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UNAUTHORIZED AND FORGED INDORESEMENTS: A GLITCH IN REVISED ARTICLE 3 OF THE UNIFORM COMMERCIAL CODE

Ada Long-Croom*

I. INTRODUCTION

The drafters of both the 1990 pre-revision [hereinafter "pre-revision" or "pre-revised"] and the 1990 revision [hereinafter "revision" or "revised"] of Article 3 of the Uniform Commercial Code [hereinafter "the Code"] recognized the harsh reality that, in forged check situations, recovery from the forger is rarely a viable solution. Both versions, therefore, include a number of rules governing loss allocation in cases involving unauthorized or forged signatures. Working together, these rules are designed to create a scheme which places the losses occasioned by unauthorized and forged signatures on the party in the best position to have avoided their making. In most cases, this objective is accomplished by allocating the loss to the person who obtained the instrument from the wrongdoer. However, where a party to the instrument has acted in a negligent manner, and this negligence substantially contributed to the forgery of a signature on the

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1. Although an unauthorized signature may be technically distinguishable from a forged signature, as used in this article, the terms are viewed as interchangeable. For an enlightened, albeit brief, discussion of unauthorized signatures which are not forgeries, see Arthur G. Murphey, Jr., Revised Article 3 and Amended Article 4 of the Uniform Commercial Code: Comments on the Changes They Will Make, 46 Ark. L. Rev. 501, 567-68 (1993).

2. See, e.g., U.C.C. §§ 3-405 (Pre-revision 1990) (impostors and fictitious payees), 3-406 (negligence contributing to unauthorized signature), 3-417 (presentment and transfer warranties) and 3-419 (conversion of instrument), and revision §§ 3-404 (impostors and fictitious payees), 3-405 (employer's responsibility for fraudulent indorsement by employee), 3-406 (negligence contributing to forged signature), 3-416 (transfer warranties), 3-417 (presentment warranties) and 3-420 (conversion of instrument).
instrument, the negligent party is often in a superior position to have prevented the fraud.

In both versions, the drafters included special rules, found in section 3-406, which may be used in negligence cases to shift the loss to the negligent person either entirely or to the extent the negligence contributed to the loss. In the past, application of the loss allocation rules, in a manner which would produce results consistent with the underlying policy, frequently proved problematic to courts. The pre-revision contained several gaps and inconsistencies which often frustrated the ability of courts to shift the loss to the negligent party and, consequently, thwarted the goal of placing the ultimate loss on the person who could have best prevented it.

Application of section 3-406 in a manner which consistently allocates the loss to the person who could best have prevented it is particularly vexing in situations involving forged or unauthorized payee indorsements. In the case of checks, whether a loss may ultimately be shifted to the negligent person often rests on whether the person seeking to shift the loss still possesses the instrument. In most cases, this depends on whether the drawee honors or dishonors a check when it is presented for payment. In instances in which the check is honored the drawee can usually recover the amount paid by shifting the loss to the person who took the check from the wrongdoer in a warranty action. However, whether the loss

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3. Section 3-406 of the pre-revision employs a strict contributory negligence standard to allocate the entire loss to the negligent party where loss shifting is applicable. See U.C.C. § 3-406 (Pre-revision 1990).

4. Revised § 3-406 utilizes a comparative negligence standard where the negligence of a party has contributed to a loss occasioned by a forged signature. See U.C.C. § 3-406 (1990 Revision).

5. A "drawee" is defined as "a person ordered in a draft [including a check] to make payment." U.C.C. § 3-103(a)(2) (1990 Revision). The drawee on a check is the bank whose name is printed on the check as the bank where the person writing the check maintains a checking account.

6. A check that is honored by the drawee upon presentment for payment is retained by the drawee. The check is thereafter forwarded to the drawer, or information pertaining to payment of the check made available to the drawer, in the drawer's statement of account. See U.C.C. § 4-406 (1990 Revision). A check that is dishonored when presented for payment is returned to the presenter. See U.C.C. § 3-419(1)(b) (Pre-revision 1990) and U.C.C. § 3-420 (1990 Revision).

7. The ability to shift the loss to the person who took the check from the wrongdoer is achieved through the use of the warranty provisions found in section 3-416 and section 3-417 of the pre-revision.
can further be shifted to the negligent person remains problematic.

In construing the provisions of section 3-406 under the pre-revision, judges generally interpreted Article 3 as disallowing recovery from a person whose negligence substantially contributed to the making of a forged or unauthorized signature by way of an affirmative action brought directly against the negligent person. In many such cases the only recourse for the transferee who obtained the instrument from a wrongdoer was to attempt to recover from the wrongdoer—who had usually absconded with the proceeds—or to attempt to recover from the negligent person who contributed to the making of the unauthorized signature by way of a negligence action grounded in tort. Thus far, however, a federal court applying New Jersey law is apparently the only jurisdiction to permit a cause of action in tort in these circumstances.

Many of the areas which created difficulties under the pre-revision are solved in the 1990 revision. However, where a payee's negligence substantially aids a thief in forging the payee's indorsement, the revision leaves available to a negligent payee a major loophole. This loophole will continue to propagate results contrary to the general policy in unauthorized or forged signature situations of shifting the loss to the negligent person whose actions substantially contributed to enabling the wrongdoer to successfully perpetrate the fraud.


