applies to instruments). Cf. id. § 3-206(c) (bank failing to apply proceeds consistently with restrictive indorsement is liable for conversion).

\textsuperscript{350} See id. §§ 3-302(a) (definition of “holder in due course” (“HDC”)) & 3-306 (rights of HDC). But see id. § 3-305(b) (certain legal defects negate HDC status).
to be a holder in due course a transferee must take for value, in good faith, and without notice of claims, defenses or that the instrument is overdue. Under both the former and revised Article 3 provisions, notice has objective elements.

Under subsection 1-201(25)(c) a person has notice of a fact when, from all the facts and circumstances known to him, he has reason to know the fact. Therefore, a transferee could have been held to have notice of a claim or defense and, therefore, not be a holder in due course even though the transferee did not have actual knowledge of the defense. Nevertheless, some courts have held that failing to investigate, even when a reasonably prudent person would investigate, does not necessarily establish "notice" and also is not probative of a lack of good faith. The new good faith definition, however, may overrule such cases and give additional force to the "without notice" requirement for holder in due course status.

It is natural to assume that the new requirement that a transferee must observe "reasonable commercial standards of fair dealing" in order to be acting in good faith requires courts to apply a test similar to the "suspicious circumstances" or "negligence test" that some courts applied prior to the adoption of the Uniform Negotiable Instruments Law. Revised Article 3, however, is drafted on the assumption that "good faith" is not synonymous with "ordinary care" which is the Code term for lack of negligence. Both terms are defined in revised Article 3. As noted above, good faith is defined as "honesty in fact and the observance of reasonable standards of fair dealing." "Ordinary care in the case of a person engaged in business" is defined as the "observance of reasonable commercial standards, prevailing in the area in

351. Compare id. § 3-302(a)(2) with U.C.C. § 3-302 (1989).
352. U.C.C. § 1-201(25)(c) (1989) ("A person has 'notice' of a fact when from all the facts and circumstances known to him at the time in question he has reason to know it exists.").
355. See W. Britton, BILLS AND NOTES 244-46 (2d ed. 1961).
which the person is located, with respect to the business in which the person is engaged.\footnote{357}

The comments to revised Articles 3 and 4 do not indicate in any detail the difference between "observance of reasonable commercial standards of fair dealing," the test for good faith, on the one hand, and "observance of reasonable commercial standards prevailing in the area in which the person is located," the test of ordinary care. Comment 4 to section 4-406 does offer this distinction: "The term 'good faith' is defined in Section 3-103(a)(4) as including 'observance of reasonable commercial standards of fair dealing.' The connotation of this standard is fairness and not absence of negligence."\footnote{358} However, in the context of holder in due course status, "fair dealing" must relate to protection of parties, other than the transferor, whose interests may be adversely affected by the transfer. Therefore, in spite of the comment's attempt to disassociate good faith and negligence, "fair dealing" would seem to require making inquiries to determine whether the transfer is in derogation of the claim or right of some prior party if "reasonable commercial standards" would require making such an inquiry.\footnote{359} If, for example, a transferee, including a bank, fails to investigate when the circumstances are such that a reasonable transferee in the circumstances would have investigated, such transferee is likely to be denied holder in due course status because of its lack of "fair dealing." For example, if it is proven that banks in a particular locality will not accept for deposit to the account of an employee a check drawn by the employer and payable

\footnote{357. Id. § 3-103(a)(7). Revised subsection 3-103(a)(7) provides as follows: "Ordinary care" in the case of a person engaged in business means observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged. In the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general banking usage not disapproved by this Article or Article 4. Id.}

\footnote{358. U.C.C. § 4-406 comment 4 (1990).}

\footnote{359. See W Britton, Bills and Notes 245 (2d ed. 1961). See also N.Y.L. Revision Comm'n, 2 Report, Study of the Uniform Commercial Code 132-45 (1955). (A "suspicious circumstances" test for holder in due course status can be viewed as the same as a "lack of due care" standard, since the reasonable transferee would have investigated to determine the facts before taking the instrument.).}
to the bank, then a bank that does so accept will likely not be a holder in due course, even though it may have acted in complete honesty, and had no reason to know of a claim or defense. In any event, the new “good faith” test will clearly deny holder in due course status to some transferees who may have been “honest in fact” in taking the instrument, but, nevertheless, failed to comply with procedures that reasonably should have been followed.

