

# Liability of Payee for Accepting Fraudulent Checks In Payment of a Fiduciary's Personal Debt

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## ***I. Introduction***

Fidelity insurers seeking recovery following payment of check fraud losses typically examine, as potential sources of recovery, either the drawee bank that paid unauthorized checks drawn on the insured's checking account or the depository bank that accepted the checks for collection or payment. In some instances, the payees that received unauthorized checks may be another viable source of recovery.

Banks in particular have sought legislation to insulate themselves from liability when they deal in good faith with fiduciaries, such as section 3-307 of the Uniform Commercial Code<sup>1</sup> and aspects of the Uniform Fiduciaries Act.<sup>2</sup> When a payee receives a check from a fiduciary, it typically is not in a position to know whether the fiduciary has exceeded his authority in drawing the check; and, as a general rule, the payee is not liable to the principal if the fiduciary has misapplied the principal's funds. A red flag should go up, however, when the principal's check is delivered to a bank or other payee for the benefit of the *fiduciary*.

A claim against the payee on an unauthorized check predicated upon the UCC may be problematic because it is often difficult for the claimant to satisfy at least one necessary condition of liability—that the payee knew the wrongdoer was a fiduciary when it accepted the check from him. Courts, however, have sustained affirmative claims against payees based upon the UFA.

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<sup>1</sup> Hereinafter UCC.

<sup>2</sup> Hereinafter UFA.

## *II. Uniform Commercial Code*

Articles 3 and 4 of the UCC govern claims arising from the negotiation of negotiable instruments. In analyzing the potential liability of a payee to the drawer of the instrument, the analysis begins with UCC § 3-306, which provides as follows:

A person taking an instrument, other than a person having rights of a holder in due course, is subject to a claim of a property or possessory right in the instrument or its proceeds, including a claim to rescind a negotiation and to recover the instrument or its proceeds. A person having rights of a holder in due course takes free of the claim to the instrument.<sup>3</sup>

### **A. DUTY OF INQUIRY**

Under UCC § 3-306, a payee who takes a fraudulent check, but does not credit it to the account of the drawer of the check, is subject to a claim to the instrument or its proceeds, unless the payee is a holder in due course. UCC § 3-302 defines when a person is a holder in due course. Among other criteria, a holder in due course must take the instrument (1) without notice that the instrument contains an unauthorized signature or alteration, and (2) without notice of any claim to the instrument.<sup>4</sup>

Assume that a corporation issues a check payable to its bank and instructs its employee to deliver the check to the bank in payment of the company's debt. The employee instead cashes the check or delivers the check in satisfaction of the employee's personal debt. If the bank, when it took the check, was unaware that the corporation had a claim to the check proceeds and otherwise met the conditions of a holder in due course, then the bank took the check free of the corporation's claim.<sup>5</sup>

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<sup>3</sup> UCC § 3-306 (2004).

<sup>4</sup> UCC § 3-302(a)(2).

<sup>5</sup> UCC § 3-302 cmt. 4, case #3; *Trail Leasing, Inc. v. Drovers First Am. Bank*, 447 N.W.2d 190 (Minn. 1989).

Some courts have held that, when a corporate check is payable to the drawee bank at which the corporation maintains an account, the bank owes a common law duty of inquiry to its customer. In *Federal Insurance Co. v. NCNB National Bank of North Carolina*,<sup>6</sup> for example, a customer's employee presented company checks payable to NCNB in exchange for cashiers checks. The court held as follows:

A bank that receives a check payable to it, where the drawer is not indebted to it, has a duty, before paying the check, to inquire whether the drawer's agent is authorized to negotiate the check, since the bank is authorized to pay the check only in accordance with the drawer's directions.<sup>7</sup>

In *Dalton & Marberry, P.C. v. NationsBank, N.A.*,<sup>8</sup> plaintiff's employee induced an authorized signatory to issue and sign checks payable to its bank, and the employee used the checks to purchase blank cashier's checks and money orders. Upon discovery, plaintiff sued the bank for negligence deriving from the breach of its common law duty of inquiry, and the bank denied liability on the ground that it was a holder in due course. The court held that the bank could be liable for failing to inquire regarding the employee's authority and that a drawee bank that is the payee on a check cannot be a holder in due course.<sup>9</sup>

In *Douglas v. Wones*,<sup>10</sup> the court applied the duty of inquiry to depository banks, finding that the banks' status as holders in due course did not necessarily insulate them from liability. In the case, a fraudster induced plaintiff to issue checks payable to three banks at which plaintiff maintained no customer relationships. Plaintiff alleged that the payee banks had a duty to inquire whether plaintiff had been fraudulently induced to draw the checks. The court agreed, holding that when the payee is a bank, and the presenter, who is not the drawer, requests that

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<sup>6</sup> 958 F.2d 1544 (11th Cir. 1992).

<sup>7</sup> *Id.* at 1549; *see also* Pettigrew v. Citizens Trust Bank, 229 B.R. 39, 43-44 (Bankr. N.D. Ga. 1998); Transamerica Ins. Co. v. U.S. Nat'l Bank, 558 P.2d 328, 333 (Or. 1976).

<sup>8</sup> 982 S.W.2d 231 (Mo. 1999).

<sup>9</sup> *Id.* at 234-35.

<sup>10</sup> 458 N.E.2d 514 (Ill. App. Ct. 1983).

the bank credit his personal account with the proceeds, the bank is held to a higher standard, and notice of potential fraud is deemed to have been given by the terms of the instrument itself. The court found that, in such cases, a bank holds the check proceeds subject to the drawer's order, and not the presenter's, and generally cannot be a holder in due course as against the drawer if it has allowed the presenter to use the proceeds of the check without taking precautions to determine the authority of the person to receive them.<sup>11</sup>

A different standard may be applied, however, if the employee who delivered the check to the bank as payee is a fiduciary of the corporation. A claim founded upon breach of fiduciary duty could be asserted under UCC § 3-306.<sup>12</sup> UCC § 3-307 outlines the circumstances under which a person who has taken an instrument from a fiduciary did so "without notice of any claim" and, therefore, is a holder in due course and protected from liability. It states in relevant part as follows:

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

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(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

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<sup>11</sup> *Id.* at 522.

<sup>12</sup> UCC § 3-307 cmt. 2.

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.<sup>13</sup>

Under the foregoing provision, if the fraudulent check was payable to the fiduciary, the taker of the check would have rights of a holder in due course unless it was aware of the presenter's fiduciary status and had notice of the breach of fiduciary duty.<sup>14</sup> If the fraudulent check was payable to the *bank*, whether the bank is a holder in due course and insulated from liability depends on (1) whether the employee who presented the check is a fiduciary, (2) whether the check was taken for the employee's account or benefit, and (3) whether the bank that took the check was aware of the employee's fiduciary status.<sup>15</sup>

#### **B. DID THE TAKER HAVE NOTICE OF THE BREACH OF FIDUCIARY DUTY?**

A "fiduciary" is defined under UCC § 3-307 as "an agent, trustee, partner, corporate officer or director, or other representative owing a fiduciary duty with respect to an instrument."<sup>16</sup> Not all fiduciaries necessarily fall within the scope of the provision. The person presenting the check must be a fiduciary "with respect to an instrument."

In *Mutual Service Casualty Insurance Co. v. Elizabeth State Bank*,<sup>17</sup> an employee had authority to draw checks on a payroll and tax account, but not on the operating account from which he embezzled funds. The court found that the employee "may have been a fiduciary for some purposes, but he did not qualify as a fiduciary with respect to checks drawn on the operating account and made payable to the bank's order."<sup>18</sup> Therefore, UCC § 3-307 was inapplicable to the claim.

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<sup>13</sup> *Id.* § 3-307(b).

<sup>14</sup> *Id.* § 3-307(b)(3).

<sup>15</sup> *Id.* § 3-307(b)(4).

<sup>16</sup> *Id.* § 3-307(a)(1).

<sup>17</sup> 265 F.3d 601 (7th Cir. 2001).

<sup>18</sup> *Id.* at 622.

A court requires clear evidence that a party is a fiduciary. In *Belfance v. Huntington National Bank (In re World Metals, Inc.)*,<sup>19</sup> the court found summary judgment was not appropriate where there was a genuine issue of material fact as to whether the employee who misappropriated the funds, a bookkeeper employed by the drawer, was a fiduciary. Because of the parties did not stipulate to her fiduciary status, the court could not determine if UCC § 3-307 applied.

Assuming the employee was a fiduciary, the protections of UCC § 3-307 do not apply if the taker of the check, typically a bank, had notice of the breach of fiduciary duty.<sup>20</sup> The taker is *deemed* to have such notice if the instrument was:

- (a) taken in payment of a debt known by the taker to be the personal debt of the fiduciary,
- (b) taken in a transaction known by the taker to be for the personal benefit of the fiduciary, or
- (c) deposited to an account other than an account of the represented person.<sup>21</sup>

Under the foregoing criteria, when an employee seeks to deposit a third-party check payable to the employer into the employee's personal account, the bank is deemed to have notice of the breach of fiduciary duty. Also, an unauthorized check would meet the foregoing criteria where the check was drawn on the employer's account payable to the bank and was taken by a bank in payment of the employee's personal obligations. For example, where the employee seeks to apply a check against the balance due on his personal credit card balance or line of credit account, the bank would be deemed to have notice of the breach of fiduciary duty. One court opined when notice of such a breach is established:

[N]otice of a breach of a fiduciary duty is established if the taker had knowledge that the deposit was made to a

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<sup>19</sup> 313 B.R. 720 (Bankr. N.D. Ohio 2004).

