

**ISSUES IN LITIGATION BY AND AGAINST BANKS**  
**ARISING UNDER THE UNIFORM FIDUCIARIES ACT,**  
**RELATED PROVISIONS OF THE UNIFORM COMMERCIAL CODE**  
**AND THE RELATED CASES**

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**ISSUES IN LITIGATION BY AND AGAINST BANKS ARISING UNDER THE UNIFORM FIDUCIARIES ACT, RELATED PROVISIONS OF THE UNIFORM COMMERCIAL CODE AND THE RELATED CASES**

The allocation of fraudulent check loss is determined by the rules set forth in Articles 3 and 4 of the Uniform Commercial Code. Fidelity insurers need to be aware of these allocation rules in order to analyze the potential liability of their insureds (and their own exposure) as well as their opportunities for salvage via assignment of and subrogation to their insureds rights against third parties. These rules, analyzed elsewhere<sup>1</sup> and set out in Appendix 1, are not the focus of this paper. Rather, this paper will focus on issues facing fidelity insurers and sureties under the Uniform Fiduciary Act (UFA) and related provisions of the Uniform Commercial Code (UCC).

In attempting to recoup payments made under a fidelity bond, banker's blanket bond, or public official bond via subrogation or assignment, sureties have often been faced with defalcating fiduciaries who have already spent the embezzled funds. Accordingly, sureties have often looked to third parties, particularly financial institutions from which the funds were embezzled or into which embezzled funds were placed, for a deeper pocket.<sup>2</sup>

Unlike situations involving forged checks or forged signatures and/or indorsements by persons unauthorized to sign checks on their principal's behalf, the UFA and the related provisions of Revised Article 3 of the UCC often involve fiduciaries with the authority to transfer funds and sign checks.

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<sup>1</sup> See, Baskind, Stephen L., "Who Ultimately Bears the Loss - Assignment, Subrogation, and Risk Allocation Pursuant to The Uniform Commercial Code", ABA TIPS, Fidelity and Surety Law Committee, Annual Mid-Winter CLE Meeting, January 26, 1996; "Apportionment of Loss Under the Revised U.C.C.", Surety Claims Institute, June 20-22, 1996.

<sup>2</sup> See, e.g., National Casualty Company v. Caswell Company, 317 Ill.App. 66, 45 N.E.2d 698 (Ill.App.1942); State Bank and Trust Company v. Commercial Trust and Savings Bank, 21 N.E.2d 157, 300 Ill.App.435 (Ill.App.1939); Citizens National Bank of Waco, Texas v. Fidelity & Deposit Company of Maryland, 117 F.2d 852 (5th Cir. 1941); FDIC v. American Surety Corp, 39 F.Supp. 551 (W.D.Ky.1941); English v. Palmer National Bank of Danville, 202 Ill.App., 372 (Ill.App.1916).

## I. THE COMMON LAW

Traditionally, sureties have looked to the common law for actions enabling them to recover funds from these financial institutions. These actions have included conversion, unjust enrichment, money had and received, negligence, constructive trusts, actions for assumpsit, fraud, civil conspiracy, restitution, breach of warranty and the common law action for facilitating or enabling a breach of trust.

At common law, a bank acted at its peril and was charged with a legal duty to ensure that fiduciary funds transferred to or from it were not being transferred in breach of a fiduciary duty,<sup>3</sup> for in the eyes of the law, the transfer from a trust account to a personal account did not affect its fiduciary character.<sup>4</sup> At the very least, under the common law, if a bank had notice that a fund was impressed with a trust and accepted money from that fund in payment of or as security for a personal debt of the fiduciary to it, the bank would be liable to the principal if the fiduciary in fact misappropriated the fund.<sup>5</sup> Under the common law, a court would, in effect, disregard a transaction whereby

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<sup>3</sup> Citizens National Bank of Waco, Texas v. Fidelity & Deposit Company of Maryland, 117 F.2d 852 (5th Cir. 1941); Research-Planning, Inc. v. Bank of Utah, 690 P.2d 1130 (Utah, 1984); National Bank v. Insurance Company, 104 U.S. 54, 68-69, 26 L.Ed. 693 (1881); Colby v. Riggs National Bank, 92 F.2d 183, 186 (D.C.Cir.1937); Park Bank v. Yerington, 275 S.W. 970, 972 (Mo.App.1925); Allen v. Puritan Trust Co., 211 Mass. 409, 97 N.E. 916 (Mass. 1912); People v. Peoples Loan & Trust Co., 285 Ill.App.552, 2 N.E.2d 763 (Ill.App.1936); People ex rel. Nelson v. Peoples Bank & Trust Co., 271 Ill.App.41 (Ill.App.1933); Paine v. Sheridan Trust & Savings Bank, 255 Ill.App.250 (Ill.App.1929).

<sup>4</sup> National Bank v. Insurance Company, *supra*; Colby v. Riggs National Bank, *supra*; Park Bank v. Yerington, *supra*.

<sup>5</sup> Allen v. Puritan Trust Co., *supra*; Colby, 92 F.2d at 186-87; For example in Massachusetts Bonding and Insurance Company v. Standard Trust and Savings Bank, 334 Ill. 494, 166 N.E. 123, the court stated:

“The settled rule is, that if a depositor seeks to pay his own debt to the bank by an appropriation of the funds to his credit in a fiduciary capacity, the bank is affected with knowledge of the unlawful character of the appropriation and will be compelled to refund. \*\*\* The reason for the rule is that the bank has knowledge that the check is in payment of the trustee’s private debt. The bank officials may be said to have knowledge of the character of a transaction when a reasonably intelligent person would have such knowledge.”

embezzled fiduciary funds were transferred and make the offending bank give the funds back to the principal.

Moreover, under the common law, where a bank upon accepting a check drawn to its order by one who was not indebted to it and with whom it had no account, credited the proceeds thereof to the account of the person presenting it without taking any precaution to determine the authority of the person receiving the same, it would be held liable to the maker for failure to hold the proceeds of the instrument subject to the order of the maker.<sup>6</sup>

## **II. THE UFA, THE UCC AND THEIR EFFECT ON THE LIABILITY OF BANKS INVOLVED IN TRANSACTIONS INVOLVING DEFALCATING FIDUCIARIES**

Although many of these common law actions may still exist, the enactment of the Uniform Fiduciaries Act (UFA) in approximately half of the states,<sup>7</sup> and the Uniform Commercial Code (UCC) enacted in all 50 states plus the District of Columbia, Virgin Islands and Guam), alter the common law liability of banks by either displacing the common law entirely or providing significant defenses to a bank in situations where the bank is involved with a defalcating fiduciary.<sup>8</sup>

### **A. THE UFA**

#### **1. THE ACT**

The Uniform Fiduciaries Act provides as follows:

#### **UNIFORM FIDUCIARIES ACT**

##### **§1. Definition of Terms**

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<sup>6</sup> People v. Peoples Loan & Trust Co., *supra*; People ex rel. Nelson v. Peoples Bank & Trust Co., *supra*; Paine v. Sheridan Trust & Savings Bank, *supra*.

<sup>7</sup> See Appendix 2 for a table of jurisdictions where the UFA has been enacted.

<sup>8</sup> See, Appley v. West, 832 F.2d 1021, 1031 (7th Cir.1987).

(1) In this act unless the context or subject-matter otherwise requires: <sup>9</sup>

“Bank” includes any person or association of persons, whether incorporated or not, carrying on the business of banking.

“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.

“Person” includes a corporation, partnership, or other association, or two or more persons having a joint or common interest.

“Principal” includes any person to whom a fiduciary as such owes an obligation.

(2) A thing is done “in good faith” within the meaning of this act, when it is in fact done honestly, whether it be done negligently or not.

## **§2. Application of Payments Made to Fiduciaries.<sup>10</sup>**

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.

## **§4. Transfer of Negotiable Instrument by Fiduciary**

If any negotiable instrument payable or indorsed to a fiduciary as such is indorsed by the fiduciary, or if any negotiable instrument payable or indorsed to his principal is indorsed by a fiduciary empowered to indorse such instrument on behalf of his principal, the indorsee is not bound to inquire whether the fiduciary is committing a breach of his obligation as fiduciary in indorsing or delivering the instrument, and is not chargeable with notice that the fiduciary is committing a breach of his obligation as fiduciary unless he takes the instrument with actual knowledge of such breach or with knowledge of such facts that his action in taking the instrument amounts to bad faith. If, however, such instrument is transferred by the fiduciary 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, the creditor or other transferee is liable to the principal if the fiduciary in fact commits a breach of his obligation as fiduciary in transferring the instrument.