10. Id. at 1240.

11. One major problem involves the requirement that one must either be a holder in due course, a drawee, or other payor to invoke the negligence preclusion of section 3-406. See infra notes 63-64 and accompanying text. Another chief problem is the inability of a warrantor to invoke section 3-406 as a defense in a warranty action by a drawee. See infra notes 138-142 and accompanying text.

12. See infra notes 142, 151-52 and accompanying text.

13. Although not expressly defined in the Code, a "payee" referes to the person who is named on a check as the person to whose order the drawee is directed to make payment. For example, Susan Smith is the payee in "Pay to the order of Susan Smith $_______."
This article will focus on negligence which substantially contributed to forged or unauthorized payee indorsements and will address three primary areas: 1) loss allocation under the pre-1990 revision; 2) changes in the 1990 revision, which solved some of the problems inherent in the pre-revision; and 3) the problem carried forward under the revision, which continues to allow a negligent payee to circumvent the general loss allocation rules. While many of the rules discussed in this article are applicable to negotiable instruments other than checks, this article will limit its discussion to transactions involving checks.

II. BACKGROUND

When a check is presented to a drawee for payment, unless it has previously been accepted, the drawee has two options: it may honor the check by paying the presenter the face amount of the check, or it may dishonor the check by refusing to pay the face amount to the presenter. A dishonored check is normally returned to the presenter who may then seek payment from the drawer under the drawer’s contract obligation, or from a previous indorser under the in-

14. Other negotiable instruments which are not checks include drafts which are not drawn on a bank and promissory notes.

15. As stated in revised section 3-104(f): “‘Check’ means (i) a draft other than a documentary draft, payable on demand and drawn on a bank or (ii) a cashier’s check or teller’s check. An instrument may be a check even though it is described on its face by another term, such as ‘money order.’” U.C.C. § 3-104(f) (1990 Revision).

16. “Acceptance” is defined as the drawee’s signed engagement or agreement to honor the check upon presentment for payment. See U.C.C. § 3-410(1) (Pre-revision 1990); U.C.C. § 3-409(a) (1990 Revision).

17. Under section 3-408 of the revision and section 3-409(1) of the pre-revision, an unaccepted check does not operate as an assignment of funds in the drawer’s account. Further, under section 3-402(a) of both versions, a party is not obligated on an instrument which that party or the party’s representative has not signed.

18. A “drawer” is defined as “a person who signs or is identified in a draft [including a check] as a person ordering payment.” U.C.C. § 3-103(a)(3) (Pre-revision 1990). For example, if James Jones writes Susan Smith a check for $100, James Jones is the drawer.

19. Under section 3-414 of the revision, upon presentment, dishonor and notice, a drawer of an unaltered, unaccepted check is obligated to pay the holder, or other person entitled to enforce the check the amount of the check. Section 3-413 of the pre-revision mandates a similar duty extending to the holder or indorsers, unless the drawer disclaimed this obligation. See U.C.C. § 3-413 (1990 Revision).
dorser's contract obligation. If the drawee honors the check, the drawee then debits the amount of the check from the drawer's account. Thus, regardless of whether the check is honored or dishonored by the drawee, if the check has been properly issued and indorsed, normally the presenter is able to obtain payment of the check. If, on the other hand, the payee's indorsement has been forged, the ability of the presenter to ultimately obtain or retain payment on the check becomes significantly more complicated and in some cases impossible.

Where the payee's negligence has made the forgery of his or her indorsement to the check possible, the payee is often in a superior position to have prevented the fraud than the person who acquired the check from the forger. In recognition of the crucial function negligence plays in who should ultimately bear the loss in forgery cases, both versions of Article 3 include provisions in section 3-406 which deal with negligent acts that contribute to the making of a forged signature. In the absence of the ability to recover from the forger, these provisions are intended to shift the ultimate loss to the party whose negligence played a major role in making the forgery possible.

A major problem area under the pre-revision of Article 3 involved the interpretation and application of the language of section 3-406 which provides:

Any person who by his negligence substantially contributes to . . . the making of an unauthorized signature is precluded from asserting the . . . lack of authority against a holder in due course or against a drawee or other payor

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20. The contract obligation of an indorser is similar to that of the drawer. If a prior indorser is called upon to pay the amount of the check the indorser may recover from the drawer under the drawer's contract liability. See U.C.C. § 3-414 (Pre-revision 1990) and U.C.C. § 3-415 (1990 Revision).

21. See U.C.C. § 4-401 (1990 Revision) (both versions permit the bank to debit its customer's account for items which are properly payable from the account). See infra text accompanying notes 155-59.

22. Revised section 3-105(a) defines "issue" as "the first delivery of an instrument by the maker or drawer, whether to a holder or a non-holder, for the purpose of giving rights on the instrument to any person." U.C.C. § 3-105(a) (1990 Revision).

23. The ability to initially obtain payment is the problem where the check is dishonored.

24. The ability to retain the benefit of payment by avoiding payment to the drawee under a warranty claim is the problem where the check has been honored.
who pays the instrument in good faith and in accordance with reasonable commercial standards of the drawee's or payor's business.