<sup>20</sup> *Halifax Corp. v. Wachovia Bank*, 604 S.E.2d 403, 412 (Va. 2004).

<sup>21</sup> UCC § 3-307(b)(4).

personal account of the fiduciary or to an account other than that of the fiduciary as such or an account of the represented person. In such a case, the deposit constitutes notice of a breach of a fiduciary duty, precluding the taker from asserting a holder in due course defense.<sup>22</sup>

Such facts should be a red flag alerting the bank to the employer's potential claim to the proceeds.<sup>23</sup>

### C. KNOWLEDGE OF FIDUCIARY STATUS

A bank that takes from a fiduciary an unauthorized check payable to the bank and credits the check to the fiduciary's account may nevertheless take the check as a holder in due course, free of claims to the instrument. To impose liability on the bank, the principal must also prove that the bank that took the check from the fiduciary, for payment or collection or for value, had "knowledge of the fiduciary status of the fiduciary."<sup>24</sup>

A person has "knowledge" of a fact when he has "*actual knowledge*" of it.<sup>25</sup> "Knowledge" is effective as to an organization "from the time it is brought to the attention of the individual conducting that transaction and, in any event, from the time when it would have been brought to his attention if the organization had exercised due diligence," such as by establishing "reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines."<sup>26</sup>

When a bank has taken a fraudulent check from a fiduciary, it may be difficult to prove that the bank had actual knowledge that the person presenting the check was a fiduciary. An argument could be advanced that a bank had constructive knowledge that the employee was

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<sup>22</sup> Progressive Cas. Ins. Co. v. PNC Bank, N.A., No. CIV.A.98-6840, 1999 WL 557292, at \*3 (W.D. Pa. July 26, 1999).

<sup>23</sup> Douglass v. Wones, 458 N.E.2d 514, 523-24 (Ill. App. Ct. 1983).

<sup>24</sup> UCC § 3-307(b).

<sup>25</sup> UCC § 1-202(b) (emphasis added).

<sup>26</sup> UCC § 1-202(f).

a fiduciary of the employer if, for example, the employee's account documents identify his employer and employment capacity, or if the employee signed the employer's checks. The Official Comment, however, suggests that a subjective standard should apply. It provides that, if the individual who takes the instrument for payment or collection is a bank, "knowledge of the organization is determined by the knowledge of the 'individual conducting that transaction,' *i.e.*, the clerk who receives and processes the instrument."<sup>27</sup>

In *United Catholic Parish Schools of Beaver Dam Educational Ass'n v. Card Services Center*,<sup>28</sup> plaintiff's bookkeeper, Gittus, wrote checks on the school district's account in payment of Gittus's personal credit card debt. The court held that the bank that negotiated the checks was a holder in due course under section 3-307 and, therefore, was not subject to a claim of conversion. The court noted that the school district had submitted no proof that the bank had actual knowledge that Gittus was a fiduciary when the transactions occurred.<sup>29</sup>

Larger financial institutions process a high volume of checks every day, so it may be difficult to identify the clerks who handled the items, or if identified, for them to recall the specific checks at issue. Moreover, many financial institutions process checks and other payments in some automated manner, with very little involvement of any individual clerk. The UCC recognizes that banks take checks for collection or payment by automated means. Reasonable commercial standards do not require a bank to examine a check manually if the failure does not violate the bank's prescribed procedures and those procedures are reasonably consistent with general banking usage.<sup>30</sup> For these reasons, in some cases it may be difficult to meet the burden of proving that the payees had actual knowledge of the employee's fiduciary status, as required by section 3-307.

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<sup>27</sup> UCC § 3-307 cmt. 2; *see also* Progressive Cas. Ins. Co. v. PNC Bank, N.A., No. CIV.A.98-6840, 1999 WL 557292, at \*5 (W.D. Pa. July 26, 1999).

<sup>28</sup> 636 N.W.2d 206 (Wis. Ct. App. 2001).

<sup>29</sup> *See also* Grand Rapids Auto Sales, Inc. v. MBNA Am. Bank, No. 1:01-CV-660, 2002 WL 31268215, at \*7 (W.D. Mich. July 24, 2002) (plaintiff could not show bank had notice of fiduciary status).

<sup>30</sup> UCC § 3-103(9).

### ***III. Uniform Fiduciaries Act***

The purpose of the UFA is to “cover situations that arise when one person honestly deals with another knowing him to be a fiduciary”<sup>31</sup> and to “place on the principal the burden of employing honest fiduciaries.”<sup>32</sup> The UFA provides protection for the banking institution that acts in good faith with an authorized fiduciary unless it can be shown that the bank is aware the fiduciary is breaching its duty or the bank’s dealing with the fiduciary amounts to bad faith.<sup>33</sup>

The National Conference of Commissioners on Uniform State Laws enacted the UFA in 1922. A version of the Act has since been enacted by legislatures in 25 states and the District of Columbia. The UFA does not cover the scope of the fiduciary’s duties or liabilities, but rather addresses the liability of banks and other persons who deal with a fiduciary who is in breach of his fiduciary duties.

At common law, banks had a duty to inquire into the propriety of each transaction conducted by a fiduciary.<sup>34</sup> The UFA originated as a means to insulate banks from liability when they deal in good faith with a fiduciary and to relieve banks from the duty of seeing that funds are applied consistently with the principal’s interests.<sup>35</sup> Each section of the UFA addresses questions relating to when a bank or other person who deals with a fiduciary has notice that the fiduciary has breached his obligations, in the following factual contexts:

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<sup>31</sup> Johnson v. Citizens Nat’l Bank, 334 N.E.2d 295, 298 (Ill. App. Ct. 1975).

<sup>32</sup> County of Macon v. Edgcomb, 654 N.E.2d 598, 601 (Ill. App. Ct. 1995).

<sup>33</sup> Master Chem. Corp. v. Inkrott, 563 N.E.2d 26, 29 (Ohio 1990).

<sup>34</sup> See Nat’l Cas. Co. v. Caswell & Co., 45 N.E.2d 698, 700 (Ill. App. Ct. 1942); Motor Castings Co. v. Milwaukee County Bank, 36 N.W.2d 687, 689 (Wis. 1949).

<sup>35</sup> See Lehigh Presbytery v. Merchs. Bancorp, Inc., 600 A.2d 593, 595 (Pa. Super. Ct. 1991) (UFA relieves the depository of the responsibility of seeing that a fiduciary uses entrusted funds for proper purposes); see also Nat’l Union Fire Ins. Co. v. First Nat’l Bank, No. 90C6851, 1991 WL 47376, at \*4 (N.D. Ill. Mar. 27, 1991).

- Section 2      Application of Payments Made to a Fiduciary**  
Liability of a bank that pays money to a fiduciary who is authorized to receive payment.
- Section 4      Transfer of a Negotiable Instrument by a Fiduciary**  
Liability of a transferee bank, when a fiduciary has endorsed a check payable or endorsed to himself.
- Section 5      Check Drawn by a Fiduciary Payable to a Third Person**  
Liability of a payee on a check drawn by a fiduciary, or in the name of the fiduciary's principal.
- Section 6      Check Drawn by and Payable to a Fiduciary**  
Liability of a bank or other transferee of a check, drawn by and payable to the fiduciary personally, or to a third party who endorsed the item back to the fiduciary.
- Section 7      Deposit in the Name of a Fiduciary as Such**  
Liability of a bank for payment of amounts that were deposited to the credit of the fiduciary as such.
- Section 8      Deposit in the Name of the Principal**  
Liability of a drawee bank for payment of checks drawn on the principal's account by a fiduciary empowered to draw checks.
- Section 9      Deposit in a Fiduciary's Personal Account**  
Liability of a bank, when a fiduciary has deposited, to the fiduciary's credit, checks drawn by him as fiduciary or upon the principal's account.

#### A. SECTIONS 5 AND 9 OF THE UFA

The UFA, in substance, addresses the same type of transactions as UCC § 3-307.<sup>36</sup> However, there are substantive differences between the UCC and UFA that would give a claimant an alternative basis for

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<sup>36</sup> The Official Comment to UCC § 3-307 states that the UFA is consistent with that section.

pursuing an affirmative claim against the payees of unauthorized checks, particularly under sections 5 and 9 of the UFA.

Under UFA § 5, if a check is drawn by a fiduciary or in the name of the fiduciary's principal, the payee is not bound to inquire whether the fiduciary is committing a breach of a fiduciary obligation and is not charged with notice that the fiduciary is committing a breach unless the payee takes the instrument (1) with actual knowledge of the breach or (2) with knowledge that his actions in taking the instrument amount to bad faith. The last sentence of section 5 concludes as follows:

If, however, such instrument is payable to a personal creditor of the fiduciary and delivered to the creditor in payment of or as security for a personal debt of the fiduciary to the actual knowledge of the creditor, or is drawn and delivered in any transaction known by the payee to be for the personal benefit of the fiduciary, the creditor or other payee is liable to the principal if the fiduciary in fact commits a breach of his obligation as fiduciary in drawing or delivering the instrument.<sup>37</sup>

Under the foregoing section, if a payee accepts a fraudulent check from a fiduciary, the payee is insulated from liability, unless the payee was aware of the fraud or otherwise took the check in bad faith. The burden of proof for imposing liability on the payee is significantly diminished, however, if the payee is a personal creditor of the fiduciary and the payee is aware that the check has been delivered for the personal benefit of the fiduciary. In that event, the payee is liable to the principal for the breach of the fiduciary's duties.