## **§5. Check Drawn by Fiduciary Payable to Third Person<sup>11</sup>**

If a check or other bill of exchange is 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, the payee is not bound to inquire

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<sup>9</sup> See, Seymour v. National Biscuit Co., 107 F.2d 58, cert. denied 60 S.Ct. 590, 309 U.S. 665, 84 L.Ed. 1012 (1939); In Re Windsor Plumbing Supply Co., Inc., 170 B.R. 503 (Bkrcty. E.D.N.Y.1994); In re Barker, 40 B.R. 356 (Bkrcty. D.Minn.1984); Minnesota Valley Country Club, Inc. v. Gill, 356 N.W. 2d 356 (Minn.App.1984); Kim v. Professional Business Brokers Ltd., 328 S.E.2d 296, 74 N.C.App. 48 (N.C.App.1985); Savin v. Central Trust Co., 1995 WL 566627 (Ohio App.1995).

<sup>10</sup> See, Leyba v. Whitley, 118 N.M. 435, 882, P.2d 26 (N.M. 1994); National Casualty Co. v. Caswell & Co., supra; Cassel v. Mercantile Trust, 393, S.W.2d 433 (Mo.1965).

<sup>11</sup>See, Hosselton v. K's Merchandise Mart, Inc., supra; Heffner v. Cahaba Bank and Trust Co., 523 So.2d 113 (Ala.1988); Baton Rouge Bank & Trust Co. V. Roland W. Laurent & Associates, Inc., 517 So.2d 850 (La.App.1987); Matter of Bishop, Baldwin, Rewald, Dilingham & Wong, Inc., supra.

whether the fiduciary is committing a breach of his obligation as fiduciary in drawing or delivering the instrument, and is not chargeable with notice that the fiduciary is committing a breach of his obligation as fiduciary unless he takes the instrument with actual knowledge of such breach or with knowledge of such facts that his action in taking the instrument amounts to bad faith. 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.

#### **§6. Check Drawn by and Payable to Fiduciary<sup>12</sup>**

If a check or other bill of exchange is 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, payable to the fiduciary personally, or payable to a third person and by him transferred to the fiduciary, and is thereafter transferred by the fiduciary whether in payment of a personal debt of the fiduciary or otherwise, the transferee is not bound to inquire whether the fiduciary is committing a breach of his obligation as fiduciary in transferring the instrument, and is not chargeable with notice that the fiduciary is committing a breach of his obligation as fiduciary unless he takes the instrument with actual knowledge of such breach or with knowledge of such facts that his action in taking the instrument amounts to bad faith.

#### **§7. Deposit in Name of Fiduciary as Such<sup>13</sup>**

If a deposit is made in a bank to the credit of a fiduciary as such, the bank is authorized to pay the amount of the deposit or any part thereof upon the check of the fiduciary, signed with the name in which such deposit is entered, without being liable to the principal, unless the bank pays the check with actual knowledge that the fiduciary is committing a breach of his obligation as fiduciary in drawing the check or with knowledge of such facts that its action in paying the check amounts to bad faith. If, however, such a 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.

#### **§8. Deposit in Name of Principal<sup>14</sup>**

If a check is drawn upon the account of his principal in a bank by a fiduciary who is empowered to draw checks upon his principal's account, the bank is authorized to pay such check without being liable to the principal, unless the bank pays the check with actual knowledge that the fiduciary is committing a breach of his obligation as fiduciary in drawing such check, or with knowledge of such facts that its action in paying the check amounts to bad faith. If, however, such a 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.

#### **§9. Deposit in Fiduciary's Personal Account<sup>15</sup>**

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<sup>12</sup> See, Coeur d'Alene Mining Co. v. First National Bank of North Idaho, 800 P.2d 1026, 118 Idaho 812 (Idaho 1990); Matter of Bishop, Baldwin, Rewald, Dillingham & Wong, Inc., supra.

<sup>13</sup> See, Coeur D'Alene Mining Co. v. First National Bank of North Idaho, supra.

<sup>14</sup> See, Minnesota Valley Country Club, Inc. v. Gill, supra.

<sup>15</sup> See, Schneider Fuel & Supply Co. v. West Allis State Bank, 70 Wis.2d 1041, 236 N.W.2d 266 (Wis. 1974); Lehigh Presbytery v. Merchants Bancorp, Inc., 410 Pa. Super. 557, 600 A.2d 593 (Pa. Super. 1991); LaVecchia v. North Carolina Joint Stock Land Bank, 9 S.E.2d 489, 218 N.C.35 (N.C.1940); Matter of Bishop, Baldwin, Rewald, Dillingham & Wong, Inc., supra; Savin v. Central Trust Co., supra;

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 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.

#### **§10. Deposit in Names of Two or More Trustees**

When a deposit is made in a bank in the name of two or more persons as trustees and a check is drawn upon the trust account by any trustee or trustees authorized by the other trustee or trustees to draw checks upon the trust account, neither the payee nor other holder nor the bank is bound to inquire whether it is a breach of trust to authorize such trustee or trustees to draw checks upon the trust account, and is not liable unless the circumstances be such that the action of the payee or other holder or the bank amounts to bad faith.

#### **§11. Act Not Retroactive**

The provisions of this act shall not apply to transactions taking place prior to the time when it takes effect.

#### **§12. Cases Not Provided For in Act**

In any case not provided for in this act the rules of law and equity, including the law merchant and those rules of law and equity relating to trusts, agency, negotiable instruments and banking, shall continue to apply.

#### **§13. Uniformity of Interpretation**

This act shall be so interpreted and construed as to effectuate its general purpose to make uniform the law of those states which enact it.

#### **§14. Short Title**

This act may be cited as the Uniform Fiduciary Act.

#### **§15. Inconsistent Laws Repealed**

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Cassel v. Mercantile Trust Company, *supra*; Sugarhouse Finance Company v. Zion's First National Bank, 21 Utah 2d 68, 440 P.2d 869 (1968); Hosselton v. First American Bank, N.A., *supra*; General Insurance Company v. Commerce Bank of St. Charles, *supra*; Johnson v. Citizens National Bank of Decatur, 30 Ill.App. 3rd 1066, 1069 334 N.E.2d 295, 298 (Ill.App. 1975); Robinson Protective Alarm Co. v. Bolger & Picker, 516 A.2d 299, 512 Pa.116 (Pa.1986); Southern Agency Company v. Hampton Bank of St. Louis, 452 S.W.2d 100 (Mo.1970); Cassel v. Mercantile Trust Company, *supra*; Maryland Casualty Company v. Bank of Charlotte, 340 F.2d 550 (4th Cir. 1965); Rheinberger v. First National Bank of St. Paul, 276 Minn. 194, 150 N.W.2d 37 (1967); Southern Agency Company v. Hampton Bank, *supra*; Peoples National Bank v. Guier, 284 Ky. 702, 145 S.W.2d 1042 (1940); *also see*, Taylor v. Citizens Bank, 290 Ky. 149, 160 S.W.2d 639 (1942).

All Acts or parts of acts inconsistent with this act are hereby repealed.

**§16. Time of Taking Effect**

This act shall take effect [                      ].

**2. THE PURPOSE OF THE UFA**

The UFA was approved by the National Conference of Commissioners on Uniform State Laws and the American Bar Association in 1922 and covers situations which arise where one deals with another person whom he knows to be a fiduciary. In particular, it deals with questions relating to notice of the breach of a fiduciary obligation. The liabilities of the fiduciary himself are not dealt with, but only the liabilities of the persons dealing with the fiduciary.

The general purpose of the UFA was ostensibly to establish uniform and definite rules in place of the diverse and indefinite rules prevailing under the common law as to “constructive notice” of breaches of fiduciary obligations<sup>16</sup> and to facilitate banking transactions by relieving depository banks of their common law duty to inquire into the propriety of fiduciary transactions. The UFA has relieved banks of the duty of seeing that funds are properly applied and has permitted them to indulge in the presumption that the fiduciary in withdrawing funds from his fiduciary account is acting lawfully and in accordance with his duties. However, the effect of the UFA has been to transfer to the principal the burden to employ honest fiduciaries,<sup>17</sup> and in many cases, to transfer the loss resulting from a defalcating fiduciary from the bank to the defalcating fiduciary’s principal by relaxing the stringent common law rules requiring of a bank “the highest

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<sup>16</sup> LaVecchia v. North Carolina Joint Stock Land Bank, *supra*.

<sup>17</sup> County of Macon v. Edgcomb, 274 Ill.App.3d 432, 654 N.E.2d 598 (Ill.App.1995).

degree of vigilance in the detection of a fiduciary's wrongdoing".<sup>18</sup> Ultimately, this has impaired a surety's ability to recoup its bond payments.