In spite of the close affinity between “good faith” and “ordinary care” under revised Articles 3 and 4, a number of sections in both Articles state rules applicable to cases in which a transferee has acted in good faith but has failed to exercise ordinary care. Among those sections are revised sections 3-404, 3-405, and 3-406.\(^\text{360}\) The scheme of those sections is that, in the situations described therein, indorsements,\(^\text{361}\) though made without authority, are effective in favor of good faith transferees, but are not effective as against transferees not in good faith. However, if the good faith transferee failed to exercise ordinary care, some or all of the loss resulting from the unauthorized signature may be shifted to the transferee.\(^\text{362}\) The sections, therefore, invite courts to attempt to draw distinctions between acting in good faith and acting with ordinary care.

5. Revised U.C.C. Section 3-405.—A major issue in commercial paper law is the proper balance between imposing loss on the employer, and imposing loss on third parties, including banks, that deal with dishonest employees who misappropriate negotiable instruments payable to, or drawn by, the employer. As previously noted, section 3-307 of revised Article 3 departs from the U.F.A. by imposing liability for any subsequent misappropriation of the funds on the bank if it accepts for deposit into the personal account of an fiduciary, checks payable to the beneficiary, to the employee as fiduciary, or to the bank.\(^\text{363}\) These rules apply to employees who are fiduciaries. On the other hand, revised section 3-

---

\(^{360}\) See infra note 383 (quoting revised section 3-404); infra note 368 (quoting revised section 3-405); infra note 389 (quoting revised section 3-406). Section 3-405 is discussed infra at text accompanying notes 364-82. Sections 3-404 and 3-406 are discussed infra at text accompanying notes 383-90.

\(^{361}\) Section 3-406 also applies to unauthorized alteration.

\(^{362}\) U.C.C. §§ 3-404(d), 3-405(b) & 3-406(b) (1990).

\(^{363}\) Compare id. § 3-307 with UNIF. FIDUCIARIES ACT § 9, 7A U.L.A. 417 (1985). See also supra notes 55-55 & 267-88 and accompanying text.
405\textsuperscript{364} goes in the other direction, imposing more responsibility on the employer for employee wrongdoing than was the case under former Article 3.\textsuperscript{365} Under former Article 3, transferees assumed much of the risk of employee fraud. Employees often steal checks from their employer, forge the indorsement of the payee, and deposit the checks in their own personal accounts. The stolen checks may be either checks payable to the employer, or checks drawn by the employer and payable to some third party. In both cases, under former Article 3, the employer can successfully claim that the indorsements are forgeries, thereby shifting the loss to parties who took the check from the employee, unless the employer's negligence substantially contributed to the employee's opportunity to commit the forgery.\textsuperscript{366} The only case in which former Article 3 shifted the loss for employee fraud to the employer without proof of negligence on the part of the employer was in the "padded payroll" cases in which an employee provided the name of a person to whom the employer should issue a check intending that person to have no interest in the check.\textsuperscript{367} Revised section 3-405 extends "padded payroll" type employer liability to cases in which "responsible employees" steal checks and forge the payee's indorsement thereon. Under revised section 3-405,\textsuperscript{368} if an employee has responsibility

\textsuperscript{364} U.C.C. § 3-405 (1990).
\textsuperscript{365} Compare id. § 3-405 with U.C.C. § 3-405(1)(c) (1989).
\textsuperscript{366} Cf. U.C.C. § 3-406 (1989). If the indorsement is a forgery, no transferee can be a holder, and therefore, cannot be a holder in due course who would take free of the claim of the employers that the instrument has been stolen. U.C.C. §§ 3-201 & 3-202 (1989).
\textsuperscript{367} U.C.C. § 3-405(1)(c) & comment 4 (1989). The "padded payroll rule" is commercially justifiable as follows:

\[ W \]here the drawer's agent or employee prepares the check for signature or otherwise furnishes the signing officer with the name of the payee[, ] \[ t\]he 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.

\textit{Id.} § 3-405 comment 4.
\textsuperscript{368} Revised section 3-405 provides:

Employer's Responsibility for Fraudulent Indorsement by Employee

(a) In this section:

(1) "Employee" includes an independent contractor and employee of an independent contractor retained by the employer.
with respect to instruments of the employer, an indorsement by the employee in the name of the payee is effective in favor of transferees, including depositary banks, that in good faith take the instrument.