UFA § 9 applies when a fiduciary delivers a check payable to a bank for deposit into a fiduciary's personal bank account and then withdraws the funds. Section 9 provides as follows:

[T]he 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

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<sup>37</sup> UFA § 5 (2002).

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.

Section 9 insulates the bank from liability unless the bank was aware of the breach or acted in bad faith in accepting the check for deposit or permitting the withdrawal. Note that section 9 does not insulate all banks from liability. It applies only when the bank accepts an unauthorized check for deposit. Therefore, if the check is payable to the bank in payment of a personal debt of the fiduciary, rather than for deposit, then section 5 should apply.

#### **B. AFFIRMATIVE CLAIMS UNDER THE UFA**

Cases construing the UFA do not always do so consistently. Some courts have held that the UFA does not create an affirmative claim, but rather acts only as a defense to allegations of negligence against a bank.<sup>38</sup> There is ample authority to the contrary.<sup>39</sup>

In *Appley v. West*,<sup>40</sup> the plaintiff's trustee diverted trust assets to an account at the defendant-bank; and the plaintiff sought recovery against the bank for negligence and for facilitating the fraudulent

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<sup>38</sup> *E.g.*, *Appley v. West*, 832 F.2d 1021, 1031 (7th Cir. 1987); *First Nat'l Bank*, 1991 WL 47376, at \*4; *see also* *Micale v. Bank One N.A.*, 382 F. Supp. 2d 1207, 1217 (D. Colo. 2005) ("Colorado courts that have addressed this statute treat it as a defense to a common law cause of action. . . . I do not need to determine whether Colorado recognizes an independent cause of action . . .").

<sup>39</sup> *See, e.g.*, *Md. Cas. v. Bank*, 340 F.2d 550, 553-54 (4th Cir. 1965); *Sonders v. PNC Bank, N.A.*, No. Civ.A.01-3083, 2003 WL 22310102, at \*6 (E.D. Pa. June 3, 2003) ("a plaintiff may state a claim for bad faith under the UFA"); *County of Macon v. Edgcomb*, 654 N.E.2d 598 (Ill. App. Ct. 1995); *ATS Ohio, Inc. v. Shively*, No. 99CA5, 1999 WL 770196 (Ohio Ct. App. Sept. 2, 1999).

<sup>40</sup> 832 F.2d 1021 (7th Cir. 1987).

scheme. The Seventh Circuit found that the plaintiff stated a cause of action against the bank by alleging the bank knew the trustee had breached his fiduciary obligations and had acted in bad faith. Construing the bank's defense under the UFA, the court noted that UFA § 9 did not create the claim against the bank, but is a defense to such a claim "unless the bank has actual knowledge that the fiduciary is breaching his fiduciary obligations or the bank acts with bad faith."<sup>41</sup>

The *Appley* and *First National Bank* cases were decided under section 9, not under section 5.<sup>42</sup> Section 9, on its face, does not appear to create a claim against the depository bank. Rather, the claim may arise under the UCC (e.g., conversion under section 3-420) or perhaps at common law. The bank would raise section 9 as a defense to liability, if it could meet the necessary conditions. Likewise, the first portion of section 5 is a defense to liability that the payee of a check can raise. In contrast to section 9, however, section 5 has a concluding sentence, quoted above, that imposes liability on the payee under certain limited circumstances (the "payee is liable to the principal").

Courts have recognized that the concluding portion of UFA § 5 creates a basis for asserting an affirmative claim. In *County of Macon v. Edgcomb*,<sup>43</sup> the county sued two banks to recover amounts embezzled by its former treasurer, who had caused checks to be issued by the county for his personal benefit. Three of the checks had been used to make payments on personal loans at the banks. As to those checks, the court held that the complaint stated a claim against the banks under section 5 of the UFA.

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<sup>41</sup> *Id.* at 1031; accord *Nat'l Union Fire Ins. Co. v. First Nat'l Bank*, No. 90C6851, 1991 WL 47376, at \*4 (N.D. Ill. Mar. 27, 1991) (UFA § 9 does not create a cause of action but rather acts as a defense against a negligence claim.).

<sup>42</sup> Although the UFA has existed for almost eighty-five years, there are relatively few cases construing the Act, and only a handful involve § 5. That is probably because, as a practical matter, wrongdoers typically deposit fraudulent checks into a bank account (§ 9) and less frequently write checks directly to creditors (§ 5).

<sup>43</sup> 654 N.E.2d 598 (Ill. App. Ct. 1995).

Similarly, in *Maryland Casualty Co. v. Bank of Charlotte*,<sup>44</sup> the Fourth Circuit held that the language in section 5 imposed liability on a bank that accepted corporate checks to reduce a fiduciary's personal debts:

Section 5 of that Act codifies the common law rule that a fiduciary's creditor is liable to the fiduciary's principal if it applies to the personal debt of the fiduciary a check of the principal designating the creditor as payee. . . . The Bank is liable for this amount under the very language of the statute . . . .<sup>45</sup>

In *ATS Ohio, Inc. v. Shively*,<sup>46</sup> ATS maintained a corporate checking account at Bank One. Its controller embezzled funds by issuing ATS checks, payable to Bank One, to pay the balance on his personal loans. ATS and its insurer brought a claim against Bank One under section 9 of the Ohio Act. They apparently did so because Ohio has not enacted section 5 of the UFA. Ohio did, however, append to section 9 some additional language, equivalent to the last sentence in section 5, that imposes liability upon a drawee bank when the bank is the payee on a check delivered to it for the benefit of the fiduciary.<sup>47</sup> The court reversed the decision below, holding that the statute imposed liability on the bank:

Based on the language of the above statute, we find the second paragraph . . . expressly creates liability of Bank One. Checks were drawn on [the plaintiff's] account by . . . fiduciaries empowered to do so. Further, the checks at issue were payable to Bank One, the drawee

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<sup>44</sup> 340 F.2d 550 (4th Cir. 1965).

<sup>45</sup> *Id.* at 552.

<sup>46</sup> No. 99CA5, 1999 WL 770196 (Ohio Ct. App. Sept. 2, 1999).

<sup>47</sup> Section 9 of the Ohio statute concludes: "If such check is payable to the drawee bank and is delivered to it in payment of or as security for a personal debt of the fiduciary to it, the bank is liable to the principal if the fiduciary in fact commits a breach of his obligation as fiduciary in drawing or delivering the check." OHIO REV. CODE ANN. § 1339.08.

bank and were delivered to it in payment of fiduciary [the thief's] personal debt.<sup>48</sup>

Another recent decision likewise upheld an affirmative claim asserted under section 9 of the UFA. In *Continental Casualty Co. v. American National Bank and Trust Co.*,<sup>49</sup> CNA brought a claim, as assignee of its insured, against the bank at which its insured maintained a corporate checking account. The controller induced the company to issue checks payable to the bank, ostensibly to cover payroll taxes, but the controller deposited the checks into his personal checking account at the bank. The complaint asserted claims for breach of contract and for violation of section 9 of the UFA. Contrary to the holdings in *Appley* and *First National Bank*, the court held that the complaint stated an affirmative claim for relief under section 9 because the complaint alleged sufficient facts to support a finding that the bank had acted in bad faith when it paid the checks.<sup>50</sup>

A bank's failure to inquire into a fiduciary's authority to deposit checks into his personal account also constitutes a breach of its common law duties. "[W]hen a drawer owes nothing to a bank but writes a check payable to the bank's order, . . . the bank may not . . . treat the check as bearer paper and blindly disburse the proceeds according to the instructions of any individual who happens to present the check to the bank."<sup>51</sup> In these circumstances, a bank owes a common law duty of inquiry. It must inquire into the customer's authority to negotiate the checks. If it does not do so, it is liable for the resulting loss.<sup>52</sup>

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<sup>48</sup> *ATS Ohio*, 1999 WL 770196, at \*5.

<sup>49</sup> 768 N.E.2d 352 (Ill. App. Ct. 2002).

<sup>50</sup> *Id.* at 366-67.

<sup>51</sup> *Mut. Serv. Cas. Ins. Co. v. Elizabeth State Bank*, 265 F.3d 601, 613-14 (7th Cir. 2001).

<sup>52</sup> *Travelers Cas. & Sur. Co. v. Wells Fargo Bank N.A.*, 374 F.3d 521, 526 (7th Cir. 2004); *Progressive Cas. Ins. Co. v. PNC Bank, N.A.*, No. CIV.A.98-6840, 1999 WL 557292, at \*3 (W.D. Pa. July 26, 1999); *Douglass v. Wones*, 458 N.E.2d 514, 522-23 (Ill. App. Ct. 1983); *Milano v. Sheridan Trust & Sav. Bank*, 1926 WL 3944, at \*5 (Ill. App. Ct. Nov. 29, 1926).

### C. ELEMENTS OF A CLAIM UNDER SECTION 5

At common law, a bank was liable for losses resulting from its acceptance of corporate checks in payment of a fiduciary's personal debts.<sup>53</sup>

[W]hen a drawer owes nothing to a bank but writes a check payable to the bank's order, the drawer places that check in the bank's custody, with the expectation that the bank will negotiate the check according to the *drawer's* wishes; the bank may not . . . blindly disburse the proceeds according to the instructions of any individual who happens to present the check to the bank.<sup>54</sup>

"If the bank assumes without investigation that the instructions of the presenter are those of the drawer, it takes a risk . . . [and] is liable to the drawer for paying the check to such person."<sup>55</sup> Section 5 of the UFA, consistent with common law, codifies this claim:

If . . . [an] instrument is payable to a personal creditor of the fiduciary and delivered to the creditor in payment of or as security for a personal debt of the fiduciary to the actual knowledge of the creditor, or is drawn and delivered in any transaction known by the payee to be for the personal benefit of the fiduciary, the creditor or other payee is *liable to the principal* if the fiduciary in fact commits a breach of his obligation as fiduciary in drawing or delivering the instrument.<sup>56</sup>

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<sup>53</sup> *Douglass*, 458 N.E.2d at 519-20; *Milano*, 1926 WL 3944, at \*5.