### **3. STANDARDS OF LIABILITY UNDER THE UFA**

The UFA applies only to situations where the bank is dealing with a known fiduciary.<sup>19</sup> The UFA relieves the bank of liability to the principal unless:

- (1) the bank has **actual knowledge** that the fiduciary is committing a breach of his obligation; or
- (2) the bank has knowledge of facts that amounts to **bad faith**;<sup>20</sup> or
- (3) where the fiduciary uses fiduciary funds for the payment of a **personal debt** to the bank with the bank's actual knowledge, or uses such funds in a transaction known by the payee to be for the **personal benefit** of the fiduciary.<sup>21</sup>

However, the bank's liability to the principal necessarily depends upon the bank's knowledge of the breach of fiduciary duty or of the personal nature of the transaction. Where the bank has no actual or bad faith knowledge of either the breach of fiduciary duty or the personal nature of the transaction, there is generally no basis for imposing liability on the bank.

#### **a. BAD FAITH**

Although "bad faith" is not defined in the UFA, "good faith", is referred to in Section 1 of the UFA wherein it is stated that "a thing is done in good faith within the

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<sup>18</sup> National Casualty Co. v. Caswell, *supra*.

<sup>19</sup> Terre Haute Industries, Inc. v. Pawlik, 765 F.Supp.925 (N.D.Ill.1991); Levy v. First Pennsylvania Bank, N.A., 487 A.2d 857, 338 Pa. Super. 73 (Pa.Super.1985); Zion's First National Bank v. Clark Clinic Corp., *supra*.

<sup>20</sup> Go-Tane Services Stations, Inc. v. Sharp, 397 N.E.2d 249, 78 Ill.App.34d 785 (Ill.App.1979); E.F. Hutton Mortgage Corp. v. Equitable Bank, N.A., 678 F. Supp. 567 (D.Md. 1988); In Re Broadview Lumber Co., Inc., 168 B.R. 941 (Bkrcty. W.D.Mo.1994).

<sup>21</sup> Savin v. Central Trust Co., 1995 WL 566627 (Ohio App. 1995).

meaning of this act when it is in fact done honestly, whether it be done negligently or not.”<sup>22</sup>

“Bad” being the antonym for “good”, it has been construed that a thing is done in “bad faith” when it is in fact done dishonestly and not merely negligently.<sup>23</sup> Neither evil motive nor moral guilt are, however, a requirement of “bad faith”; rather, it is whether it is “commercially unjustifiable for the bank to disregard or refuse to learn facts readily available.”<sup>24</sup> The facts and circumstances must be so cogent and obvious that to remain passive would amount to a willful blindness, i.e. . . . deliberate desire to evade knowledge because of a belief or fear that inquiry would disclose a defect in the transaction.<sup>25</sup>

While neither mere negligence nor failure to inquire about suspicious circumstances are enough to render a bank liable to the principal,<sup>26</sup> if a bank has knowledge that a fiduciary intends to appropriate trust funds to his own use, and that its action will aid in that breach of trust, then the bank will be held to have acted in “bad faith”.<sup>27</sup> Furthermore, the UFA does not permit a bank to ignore an irregularity where it is of a nature to place a bank on notice of the improper conduct by a fiduciary or, where

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<sup>22</sup> See, National Casualty Company v. Caswell, *supra*; Southern Agency Co., Inc. v. Hampton Bank of St. Louis, *supra*.

<sup>23</sup> Research-Planning, Inc. v. Bank of Utah, 690 P.2d 1130 (Utah, 1984); Trenton Trust Co. v. Western Surety Co., *supra*; Davis v. Pennsylvania Company, 337 Pa. 456, 12 A.2d 66 (1940), Sugarhouse Finance Co. v. Zion’s First National Bank, *supra*.

<sup>24</sup> Maryland Casualty Company v. Bank of Charlotte, *supra*; Savin v. Central Trust Co., *supra*.

<sup>25</sup> Transport Trucking Company v. First National Bank in Albuquerque, 61 N.M. 320, 300 P.2d 476 (1956); Maryland Casualty Company v. Bank of Charlotte, *supra*; Edwins v. Lilly, 422 So.2d 1217 (La.App.1982); County of Macon v. Edgcomb, *supra*; General Insurance Company of America v. Commerce Bank of St. Charles, *supra*; In re Broadview Lumber Co., Inc., *supra*; Savin v. Central Trust Co., *supra*.

<sup>26</sup> In Re Bishop, Baldwin, Rewald, Dilingham & Wong, Inc., *supra*; Sugarhouse Finance Co. v. Zion’s First National Bank, *supra*; Hosselton v. K’s Merchandise Mart, Inc., *supra*; Johnson v. Citizens National Bank, *supra*.

<sup>27</sup> Robinson Protective Alarm Co. v. Bolger & Picker, *supra*.

circumstances suggestive of the fiduciary's breach becomes sufficiently obvious that it is "bad faith" to remain passive.<sup>28</sup>

In Davis v. Pennsylvania Company for Insurance on Lives and Granting Annuities, 337 Pa. 456, 12 A.2d 66 (Pa.1940), the court inquired into the proper construction of the term "bad faith" as it is used in the UFA and gave a helpful explanation of the concept:

"At what point does negligence cease and bad faith begin? The distinction between them is that bad faith, or dishonesty is, unlike negligence, willful. The mere failure to make inquiry, even though there be suspicious circumstances, does not constitute bad faith (Union Bank & Trust Company v. Girard Trust Company, 307 Pa. 488, 500, 501, 161A. 865), unless such failure is due to the deliberate desire to evade knowledge because of a belief or fear that inquiry would disclose a vice or defect in the transaction - that is to say, where there is an intentional closing of the eyes or stopping of the ears."

Clearly, the fact that one dealing with a fiduciary benefits financially from the transaction is a factor to be considered in determining whether one acted in bad faith under the UFA. Thus, where a bank engages in transactions with the fiduciary and has "both reason to suspect a misappropriation by a fiduciary and a monetary interest in the continuance of such activity," the bank acts in bad faith.<sup>29</sup>

#### **b. ACTUAL KNOWLEDGE**

Under the UFA, a bank is liable if it has knowledge that a fiduciary intends to misappropriate funds and the bank fails to prevent the act.<sup>30</sup> "Actual knowledge" has

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<sup>28</sup> Peoples National Bank v. Guier, *supra*; Guarantee Bank & Trust Company, 260 La. At 1187, 258 S.2d at 547; Maryland Casualty, *supra*.

<sup>29</sup> Maryland Casualty, *supra*; Trenton Trust Co. v. Western Surety Co., *supra*; Union Bank & Trust Company v. Girard Trust Company, *supra*; See, also, St. Stephens Evangelical Lutheran Church v. Seaway National Bank, 38 Ill.App.3d 1021, 1026 315 N.E.2d 128, 132 (Ill.App.1976); People, ex rel. Barrett v. State Bank of Herrick, 290 Ill.App. 130, 134, 8 N.E.2d 71, 73 (Ill.App.1937); LaVecchia v. North Carolina Joint Stock Land Bank, *supra*; Farmers Banking & Trust Company of Montgomery County v. Bender, 175 Md. 625, 380 2d. 743, 745-46 (1930); Downey v. DuQuesne City Bank, 146 Pa. Super. 289, 292, 22 A.2d 1324, 127 (1941); Pennsylvania Company For Insurance v. Ninth Bank & Trust Company, 306 Pa. 148, 149, 158 A. 251, 252 (1932); Schneider Fuel & Supply Company v. West Alice State Bank, *supra*; Matter of Knox, 488 N.Y.S.2d 146, 64 N.Y.2d 434, 477 N.E.2d 448 (N.Y.1985).

<sup>30</sup> Schwartz v. Pierucci, 60 B.R.397 (E.D.Pa.1986); Edwin v. Lilly, *supra*.

been defined as “awareness at the moment of the transaction that the fiduciary is defrauding the principal” and “express factual information that the funds are being used for private purposes in violation of a fiduciary relationship.”<sup>31</sup>

“Actual” means existing in reality, or existing at the time, and “knowledge” means the fact or state of knowing. “Know” means to be aware of. Webster’s New World Dictionary, 1987. In the context of the UFA, “actual knowledge”, therefore, means awareness, at the moment, that the fiduciary was defrauding his principal for his own gain, i.e., actual knowledge of the misappropriation,<sup>32</sup> or at the very least express factual information that fiduciary funds are being used for private purposes,<sup>33</sup> or that the fiduciary has otherwise breached his fiduciary duty.