Most of the cases construing this section under the pre-revision involved a drawer whose negligence resulted in the forgery of the payee's signature. Courts have split on whether to allow section 3-406 to shift the loss to the negligent person by way of an affirmative action, as apposed to allowing the preclusion to serve solely as a defense against the negligent person who sought to replevy the check or to recover the proceeds in a conversion action. A major factor engendering misapplication in some cases stemmed from an apparent inability of jurists to differentiate between liability grounded in contract and liability founded on breach of warranty principles. Moreover, even when the provisions of section 3-406 were correctly applied, a court's rationale regarding the applicability of the section's preclusion in a particular case was not always clearly articulated.

25. See, e.g., Koerner & Lambert v. Allstate Ins. Co., 374 So. 2d 179 (La. Ct. App. 1979). In this case, Burnell Robinson and George Driscoll were both insured by Allstate. Without notifying either of them, Allstate delivered checks to Paul Boucher, the owner of Marina-Rama, for repairs to Robinson's and Driscoll's boats. The check covering Robinson's repairs named Robinson as the sole payee. The check covering Driscoll's repairs was jointly payable to Driscoll and Marina-Rama. Although the boats were never repaired, Boucher forged Robinson's name and directed the forgery of Driscoll's name to the checks then transferred them to the law firm of Koerner & Lambert, to be applied to debts owed to Boucher's creditors who were contemplating bankruptcy proceedings against Boucher. The checks were deposited into Koerner & Lambert's account with its bank and were paid by the drawee. Only after payment by the drawee were the proceeds of the checks distributed to Boucher's creditors.

Several months after the checks' proceeds were disbursed to Boucher's creditors the forgeries were discovered. Utilizing the Code's warranty rules, the drawee successfully shifted the loss occasioned by payment of the checks to Koerner & Lambert's depository bank, which in turn debited Koerner & Lambert's account in the amount of the checks. Koerner & Lambert then sued Allstate to recover its loss.

In rendering judgment for Koerner & Lambert, the court held that, because of its substantial negligence in delivering the checks to Boucher without notifying Robinson and Driscoll, Allstate was precluded under section 3-406 from asserting the forgeries against Koerner & Lambert who was a holder in due course. In holding that Koerner & Lambert was a holder in due course, the court never addressed the requirement that one must first qualify as a holder in order to be a holder in due course.

III. NEGLIGENCE: CONTRACT V. WARRANTY LIABILITY

Where the instrument has been dishonored, courts liberally interpret section 3-406 as imposing liability on a negligent person whose signature was forged as the purported drawer\(^{27}\) and on an actual drawer whose negligence substantially contributed to the forging of the indorsement of the named payee.\(^{28}\) However, where an instrument bearing a forged payee's indorsement is honored by the drawee, few courts have permitted recovery against the drawer even though the drawer's negligence substantially contributed to the forged indorsement.\(^{29}\) The rationale for the different outcomes emanates from the variance between the rules governing warranty liability and those governing contract liability.

To appreciate the intricacies of many of the problems and much of the confusion in applying the Code's loss allocation rules, an explanation of the different functions a signature on an instrument may serve is required. This explanation will also be useful as a context for examining many of the related provisions in the contract and warranty areas.

A. Purposes Served by Signatures to a Check

1. Functions of a Drawer's Signature

The drawer's signature on an instrument serves two primary functions. First, it serves as an order\(^{30}\) to the drawee to pay a fixed amount of money\(^{31}\) to the person designated by

27. See, e.g., Dubin v. Hudson County Probation Dep't, 630 A.2d 1207 (N.J. Super. Ct. 1993) (construing “other payor” language in section 3-406 to include a check cashing enterprise).

28. See Park State Bank, 207 N.E.2d 158.


30. “Order” is defined as “a direction to pay and must be more than an authorization or request.” U.C.C. § 3-102(1)(b) (1990 Pre-revision). See also, U.C.C. § 3-103(a)(6) (1990 Revision).

31. In addition to other requirements, to qualify as a negotiable instrument, a writing must contain an unconditional order from the drawer to the drawee (or, in the case of a promissory note, an unconditional promise by the maker) to pay a fixed sum of money. See U.C.C. § 3-104(a) (1990 Revision) and U.C.C. § 3-104(1)(b) (Pre-revision 1990).
the payee named on the instrument. Where the drawer orders the drawee to pay a check to the order of a named payee, the drawee may legitimately debit the drawer's account only for payment which is made to the named payee or to a person designated by the named payee to receive payment. Second, the drawer's signature serves to impose liability upon the drawer to pay the check if the drawee refuses to honor the drawer's order to pay the amount specified on the check.

2. Functions of an Indorser's Signature

The term "indorsement" is not explicitly defined in the pre-revised Code. Pre-revised section 3-202(2) speaks of indorsements but merely provides that an indorsement must be made "by or on behalf of the holder." However, it is clear from other provisions of pre-revised Article 3 that an indorsement may serve three distinct purposes under negotiable instruments law: 1) to cause a transfer of the instrument to result in its negotiation; 2) to restrict payment of the instrument; and 3) to make the indorser liable on the in-

32. To qualify as a negotiable instrument under the pre-revision, an instrument must indicate that it is payable to a named payee's order, or to the bearer of the instrument. See U.C.C. § 3-104(1)(d) (Pre-revision 1990). The revision retains this requirement for all instruments other than checks to qualify as negotiable instruments. See U.C.C. § 3-104(c) (1990 Revision).