<sup>54</sup> *Mut. Serv.*, 265 F.3d at 613-14; *see also* *Dalton Marberry, P.C. v. NationsBank*, 982 S.W.2d 231, 233-34 (Mo. 1998); *Master Chem. Corp. v. Inkrott*, 563 N.E.2d 26, 28-29 (Ohio 1990).

<sup>55</sup> 9 C.J.S. *Banks and Banking* § 327, 316-17 (1996) (footnotes omitted).

<sup>56</sup> UFA § 5 (emphasis added).

Under section 5, the payee is liable regardless of whether or not it had a relationship with the drawer.<sup>57</sup> The bank's duty to the principal arises as a matter of public policy, not as a matter of contract. Addressing this issue, the Seventh Circuit held in *Travelers Casualty & Surety v. Wells Fargo* that, although the payee had no contractual relation with the drawer, the payee nonetheless owed a duty of inquiry because "[t]he duty is imposed . . . as a matter of tort law rather than contract law or UCC law . . . ."<sup>58</sup> In reaching this decision, the court explained as follows:

It is true but irrelevant that the common law's imposition of a duty of care on a bank which receives a check made out to it by a drawer who owes the bank no money is unusual because it creates a form of "good Samaritan" liability, which the common law normally refuses to impose. . . . The drawer in a case such as this, to repeat, is not a customer of the payee institution . . . or anyone else to whom the payee would owe a duty of care under normal tort principles. Rather it's a third party whom the payee is asked to "rescue" from a possible fraud. But unusual as the rule may be in our common law system, it is firmly established.<sup>59</sup>

A creditor, therefore, is liable if it knowingly accepts a corporate check in payment of a personal debt, even if it did not know the presenter had breached his fiduciary duties. The imposition of liability on the creditor "enjoys the unwavering support of a vast body of judicial opinion originating both before and after the creation of the UCC"<sup>60</sup> Pursuant to its terms, to state a claim under section 5, the claimant need allege only that the payees knowingly accepted the unauthorized check from a fiduciary in payment of the fiduciary's personal debts.

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<sup>57</sup> *Travelers Cas. & Sur. Co. v. Wells Fargo Bank N.A.*, 374 F.3d 521, 526 (7th Cir. 2004).

<sup>58</sup> *Id.*

<sup>59</sup> *Id.* at 527; *Milano*, 1926 WL 3944, at \*4 (the bank owes a duty because "[t]he public is invited to use its conveniences as places of deposit; it holds itself out as trustworthy for such purposes").

<sup>60</sup> *Bullitt County Bank v. Publishers Printing Co.*, 684 S.W.2d 289, 292 (Ky. Ct. App. 1984); see also *Mut. Serv.*, 265 F.3d at 613-14.

### 1. Payee's Knowledge of Fiduciary Status

If a check is payable and delivered to a fiduciary's personal creditor in payment of a personal debt of the fiduciary, "to the actual knowledge of the creditor," the payee is liable under the last sentence of UFA § 5. The payee is liable if it knowingly accepted the unauthorized check in payment of the fiduciary's personal debt, that is "[i]f the [] employee taking the checks for payment knew that the [debt] on which the checks were applied were personal [debts]."<sup>61</sup>

A payee may argue that, as a condition of imposing liability on the payee under UFA § 5, it is also necessary to prove that the payee had actual knowledge that the employee was a fiduciary of the drawer. The absence of such actual knowledge of the person's fiduciary status may stall a claim under UCC § 3-307, but is not an element of a claim under UFA § 5.

If a bank that accepts a fraudulent check from a fiduciary seeks to assert a defense under the UFA, section 9 requires the bank to prove "actual knowledge that the fiduciary is committing a breach of his obligation as fiduciary in making such deposit." Similarly, the first portion of section 5 includes the same requirement when payees seek to raise that section as a defense. However, the last sentence in section 5 (which imposes liability) does not include the equivalent language and does not require proof that the payee knew the fiduciary was committing a breach or knew of his fiduciary status. It requires actual knowledge that the payment was applied to his personal debt.

The Official Comment to the UFA confirms that the payee's knowledge of the fiduciary's status is not a necessary condition of liability. The Official Comment provides that, when a check is *payable to the fiduciary*, a creditor who takes the check is not liable "unless he has actual knowledge that the fiduciary was acting improperly, or acts in bad faith" because the check may represent a legitimate payment to the fiduciary. However, the Official Comment states that, when the check is payable to a *personal creditor* of the fiduciary, "there is a strong

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<sup>61</sup> County of Macon v. Edgcomb, 654 N.E.2d 598, 604 (Ill. App. Ct. 1995).

presumption that the fiduciary is acting improperly,” so the payee is liable “unless the fiduciary was acting properly.”<sup>62</sup>

Section 5 does not state that the principal must prove that the payee knew the fiduciary was the principal’s fiduciary. If the drafters of the UFA had intended to impose liability on a creditor who accepts a corporate check in payment of a personal debt only when the creditor is aware of the fiduciary’s status, that requirement would be stated expressly. The court in *County of Macon* so observed:

There is liability . . . where an instrument is taken “in payment of or as a security for a personal debt of the fiduciary to the actual knowledge of the creditor, or is transferred in any transaction known by the transferee to be for the personal benefit of the fiduciary.” [Section 4.] In those cases, the creditor (sections 4, 5), or the payor bank (if payment is made to it on a debt (sections 7, 8)), is liable, *without more*, to the principal if the fiduciary has breached his obligation.<sup>63</sup>

Nor is it necessary for the principal to prove, as a condition of liability, that the payee was aware, when it accepted the check, that the fiduciary was engaging in fraud or otherwise breaching his fiduciary duties. As the court held in *County of Macon*, a claimant need only allege that the fiduciary submitted the check in payment of a personal debt and that the payee knew the check was being applied to a personal debt:

If [the bank’s] employee taking the checks for payment knew that the loans on which the checks were applied were personal loans . . . then [the bank] is liable “if the fiduciary in fact commit[ted] a breach of his obligation

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<sup>62</sup> UFA § 6 cmt.

<sup>63</sup> *County of Macon*, 654 N.E.2d at 601 (emphasis added). But see *Watson Coatings, Inc. v. Am. Express Travel Related Servs., Inc.*, 436 F.3d 1036 (8th Cir. 2006), in which the Eighth Circuit held, without discussing the foregoing authority, that the last sentence in § 5 requires proof that the payee had actual knowledge that the employee was claimant’s fiduciary when it processed the payment.

as fiduciary in drawing or delivering the instrument.” It is not necessary, under section 5 of the Act, to allege that [the bank] had actual knowledge of the breach of fiduciary duty or bad faith.<sup>64</sup>

In *Maryland Casualty Co. v. Bank of Charlotte*,<sup>65</sup> an employee induced her employer to issue checks to her personal creditors, which she submitted in payment of her personal debts. The court held that the payee on the check was liable under section 5 even if it lacked actual knowledge of the fiduciary’s breach:

Even if we were to accept the Bank’s argument that it lacked “actual knowledge,” it still would not escape liability, for this would be to overlook the plain language of section 5 of the U.F.A. . . . That section, after laying down the requirement of “actual knowledge” of a breach or “bad faith,” declares liability on the part of a creditor who consciously applies such an instrument to its debtor’s benefit. Such conduct is by the statute explicitly made a basis of liability without stopping to categorize it as “actual knowledge” or “bad faith.”<sup>66</sup>

The court in *Maryland Casualty* also concluded that a payee’s continued acceptance of unauthorized checks after having notice of a fiduciary’s status constitutes bad faith, providing an independent basis for liability under section 5. The court held that “[t]he Bank . . . did act in ‘bad faith,’ even if it lacked ‘actual knowledge,’ when it received the second check in the series and credited the proceeds to the fiduciary’s debt in direct violation of the express statutory provision.”<sup>67</sup>

## **2. Necessary Scope of Fiduciary’s Authority Under Section 5**

Section 5 does not limit coverage to checks signed in the name of a fiduciary. It applies to all checks “drawn by a fiduciary as such, or

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<sup>64</sup> *County of Macon*, 654 N.E.2d at 604.

<sup>65</sup> 340 F.2d 550 (4th Cir. 1965).

<sup>66</sup> *Id.* at 553-54.

<sup>67</sup> *Id.* at 554-55.

in the name of his principal by a fiduciary empowered to draw such instrument in the name of his principal . . . .” Since “empower” requires only “a grant of authority,”<sup>68</sup> section 5 covers any check drawn by a fiduciary, even if the check is signed in the name of the principal. Therefore, an unauthorized check signed by the fiduciary in the name of the principal is within the scope of the UFA, as long as the fiduciary was authorized to affix the principal’s signature.