(2) "Fraudulent indorsement" means (i) in the case of an instrument payable to the employer, a forged indorsement purporting to be that of the employer, or (ii) in the case of an instrument with respect to which the employer is the issuer, a forged indorsement purporting to be that of the person identified as payee.

(3) "Responsibility" with respect to instruments means authority (i) to sign or indorse instruments on behalf of the employer, (ii) to process instruments received by the employer for bookkeeping purposes, for deposit to an account, or for other disposition, (iii) to prepare or process instruments for issue in the name of the employer, (iv) to supply information determining the names or addresses of payees of instruments to be issued in the name of the employer, (v) to control the disposition of instruments to be issued in the name of the employer, or (vi) to act otherwise with respect to instruments in a responsible capacity. "Responsibility" does not include authority that merely allows an employee to have access to instruments or blank or incomplete instrument forms that are being stored or transported or are part of incoming or outgoing mail, or similar access.

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

(c) Under subsection (b), an indorsement is made in the name of the person to whom the instrument is payable if (i) it is made in a name substantially similar to the name of that person or (ii) the instrument, whether or not indorsed, is deposited in a depositary bank to an account in a name substantially similar to the name of that person.

Id. § 3-405.

369. Id. § 3-405(a)(3) (defining “responsibility”).

370. See id. § 3-405(b). Revised subsection 3-405(b) provides as follows:

[T]he indorsement is effective as the indorsement of the person to whom the instrument is payable if it is made in the name of that person. [However if the person paying the [forged] instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the [forged] instrument and that failure substantially contributes to loss resulting from the fraud, the person bearing the loss may recover from the person failing to exercise ordinary care]

Id. § 3-405(b) (emphasis added). But see id. §§ 3-406(a) (employer may be “precluded from asserting the alteration or the forgery where the employer has fail[ed] to exercise ordinary care”) & 3-406(b) (comparative negligence allocation scheme applicable to the extent
Under revised subsection 3-405(b), if the transferee takes the instrument in good faith, but fails to exercise ordinary care in paying or taking the instrument and such failure substantially contributes to loss from fiduciary fraud, then the transferee is liable to the employer to the extent such failure to exercise ordinary care contributed to the loss. As noted earlier in the discussion of good faith under revised Article 3, the distinction between the failure to observe "reasonable commercial standards of fair dealing" (the good faith standard) and the failure to exercise ordinary care is difficult, if not impossible, to draw; but it is clear that revised section 3-405 invites such a distinction. The section, therefore, permits a court to impose the entire loss on the employer by finding that the transferee acted in good faith, impose the entire loss on the transferee by finding that the transferee did not act in good faith, or split the loss on what is, in effect, a comparative fault basis, by finding that the transferee did act in good faith, but nevertheless, failed to exercise ordinary care.

Assume, then, a case to which revised section 3-405 applies. Employee, who has authority to process incoming checks for bookkeeping purposes, steals a check, forges her employer's indorsement, and deposits the check in her personal account, after adding her indorsement below the forged indorsement of her employer. Assume that Employee is not a fiduciary, so that revised section 3-307 does not apply. If the bank has acted in good faith, the indorsement is treated as genuine, and the bank can take free of the employer's claim to the instrument. If, however, Em-

---

371. See supra notes 347-62 and accompanying text.

372. The statutory language is that the negligent transferee bears the loss "to the extent the failure to exercise ordinary care contributed to the loss." U.C.C. § 3-405 (1990). Draft comment 4 to revised section 3-405 gives a hypothetical case in which a court could find that the transferee depositary bank was in good faith but negligent; the comment then states that in such a case: "The trier of fact could allow recovery by Employer from Depositary Bank for all or part of the loss suffered by Employer." Id. § 3-405 comment 4.

373. Id. § 3-307.

374. See supra notes 264 & 269-319 and accompanying text.

375. Under former Article 3, the employer would be liable on the facts stated only if the employer had been negligent in its selection of the employee, or in the establishment or maintenance of internal security and auditing procedures. See B. CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS, AND CREDIT CARDS § 8.04[7][a] (3d ed. 1990).
ployee is a fiduciary, revised section 3-307 applies and the bank will not take free of the employer’s rights in the instrument. The result seems peculiar; the greater the authority the employer has vested in the employee, the more likely the risk of loss will be shifted to a bank that takes the instrument from the employee.