**c. PAYMENT OF PERSONAL DEBT OR TRANSACTION FOR PERSONAL BENEFIT OF FIDUCIARY**

Where a fiduciary makes a deposit in his personal account and subsequently pays a personal debt to the bank by check on that account, the bank must ascertain what is done with the funds withdrawn and will be liable if it does not.<sup>34</sup> Thus, if the fiduciary transfers (§4) or delivers (§§5, 7, 8) an instrument in payment of or as security for a personal debt to the actual knowledge of the bank receiving the instrument, that bank is subject to liability if the fiduciary breaches his fiduciary duty in doing so.<sup>35</sup>

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<sup>31</sup> General Insurance Company of America v. Commerce Bank of St. Charles, supra; Master Chemical v. Inkrott, 55 Ohio S.T.3d 23 (1990).

<sup>32</sup> Southern Agency Company, Inc. v. Hampton Bank of St. Louis, supra, [citing Colby v. Riggs National Bank, supra].

<sup>33</sup> Maryland Casualty Company v. Bank of Charlotte, supra.

<sup>34</sup> Schneider Fuel & Supply Co. v. West Alice State Bank, supra; Accord, Edwins v. Lilly, supra.

<sup>35</sup> Modern cases and statutes have broadly defined “debt.” For example, the Uniform Fraudulent Conveyance Act defines “debt” as “liability on a claim” and a “claim” is defined as “a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.

According to Black’s Law Dictionary, the meaning of the word “debt” is defined as:  
a “specified sum of money owed by one person or another, including the

Likewise, if the fiduciary transfers or delivers an instrument in a transaction known by the bank or other third party receiving the instrument to be for the fiduciary's personal benefit,<sup>36</sup> the bank is subject to liability.

d. **SUMMARY OF LIABILITY UNDER THE UFA**

In sum, liability under the UFA can generally only occur if the fiduciary has breached his fiduciary duty and the bank (or other third party) possesses one of the following levels of knowledge:

- (1) **Actual Knowledge** of the breach of fiduciary duty; or
- (2) **Bad Faith** knowledge of the breach of fiduciary duty; or
- (3) Payment of a **Personal Debt** to the bank with the bank's actual knowledge or a transaction known by the bank to be for the **Personal Benefit** of the fiduciary.

**B. THE UNIFORM COMMERCIAL CODE**

Article 3 of the Uniform Commercial Code (UCC), as revised,<sup>37</sup> has provided yet another variance on a surety's common law rights to recover from banks involved in transactions with defalcating fiduciaries. Section 3-307, "Notice of Breach of Fiduciary Duty," largely mirrors the provisions of the UFA in those jurisdictions that have enacted the UFA; in those jurisdictions that have not enacted the UFA, it significantly affects the common law rules for determining when a person who has taken an instrument from a fiduciary has notice of a breach of fiduciary duty.

**1. THE HOLDER IN DUE COURSE**

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obligation of the debtor to pay, and the right of the creditor to enforce payment." (Black's Law Dictionary 363 (5th Ed.1979.)

<sup>36</sup> "Personal" means individual. "Benefits" means advantage. Webster's New World Dictionary, (1987). Thus, a transaction for the "personal benefit" of the fiduciary would be one made for his individual advantage, rather than for the advantage of his principal. Under traditional agency and trust principles, this would clearly be a breach of the agent's fiduciary's duty to his principal.

Before discussing how the UCC treats notice of breach of fiduciary duty under 3-307, it will be helpful to review the related Article 3 concepts and provisions. Paramount among these is the concept of a “holder in due course” under section 3-302, which provides, in pertinent part, as follows:

**Section 3-302. Holder in Due Course.**

- (a) Subject to subsection (c) and Section 3-106(d), “holder in due course” means the holder of an instrument if:
- (1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity; and
  - (2) the holder took the instrument (i) for value, (ii) in good faith, (iii) without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, (iv) without notice that the instrument contains an unauthorized signature or has been altered, (v) without notice of any claim to the instrument described in Section 3-306, and (vi) without notice that any party has a defense or claim in recoupment described in Section 3-305(a).

The significance of being a “holder in due course” is that the holder in due course takes free of most defenses of prior parties to an instrument and free of conflicting title claims to the instrument itself.<sup>38</sup>

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<sup>37</sup> More than 35 states have adopted “Revised Article 3.”

<sup>38</sup> **Section 3-305. Defenses and Claims in Recoupment.**

- (a) Except as stated in subsection (b), the right to enforce the obligation of a party to pay an instrument is subject to the following:
- (1) a defense of the obligor based on (i) infancy of the obligor to the extent it is a defense to a simple contract, (ii) duress, lack of legal capacity, or illegality of the transaction which, under other law, nullifies the obligation of the obligor, (iii) fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms, or (iv) discharge of the obligor in insolvency proceedings;
  - (2) a defense of the obligor stated in another section of this Article or a defense of the obligor that would be available if the person entitled to enforce the instrument were enforcing a right to payment under a simple contract; and
  - (3) a claim in recoupment of the obligor against the original payee of the instrument if the claim arose from the transaction that gave rise to the instrument; but the claim of the obligor may be asserted against a transferee of the instrument only to reduce the amount owing on the instrument at the time the action is brought.

## **2. NOTICE OF BREACH OF FIDUCIARY DUTY AND ITS PRECLUSIVE EFFECT ON HOLDER IN DUE COURSE STATUS**

As previously stated, Section 3-307 largely mirrors the UFA. Moreover, its rules for determining when a person who has taken an instrument from a fiduciary has notice of a breach of fiduciary duty are important for, under Section 3-307(b)(1), “[n]otice of breach of fiduciary duty is notice of the claim of the represented person”. . Thus, a person with such notice cannot, under Section 3-302(a)(2)(v), be a “holder in due course”. Moreover, depending on the situation, the facts giving rise to such notice will often be such as to “call into question [the instrument’s] authenticity” and thereby: prevent a bank from being a holder in due course under 3-302(a)(1); negate the “good faith” requirement of 3-302(a)(2)(ii); and give rise to notice under 3-302(a)(2)(iv), (v) and (vi). The bottom line is that notice of breach of fiduciary duty by a bank under 3-307 prevents that bank from being a “holder in due course,” and thereby exposes the bank to

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- (b) The right of a holder in due course to enforce the obligation of a party to pay the instrument is subject to defenses of the obligor stated in subsection (a)(1), but is not subject to defenses of the obligor stated in subsection (a)(2) or claims in recoupment stated in subsection (a)(3) against a person other than the holder.
  - (c) Except as stated in subsection (d), in an action to enforce the obligation of a party to pay the instrument, the obligor may not assert against the person entitled to enforce the instrument a defense, claim in recoupment, or claim to the instrument (Section 3-306) of another person, but the other person’s claim to the instrument may be asserted if the other person is joined in the action and personally asserts the claim against the person entitled to enforce the instrument. An obligor is not obliged to pay the instrument if the person seeking enforcement of the instrument does not have rights of a holder in due course and the obligor proves that the instrument is a lost or stolen instrument...

### **Section 3-306. Claims to an Instrument.**

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.

liability on claims from a principal. Such claims include Article 3-420 conversion claims, common law claims and claiming under the UFA.

Section 3-307 provides:

**Section 3-307. 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 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 the 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 for 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.

This section closely parallels the UFA and, like the UFA, only has impact if the person dealing with the fiduciary “has knowledge of the fiduciary status of the fiduciary.”

“Knowledge” is defined in Section 1-201(25) as follows:

- “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;
  - (c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists. A person “knows” or has “knowledge” of a fact when he has actual knowledge of it.”

Knowledge of an organization is determined by the rules stated in Section 1-201(27), whereby knowledge of an organization is determined by the knowledge of the “individual conducting that transaction”.<sup>39</sup>

Section 3-307(b)(2) follows UFA Section 4. It provides that if the instrument is payable to the fiduciary, as such, or to the “represented person” (i.e. the principal), the taker has notice of a claim if the instrument is negotiated for the fiduciary’s personal debt or taken in a transaction known by the taker to be for the fiduciary’s personal benefit. Moreover, if the fiduciary funds are deposited into a personal account of the fiduciary or into an account other than an account of the fiduciary as such or the “represented party”, Section 3-307(b)(2)(iii) states that the bank is given notice of the breach of fiduciary duty. **This is in conflict with UFA Section 9, which states that the bank is not on notice unless it has knowledge of facts that makes its receipt of the deposit an act of bad faith.**<sup>40</sup>

Section 3-307(b)(3) is analogous to UFA Section 6 and applies when the instrument is issued by the principal or the fiduciary as such and made payable to the

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<sup>39</sup> “Notice, knowledge or a notice or notification received by an organization is effective for a particular transaction from the time when 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. An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.” 1-201(27).