Courts have found creditors liable even when an authorized signatory knowingly signed the claimed check.<sup>69</sup> In *Maryland Casualty Co.*, an employee induced an authorized signatory to sign checks made payable to her personal creditors. Although the employee did not sign the checks, the Fourth Circuit nonetheless held that the bank was liable under section 5, though the employee did not sign the checks.<sup>70</sup>

The *Continental* court upheld a claim under UFA § 9, even though the alleged thief was not an authorized signatory on the plaintiff’s account. In that case, Lawrence Cohn instructed authorized signatories to issue checks payable to American National Bank. Although Cohn was not an authorized signator on the principal’s account, the court nonetheless held that the plaintiff could seek relief under UFA § 9.<sup>71</sup>

In *Guaranty Bank*, an employee induced an authorized signatory to co-sign a check payable to his personal creditor, which he thereafter submitted in payment of his personal debt. The Louisiana Supreme Court rejected the bank’s argument that section 5 did not apply to checks signed by two signatories, when only one conspired in the fraud:

Plaintiff argues that when there are two fiduciaries, the act does not apply. There is no merit to the contention . . . . [N]o reason has been discovered to relieve a payee-creditor of liability when there are two

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<sup>68</sup> BLACK’S LAW DICTIONARY 525 (7th ed. 1999).

<sup>69</sup> *E.g.*, *Guar. Bank & Trust Co. v. C & R Dev.*, 258 So. 2d 543, 547-48 (La. 1972); *Am. Sur. v. Smith, Landeryou & Co.*, 4 N.W.2d 889, 894 (Neb. 1942).

<sup>70</sup> *Md. Cas. Co. v. Bank*, 340 F.2d 550, 552 (4th Cir. 1965).

<sup>71</sup> *Cont’l Cas. Co. v. Am. Nat’l Bank & Trust Co.*, 768 N.E.2d 352, 367 (Ill. App. Ct. 2002).

fiduciaries breaching obligations, and imposing liability when there is one fiduciary breaching his obligation . . . . [The UFA] defines “fiduciary” to include “any other persons acting in a fiduciary relationship,” and defines “person” to include “two or more persons having a joint or common interest.”<sup>72</sup>

Therefore, the checks bearing multiple signatures are within the scope of section 5.

A payee may also be liable under UFA § 5 when the unauthorized check contains forged or unauthorized signatures. The language of section 5 supports that construction.

First, section 5 applies to all checks “drawn by a fiduciary as such, or in the name of his principal by a fiduciary empowered to draw such instrument in the name of his principal.” It does not exclude checks drawn by a fiduciary that contain a forged or unauthorized signature. Courts have applied the UFA to checks bearing a forged or unauthorized signature.<sup>73</sup> For example, the plaintiff in *Appley* sought recovery under the UFA for losses resulting from a bank’s negotiation of checks on which signatures were forged. Reversing the dismissal of the claim, the Seventh Circuit held that the claim was within the scope of the UFA, even if the fiduciary used unauthorized signatures to perpetrate his fraud.<sup>74</sup>

Second, section 5 is not limited to claims based upon the issuance of an unauthorized check. The payee is liable if the fiduciary “committ[ed] a breach of his obligations as a fiduciary in drawing *or delivering* the instrument . . . .”<sup>75</sup> To impose liability on the payee under section 5, therefore, the principal is not required to prove that the fiduciary was authorized to sign checks and an unauthorized check need

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<sup>72</sup> *Guar. Bank*, 258 So. 2d at 548.

<sup>73</sup> *Appley v. West*, 832 F.2d 1021 (7th Cir. 1987); *Coeur d’Alene Mining Co. v. First Nat’l Bank*, 800 P.2d 1026 (Idaho 1990) (same); *UNR Rohn, Inc. v. Summit Bank*, 687 N.E.2d 235 (Ind. Ct. App. 1997) (UFA section 5 applied to checks bearing forgeries).

<sup>74</sup> *Appley*, 832 F.2d at 1031.

<sup>75</sup> UFA § 5 (emphasis added).

not bear a forged or unauthorized signature. The payee is liable if the fiduciary breached his fiduciary duty in *delivering* the unauthorized check in payment of his personal debts.

The UFA's definition of "fiduciary" is not limited to agents who are empowered to draw checks. Rather, the UFA broadly defines "fiduciary" as "a trustee . . . 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."<sup>76</sup> It is not essential, therefore, that the fiduciary was authorized to sign checks. He may be a fiduciary because he had authority to deliver checks or other responsibilities.

#### **D. ELEMENTS OF A CLAIM UNDER SECTION 9**

When unauthorized checks are deposited by the fiduciary and not submitted in payment of a personal debt, the claim is no longer governed by UFA § 5. The claim is governed by UFA § 9. Under section 9, a bank that allows a fiduciary to deposit such checks into a personal account is liable for any resulting loss if (1) it had actual knowledge that the fiduciary was committing a breach of fiduciary duties, or (2) its action in receiving the check amounted to bad faith. Section 9 states as follows:

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 payable 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

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<sup>76</sup> UFA § 1.

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.<sup>77</sup>

A bank is liable under UFA § 9 if it deposits or pays a check with actual knowledge that the fiduciary has breached his fiduciary obligations. A bank has “notice of potential foul play when the employee of a drawer attempts to negotiate a check payable to the order of the bank, and the drawer owes no debt to the bank.”<sup>78</sup> Because the check “poses an unanswered question as to whom the bank is to pay,” the bank cannot blindly accept the check for deposit.<sup>79</sup> If it does so, it is liable under UFA § 9.<sup>80</sup>

While a bank may be liable under UFA § 9 if it deposits or pays a check with actual knowledge of the fiduciary’s status, it need not have actual knowledge of the fiduciary’s status to invoke the protections of section 9. In *Springfield Township v. Mellon PSFS Bank*,<sup>81</sup> the town’s pension plan administrator deposited checks payable to the town’s pension plan into a personal business account and embezzled the proceeds. The Pennsylvania Supreme Court ruled the “statute does not list knowledge of a fiduciary’s status as a requisite to the bank’s insulation from liability . . . .”<sup>82</sup>

To support a claim under UFA § 9, the principal need not allege that the bank conspired in the fraud, or even that it knew that the fiduciary was breaching his fiduciary duties. It is sufficient if the bank acted with sufficient knowledge of facts that its action in receiving a deposit or paying the check amounts to bad faith. In determining whether a bank has acted in bad faith, “courts have asked whether it was

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<sup>77</sup> UFA § 9.

<sup>78</sup> *Mut. Serv. Cas. Ins. Co. v. Elizabeth State Bank*, 265 F.3d 601, 621 (7th Cir. 2001).

<sup>79</sup> *Id.*

<sup>80</sup> *E.g., Cont’l Cas. Co. v. Am. Nat’l Bank*, 768 N.E.2d 352, 366 (Ill. App. Ct. 2002).

<sup>81</sup> 889 A.2d 1184 (Pa. 2005).

<sup>82</sup> *Id.* at 1190.

‘commercially’ unjustifiable for the payee to disregard and refuse to learn facts readily available . . . . At some point, obvious circumstances become so cogent that it is ‘bad faith’ to remain passive.”<sup>83</sup>

The bank’s conduct may amount to bad faith if its policies enable a fiduciary to deposit unauthorized checks payable to the bank into his personal account.<sup>84</sup> In *Continental*, consistent with its policies, a bank accepted unauthorized checks for deposit through an ATM machine without any review. Although the bank did not have actual knowledge of the fraud, the court held that the complaint stated a cause of action under UFA § 9:

[I]t was commercially unreasonable for [the bank] to establish and maintain an ATM deposit procedure that allowed Cohn to randomly deposit nine unaltered, nonforged checks . . . into his personal account, where he was not a signatory to the account, and where the checks were payable to the order of [the bank] and drawn on [the principal’s] corporate account at [the bank]. . . . [The principal’s] complaint includes enough facts and allegations to support its claim that [the bank] acted in bad faith when it paid the checks to Cohn. Therefore, [the principal’s] bad faith claim under the Act provides it with a viable legal theory on which it can possibly recover.<sup>85</sup>

The Ohio Supreme Court reached the same conclusion in *Master Chemical Corp. v. Inkrott*.<sup>86</sup> Although the bank did not know about the fraud, the court nonetheless held that its acceptance of checks payable to itself for deposit into a personal account amounted to bad faith because the bank’s established procedure permitted transfer from one corporate account to another and such transfer would be presumed correct and would not be questioned. The court rejected the bank’s characterization of its conduct as mere negligence:

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<sup>83</sup> Md. Cas. Co. v. Bank, 340 F.2d 550, 553-54 (4th Cir. 1965).

<sup>84</sup> *Cont’l Cas. Co.*, 768 N.E.2d at 367.

<sup>85</sup> *Id.*

<sup>86</sup> 563 N.E.2d 26 (Ohio 1990).

“In an age of white-collar crime, it is more than negligent for a bank to make such a presumption in the development of its policies when dealing with fiduciaries presenting checks payable to the bank.”<sup>87</sup>

In *Rose Lee Manufacturing, Inc. v. Chemical Bank*,<sup>88</sup> a bank allowed a customer’s employee to deposit multiple checks payable to the bank into the employee’s personal account, without endorsement and without inquiring regarding the circumstances. The court held that, based on these factual allegations, the plaintiff had stated a claim against the bank for “commercial bad faith.”<sup>89</sup>

The New Jersey Supreme Court, in *New Jersey Title Insurance Co. v. Caputo*,<sup>90</sup> analyzed the meaning of “bad faith” under the UFA. In that case, an attorney raided his trust accounts to gamble in Atlantic City. Two branch managers of the bank were aware of his gambling activity from observing the ATM withdrawals from his business account, which was often overdrawn. The lower court granted summary judgment in favor of the bank because the bank did not have “actual knowledge” of Caputo’s breach of fiduciary duty and was therefore immune from liability under the UFA. The Supreme Court reversed:

We hold that bad faith denotes a reckless disregard or purposeful obliviousness of the known facts suggesting impropriety by the fiduciary. It is not established by negligent or careless conduct or by vague suspicion. Likewise, actual knowledge of and complicity in the fiduciary’s misdeeds is not required. However, where facts suggesting fiduciary misconduct are compelling

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<sup>87</sup> *Id.* at 28.