Of course, under revised section 3-405, the bank will be able to treat the indorsement as genuine only if it has acted in good faith. Further, as indicated in the previous discussion of “good faith,” the fact that a bank permits an employee to deposit a check payable to the employer into her personal account may be sufficient, in any event, to prevent the bank from taking in “good faith.” Therefore, revised section 3-405 may protect a bank only in the case where the bank does not know that the person depositing the check is a “responsible employee” of the payee. If so, there may be no overlap between revised sections 3-405 and 3-307.

However, good faith, even when it includes a requirement of observance of reasonable commercial standards of fair dealing, probably would not require a depositary bank to make inquiries of an employer in every imaginable situation in which an employee presents for deposit, to her personal account, a check indorsed in blank by the employer. Therefore, it is likely that there is, in fact, overlap and inconsistency between revised sections 3-307 and 3-405. Revised section 3-405 imposes greater risk on the employer for employee fraud, including fraud by employee fiduciaries than was the case under prior law. It does that by making the employee’s indorsement effective in cases in which it would not have been effective under former Article 3. On the other hand, revised section 3-307 imposes greater risk on persons who deal with fiduciaries than is presently the case in those states that have adopted the U.F.A., as well as in those non-U.F.A. states that do not impose automatic liability on a bank that permits a known fiduciary

377. Id. § 3-405(b) & comment 2.
378. See supra notes 347-62 and accompanying text.
379. Id.
380. See supra note 366.
381. See U.C.C. § 3-405(b) & comment 1 (1990). “Under former Section 3-406, the employer took the loss only if negligence of the employer could be proved. Under revised Article 3, Section 3-406 need not be used with respect to forgeries of the employer’s indorsement. Section 3-405 imposes the loss on the employer without proof of negligence.” Id. § 3-405 comment 1.
to deposit fiduciary checks to the personal account of the fiduciary.  

6. Revised U.C.C. Sections 3-404 and 3-406.—Sections 3-404 and 3-406 of revised Article 3 are also relevant to consideration of the new rules applicable to bank liability for fiduciary fraud. Revised section 3-404 is the imposter-padded payroll section which replaces 3-405 in former Article 3. Among the cases covered by the revised section are cases in which an employee having power to sign checks makes checks payable to a payee intending the payee to have no interest in the instrument or in which an employee, intending the payee to have no interest in the instrument, supplies the name of the payee to the person having authority to sign checks. In both cases, an indorsement by any person in the name of the payee is effective in favor of a good faith transferee or payor. However, if the transferee acts in good faith but fails to

382. See U.C.C. § 3-307 (1990); see also supra notes 78-79, 280-84 & 296-97 and accompanying text.

383. Revised section 3-404 provides:

Impostors; Fictitious Payees.

(a) If an imposter, by use of the mails or otherwise, induces the issuer of an instrument to issue the instrument to the imposter, or to a person acting in concert with the imposter, by impersonating the payee of the instrument or a person authorized to act for the payee, an indorsement of the instrument by any person in the name of the payee is effective as the indorsement of the payee in favor of a person who, in good faith, pays the instrument or takes it for value or for collection.

(b) If (i) a person whose intent determines to whom an instrument is payable (Section 3-110(a) or (b)) does not intend the person identified as payee to have any interest in the instrument, or (ii) the person identified as payee of an instrument is a fictitious person, the following rules apply until the instrument is negotiated by special indorsement:

(1) Any person in possession of the instrument is its holder.

(2) An indorsement by any person in the name of the payee stated in the instrument is effective as the indorsement of the payee in favor of a person who, in good faith, pays the instrument or takes it for value or for collection.

(c) Under subsection (a) or (b), an indorsement is made in the name of a payee if (i) it is made in a name substantially similar to that of the payee or (ii) the instrument, whether or not indorsed, is deposited in a depositary bank to an account in a name substantially similar to that of the payee.

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


384. Id. § 3-404(b)(2).
exercise ordinary care, as under revised 3-405, the court can apportion the loss between the drawer and the transferee or payor on what are, in effect, comparative fault principles. In allowing courts to shift some or all of the loss to a transferee or payor who acts in good faith but is negligent, revised 3-404 imposes greater risk on depositary or paying banks than was the case in most states under former section 3-405. Former section 3-405 did not state the circumstances under which the indorsement would not be effective in favor of a transferee or payor but most courts held that only bad faith of the transferee or payee deprived it of the right to rely on the indorsement. Even though shifting a part of the loss to a transferee or payor that acts in good faith but fails to exercise ordinary care in the 3-404 case increases the risk of transferees or payors, it is consistent with the same result in the similar 3-405 cases already discussed.