33. See U.C.C. § 4-401 (1990 Revision) and infra text accompanying notes 155-57 (discussing when an instrument is properly payable).

34. Pre-revised section 3-413(2) permitted a drawer to avoid contractual liability on any instrument by indicating the instrument was drawn without recourse. Under the revision, a drawer may no longer avoid contract obligations where checks are concerned. Specifically, revised section 3-414(e) states in pertinent part:

If a draft states that it is drawn "without recourse" or otherwise disclaims liability of the drawer to pay the draft, the drawer is not liable to pay the draft if the draft is not a check. A disclaimer of liability stated in subsection (b) is not effective if the draft is a check.

U.C.C. § 3-414(e) (1990 Revision) (emphasis added).

35. See infra note 56 and accompanying text.

36. One of the major complaints concerning the text of Article 3, is that to understand what it says, "you must first know the law of negotiable instruments. In other words, the Code is not a code that tells a student or banker or a lawyer what the law is. It is rather a compilation of notes that may serve to remind you of the law you had better know before you read the UCC." David Mellinkoff, The Language of the Uniform Commercial Code, 77 YALE L.J. 185, 192-93 (1967). For a discussion of the difficulty in grasping the meaning of the term "indorsement," see id. at 193.

37. U.C.C. § 3-202(2) (Pre-revision 1990).

38. See infra note 44 and accompanying text.

39. Pre-revised section 3-205 provides:
instrument if it is dishonored by the drawee.\textsuperscript{40} Section 3-204 of the revision expressly defines the term indorsement as “a signature, other than that of a signer as maker, drawer or acceptor,” made for the purpose of “(1) negotiating the instrument, (2) restricting payment of the instrument, or (3) incurring indorser’s liability on the instrument.”\textsuperscript{41} While, in most instances an indorsement will serve more than one of these functions,\textsuperscript{42} it is important to distinguish between the functions being served in a particular situation and to apprehend the import of these distinctions.

The indorsement of the named payee on a check is a \textit{sine qua non} to the negotiation of a check. A negotiation is defined under section 3-202(1) of the pre-revision as “the transfer of an instrument in such form that the transferee becomes a holder. If the instrument is payable to order it is negotiated by delivery with the necessary indorsement; if payable to bearer it is negotiated by delivery [alone].”\textsuperscript{43} Similarly, under the revision, the transfer of an instrument which names a payee results in a negotiation only if indorsed by the payee and transferred in a manner whereby the transferee becomes a holder.\textsuperscript{44} Under both versions of the Code, there-

\begin{itemize}
  \item An indorsement is restrictive which either
  \begin{enumerate}
    \item is conditional; or
    \item purports to prohibit further transfer of the instrument; or
    \item includes the words “for collection”, “for deposit”, “pay any bank”, or like terms signifying a purpose of deposit or collection; or
    \item otherwise states that it is for the benefit or use of the indorser or of another person.
  \end{enumerate}
\end{itemize}

U.C.C. § 3-205 (Pre-revision 1990).
\textsuperscript{40} See U.C.C. § 3-414 (Pre-revision 1990).
\textsuperscript{41} U.C.C. § 3-204 (1990 Revision).
\textsuperscript{42} For example, an unrestricted indorsement by Janet Jones on a check on which she is the named payee is required under pre-revised section 3-205 before any subsequent transferee can become a holder. Her indorsement also makes her liable as an indorser to pay the instrument under section 3-414 upon timely notice of its dishonor.
\textsuperscript{43} U.C.C. § 3-202 (Pre-revision 1990).
\textsuperscript{44} Revised section 3-201 provides that:
\begin{enumerate}
  \item “Negotiation” means a transfer of possession, whether voluntary or involuntary, of an instrument by a person other than the issuer to a person who thereby becomes its holder.
  \item Except for negotiation by a remitter, if an instrument is payable to an identified person, negotiation requires transfer of possession of the instrument and its indorsement by the holder. If the instrument is payable to bearer, it may be negotiated by transfer of possession alone.
\end{enumerate}

U.C.C. § 3-201 (1990 Revision).
fore, a check must be negotiated in order for a transferee of
the check to qualify as its holder. Additionally, while a check
which names a specified payee may be transferred without
the transferee becoming its holder, the transferee is not enti-
tled to obtain payment on the check unless she qualifies as a
holder or has acquired the rights of a holder as a result of the
transfer.45

The second function an indorsement may serve is to
place restrictions on actual payment of the instrument. Such
restrictions may operate to place limitations on who may sub-
sequently obtain payment on the instrument,46 or to restrict
the manner in which the proceeds of payment of the instru-
ment are to be applied.47 An indorser may place a “special” or
“blank” indorsement on a check.48 A blank indorsement is ac-
complished by simply signing one's name to a check other
than as its drawer or drawee. A blank indorsement causes
the check to become a bearer instrument which may be re-
peatedly negotiated without additional indorsements by sub-
sequent transferors.49 For example, without indorsing it,
Sam Smith may negotiate a check to Bob Brown on which
Janet Jones is the payee named on the face of the check if
Janet Jones has indorsed the check in blank. However, Janet
may restrict Sam's ability to negotiate the check without his
indorsement by designating Sam Smith as the new payee
when she indorses the check. An indorsement, such as this,
which specifies a particular payee is referred to as a special
indorsement.50 Thus, an indorsement which reads "Pay Sam
Smith /s/ Janet Jones," cannot be negotiated by Sam without
his blank or special indorsement. Additionally, while an in-