<sup>88</sup> 563 N.Y.S.2d 965 (Sup. Ct. 1990).

<sup>89</sup> *Id.* at 967; *see also* Pargus, Inc. v. Estate of Taylor, 416 So. 2d 1358, 1361-62 (La. Ct. App. 1982) (it was commercially unacceptable for depository bank to allow third-party checks payable to a corporation, endorsed with a rubber stamp, to be diverted into a manager’s personal account without inquiry); *Gen. Ins. Co. v. Commerce Bank of St. Charles*, 505 S.W.2d 454, 458 (Mo. Ct. App. 1974) (“Evil motive is not the gauge; it is whether it is “‘commercially unjustifiable’ for the bank to disregard or refuse to learn facts readily available [to it].”).

<sup>90</sup> 748 A.2d 507 (N.J. 2000).

and obvious, it is bad faith to remain passive and not inquire further because such inaction amounts to a deliberate desire to evade knowledge.<sup>91</sup>

One court has found that issuing a debit card to a fiduciary/guardian does not by itself establish section 9 liability. In *Rinehart v. Bank One*,<sup>92</sup> the court found that transactions made with a debit card were covered by the UFA. “[S]tatutory language that has often lagged behind technological banking reality as the national banking system shifts from a paper-based check processing system to one of electronic transfers . . . .”<sup>93</sup> The court noted that, while it may be unwise for a guardian to accept a debit card to make transactions on behalf of his ward, there was no law against issuing a card. Therefore, when the guardian later misappropriated funds in the account, the bank was able to seek protection under the UFA.

#### **E. CLAIMS AGAINST CREDIT CARD COMPANIES**

In some instances, a fiduciary may issue unauthorized checks to pay the fiduciary’s credit card debt. There is nothing in section 5 to suggest that a credit card company is not a payee for purposes of section 5, but a few cases have declined to impose liability against credit card companies who were payees on fraudulent checks.

In *Grand Rapids Auto Sales, Inc. v. MBNA America Bank*,<sup>94</sup> the manager of a car dealership wrote checks without authority on the corporate checking account payable to MBNA Bank; and MBNA applied the payments to the credit card debt of the employee’s spouse. The dealer sued the bank for breach of the common law duty of inquiry and

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<sup>91</sup> *Id.* at 514; *see also* *Sonders v. PNC Bank, NA*, No. Civ.A.01-3083, 2003 WL 22310102, at \*7 (E.D. Pa. June 3, 2003) (noting that Pennsylvania has a similar standard of bad faith). *But see In re Bishop, Baldwin, Rewald, Dillingham & Wong, Inc.*, 751 P.2d 77, 81 (Haw. 1988) (bank was not liable, although it knew funds deposited by faithless fiduciary were for his personal use, because it transferred the funds in good faith and without knowledge they were taken in violation of fiduciary duties).

<sup>92</sup> 709 N.E.2d 559 (Ohio Ct. App. 1998).

<sup>93</sup> *Id.* at 567.

<sup>94</sup> 227 F. Supp. 2d 721 (W.D. Mich. 2002).

for conversion of the checks. The court held that it is impractical to impose on a credit card company an obligation to examine checks submitted for credit card payments. The court noted that MBNA received more than 500,000 payments each day, so requiring it to inspect each check would impose a severe burden on the automated processing of checks and would significantly increase the cost to consumers.<sup>95</sup> Other cases, such as *Hartford Accident and Indemnity Company v. American Express*, have held that, even if banks examined credit card payments, it would not necessarily prevent loss because there are legitimate reasons for an employer's payment of an employee's credit card balance.<sup>96</sup>

Neither the *Hartford* nor the *Grand Rapids* case addressed a creditor's liability under the UFA. They could not do so because New York and Michigan law applied in those cases, and neither State has enacted section 5. The *United Catholic* case applied the law of Wisconsin, which has enacted section 5, but the claim was brought under the UCC. The case may be correctly decided under the UCC, but the reasoning should not apply to an analogous claim brought under the last sentence in section 5 of the UFA. A plaintiff does not have the burden under section 5 to prove the payee failed to act in good faith. Rather, the threshold issue under section 5 is whether the creditor had "actual knowledge" that the payment was for the personal benefit of the fiduciary and not the principal. If the creditor had such knowledge, then the creditor is liable unless the fiduciary was acting properly.<sup>97</sup>

In *Watson Coatings, Inc. v. American Express Travel Related Services, Inc.*,<sup>98</sup> the Eighth Circuit held that a credit card company did not violate section 5 when it accepted forty-five fraudulent checks drawn by a fiduciary on her employer's bank account. She did so over the

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<sup>95</sup> *Id.* at 727.

<sup>96</sup> See *Hartford Acc. & Indem. Co. v. Am. Express*, 542 N.E.2d 1090, 1095 (N.Y. App. Div. 1989) (employers frequently pay an employee's expenses); *United Catholic Parish Schools of Beaver Dam Educ. Assoc. v. Card Servs. Ctr.*, 636 N.W.2d 206, 211 (Wis. Ct. App. 2001) (no evidence of bad faith in accepting payments because checks could have been a legitimate reimbursement for purchases made for the employer on the credit card).

<sup>97</sup> UFA §§ 5-6 cmt.

<sup>98</sup> 436 F.3d 1036 (8th Cir. 2006).

course of four years to pay her husband's personal credit card balance. Affirming defendant's motion for summary judgment, the court held that American Express could invoke the first sentence of section 5 in defense of the claim because plaintiff failed to show the payee acted in bad faith when it took the checks. To establish bad faith, the court held that plaintiff had to prove American Express knew or disregarded knowledge that the employee was a fiduciary and was breaching her fiduciary duties. American Express had no such knowledge because it processed the checks electronically, which the court deemed "commercially reasonable."<sup>99</sup>

The court applied a similar actual-knowledge standard in rejecting plaintiff's affirmative claim under the last sentence of section 5, although bad faith is not a necessary element of that claim. The last sentence applies to an instrument that is delivered to a creditor "in payment of . . . a personal debt of the fiduciary to the actual knowledge of the creditor . . . ."<sup>100</sup> The court absolved American Express of liability because it had no actual knowledge that the employee was plaintiff's fiduciary when it processed the checks, so it could not have known that she was using the checks to pay her personal obligations.<sup>101</sup> The court construed the last sentence in section 5 to require actual knowledge of the employee's fiduciary status and not simply knowledge that the checks were being applied for her personal benefit, rather than the drawer's benefit.<sup>102</sup>

Construing similar facts, a court in Florida came to a different conclusion in *Travelers Casualty and Surety Co. v. Citibank N.A.*,<sup>103</sup> finding that the defendant credit card company was not entitled to summary judgment. In *Travelers*, the employee issued checks drawn on her employer's account to pay the personal balance on her and her

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<sup>99</sup> *Id.* at 1041-42.

<sup>100</sup> *Id.* at 1040.

<sup>101</sup> *Id.* at 1043.

<sup>102</sup> *Id.* The court also rejected the claim under § 5 because the checks were not issued for the benefit of the fiduciary, but rather for her husband's benefit.

<sup>103</sup> *Travelers Cas. & Sur. Co. v. Citibank, N.A.*, No. 8:03-CV-2548-T-23TGW (M.D. Fla. Sept. 29, 2005) (magistrate judge's Report and Recommendation on defendant's motion for summary judgment).

husband's credit card. Plaintiff brought common law and UCC claims and did not seek recovery under the UFA, but the decision is nevertheless instructive. The credit card company maintained that, due to the high volume of payments processed, it had no duty of inquiry with regard to checks received and, therefore, it was a holder in due course. Rejecting the argument, the court noted that, pursuant to the defendant's fraud prevention protocols, many checks were handled manually; but the defendant often did not follow its own procedures to ensure that checks were not fraudulent. The court concluded a jury could find a defendant breached a duty of inquiry.

#### F. CLAIMS AGAINST BROKERAGE FIRMS

If a fiduciary draws checks payable to a brokerage firm for personal investment, or deposits an unauthorized check into a personal brokerage account, the drawer may be able to assert a claim against the brokerage firm under the UFA.

In *Smith v. Smith, Barney, Harris, Upham & Co.*,<sup>104</sup> the court concluded that a stockbroker owed its customer the duty to make certain inquiries once it had been put on notice of possible wrongdoing. The court held that the common law duty imposed on the stockbroker arose from the stockbroker-customer relationship. In *Penalosa Coop. Exch. v. A.S. Polonyi Co.*,<sup>105</sup> plaintiff's employee drew checks on the company's checking account payable to a broker for the purpose of engaging in personal commodities trading. The court held that the plaintiff stated a claim under sections 4 and 5 of the Missouri version of the UFA. In *Norristown-Penn Trust Co. v. Middleton*,<sup>106</sup> a fiduciary drew checks payable to a broker to satisfy margin calls. The court held that the plaintiff stated claims under UFA §§ 5 and 6.

Section 9 addresses liability that arises when a fiduciary "makes a deposit in a bank." The foregoing cases do not construe whether section 9 might apply when checks are deposited in a brokerage account, but *Travelers Casualty and Surety Co. v. Wells Fargo Bank*<sup>107</sup> is

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<sup>104</sup> 505 F. Supp. 1380 (W.D. Mo. 1981).