Section 3-406 in revised Article 3 continues the rule of 3-406 in former Article 3 that a person whose negligence substantially contributes to the making of an unauthorized signature is precluded from asserting the forgery against a person who in good

---

385. *Id.* § 3-404(d). Revised subsection 3-404(d) reads in pertinent part as follows:

[I]f a person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss resulting from payment of the instrument, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.

*Id.*

The second paragraph of comment 3 to 3-404 states that if a transferee or drawer has been negligent, the drawee has a cause of action against the transferee or drawee to recover a portion of the loss with the amount of loss to be allocated to each party to be left to the finder of fact. *Id.* § 3-404 comment 3.

386. U.C.C. § 3-405 (1989). The section merely provided that in the situations stated an indorsement by any person was effective. It said nothing about the persons in whose favor the indorsement was effective.

387. See, e.g., Northbrook Property & Casualty Ins. Co. v. Citizens & S. Nat'l Bank, 184 Ga. App. 326, 361 S.E.2d 531 (1987) (holding that negligence on the part of a transferee did not prevent indorsements good under former section 3-405 from being effective in favor of the transferee). The *Northbrook* court thought that denying transferees the protection of former section 3-405 only if they acted in bad faith effectuated the purpose of 3-405 to shift the risk of faithless employees from the transferees or drawees who deal with the employee to the employer who selected and had means of control over the employee. The court cited cases from seven other jurisdictions reaching the same result. The California Court of Appeals did hold in a 1983 case that negligence of a depositary bank might preclude it from relying on the validity of indorsements under 3-405. E.F Hutton Co., Inc. v. City Nat'l Bank, 149 Cal. App. 3d 60, 190 Cal. Rptr. 614 (1983).

388. See *supra* notes 383-81 and accompanying text.
faith takes or pays the instrument. That revised section, also, now adopts a comparative negligence rule under which if a transferee or drawee is in good faith but negligent, "the loss is allocated between the person precluded [from asserting the forgery] and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss."  

D Summary of Revised Article 3 Rules as to Bank Liability for Fiduciary Fraud

Revised sections 3-404 and 3-405 give the courts substantial flexibility in determining whether on the facts of a particular case the loss should fall on an employer or other beneficiary or on the transferee from the beneficiary's fiduciary. Also, revised section 3-406 adopts the same flexibility in cases involving negligence of a drawer or other party that contributes to the making of an unauthorized signature or an alteration. On the other hand, revised 3-307 imposes automatic liability on a bank which accepts a fiduciary instrument for deposit to the personal account of a fiduciary. It is

389. Revised section 3-406 provides:
Negligence Contributing to Forged Signature or Alteration of Instrument.
(a) A person whose failure to exercise ordinary care substantially contributed to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection.
(b) Under subsection (a), if the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss.
(c) Under subsection (a), the burden of proving failure to exercise ordinary care is on the person asserting the preclusion. Under subsection (b), the burden of proving failure to exercise ordinary care is on the person precluded.


390. Id. § 3-406(b). Former section 3-406 operated in favor of drawees only if they paid in good faith and in accordance with the reasonable commercial standards of their business. Therefore, if a drawee bank was held to have failed to act in accordance with reasonable commercial standards, it took the entire loss. See, e.g., Owensboro Nat'l Bank v. Crisp, 608 S.W.2d 51 (Ky. 1980), where, even though the drawer may have been negligent, the drawee bank took the loss where it was found that it had failed to follow reasonable commercial standards in paying the check. In that case, revised 3-406 is more favorable for the drawee bank since a bank's negligence will not be an absolute bar to recovery.
instructive to consider three recent cases and how they might be decided under revised Article 3.