45. Article 3 recognizes that an instrument may be legitimately transferred
without the transferee becoming a holder. See U.C.C. § 3-201(1) (Pre-revision
1990). See also U.C.C. § 3-203 (1990 Revision). In certain instances revised
section 3-203(b) and pre-revised section 3-201(1) permit a transferee who is not
a holder to enforce the instrument by stepping into the shoes of a prior holder.
Neither version permits the enforcement of a check which was never negotiated
by the named payee. See U.C.C. § 3-301 (Pre-revision 1990 and 1990 Revision).
46. See U.C.C. § 3-205 (1990 Revision); U.C.C. § 3-204 (Pre-revision 1990)
and infra text accompanying note 50.
47. See U.C.C. § 3-206 (1990 Revision); U.C.C. § 3-205 (Pre-revision 1990)
and infra text accompanying note 52.
48. U.C.C. § 3-205 (1990 Revision); U.C.C. § 3-204 (Pre-revision 1990).
49. See U.C.C. § 3-205(b) (1990 Revision); U.C.C. § 3-204(2) (Pre-revision
1990).
50. See U.C.C. § 3-205(a) (1990 Revision); U.C.C. § 3-204(1) (Pre-revision
1990).
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dorsement may not be used to entirely prohibit the instrument's further transfer or negotiation, a special or blank indorsement may include accompanying language which places some restrictions on how the proceeds of the instrument shall be used, as for instance, "for deposit only," followed by an indorsement.

The third purpose an indorsement may serve is to impose contract obligations upon an indorser. Unless expressly disclaimed, any indorsement on an instrument, whether required for negotiation or not, imposes upon the signer the contract obligations of an indorser. Therefore, if Sam Smith places his unqualified indorsement on a check made payable to Janet Jones which Janet has indorsed in blank, Sam Smith assumes the same contract obligations as Janet. As these examples illustrate, an indorsement may simultaneously serve all three functions. For example, by placing an unqualified special indorsement on a check made payable to her, and transferring it to Sam Smith, Janet Jones negotiates the check, places restrictions on its payment and incurs contract obligations as an indorser.

An understanding of the different functions a signature may serve on an instrument, and the function being served in any given situation is crucial to understanding how losses are allocated under contract versus warranty principles. The significance of the different purposes becomes even more important when the instrument contains a forged signature, partic-

51. For example, an indorsement which also states that it is payable "only" to Sam Smith, will not preclude Sam from indorsing the instrument and further negotiating it. See U.C.C. § 3-206(a) (1990 Revision); U.C.C. § 3-206(1) (Pre-revision 1990).

52. See U.C.C. § 3-206(c) (1990 Revision); U.C.C. §§ 3-205, 3-206 (Pre-revision 1990).

53. See U.C.C. § 3-415 (1990 Revision); U.C.C. § 3-414 (Pre-revision 1990). See infra notes 57-58 and accompanying text.

54. Both versions of Article 3 permit an indorser to avoid the imposition of the contract obligation of an indorser to pay the check in the event it is dishonored by stating on the check that the indorsement is made "without recourse," or through the use of similar language disclaiming any obligation to pay the check if it is later dishonored. See U.C.C. § 3-415(b) (1990 Revision); U.C.C. § 3-414(1) (Pre-revision 1990).

55. The term "unqualified" is used here to refer to an indorsement which is not supplemented by language which purports to disclaim an indorser's contract liability. See U.C.C. § 3-414(1) (Pre-revision 1990); U.C.C. § 3-414(e) (1990 Revision).
ularly when the negligence of a purported party to the instrument substantially contributed to the forgery.

B. Contract Liability

1. General Requirements for Contract Liability

The contract obligations of a drawer are contained in subsection (b) of revised section 3-414 which provides that, where an unaccepted check is dishonored "the drawer is obliged to pay [it] according to its terms at the time it was issued or . . . first came into possession of a holder . . . , to any person entitled to enforce it, or to an indorser who paid [it]." Subsection (a) of revised section 3-415 sets out the contract obligations of an indorser and provides in pertinent part that, "if an instrument is dishonored, an indorser is obliged to pay the amount due on the instrument . . . according to the terms of the instrument at the time it was indorsed." However, under both versions of the Code, whether a person assumes contract liability on an instrument as a drawer or an indorser is predicated on whether that person's binding signature appears on the instrument.