<sup>105</sup> 745 F. Supp. 580 (W.D. Mo. 1990).

<sup>106</sup> 150 A. 885 (Pa. 1930).

<sup>107</sup> 205 F. Supp. 2d 920 (N.D. Ill. 2002).

instructive. Plaintiff's agent embezzled funds from a medical plan account by forging checks payable to Wells Fargo and to Charles Schwab. The complaint did not assert a claim under the UFA, but the court did consider whether Schwab may be considered a "bank" for purposes of liability under UCC § 3-306. Denying the defendant's motion to dismiss, the court held that, because the complaint alleged Schwab performed various "financial services," there was a question of fact whether Schwab could be considered a bank.

### G. PREEMPTION DEFENSES

Banks and other payees often attempt to use defenses provided in the UCC as a means to avoid liability under the UFA, arguing that the UCC preempts the UFA. Courts have generally rejected such arguments.

#### 1. UCC § 3-307 Does Not Displace UFA § 5

The language of section 5 does not state that a claimant must prove that a payee knew of the presenter's fiduciary status. In contrast, under UCC section 3-307, a bank that takes from a fiduciary an unauthorized check payable to the bank, and credits the check to the fiduciary's account, takes the check free of claims to the instrument, absent proof that the bank had "knowledge of the fiduciary status of the fiduciary."<sup>108</sup> No court has held that UCC section 3-307 preempts UFA section 5, and the court in *Continental* rejected that argument.

In *Continental*, Bank One allowed a fiduciary to divert the proceeds of a corporate check made payable to Bank One. The court held that the UCC could not preempt the plaintiff's UFA claim because the UCC did not address a bank's liability for diverting the proceeds of a check made payable to itself:

Presently, there is no provision of the UCC that delineates what a bank's rights and obligations are when an individual presents a corporate check payable to the

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<sup>108</sup> UCC § 3-307(b).

bank and then instructs the bank to divert the proceeds of the check to his own benefit.<sup>109</sup>

Other courts have likewise concluded that the UCC does not “terminate a bank’s established . . . duty to make inquiry before paying checks to it from a party not indebted to it.”<sup>110</sup> These courts have reached this conclusion because UFA § 5 and UCC § 3-307 address different issues. UCC § 3-307 does not address a payee’s liability for accepting corporate checks in payment of a personal debt. Rather, it addresses only whether the taker of an instrument has notice of a breach of fiduciary duty for purposes of determining whether it is a holder in due course. The Official Comment to UCC § 3-307 makes that point. The Comment identifies and discusses potential conflicts with UFA but, in doing so, never mentions section 5.<sup>111</sup>

*County of Macon* likewise does not hold that UCC § 3-307 preempts UFA § 5. It does, however, comment on distinctions between UCC section 3-307 and UFA § 9, which applies to a bank that deposits an unauthorized check to a fiduciary’s account and permits the proceeds to be withdrawn. The court notes that the burden of proof under UCC § 3-307 is less than under UFA § 9:

There is no liability under [UFA § 9] even when those withdrawals are used to pay a personal debt owed the bank, in the absence of actual knowledge or bad faith. . . . A conflicting rule was adopted by the Commissioners when they revised article 3 of the Uniform Commercial Code in 1990. . . . [UCC § 3-307]

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<sup>109</sup> Cont’l Cas. Co. v. Am. Nat. Bank & Trust Co., 768 N.E.2d 352, 362 (Ill. App. Ct. 2002); *see also* Mut. Servs. Cas. Ins. Co. v. Elizabeth State Bank, 265 F.3d 601, 614 (7th Cir. 2001).

<sup>110</sup> Fed. Ins. Co. v. NCB Nat’l Bank, 958 F.2d 1544, 1550 (11th Cir. 1992); *accord* Coeur d’Alene Mining Co. v. First Nat’l Bank of N. Idaho, 800 P.2d 1026, 1032 (Idaho 1990); Bullitt County Bank v. Publishers Printing Co., 684 S.W.2d 289, 292 (Ky. Ct. App. 1984); Kaiser-Georgetown Cmty. Health Plan, Inc. v. Bankers Trust Co., 442 N.Y.S.2d 48 (N.Y. Sup. Ct. 1981); Bank of S. Md. v. Robertson’s Crab House, Inc., 389 A.2d 388, 393 (Md. Ct. Spec. App. 1978); Transamerica Ins. Co. v. U.S. Nat’l Bank, 558 P.2d 328, 333 (Or. 1976).

<sup>111</sup> UCC § 3-307 cmt.

provides a bank “has notice of the breach of fiduciary duty” if an instrument payable to the principal or the fiduciary as such is “deposited to an account other than an account of the fiduciary, as such, or an account of the represented person.”<sup>112</sup>

The UFA addresses different issues than, and is not superseded by, UCC § 3-307.

## **2. UCC § 4-406 Preclusions Do Not Apply to a UFA Claim**

A bank cannot assert UCC § 4-406 as a defense to a claim under the UFA because it applies only to claims by a customer against a drawee bank, not to claims against a payee or depository bank. The only cases that address this issue—*Appley* and *Wells Fargo*—reject this defense under the UFA.<sup>113</sup>

UCC section 4-406 addresses a customer’s duty to discover and report an unauthorized signature or alteration. Under that provision, if a bank sends an account statement to a customer, the customer must promptly examine the statement to determine whether any payment was not authorized because of an alteration or an unauthorized signature by or on behalf of the customer and must promptly notify the bank of the relevant facts. If the bank proves that the customer failed, with respect to a check, to comply with that duty, the customer may be precluded from asserting against the bank (1) the customer’s unauthorized signature or an alteration on the item, and (2) the customer’s unauthorized signature or alteration by the same wrongdoer on any other item paid in good faith by the bank before the bank received notice from the customer.<sup>114</sup>

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<sup>112</sup> *County of Macon v. Edgcomb*, 654 N.E.2d 598, 601-02 (Ill. App. Ct. 1995).

<sup>113</sup> *Travelers Cas. & Sur. Co. v. Wells Fargo Bank N.A.*, 374 F.3d at 525; *Appley v. West*, 832 F.2d 1021, 1031 (7th Cir. 1987).

<sup>114</sup> UCC § 4-406. If the customer proves that the bank failed to exercise ordinary care in paying the item and that the failure substantially contributed to loss, the loss may be allocated between the customer and the bank to the extent that each contributed to the loss. UCC § 406(e).

In *Appley*, the bank argued that the plaintiff's UFA claim was untimely under UCC § 4-406 because the plaintiff had failed to give the drawee bank timely notice of the forged and/or unauthorized signatures on the checks. Reversing dismissal of the claim, the Seventh Circuit rejected that argument, holding "that this cause of action is separate enough from a cause of action under the UCC that the statute of limitations period in UCC § 4-406(4) does not apply."<sup>115</sup>

In *Wells Fargo*, the bank argued that plaintiff's claim for losses resulting from the bank's acceptance of checks payable to itself for deposit into a personal account was barred by UCC § 4-406. The court rejected this defense, holding that while section 4-406 might be a defense to a claim against the drawee bank, it "cannot provide a defense for [the payee], because [the drawer] was not a customer of [the payee]."<sup>116</sup>

UCC § 4-406 and UFA § 9 are mutually exclusive. UCC § 4-406 applies, if at all, only to checks that are not authorized because of an alteration or an unauthorized signature by or on behalf of the customer. UFA §§ 5 and 9 apply to a fiduciary who is "empowered" to draw or endorse checks on behalf of his principal.

The plain language of UCC § 4-406 also confirms that it applies only to claims against the drawee bank. Section 4-406(f) provides that a customer who fails to report a forged or unauthorized signature within a year of receiving its statements is "precluded from asserting against the *bank* the unauthorized signature or alteration."<sup>117</sup> The "bank" is a reference to the bank that provided the statements, not every bank in the collection process. The court recognized this distinction in *Euro Motors Inc. v. Southwest Financial Bank and Trust Co.*<sup>118</sup> The court noted that "[f]ailure to 'discover and report' an unauthorized signature within one year from the time the bank makes available to the customer a statement of account and accompanying items precludes the customer's assertion

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<sup>115</sup> *Appley*, 832 F.2d at 1031. Although *Appley* was decided under the pre-1990 version of the UCC, the 1990 version of UCC § 4-406 is substantially unchanged and therefore does not undermine the holding.

<sup>116</sup> *Wells Fargo*, 374 F.3d at 525.

<sup>117</sup> UCC § 4-406(f) (emphasis added).

<sup>118</sup> 696 N.E.2d 711 (Ill. App. Ct. 1998).

of a claim *against the bank*.”<sup>119</sup> To the extent a claim under UFA §§ 5 or 9 is asserted against the payee of a check and/or a depository bank, UCC § 4-406 is not a defense.

Banks may argue that UCC § 3-417(c) and § 4-208(c) give the bank the right to assert UCC § 4-406 as a defense to claims under the UFA. These provisions are not relevant to a claim under the UFA. UCC § 3-417(c) and § 4-208(c) allow a warrantor to assert a drawee’s defenses against the drawer when a drawee asserts a claim for breach of warranty.<sup>120</sup> Because a claim under the UFA “is not under a warranty theory of liability,” these sections are irrelevant.<sup>121</sup> Moreover, because a drawer may not pursue a warranty claim under UCC § 3-417, it would not be reasonable to allow a bank to raise these sections as a defense.