_E.F Hutton & Co. v. City National Bank_ 391 involved an employee who supplied the employer with the names of payees intending them to have no interest. He then stole the checks, forged the payees' indorsements, and deposited them into his personal account at the defendant bank. Over the course of a year, he deposited eighteen checks, the largest in the amount of $81,598, and the smallest for $10,000. The court held that the employer had stated a cause of action in negligence against the bank. 392 Similarly, in _Transamerica Insurance Co. v. United States National Bank of Oregon_, 393 the court held that the issue was whether the bank was negligent in accepting checks payable to the bank for deposit into the account of an employee of the drawer. 394 In _Douglas v. Wones_, 395 the court held that a bank, as payee of a check, was not a holder in due course when the bank took the check from a person other than the drawer since the bank did not inquire of the drawer regarding the presenter's authorization to receive proceeds from the check. 396

---


393. 276 Or. 945, 558 P.2d 328 (1976).

394. _Transamerica Ins._, 276 Or. at 951, 558 P.2d at 333 ("The issue is not whether the bank should have accepted the signatures on the checks as valid, but whether, assuming the validity of the signatures, the bank was justified in transferring funds represented by the checks to the accounts of third parties who were not the named payees.").


396. _Douglass_, 120 Ill. App. 3d at 46, 458 N.E.2d at 522. The court reasoned as follows: [U]nder these [suspicious] circumstances the bank is required to hold the proceeds of the instrument subject to the order of the drawer, and not the presenter, and it generally cannot be a holder in due course as against the drawer if it has permitted the presenter to withdraw or otherwise use the proceeds of the check without taking precautions to determine the authority of the person to receive them.

_Id._ (citing _People ex rel. Nelson v. Peoples Bank & Trust Co._, 271 Ill. App. 41, _cert. denied_, 353 Ill. 479, 187 N.E. 522 (1933)).

In all three of the above cases, there are several possible results under revised Article 3. In *E.F Hutton*, because the check was not payable to E.F Hutton, nor to the employee as fiduciary, nor to the bank, revised 3-307 would not apply even if the employee was a fiduciary and the bank knew of that fact. However, 3-307 would be applicable to both the *Transamerica* and *Douglass* cases, since the checks in those cases were payable to the bank. Therefore, if the depositors in *Transamerica* and *Douglass* were fiduciaries and the banks knew that they were, the banks would be automatically liable for any misappropriation of the funds by the fiduciaries. If, however, the depositors in *Transamerica* and *Douglass* were not fiduciaries, or the banks did not know that they were, then none of the three cases would be subject to 3-307, but all three might be subject to revised sections 3-404, 3-405, or 3-406.

Revised section 3-404 would apply if the depositors provided the drawers with the names of the payees intending them to have no interest. If 3-404 did not apply, section 3-405 would apply if the depositors were employees or independent contractors who had responsibility with respect to the instruments. Under either 3-404 or 3-405 there are three possible results: loss on the employer if the depositary bank acted in good faith and exercised ordinary care,

“There is a marked difference between the obligations of a banking institution receiving funds and an individual. The latter does not ordinarily receive checks payable to his order from persons not indebted to him; he is not the custodian of funds in which he has no interest; nor is he a depositary for such members of the public as wish to avail themselves of his services. On the other hand, a bank is all of these. The public is invited to use its conveniences as places of deposit; it holds itself out as trustworthy for such purposes; when it is named as the payee in a check by a party not indebted to it, it will be presumed that it accepts the same subject to the directions of the drawer and not to the directions of a stranger to the paper who happens to present it.”


397. Revised section 3-307 applies only to instruments payable to the beneficiary or to the fiduciary as such and instruments drawn by the beneficiary or the fiduciary as such and payable to the taker of the instrument, including a depositary bank. See U.C.C. § 3-307 (1990).

398. Under 3-307, if the bank, knowing that the depositor is a fiduciary, allows deposit of an instrument drawn by the beneficiary or the fiduciary as such to be deposited to the personal account of the fiduciary, the bank is on notice of the claim of the beneficiary. Id. § 3-307(b)(1) & (4).

399. Under revised sections 3-404, 3-405 and 3-406, the finder of fact can flexibly apportion the loss. See *supra* notes 363-82 and accompanying text.
loss on the bank if it failed to act in good faith (including the observance of reasonable commercial standards of fair dealing), or loss apportioned between the drawer and the bank if the bank acted in good faith but failed to exercise ordinary care.

If sections 3-307, 3-404, and 3-405 did not apply, section 3-406 might apply if the drawers of the checks were found to be negligent. In that case, the same three outcomes as under 3-404 and 3-405 are possible. Interestingly, in the Transamerica case, the drawer of the checks in question, a real estate escrow company, regularly drew checks payable to the depositary bank for credit to the account of sellers of real estate. On those facts, the court suggested that the finder of fact might find the bank not negligent, at least as to checks which were submitted to the bank in the same manner as checks submitted to the bank in transactions authorized by the drawer. Revised section 3-307, however, does not seem to permit that flexibility except through a holding that the bank did not know of the fiduciary status of the depositor.