Subsection (a) of revised section 3-401 provides that: "A person is not liable on an instrument unless (i) the person signed the instrument, or (ii) the person is represented by an agent or representative who signed the instrument and the signature is binding on the represented person . . . ." Subsection (1) of pre-revised section 3-401, similarly provided that "[n]o person is liable on an instrument unless his signature appears thereon." It is important to note that neither version of section 3-401 operates to impose liability, but oper-

56. Section 3-413(2) of the pre-revision similarly provides that, subject to presentment, dishonor and any necessary notice of dishonor, the basic contract of a drawer is to pay the instrument to any holder or indorser who pays the instrument.
57. U.C.C. § 3-415(a) (1990 Revision). Subsection (1) of pre-revised section 3-414 contains essentially the same requirement.
58. See U.C.C. § 3-401(a) cmt. 1 (1990 Revision); U.C.C. § 3-401(l) cmt. 1 (Pre-revision 1990).
59. See U.C.C. § 3-401(a) (1990 Revision). As explained in Official Comment 1 to revised section 3-401, and further detailed in revised section 3-402, the signature does not have to be made by the person sought to be charged, nor is it necessary that the actual name of a person appear in the signature where the signature is made by an agent or representative authorized to act on behalf of the person. See U.C.C. §§ 3-401 cmt. 1, 3-402 (1990 Revision).
60. U.C.C. § 3-401 (Pre-revision 1990).
ates only to restrict the imposition of liability created under other sections of the Code. Section 3-401 has generally been interpreted to stand for the proposition that no drawer or indorser contract ensues unless the instrument is signed by the person sought to be charged with drawer or indorser liability or has been signed by that person's authorized agent or representative. In other words, it is the sections governing the contract obligations of drawers and indorsers which operate to impose liability on a party to an instrument, not section 3-401. Section 3-401 makes it clear, however, that no contract obligations arise with respect to a person who may have dealt with the instrument—for example a transferor—but who has not signed the instrument either personally or through another person. The impact of section 3-401 becomes particularly significant when a check bears a forged drawer's signature or a forged payee's indorsement.

2. Effect of Forged Signatures on Contract Liability

When determining the effect of a forged signature on the potential contract liability of a party, it is necessary to examine its effect on the forger as well as the person whose name is forged. The rules under both versions of the Code governing the effect of a forged signature are essentially the same. Pre-revised section 3-404(1) provides:

Any unauthorized signature is wholly inoperative as that of the person whose name is signed unless he ratifies it or is precluded from denying it; but it operates as the signature of the unauthorized signer in favor of any per-

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61. Authority to sign another's name given after the signing operates retroactively to cause what was initially an unauthorized signature to be authorized from the moment of its making. Subsection (2) of pre-revised section 3-404 provides: "[a]ny unauthorized signature may be ratified for all purposes of this Article." U.C.C. § 3-404(2) (1990 Pre-revision). Revised section 3-403(a), likewise, provides that: "[a]n unauthorized signature may be ratified for all purposes of this Article." U.C.C. § 3-403(a) (1990 Revision). See U.C.C. § 3-404 cmt. 3 (1990 Pre-revision); Guaranty Bank & Trust Co. v. Federal Reserve Bank of Kansas, 454 F. Supp. 488, 491-92 (W.D. Okla. 1977); Murphey, supra note 1.

62. U.C.C. § 3-414 (1990 Revision); U.C.C. § 3-413 (Pre-revision 1990).

63. U.C.C. § 3-415 (1990 Revision); U.C.C. § 3-414 (Pre-revision 1990).

64. Revised section 3-403(a) provides that: "Unless otherwise provided in ... Article [3] or Article 4, an unauthorized signature is ineffective except as the signature of the unauthorized signer in favor of a person who in good faith pays the instrument or takes it for value ..." U.C.C. § 3-403 (1990 Revision). The same rule is provided in U.C.C. section 3-404(1) (Pre-revision 1990).
The effect on the actual forger of a forged signature to a check is uncomplicated and clear. Regardless of the name used, under both versions of the Code, a forged signature is effective as the signature of the forger for any and all purposes which the signature on the check may be relevant. For example, consider a situation where Sally Swift steals a blank check from Dan Drawer and forges his signature. Because her forgery of Drawer's name is effective as her signature, Sally becomes obligated as a drawer even though her name does not appear on the check. Likewise, if Sally steals a check issued by Dan to Janet Jones, then forges Janet's name, the forgery, once again, is effective as Sally's signature and Sally assumes the contract obligations of an indorser.

In the above cases, unless the actions of Drawer or Jones contributed to the forgeries or the actions have been ratified by them, the effect of the forgeries on Drawer and Jones is equally clear and uncomplicated. The forged signatures are wholly ineffective as their signatures. Consequently, no drawer contract obligations accrue to Dan, and Janet assumes no indorser contract obligations since neither has signed the checks as required for the imposition of liability.

Where, however, negligent behavior by Drawer or Jones substantially contributed to Swift's ability to make the forgery or unauthorized signature, the forgery may be treated both as the signature of Drawer or Jones, and as the signature of Sally. The issue of negligence and whether a forgery operates as an effective signature of the person whose name is forged can arise in either of two situations. The first occurs where the forgery is of the negligent person's name, for in-

65. U.C.C. § 3-404(1) (Pre-revision 1990).
66. "Forged signature" and "forgery" are not defined in the Code. However, an "unauthorized signature" is defined in section 1-201(43) as "one made without actual, implied or apparent authority and includes a forgery." U.C.C. § 1-201(43) (1990 Revision).
67. See supra notes 30-55 and accompanying text.
68. See supra notes 34-35 and accompanying text.
69. See supra note 57 and accompanying text.
70. Both versions of Article 3 include a number of provisions which prohibit a person from asserting that a forgery has occurred under certain extenuating circumstances. See §§ 3-404, 3-405, 3-406 (1990 Revision); §§ 3-405, § 3-406 (Pre-revision 1990).
71. See U.C.C. § 3-401 (Pre-revision 1990 and 1990 Revision).
stance where Dan Drawer's negligence results in Sally Swift's forgery of his name as drawer, or where Janet Jones' negligence results in the forgery of her signature as indorser. The second situation arises where one person's negligence contributes to the forgery of a different person's signature, as for example, where Dan Drawer's negligence results in Sally's forgery of Janet Jones' name as indorser.