One court has applied the one-year notice requirement in UCC § 4-406 as a bar to a claim asserted under the UFA.<sup>122</sup> In *Falk*, plaintiff’s agent drew checks on his account payable to cash and used the checks to pay loans and other personal obligations at the bank. Plaintiff asserted claims under the UCC and under sections 7 and 8 of the UFA. The court held that the one-year preclusion rule in UCC § 4-406 applied to all claims against the bank because public policy favors compelling customers to examine their bank statements. The rule articulated in *Falk* would appear to be limited to cases involving allegations of bad faith against a payee who is also the drawee on the checks, i.e., the customer’s bank.

### 3. UCC § 3-420 Does Not Preempt the UFA

Under UCC § 3-420, a check is converted if a bank “makes or obtains payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment.”<sup>123</sup> UCC § 3-420 prohibits the drawer of a check from pursuing a conversion claim against a depository bank. Payees may argue that, by virtue of that prohibition, a

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<sup>119</sup> *Id.* at 716 (emphasis added).

<sup>120</sup> *Steinroe Income Trust v. Cont’l Bank N.A.*, 606 N.E.2d 503 (Ill. App. Ct. 1992).

<sup>121</sup> *Appley*, 832 F.2d at 1031.

<sup>122</sup> *Falk v. N. Trust Co.*, 763 N.E.2d 380, 386 (Ill. App. Ct. 2001).

<sup>123</sup> UCC § 3-420(a).

drawer may not pursue a claim under the UFA. In effect, the argument suggests that UCC § 3-420 preempts all claims under the UFA. The argument fails for three reasons.

First, UCC § 3-420 is not a general preemption of all claims by the drawer of a check. It preempts only common law conversion claims. In *Continental*, the payee argued that UCC § 3-420 was a general preemption and therefore obviated a breach of contract action. The court rejected the argument, holding that UCC § 3-420 prohibited a drawer from bringing an action for conversion of the instrument but did not apply to a claim brought under UFA § 5.<sup>124</sup>

Second, a claim under the UFA is not the equivalent of conversion. A conversion claim is typically brought by the payee of a check from whom a check is stolen following delivery of the instrument.<sup>125</sup> The payee may have a conversion claim against a bank that takes the check for deposit or payment from a thief who forged the payee's signature. In that scenario, the payee has a property interest in the check, but the drawer does not. The check is simply an obligation that the drawer owed to the payee and is not property of the drawer.<sup>126</sup> In contrast, a claim under the UFA is not based on the violation of the drawer's property interest in the check, but rather on the breach of an affirmative duty imposed on creditors and banks that do not apply checks for the benefit of the drawer.<sup>127</sup> The duty is imposed as a matter of tort law and not UCC law.<sup>128</sup>

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<sup>124</sup> *Steinroe*, 606 N.E.2d at 505.

<sup>125</sup> UCC § 3-420, Official Cmt.

<sup>126</sup> The elements of a cause of action for conversion of a negotiable instrument are "plaintiffs' ownership of, interest in or right to possession of the check; plaintiffs' forged or unauthorized endorsement on the check; and defendant bank's unauthorized cashing of the check." *Burks Drywall Inc. v. Wash. Bank & Trust Co.*, 442 N.E.2d 648, 652 (Ill. App. Ct. 1982).

<sup>127</sup> *Milano v. Sheridan Trust & Sav. Bank*, No. 30,803, 1926 WL 3944, at \*4 (Ill. App. Ct. 1926) (bank owes duty because "the public is invited to use its conveniences as places of deposit; it holds itself out as trustworthy for such purposes").

<sup>128</sup> *Travelers Cas. & Sur. Co. v. Well Fargo Bank N.A.*, 374 F.3d 521, 527 (7th Cir. 2004).

In *Continental*, the court held that a claim under the UFA is not a conversion action. The payee argued that UFA claims are governed by the statute of limitations in UCC § 3-118, which applies to actions “for conversion of an instrument, for money had and received, or like action based on conversion . . . .”<sup>129</sup> The court rejected this argument, holding that a UFA claim was not governed by UCC § 3-118, implicitly holding that UFA claims are not claims for conversion.

In *Penolosa Cooperative Exchange v. A.S. Polonyi Co.*,<sup>130</sup> the defendant argued that the plaintiff’s claim under UFA § 4 was preempted by the UCC because it was in substance a conversion action. Denying the defendant’s motion to dismiss, the court held that the plaintiff’s claim under the UFA was not akin to a conversion claim because the “[d]efendant was the payee of the checks and wire transfers” and not simply a depository bank who took the checks for payment.<sup>131</sup>

Third, even if UCC § 3-420 could be read to prohibit a claim under the UFA, the UFA would trump UCC § 3-420 because it is more specific.<sup>132</sup> While the UCC deals with negotiable instruments in a very general sense and broadly covers topics such as conversion and warranties, UFA § 5 and § 9 apply specifically to checks taken or deposited for the benefit of a person other than the drawer of the check. The UFA, therefore, trumps UCC § 3-420.

In *Continental*, the bank argued that the drawer’s UFA § 9 claim was prohibited by UCC § 3-420 because UCC § 3-420(a) prohibits claims for conversion by a drawer and the UCC was enacted after the UFA. The court rejected this argument, holding that the UCC could not preempt the drawer’s claim because “there is no provision of the UCC

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<sup>129</sup> UCC § 3-118(g).

<sup>130</sup> 745 F. Supp. 580 (W.D. Mo. 1990).

<sup>131</sup> *Id.* at 584.

<sup>132</sup> When two statutes conflict, the more specific provision controls over the more general provision. *Nat’l Cable & Telecomms. Ass’n, Inc. v. Gulf Power Co.*, 534 U.S. 327, 335 (2002). A payee may contend that UCC § 3-420 should control because it was enacted after the UFA, but the “later enacted” rule applies only when there is a direct conflict between two statutes, not when there is an implied preemption. *Doe v. Thompson*, 332 F. Supp. 2d 124, 131 (D.D.C. 2004).

that delineates what a bank's rights and obligations are when an individual presents a corporate check payable to the bank and then instructs the bank to divert the proceeds of the check to his own benefit."<sup>133</sup> The court held that the claim under UFA § 9 was not analogous to a conversion claim because the fiduciary "deposited the checks into an ATM without forging or altering the checks," a fundamental element of a conversion claim.<sup>134</sup>

The Seventh Circuit reached the same conclusion in *Mutual Services*, rejecting the argument that the UCC supersedes a bank's common law duty to inquire before accepting a check payable to itself for deposit into a customer's personal account:

The bank suggests that the common-law duty of care on which Mutual's claim is based has been superseded generally by the Uniform Commercial Code, but we find nothing in the UCC, as adopted by the Illinois legislature, that displaces the common-law rule. The Code itself provides for supplementation by common-law principles, "[u]nless displaced by the particular provisions of this Act." [UCC § 1-103.] Although the scheme perpetrated by Hemmen is a common one, no provision of the Code delineates what a bank's rights and obligations are when a person presents a corporate check payable to the bank and instructs the bank to divert the proceeds of the check to his own benefit.<sup>135</sup>

Cases rejecting the preemption argument "are legion."<sup>136</sup> "No court that we are aware of has found the [plaintiff's common law claim]

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<sup>133</sup> *Cont'l*, 768 N.E.2d at 362.

<sup>134</sup> *Id.* at 361.

<sup>135</sup> *Mut. Serv. Cas. Ins. Co. v. Elizabeth State Bank*, 265 F.3d 601, 614 (7th Cir. 2001).

<sup>136</sup> *Govoni v. Mechanics Bank*, 742 N.E.2d 1094, 1100 (2001); *see also* *Penalosa Coop. Exch. v. A.S. Polonyi Co.*, 745 F. Supp. 580 (W.D. Mo. 1990) (holding issuer of checks could maintain action under § 4 of the UFA); *N.J. Title Ins. Co. v. Caputo*, 748 A.2d 507 (N.J. 2000) (allowing plaintiff to maintain a cause of action under § 6 of the UFA).

to be inconsistent with any provision of the Code.”<sup>137</sup> Courts have uniformly held the UCC did not “terminate a bank’s established . . . duty to make inquiry before paying checks to it from a party not indebted to it.”<sup>138</sup>

#### *IV. Conclusion*

Cases addressing the payee’s liability for accepting fraudulent checks from a fiduciary are based on a variety of legal theories, including claims under the UCC and common law claims predicated on the payee’s bad faith or breach of a duty of inquiry. In some instances, the payee may be unable to meet the evidentiary burden necessary to prove that a payee knew the person presenting a check was a fiduciary of the drawer, as required by UCC § 3-307. In such cases, a claim may nevertheless be available under sections 5 or 9 of the UFA. While the UFA was enacted as a defense to banks and others who deal in good faith with an unfaithful fiduciary, courts have acknowledged that sections 5 or 9 provide to a drawer an affirmative remedy against banks and other payees who accept and apply a fraudulent check for the benefit of the fiduciary, rather than the drawer of the check.

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<sup>137</sup> *Mut. Serv.*, 265 F.3d at 615.

<sup>138</sup> *Fed. Ins. Co. v. NCNB Nat’l Bank*, 958 F.2d 1544, 1550 (11th Cir. 1992); *see also* *Bullitt County Bank v. Publishers Printing Co.*, 684 S.W.2d 289 (Ky. 1985); *Kaiser-Georgetown Cmty. Health Plan, Inc. v. Bankers Trust Co.*, 442 N.Y.S.2d 48 (Sup. Ct. 1981); *Bank of S. Md. v. Robertson’s Crab House, Inc.*, 389 A.2d 388 (Md. Ct. Spec. App. 1978); *Transamerica Ins. Co. v. U.S. Nat’l Bank*, 558 P.2d 328 (Or. 1976).