<sup>40</sup> This conflict obviously is problematic in jurisdictions that have adopted the UFA. The resolution of the conflict will, however, likely be in a bank’s favor for even though a transaction may be sufficient to give rise to a “notice of breach of fiduciary duty” under Section 3-307 (and thereby prevent that bank from being a holder in due course), that alone will not make the bank liable. Rather, it will be subject to a claim for liability from the defalcating fiduciary’s principal, to which claim the bank will be able to assert the UFA as a defense. Upon raising this defense, the bank will only be liable if it has actual knowledge or bad faith knowledge of the breach of fiduciary duty, or knowledge of the personal (i.e. personal debt or personal benefit) nature of the transaction.

fiduciary personally. The taker is deemed to have no notice unless the taker “knows of the breach of fiduciary duty”, which, under Section 1-201(25), means “actual knowledge”.

Section 3-307(b)(4) pertains to instruments issued by the principal or the fiduciary as such to the taker as payee. Under this section, the taker has notice of the breach of fiduciary duty if the instrument is taken in payment of a person debt of or for the personal benefit of the fiduciary to the knowledge of the taker, or deposited to an account other than the account of the fiduciary as such or the account of the principal.

Substantively, the above Section 3-307 provisions mean that a taker cannot be a holder in due course, and is therefore subject to liability if :

- (1) the taker has notice of the breach of fiduciary duty; or
- (2) the instrument is taken in payment of or as security for a debt known by the taker to be the personal debt of the fiduciary; or
- (3) the instrument is taken in a transaction known to be for the personal benefit of the fiduciary; or
- (4) the instrument is payable to the taker, represented party, or fiduciary as such which is deposited into an account other than the represented party or the fiduciary’s account as such.

Section 3-307 differs from the UFA in that 3-307, unlike the UFA, provides that scenario (4) gives rise to a notice of breach of fiduciary duty. Otherwise, section 3-307 closely parallels the UFA. Moreover, the UCC provides in effect that a taker with “bad faith” <sup>41</sup>will not be a “holder in due course” under Section 3-302(a)(2)(ii), which makes

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<sup>41</sup> In Pargas, Inc. v. Hartford Accident & Indemnity Co., 416 So.2d 1358, 34 U.C.C. Rep. Serv. 1238 (La. Ct. App. 1982), the court stated:

“good faith” a prerequisite to “holder in due course” status.<sup>42</sup> This is analogous to the UFA’s treatment of bad faith.

### **3. SECTION 3-420 CONVERSION AND ITS EFFECT ON LIABILITY OF A BANK**

#### **ARTICLE 3 CONVERSION**

Article 3’s conversion section provides yet another variation on the common law. That section provides:

**Section 3-420. Conversion of Instrument.**<sup>43</sup>

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“One who suspects, or ought to suspect, is bound to inquire, and the law presumes that he knows whatever proper inquiry would disclose. While the courts are careful to guard the interests of commerce by protecting the negotiation of paper, they are also careful to guard against fraud by defeating titles taken in bad faith, or with knowledge, actual or imputed, which amounts to bad faith, when regarded from a commercial standpoint.”

[citing Rochester & C.T.R. Co. v. Paviour, 164 N.Y. 281, 58 N.E. 114]

Likewise, in Maryland Casualty Co. v. Bank of Charlotte, *supra*. The defendant bank was held liable for checks written by a defalcating fiduciary where the checks were made payable to the bank and were to pay personal obligations of the fiduciary to the bank. The court reasoned that under such circumstances, the bank had knowledge of such obvious facts that to remain silent would be to permit the fraud to continue and so the failure to inquire amounted to “bad faith”. Also, see Kraftsman Container v. United Counties Trust, 169 N.J. Super. 488, 404 A.2d 1288 (N.J. 1979) (Bad faith may be evidenced by consistent failure by the bank to monitor and investigate series of irregular transactions).

Finally, in Trenton Trust Co. v. Western Sur. Co., 599 S.W.2d 481 (Mo.S.Ct. 1980), it is stated that:

“Bad faith in taking commercial paper does not necessarily involve furtive motives, for it exists when the purchaser has notice of facts which, if unexplained, would show that he was taking the property of one who . . . owed him nothing, in payment of a claim that he held against someone else. . .”

<sup>42</sup>Furthermore, Section 3-307(b)(1), when read in conjunction with Section 1-201(25), imputes notice of breach of fiduciary duty to the taker of an instrument when the taker (a) has actual knowledge of the breach; or (b) has received notice or notification of the breach; or (c) from all the facts and circumstances known to him at the time in question, has reason to know that the breach exists. This imputation of knowledge is, in fact, more expansive than the UFA.

<sup>43</sup> Former Section 3-419 (still in effect in some jurisdictions) provided:

**Section 3-419. Conversion of Instrument; Innocent representative.**

- (1) An instrument is converted when
  - (a) a drawee to whom it is delivered for acceptance refuses to return it on demand; or
  - (b) any person to whom it is delivered for payment refuses on demand either to pay or to return it; or
  - (c) it is paid on a forged endorsement.
- (2) In an action against a drawee under subsection (1) the measure of the drawee’s liability is the face amount of the instrument. In any other action under subsection (1) the measure of liability is presumed to be the face amount of the instrument.

- (a) The law applicable to conversion of personal property applies to instruments. An instrument is also converted if it is taken by transfer, other than a negotiation, from a person not entitled to enforce the instrument or a bank makes or obtains payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment. An action for conversion of an instrument may not be brought by (i) the issuer or acceptor of the instrument or (ii) a payee or indorsee who did not receive delivery of the instrument either directly or through delivery to an agent or a co-payee.
- (b) In an action under subsection (a), the measure of liability is presumed to be the amount payable on the instrument, but recovery may not exceed the amount of plaintiff's interest in the instrument.
- (c) A representative, other than a depository bank, who 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.

This section, Revised UCC Section 3-420, is a modification of former Section 3-419.

Under Section 3-420, the law of conversion applicable to personal property also applies to instruments. Moreover, “an instrument is also converted if it is taken by transfer, other than a negotiation, from a person not entitled to enforce the instrument or a bank making or obtaining payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment”. However, under section 3-420 neither an issuer nor an acceptor of the instrument, nor a payee or indorsee who did not receive delivery of the instrument either directly or through delivery to an agent or co-payee may bring an action

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- (3) Subject to the provisions of this Act concerning restrictive indorsements a representative, including a depository or collecting bank, who has in good faith and in accordance with 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 than its immediate transferor conversion or otherwise to the true owner beyond the amount of any proceeds remaining in his hands.
  - (4) An intermediary bank or payor bank which is not a depository bank is not liable in conversion solely by reason of the fact that proceeds of an instrument indorsed restrictively (Sections 3-205 and 3-206) are not paid or applied consistently with the restrictive indorsement of an indorser other than its immediate transferor.
  - (5) faith and in accordance with 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.
  - (6) An intermediary bank or payor bank which is not a depository bank is not liable in conversion solely by reason of the fact that proceeds of an instrument indorsed restrictively (Sections 3-205 and 3-206) are not paid or applied consistently with the restrictive indorsement of an indorser other than its immediate transferor. See, Equitable Life Assurance Society v. Okey,

for conversion. Thus, the claim for conversion belongs to the true owner, usually the payee.

This section may have the effect of displacing the common law. At the very least, sureties need to be aware of its possible effect on their standing to make a claim, the amount of damages recoverable, and the applicable statute of limitations.<sup>44</sup>

#### **4. LIMITATIONS PROBLEMS**

##### **a. Section 3-118**

Another significant provision of the UCC for surety practitioners to be aware of is the Revised Article 3 statute of limitations, in particular, Section 3-118 (g), which provides:

##### **Section 3-118. Statute of Limitations.**

(g) Unless governed by other law regarding claims for indemnity or contribution, an action (i) for conversion of an instrument, for money had and received, or like action based on conversion, (ii) breach of warranty, or (iii) to enforce an obligation, duty, or right arising under this Article and not governed by this section must be commenced within three years after the [cause of action] accrues.

This section is significant for two reasons. First of all, in many cases, the statute of limitations provided by this section displaces a state's general statutes of limitations, often having the effect of shortening the time in which an action may be brought. Second of all, this section applies to, inter alia, actions "for conversion of an instrument, for money had and received, or like action based on conversion". As a result, when seeking to apply this statute of limitations, courts have often been faced with the threshold issue of the effect of Article 3, particularly the UCC's conversion provision (former 3-419 and

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812 F.2d 906 (4th Cir.1987); Peerless Ins. Co. v. Texas Commerce Bank, 791 F.2d 1177 (5th Cir. 1986).