Only in cases covered by section 3-307 does revised Article 3 clearly mandate a result. In the cases covered by 3-307, if the bank knows of the fiduciary status of its transferor, bank takes the risk that the transactions described in that section are part of a misappropriation or planned misappropriation of the beneficiary’s funds. In the similar cases covered by revised sections 3-404 and 3-405, the finder of fact can place some or all of the loss on the employer of a wrongdoing employee. Similarly, under 3-406, in the case of negligence which contributes to the making of an unauthorized signature or alteration, the finder of fact has power to allocate risk between the party whose negligence contributed to the wrongdoing and subsequent transferees or drawees on comparative fault principles. In the context of employee fraud, it seems somewhat peculiar that only in cases in which the employer has, to the bank’s knowledge, vested the employee with fiduciary powers does revised 3-307 inflexibly impose the risk of employee wrongdoing on the depositary bank. However, it must be remembered that 3-307 applies only to cases in which an instrument payable to (a) the beneficiary,

---

400. 276 Ore. 945, 558 P.2d 328 (1976).
401. Under revised subsection 3-307(b)(4) the bank is on notice of a breach of fiduciary duty if it, knowing of the fiduciary status, accepts for deposit to the personal account of the fiduciary a check drawn by the beneficiary and payable to the bank. See U.C.C. § 3-307(b)(4) (1990).
(b) the fiduciary as such, or (c) the bank, is transferred to the bank by the fiduciary in a transaction known by the bank to be for (1) the benefit of the fiduciary or (2) for deposit into the personal account of the fiduciary. It must also be remembered that, with the exception of deposits to the personal account of the fiduciary, revised section 3-307 merely continues the rules of the Uniform Fiduciaries Act, now in effect in many states.\(^4\)

### IV Conclusion

This Article has discussed those provisions of revised Article 3 that are directly relevant to bank liability to a beneficiary whose fiduciary, dealing with the bank, misappropriates funds belonging to the beneficiary. We have also reviewed the law under the previous version of Article 3 as well as the Uniform Fiduciaries Act, which has been adopted by approximately half the states. Six specific sections of revised Article 3, sections 3-110, 3-206, 3-307, 3-404, 3-405, and 3-406 plus the new definition of "good faith" have been considered.

Revised section 3-110, which deals with whether particular language following the name of a payee puts transferees on notice of the payee's fiduciary status, differs inconsequentially from former 3-117. As noted earlier, revised sections 3-206 and 3-307, with one exception, follow the provisions of the Uniform Fiduciaries Act and permit a bank to accept an instrument from a fiduciary without being liable to the beneficiary for any wrongdoing by the fiduciary, unless the bank knows that the transaction is for the personal benefit of the fiduciary or the bank otherwise acts in bad faith. The one exception is under revised section 3-307; a bank that accepts a fiduciary check for deposit into the personal account of the fiduciary, without inquiry of the beneficiary as to the right of the fiduciary to do so, is liable if the fiduciary then misappropriates the funds.\(^5\)

At least in the case where the fiduciary is an employee of the beneficiary, the imposition of liability on the bank that accepts the fiduciary instrument for deposit to the fiduciary's personal account may be inconsistent with the policy behind revised section 3-405.

---

Revised section 3-405 now makes indorsement by an employee (including an independent contractor) effective if the employer entrusted the employee with responsibility with respect to checks or other instruments. Therefore, in the situations to which revised section 3-405 applies, a bank will more likely than under present Article 3 be a holder in due course and take title to the instrument free of any claims by the employer as a result of the employee's wrongful conduct. However, also pursuant to revised section 3-405, if the transferee takes from a "responsible employee," is a holder in due course, but is nevertheless negligent, the loss may be apportioned by the trier of fact between the employer and the transferee.

It might well have been preferable to apply flexible guidelines with respect to specific factual situations, like those outlined in the comments to revised section 3-405, to all transactions by fiduciaries. Under revised section 3-307 the provisions that protect the person (including a bank) who takes from a fiduciary, provided the taker has acted in good faith, are, in fact, fairly flexible, except with respect to deposits by a fiduciary to her personal account. This is particularly true since good faith now requires the observance of reasonable commercial standards of fair dealing. However, one aspect of the revised section 3-405 rules is not available under revised section 3-307: the ability to apportion the loss between the beneficiary and the transferee.