Under the pre-revision of Article 3, where Dan's or Janet's negligence significantly aided Sally in forging or placing an unauthorized signature on an instrument, section 3-406 precludes Dan or Janet from asserting the forgery or unauthorized nature of the signature against a holder in due course, drawee, other payor\(^7\) or other person who, acting in good faith and in a commercially reasonable manner, paid the instrument.\(^7\) Revised section 3-406 affords this protection to an even larger class of claimants by precluding the negligent person from asserting the forgery against any person who, acting in good faith "pays the instrument or takes it for value or collection."\(^7\) Thus, under the revision, transferees who fail to qualify as holders, and thus holders in due course, because of the forgery, may nonetheless avail themselves to the preclusion of section 3-406.\(^7\)

With regard to the negligent person, under both versions of section 3-406, where conditions are met so that the preclusion applies, the unauthorized signature should logically, and

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\(^7\) Pre-revised Article 3 fails to define the term "other payor" and its meaning is difficult to ascertain from other provisions of the Article. The closest one comes to gleaning a sense of the drafters' intended meaning is by looking at similar terms in Article 4. According to pre-amended section 4-105(b), a payor bank "means a bank by which an item is payable as drawn or accepted." U.C.C § 4-105(b) (Pre-revision 1990). A "payor bank," according to Official Comment 2 "included a drawee bank and also a bank at which an item is payable if the item constitutes an order on the bank to pay . . . ." U.C.C. § 4-105(b) cmt. 2 (Pre-revision 1990).

\(^7\) Under pre-revised section 3-406, these situations are limited to 1) those in which allowing the person whose negligence has substantially contributed to an unauthorized signature to assert the lack of authority would operate to the disadvantage of one who would be a holder in due course but for the unauthorized signature and 2) a drawee or other person who, observing reasonable commercial standards, paid the instrument.

\(^7\) U.C.C. § 3-406 (1990 Revision).

\(^7\) Because one must first qualify as a holder in order to qualify as a holder in due course, the language of the pre-revision was confusing and difficult to apply.
by its terms, by its terms, by its terms, be treated as the valid signature of the person whose name is signed for any and all purposes which that person's signature might serve on the instrument. Thus, where Dan Drawer's negligence caused Swift's forgery of his name, he should incur the contractual obligations of a drawer just as he would had he authorized Swift to sign his name. Also, where his negligence resulted in Swift's forgery of Jones' indorsement, Drawer should be estopped from asserting the ineffectiveness of Jones' signature as a challenge to the validity of an apparent negotiation and a transferee's status as a holder.

The preclusion under section 3-406 should apply in the same manner and with equal force where a payee's negligence causes the forgery of her name as indorser. For example, where Janet Jones is the named payee on a check and her negligence enables Swift to forge Jones' indorsement, Jones should incur the contractual liability of an indorser. Additionally, Jones should be unable to assert the forgery of her signature in challenging the validity of a transfer as a valid negotiation.

Where the issue as to the effect of a forged signature on the person whose name is forged arises following the drawee's dishonor of the check, courts have exercised little reluctance in invoking section 3-406 in the manner just discussed so that the loss falls on the negligent actual or ostensible drawer. Under both versions of the Code, an ostensible drawer whose name is forged, substantially due to his own

76. The language of section 3-406 places no limitations on the applicability of the preclusions based on the purpose the forged signature serves. See U.C.C § 3-406 (1990 Revision).
77. See supra notes 30-55 and accompanying text.
78. See supra notes 43-44 and accompanying text. Dan's inability to assert the forgery of Janet's signature is adopted in the revision. See U.C.C. §§ 3-406(a), 3-417 (c) (1990 Revision). See also, infra notes 92-103 and accompanying text (discussing the impact of these changes).
79. See supra note 57 and accompanying text.
80. See supra notes 44-45 and accompanying text.
81. See, e.g., Dubin v. Hudson County Probation Dep't, 630 A.2d 1207 (N.J. Super. Ct. Law Div. 1993) (permitting a check cashing enterprise to recover against a defendant whose name was forged after thieves stole several checks then, using defendant's signature stamp, forged defendant's name as drawer); Park State Bank v. Arena Auto Auction, Inc., 207 N.E.2d 158 (Ill. App. Ct. 1965) (permitting recovery against a negligent drawer who mailed a check to the wrong party with the same name as the intended payee).
negligence, is liable under the drawer's contract provisions\textsuperscript{82} to any claimant who qualifies as a holder in due course.\textsuperscript{83} Moreover, notwithstanding the forgery, no obstacles impact the ability of transferees of a check bearing a forged drawer's signature to qualify as holders in due course.\textsuperscript{84}

Consider a scenario where Sally Swift steals one of Dan Drawer's blank checks. She makes the check payable to herself, then forges Dan's signature as drawer using his signature stamp which, along with his checkbook, he negligently left unattended. Sally, indorses the check with her own name and deposits it in Depository Bank. Upon presentment to the drawee, the check is dishonored.\textsuperscript{85} As long as Depository Bank had no knowledge or notice of the forgery and received the check in good faith, it qualifies as a holder in due course.\textsuperscript{86} However, because Dan Drawer's name is forged, Depository Bank is not a holder in due course of a check drawn by Dan Drawer, but of a check drawn by Sally Swift.\textsuperscript{87} However, by invoking section 3-406, Dan is precluded from asserting the forgery against Depository Bank because it qualifies as a holder is due course of the check drawn by Sally. The forgery is treated as though it was made by Dan and he is, therefore, liable to Depository Bank under the contract obligations of a drawer to the same extent he would be had he actually signed the check himself.\textsuperscript{88}

\textsuperscript{82} See U.C.C. § 3-414(b) (1990 Revision); U.C.C. § 3-413(2) (Pre-revision 1990).