Revised 3-420) on such traditional common law actions as conversion, unjust enrichment, and money had and received, and on Article 3's interplay with the UFA. Unfortunately, it is often unclear what law governs since there is disparate authority on (1) to what extent Article 3 of the UCC has abolished common law causes of action (including actions for which the UFA applies) pertaining to transactions involving Article 3 instruments; and (2) whether the statute of limitations in 3-118 governs particular common law causes of action to the extent that they are still viable.<sup>45</sup>

In deciding the statute of limitations issue in particular as well as the general questions of the effect of the UCC on the UFA and the common law, courts have often looked at UCC Section 1-103.

Section 1-103 provides:<sup>46</sup>

Unless displaced by the particular provisions of [the UCC], the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, unjust enrichment, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

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<sup>44</sup> The reported cases under this section frequently discuss the effect of it on actions under the common law and under the UFA. Since these cases often involve the related question of the applicable statute of limitations, these cases will be discussed in that (the next) section of this paper.

<sup>45</sup> In Guarantee National Title Company, Inc. v. J.E.G. Associates, 95 C 797, 1995 U.S. District Lexus 17772 N.D.Ill., November 28, 1995), the court, in dicta, stated that the three year limitations period provided by Section 3-118(g) applied rather than the five year general limitations statute in Illinois; However, see Maxfield v. Simmons, 70 Ill.Dec. 236, 449 N.E.2d 81 (Ill.S.Ct.1983) (Indemnity cause of action was still a valid cause of action, despite the UCC, and therefore the UCC's 4 year statute of limitation was not applicable; Drayton Public School Dist. No. 19 v. W.R. Grace & Co., 728 F.Supp. 1410 (D.N.Dak.1989) (warranty provisions of UCC do not invalidate common law warranty theories and therefore the UCC's statute of limitations does not govern case); Schwartz v. Pierucci, 60 B.R. 397 (Bkrty. E.D.Pa. 1986), (UCC's statute of limitations was not applicable to a cause of action under the UFA and since the essence of the complaint "was fraud/conversion/and/or negligence" the non-UCC statute of limitations for fraud was applicable).

<sup>46</sup> See, First Georgia Bank v. Webster, 168 Ga.App.307, 308 S.E.2d 579 (Ga.App.1983) (UCC did not bar customer's common law negligence action against bank based on representation of bank employee that the check deposited by customer was "good"); New Jersey Bank, N.A. v. Bradford Sec. Oper., Inc., 690 F.2d 339, 345-346 (3rd Cir. 1982).

In Appley v. West, 832 F.2d 1021 (7th Cir. 1987), for example, the Plaintiff brought counts based on the UCC as well as the common law of negligence and bad faith against the defendant bank. The Seventh Circuit Court of Appeals held that the three year statute of limitations in the UCC applicable to actions for breach of warranty by accepting a check having a forged endorsement was not applicable in an action against a bank based on “actual knowledge” or “bad faith” exceptions to the UFA. The court premised this holding on its finding that the UCC did not totally displace the Plaintiff’s common law causes of action.<sup>47</sup> However, there are a number of instances where

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<sup>47</sup> “The case law indicates that Illinois recognizes a cause of action against a bank that has actual knowledge of a fiduciary’s misappropriation of funds or that has knowledge of facts that render its failure to inquire bad faith. See, Go-Tane Serv. Stations, Inc. v. Sharp, 78 Ill.App.3d 785, 33 Ill.Dec. 916, 397 N.E.2d 249 (1979); St. Stephen’s Evangelical Lutheran Church v. Seaway National Bank, 38 Ill.App.3d 1021, 350 N.E.2d 128, 130-131 (1976) (citing, Maryland Casualty Co. v. Bank of Charlotte, 340 F.2d 550 (4th Cir. 1965)). The cause of action arose at common law to apply to those situations in which a third party deals with a known fiduciary who is acting in breach of his fiduciary obligation to the principal. ‘At common law a payee was often held liable to the principal if it negligently assisted a fiduciary in misappropriating the principal’s funds.’ Maryland Casualty, 340 F.2d at 553. The Uniform Fiduciaries Act (UFA or Act) altered the common law somewhat...The UFA relieves the bank of liability for negligence, but allows a cause of action when the bank has actual knowledge of the fiduciary’s misappropriation of the principal’s funds or when the bank has knowledge of sufficient facts that its action in paying the checks amounts to bad faith. Maryland Casualty, 340 F.2d at 553; see Ill. Ann. Stat. Ch. 17, paragraphs 2004-2009. In determining whether the bank acted with bad faith, ‘courts have asked whether it was ‘commercially’ unjustifiable for the payee to disregard and refuse to learn facts readily available.’ 340 F.2d at 554. ‘At some point, obvious circumstances become so cogent that it is ‘bad faith’ to remain passive.” Id. The UFA did not create the cause of action. Rather, the UFA is a defense to such an action unless the bank has actual knowledge that the fiduciary is breaching his fiduciary obligations or the bank acts with bad faith.

The district court held that the UCC Section 4-406(4) statute of limitations applied to both the UCC and the negligence causes of action. “The negligence action at common law may not be used as a means to avoid the codified period of limitations.” R.66 at 11. The court did not consider the theory under Count VII that when the bank knows that a person is a fiduciary, if the bank has actual knowledge that the fiduciary is breaching his fiduciary duties or if the bank acts with bad faith, it is liable to the principal. **We believe that this cause of action is separate enough from a cause of action under the UCC that the statute of limitations period in UCC Section 4-406(4) does not apply.** This cause of action is not under a warranty theory of liability. Therefore, the legislative design to put a short time limit on the cause of action does not apply. We agree with the court in Sun ‘N Sand, Inc. v. united Cal. Bank, 21 Cal.3d 671, 148 Cal.Rptr. 329, 582 P.2d 920 (1978), when, in addressing the argument that a common law negligence claim was barred by the limitations period of UCC Section 4-406, it stated:

‘Although superficially appealing, this argument is premised on a misunderstanding of subdivisions (4) and the intended function of its preclusion. . . This statute of limitations . . . applies only to actions seeking to establish **warranty** liability . . . Because liability in a warranty action is virtually absolute, the

principles of tort law are displaced by the UCC. In particular, provisions of the UCC regarding situations in which banks may charge the depositor's account for items drawn from that account are governed by the UCC; therefore, an allegation that a drawee bank breached the duty of due care in dealing with the terms and restrictions placed on checks of its depositor has been held to fail to state a claim for relief under a negligence theory.<sup>48</sup>

#### **b. Section 4-406**

Section 4-406<sup>49</sup> may also be raised as a defense by a bank. That provision imposes upon the drawer, i.e. the principal, the duty to examine its bank statement and

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Legislature's decision to cut short the otherwise applicable time limitations period . . . reflects a reasonable policy choice . . . Very different considerations are implicated, however, when an action is prosecuted on a theory of negligence . . . [citations omitted]'

The Sun 'N Sand court concluded that Section 4-406 'applies only to actions based on warranties set forth in the California Uniform Commercial Code.' 148 Cal.Rptr. at 348, 582 P.2d at 939. **Ms. Appley's cause of action for the 'actual knowledge' or 'bad faith' exceptions to the UFA is not merely an attempt to avoid the UCC cause of action. It encompasses much more than an action based on an unauthorized signature or endorsement or alteration on an item. Moreover, because of Ms. Appley's allegation that Republic Bank acted with bad faith, UCC Section 4-406(4) does not apply.** Section 4-406(1) requires that the items must have been "paid in good faith" for the period of limitation to run. Kierman v. Union Bank, 55 Cal.App.3d 111, 127 Cal.Rptr. 441, 443 (1976). Accordingly, we conclude that Ms. Appley's action against Republic Bank is not time barred under UCC Section 4-406(4)." [emphasis ours] Appley v. West, supra.

<sup>48</sup> See, Joffe v. United California Bank, 141 Cal.App.3d 541, 190 Cal.Rptr. 443 (Cal.App.1983); and Equitable Life Assurance Society v. Okey, 812 F.2d 906 (4th Cir.1987) (common law claim against bank for negligently accepting checks upon unauthorized endorsements was displaced by action for conversion under UCC).