The rule of revised section 3-307 that a bank is liable if it accepts a fiduciary indorsed instrument for deposit into the personal account of the fiduciary without first verifying the fiduciary's authority with the beneficiary is inconsistent with 3-405 and is of questionable policy. This rigid rule, which imposes liability without regard to the other circumstances surrounding the transaction, will no doubt at times impose liability upon the depositary bank even though the bank acted completely in good faith and without the slightest suspicion that a misappropriation of fiduciary funds was occurring. Of course, whether such a rule is justified depends substantially upon how much additional cost will be imposed upon fiduciary transactions with banks. There are two elements of such cost: (1) the costs of training bank personnel against accepting any fiduciary checks for deposit into personal fiduciary accounts, and of the extra time and attention that will be required by bank personnel to carry out such instructions; and (2) the costs and
inconvenience to beneficiaries if banks are forced to always require that a separate trust account be opened for any fiduciary who is depositing a fiduciary instrument.

Fiduciaries operate in an almost infinite variety of situations. Following are some common examples: (1) a volunteer, unpaid treasurer of a local charity or service organization; (2) an administrator or executor of an estate, which may range from small to quite large; (3) an adult child with authority to manage an elderly or incapacitated parent’s financial affairs; (4) a trustee of a trust with either large or small assets and cash flow; (5) a lawyer who regularly receives checks payable to her as attorney for a client; (6) a corporate president and sole shareholder who treats his personal assets and the corporation’s assets as interchangeable; (7) a president of a corporation with a number of stockholders; and (8) an employee of a business who has general or limited authority to write and indorse checks.

In none of these situations is it clear that the deposit into a fiduciary’s personal account is the first step in an embezzlement scheme. The mere fact of deposit into the fiduciary’s personal account does not establish that the transaction is for the personal benefit of the fiduciary. There may well be reasons for the deposit that are entirely consistent with the fiduciary’s duty; the beneficiary may not have an account with the bank or, for other reasons, may be desirable to make the deposit to the fiduciary’s personal account. Furthermore, deposit transactions are routinely mass-processed transactions. Therefore, the onerous duty of inquiry as to each and every fiduciary transaction may impose too great a burden upon banks and their personnel.

Therefore, imposing as a general rule such a burden upon the check collection system may be an inappropriate imposition of liability on banks taking deposits from fiduciaries. It is by no means clear that a bank should be automatically held liable for any embezzlement by a fiduciary after deposit by the fiduciary of a fiduciary item into the fiduciary’s personal account.

There are, however, special considerations in the case of employee fraud. It can be argued that, in the employee context, it is so unusual for a check payable or indorsed to the employer to be deposited into the personal account of an employee-fiduciary, that in all such cases the depositary should assume the risk that the employee making the deposit is breaching her fiduciary duty.
the other hand, there is the offsetting factor that, in the employee case, the employer likely has an equal or better opportunity to prevent the loss by care in the selection of "responsible employees," and in the creation of operating procedures for the prevention and discovery of employee fraud. In the case of employee-forged indorsements, revised section 3-405 recognizes that aspect of the risk of loss calculus, and implicitly makes indorsements of such employees effective, although such indorsements were otherwise treated as forgeries under former Article 3. The new rules of revised section 3-405 appropriately recognize that employers should assume greater responsibility for employee forgery, and also through the application of holder in due course and negligence rules, permit a flexible allocation of loss based upon the circumstances surrounding the individual case. It might have been better had revised Article 3 applied flexible principles like those of revised section 3-405 to the fiduciary cases dealt with by revised section 3-307.

On the other hand, it is understandable that the drafting committee would not choose to totally abandon a statutory scheme that has been adopted by approximately half the states. Further, it may be that the relative certainty that exists under revised section 3-307 is preferable to the greater flexibility, and its inherent uncertainty, under revised section 3-405. Only experience under revised Article 3 can answer that question. In the meantime, it is appropriate to suggest that courts read revised section 3-307 narrowly so that, in as many cases as possible, the usual holder in due course rules and, in appropriate cases, the negligence rules of revised Article 3 will apply.