<sup>49</sup> **Section 4-406. Customer's Duty to Discover and Report Unauthorized Signature or Alteration**

- (a) A bank that sends or makes available to a customer a statement of account showing payment of items for the account shall either return or make available to the customer the items paid or provide information in the statement of account sufficient to allow the customer reasonably to identify the items paid. The statement of account provides sufficient information if the item is described by item number, amount, and date of payment.
- (b) If the items are not returned to the customer, the person retaining the items shall either retain the items or, if the items are destroyed, maintain the capacity to furnish legible copies of the items until the expiration of seven years after receipt of the items. A customer may request an item from the bank that paid the item, and that bank must provide in a reasonable time either the item or, if the item has been destroyed or is otherwise not obtainable, a legible copy of the item.
- (c) If a bank sends or makes available a statement of account or items pursuant to subsection (a), the customer must exercise reasonable promptness in examining the statement or the items to determine

accompanying items with “reasonable promptness” and to promptly (and at least within 30 days) report any discovered problems to the bank “[i]f, based on the statement or items provided, the customer should reasonably have discovered the unauthorized payment”. If the principal fails to do this, the principal is precluded from asserting later acts of wrongdoing by the same wrongdoer against the drawee bank.

However, if the bank failed to exercise “ordinary care” in paying the item and that failure substantially contributed to the loss, the loss is allocated on a comparative fault basis. Finally, if the bank is proved to not have acted in good faith in paying the item, the bank’s 4-406 defense does not apply.

This last section of 4-406 is significant because it would appear to make 4-406 inapplicable to many, if not most, cases under the UFA and UCC Section 3-307.

Nevertheless, “without regard to care or lack of care of either the customer or the bank, a

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whether any payment was not authorized because of an alteration of an item or because a purported signature by or on behalf of the customer was not authorized. If, based on the statement or items provided, the customer should reasonably have discovered the unauthorized payment, the customer must promptly notify the bank of the relevant facts.

- (d) If the bank proves that the customer failed, with respect to an item, to comply with the duties imposed on the customer by subsection (c), the customer is precluded from asserting against the bank;
  - (1) the customer’s unauthorized signature or any alteration on the item, if the bank also proves that it suffered a loss by reason of the failure; and
  - (2) the customer’s unauthorized signature or alteration by the same wrongdoer on any other item paid in good faith by the bank if the payment was made before the bank received notice from the customer of the unauthorized signature or alteration and after the customer had been afforded a reasonable period of time, not exceeding 30 days, in which to examine the item or statement of account and notify the bank.
- (e) If subsection (d) applies and the customer proves that the bank failed to exercise ordinary care in paying the item and that failure substantially contributed to loss, the loss is allocated between the customer precluded and the bank asserting the preclusion according to the extent to which the failure of the customer to comply with subsection (c) and the failure of the bank to exercise ordinary care contributed to the loss. If the customer proves that the bank did not pay the item in good faith, the preclusion under subsection (d) does not apply.
- (f) Without regard to care or lack of care of either the customer or the bank, a customer who does not within one year from the time after the statement or items are made available to the customer (subsection (a)) discover and report the customer’s unauthorized signature on or any alteration on the item is precluded from asserting against the bank the unauthorized signature or alteration. If there is a preclusion under this subsection, the payor bank may not recover for breach of warranty under Section 4-208 with respect to the unauthorized signature or alteration to which the preclusion applies.

customer who does not within one year after the statement or items are made available to the customer (subsection (a)) discover and report the customer's unauthorized signature on or any alteration on the item is precluded from asserting against the bank the unauthorized signature or alteration.”

This section may very well be inapplicable in many breach of fiduciary duty cases since (1) it is limited to situations where “payment was not authorized because of an alteration of an item or because a purported signature by or on behalf of the customer was not authorized”; and (2) a court may hold that common law and UFA type actions exist independently of this section and are not subject to its limitations. Nevertheless, sureties should be aware that this section exists and may be raised as a bar by defendant banks. Accordingly, notice should be given to the bank immediately upon discovery of defalcated funds

## **5. SECTION 3-405**

Section 3-405<sup>50</sup> is addressed to fraudulent indorsements made by an employee with respect to instruments with respect to which the employer has given the employee.

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### <sup>50</sup> **3-405. 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.

(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.

Official Comment, Note 1. Although this scenario is neither the focus of this paper nor the focus of the UFA or those provision of the UCC pertaining to notice of breach of fiduciary duty, sureties need to be aware of this section for it shifts the risk of loss from the bank to the fiduciary. Section 3-405 covers two categories of fraudulent indorsements: Indorsements made in the name of the employer to the instruments payable to the employer and indorsements made in the name of payees of instruments issued by the employer. Section 3-405 adopts the principle that the risk of loss for fraudulent indorsements by employees who are entrusted with responsibility with respect to checks should fall on the employer rather than the bank that takes the check or pays it, if the bank was not negligent in the transaction. Section 3-405 covers fraudulent indorsements made by employees and provides a defense to the bank taking the instrument. Under Section 3-405, the burden of loss is shifted to the principal and the bank is protected from liability except to the extent that the bank failed to “exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss resulting from the fraud”, in which case, 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

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(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 an 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 depository bank to an account in a name substantially similar to the name of that person.

loss.” Thus, even when the bank has failed to exercise ordinary care, the UCC has displaced a bank’s full liability under the common law with a comparative fault standard.

### **III. SUMMARY OF LIABILITY OF A BANK UNDER THE UFA AND THE UCC**

In sum, the UFA and Section 3-307 of the UCC only apply in situations where the bank is dealing with a known fiduciary. If the bank knows that the defalcator is a fiduciary, then the bank may be liable under either the UFA or the UCC if the bank facilitates the fiduciary’s breach of fiduciary duty by accepting funds or honoring checks when:

- (1) the bank has actual knowledge that the fiduciary is committing a breach of his obligation; or
- (2) the bank has knowledge of facts that amount to bad faith; or
- (3) where the fiduciary uses fiduciary funds for the payment of a personal debt to the bank with the bank’s actual knowledge, or uses such funds in a transaction known by the bank to be for the personal benefit of the fiduciary.

In addition, under the UCC, a bank may be liable if it accepts fiduciary funds via an instrument which is payable to the taker, principal, or fiduciary as such which is deposited into an account other than the principal’s or the fiduciary’s account as such.

## APPENDIX 1

### MISCELLANEOUS ARTICLE 3 AND 4 SECTIONS PERTAINING TO ALLOCATION OF FRAUDULENT CHECK LOSS

#### **Section 3-405. 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.

(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 an 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 depository bank to an account in a name substantially similar to the name of that person.

#### **Section 3-404. Imposters; 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 (k) 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 the 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 the 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 depository 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.

**Section 3-406. Negligence Contributing to Forged Signature or Alteration of Instrument**

- (a) A person whose failure to exercise ordinary care substantially contributes 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.

**Section 3-420. Conversion of Instrument.**

- (a) The law applicable to conversion of personal property applies to instruments. An instrument is also converted if it is taken by transfer, other than a negotiation, from a person not entitled to enforce the instrument or a bank makes or obtains payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment. An action for conversion of an instrument may not be brought by (i) the issuer or acceptor of the instrument or (ii) a payee or indorsee who did not receive delivery of the instrument either directly or through delivery to an agent or a co-payee.
- (b) In an action under subsection (a), the measure of liability is presumed to be the amount payable on the instrument, but recovery may not exceed the amount of plaintiff's interest in the instrument.
- (c) A representative, other than a depository bank, who 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.

**Section 4-207. Transfer Warranties.**

- (a) A customer or collecting bank that transfers an item and receives a settlement or other consideration warrants to the transferee and to any subsequent collecting bank that:
  - (1) the warrantor is a person entitled to enforce the item;
  - (2) all signatures on the item are authentic and authorized;
  - (3) the item has not been altered;
  - (4) the item is not subject to a defense or claim in recoupment (Section 3-305(a)) of any party that can be asserted against the warrantor; and
  - (5) the warrantor has no knowledge of any insolvency proceeding commenced with respect to the maker or acceptor or, in the case of an unaccepted draft, the drawer.
- (b) If an item is dishonored, a customer or collecting bank transferring the item and receiving settlement or other consideration is obliged to pay the amount due on the item (I) according to the terms of the item at the time it was transferred, or (ii) if the transfer was of an incomplete item, according to its terms when completed as stated in Sections 3-115 and 3-407. The obligation of a transferor is owed to the transferee and to any subsequent collecting bank that takes the item in good faith. A transferor

cannot disclaim its obligation under this subsection by an indorsement stating that it is made “without recourse” or otherwise disclaiming liability.

- (c) A person to whom the warranties under subsection 9a) are made and who took the item in good faith may recover from the warrantor as damages for breach of warranty an amount equal to the loss suffered as a result of the breach, but not more than the amount of the item plus expenses and loss of interest incurred as a result of the breach.
- (d) The warranties stated in subsection (a) cannot be disclaimed with respect to checks. Unless notice of a claim for breach of warranty is given to the warrantor within 30 days after the claimant has reason to know of the breach and the identity of the warrantor, the warrantor is discharged to the extent of any loss caused by the delay in giving notice of the claim.
- (e) A cause of action for breach of warranty under this section accrues when the claimant has reason to know of the breach.

#### **Section 4-208. Presentment Warranties.**

- (a) If an unaccepted draft is presented to the drawee for payment or acceptance and the drawee pays or accepts the draft, (I) the person obtaining payment or acceptance, at the time of presentment, and (ii) a previous transferor of the draft, at the time of transfer, warrant to the drawee that pays or accepts the draft in good faith that:
  - (1) the warrantor is, or was, at the time the warrantor transferred the draft, a person entitled to enforce the draft or authorized to obtain payment or acceptance of the draft on behalf of a person entitled to enforce the draft;
  - (2) the draft has not been altered; and
  - (3) the warrantor has no knowledge that the signature of the purported drawer of the draft is unauthorized.
- (b) A drawee making payment may recover from a warrantor damages for breach of warranty equal to the amount paid by the drawee less the amount the drawee received or is entitled to receive from the drawer because of the payment. In addition, the drawee is entitled to compensation for expenses and loss of interest resulting from the breach. The right of the drawee to recover damages under this subsection is not affected by any failure of the drawee to exercise ordinary care in making payment. If the drawee accepts the draft (I) breach of warranty is a defense to the obligation of the acceptor, and (ii) if the acceptor makes payment with respect to the draft, the acceptor makes payment with respect to the draft, the acceptor is entitled to recover from a warrantor for breach of warranty the amounts stated in this subsection.
- (c) If a drawee asserts a claim for breach of warranty under subsection (a) based on an unauthorized indorsement of the draft or an alteration of the draft, the warrantor may defend by proving that the indorsement is effective under Section 3-404 or 3-405 or the drawer is precluded under Section 3-406 or 4-406 from asserting against the drawee the unauthorized indorsement or alteration.
- (d) If (I) a dishonored draft is presented for payment to the drawer or an indorser or (ii) any other item is presented for payment to a party obliged to pay the item, and the item is paid, the person obtaining payment and a prior transferor of the item warrant to the person making payment in good faith that the warrantor is, or was, at the time the warrantor transferred the item, a person entitled to enforce the item or authorized to obtain payment on behalf of a person entitled to enforce the item. The person making payment may recover from any warrantor for breach of warranty an amount equal to the amount paid plus expenses and loss of interest resulting from the breach.
- (e) The warranties stated in subsections (a) and (d) cannot be disclaimed with respect to checks. Unless notice of a claim for breach of warranty is given to the warrantor within 30 days after the claimant has reason to know of the breach and the identity of the warrantor, the warrantor is discharged to the extent of any loss caused by the delay in giving notice of the claim.
- (f) A cause of action for breach of warranty under this section accrues when the claimant has reason to know of the breach.

#### **Section 4-406. Customer's Duty to Discover and Report Unauthorized Signature or Alteration**

- (a) A bank that sends or makes available to a customer a statement of account showing payment of items for the account shall either return or make available to the customer the items paid or provide information in the statement of account sufficient to allow the customer reasonably to identify the items paid. The statement of account provides sufficient information if the item is described by item number, amount, and date of payment.
- (b) If the items are not returned to the customer, the person retaining the items shall either retain the items or, if the items are destroyed, maintain the capacity to furnish legible copies of the items until the expiration of seven years after receipt of the items. A customer may request an item from the bank that paid the item, and that bank must provide in a reasonable time either the item or, if the item has been destroyed or is otherwise not obtainable, a legible copy of the item.
- (c) If a bank sends or makes available a statement of account or items pursuant to subsection (a), the customer must exercise reasonable promptness in examining the statement or the items to determine whether any payment was not authorized because of an alteration of an item or because a purported signature by or on behalf of the customer was not authorized. If, based on the statement or items provided, the customer should reasonably have discovered the unauthorized payment, the customer must promptly notify the bank of the relevant facts.
- (d) If the bank proves that the customer failed, with respect to an item, to comply with the duties imposed on the customer by subsection (c), the customer is precluded from asserting against the bank;
  - (1) the customer's unauthorized signature or any alteration on the item, if the bank also proves that it suffered a loss by reason of the failure; and
  - (2) the customer's unauthorized signature or alteration by the same wrongdoer on any other item paid in good faith by the bank if the payment was made before the bank received notice from the customer of the unauthorized signature or alteration and after the customer had been afforded a reasonable period of time, not exceeding 30 days, in which to examine the item or statement of account and notify the bank.
- (e) If subsection (d) applies and the customer proves that the bank failed to exercise ordinary care in paying the item and that failure substantially contributed to loss, the loss is allocated between the customer precluded and the bank asserting the preclusion according to the extent to which the failure of the customer to comply with subsection (c) and the failure of the bank to exercise ordinary care contributed to the loss. If the customer proves that the bank did not pay the item in good faith, the preclusion under subsection (d) does not apply.
- (f) Without regard to care or lack of care of either the customer or the bank, a customer who does not within one year from the time after the statement or items are made available to the customer (subsection (a)) discover and report the customer's unauthorized signature on or any alteration on the item is precluded from asserting against the bank the unauthorized signature or alteration. If there is a preclusion under this subsection, the payor bank may not recover for breach of warranty under Section 4-208 with respect to the unauthorized signature or alteration to which the preclusion applies.

## APPENDIX 2

Table of Jurisdictions Where The Uniform Fiduciaries Act Has Been Adopted

Jurisdiction	Laws	Effective Date	Statutory Citation
Alabama .....	1943, p. 544	7-7-1943	Code 1975, §§ 19-1-1 to 19-1-13.
Arizona .....	1951, c. 139	3-29-1951	A.R.S. §§ 14-7501 to 14-7512.
Colorado.....	1923, c. 65	4-16-1923	West's C.R.S.A. §§ 15-1-101 to 15-1-113.
District of Columbia.	1928, 45 Stat. 509	5-14-1928	D.C.Code 1981, §§ 21-1701 to 21-1712.
Hawaii.....	1945, c. 197	5-17-1945	HRS §§ 556-1 to 556-10.
Idaho.....	1925, c. 217	3-17-1925	I.C. §§ 68-301 to 68-315.
Illinois.....	1931, p. 676	7-7-1931	S.H.A. 760 ILCS 65/1 to 65/12.
Indiana.....	1927, c. 17	5-16-1927	West's A.I.C. 30-2-4-1 to 30-2-4-14.
Louisiana.....	1924, No. 226	1-1-1925	LSA-R.S. 9:3801 to 9:3814.
Maryland.....	1929, c. 572	4-11-1929	Code, Estate and Trusts, §§ 15-201 to 15-211.
Minnesota.....	1945, c. 202	3-31-1945	M.S.A. §§ 520.01 to 520.13.
Missouri.....	1959, S.C. No. 121	8-29-1959	V.A.M.S. §§ 456.240 to 456.350.
Nevada.....	1923, c. 44	3-1-1923	N.R.S. 162.010 to 162.140.
New Jersey.....	1927, c. 30	7-4-1927	N.J.S.A. 3B:14-52 to 3B:14-61.
New Mexico.....	1923, c. 26		NMSA 1978, §§ 46-1-1 to 46-1-11.
New York.....	1948, c. 866	4-6-1948	McKinney's General Business Law §§ 359-I, 359-I.
North Carolina.....	1923, c. 85	2-27-1923	G.S. 1§ 32-1 to 32-13.
Ohio.....	1943, p. 343	8-27-1943	R.C. §§ 1339.03 to 1339.13.
Pennsylvania.....	L.1923	5-31-1923	7 P.S. §§ 6351 to 6404.
Rhode Island.....	1961, c. 147	1-2-1962	Gen.Laws 1956, §§ 18-4-15 to 18-4-23.
South Dakota.....	1943, c. 19	2-6-1943	SCDL 55-7-2 to 55-7-15.
Tennessee.....	1953, c. 82	4-6-1953	T.C.A. §§ 35-2-101 to 35-2-112.
Utah.....	1925, c. 86	5-12-1925	U.C.A.1953, 22-1-1 to 22-1-11.
Virgin Islands.....	1957, Act. No. 160	9-1-1957	15 V.I.C. 1§ 1041 to 1053.
Wisconsin.....	1925, c. 227	6-1-1925	W.S.A. 112.01(1 to 16).
Wyoming.....	1929, c. 90	2-21-1929	W.S.1977, §§ 2-3-201 to 2-3-211.