\textsuperscript{83} See U.C.C. § 3-406 (1990 Revision and Pre-revision 1990). Under the revision, holders in due course are included in those persons who, in good faith, take the instrument for value or collection.

\textsuperscript{84} As long as a transferee meets the criteria of pre-revised section 3-302(1) or revised section 3-302(a), that person is a holder in due course, albeit not of the instrument of the purported drawer, but of an instrument drawn by the wrongdoer. See U.C.C. § 3-302(1) (Pre-revision 1990); U.C.C. § 3-302(a) (1990 Revision).

\textsuperscript{85} The check may have been dishonored for a number of reasons. For example, Dan may have realized the theft and notified the drawee of the possible forgery and the drawee dishonored it as a result. Other possibilities include Dan's issuance of a stop payment order, insufficient funds in Dan's account to cover the amount of the check or the account upon which the check was drawn is no longer an active account.

\textsuperscript{86} See supra note 84.

\textsuperscript{87} See supra notes 66-69, 84 and accompanying text.

\textsuperscript{88} In this scenario, both Dan and Sally are subject to the potential contract liability of a drawer. Sally may be held liable because under pre-revised section 3-404 and revised section 3-403, Dan's forged signature is effective as Sally's signature. See supra notes 62-63 and accompanying text.
Likewise, where a drawer’s negligence results in the for-
gery of the payee’s signature, and the check is thereafter dis-
honored, section 3-406 has successfully been invoked to per-
mit recovery against the drawer. Consider this situation in
a scenario where Dan actually signed as drawer on a check
which he made payable to Janet Jones. Instead of delivering
the check to Janet he negligently placed it in Sally Swift’s
possession. After forging Janet’s name as indorser, Sally in-
dorsed the check with her own name, then deposited the
check in Depository Bank. As an indorser, Depository Bank
is entitled to recover from Dan under Dan’s contract obliga-
tions. This result, although doubtlessly correct, is not
clearly justified under either version of the Code.

Under both versions of the Code, the ability to enforce
the obligations on a check is conditioned on the ability of the
persons seeking enforcement to establish that they are hold-
ers or are vested with the rights of a prior holder. Depository Bank, in the above example, cannot qualify as a holder
under the pre-revision without first invoking section 3-406 to
preclude Dan from asserting the forgery of Janet’s indorse-
ment—an indorsement which is required before any person
can qualify as a holder. But, to invoke the preclusion under
pre-revised section 3-406, Depository Bank must qualify as
either a drawee, holder in due course, or other payor. Clearly, Depository Bank does not qualify as a drawee and
its failure to qualify as a holder precludes it from qualifying
as a holder in due course. Depository Bank may qualify as
an “other payor,” although the criteria for acquiring this sta-

89. Park State Bank v. Arena Auto. Auction, Inc., 207 N.E.2d 158 (Ill. App. Ct. 1965). Presumably, Arena Auto Auction’s liability to Park State was based on Arena Auto Auction’s drawer’s contract liability. Unfortunately, the basis used by the court to justify liability is not entirely clear. Id.
90. See U.C.C. § 3-415(a) (1990 Revision); U.C.C. § 3-414(1) (Pre-revision 1990).
91. See U.C.C. §§ 3-301, 3-201(1) (Pre-revision 1990); U.C.C. §§ 3-203(b), 3-
301, 3-305 (1990 Revision).
92. See supra notes 43 and accompanying text.
93. Although not expressly defined in the pre-revision, a drawee as used throughout the Code refers to the person to whom an order to pay a check or other draft is directed. Revised U.C.C. section 3-103(a)(2) defines a drawee as “a person ordered in a draft to make payment.” U.C.C. § 3-103(a)(2) (1990 Revision).
94. U.C.C. § 3-302(a)(1) (1990 Revision); U.C.C. § 3-302(1) (Pre-revision 1990).
tus are not clearly set out in the Code. If the other payor language in section 3-406 is construed to include a transferee who paid the face amount of a check to its transferor, but who was refused payment upon presentment, then Depository Bank may utilize section 3-406 to preclude Dan Drawer from asserting the forgery of Janet's signature. Estopped under section 3-406 from asserting the forgery, Dan is unable to contest the validity of the transfer to Depository Bank as a valid negotiation or its status as a holder in due course.

Depository Bank's ability to recover from Dan Drawer under the drawer contract provisions of the revised Code is more easily achieved. Reaching this result via a well reasoned avenue requires meticulous study and application of several Code provisions, however. Under the revision:

[T]he drawer is obliged to pay the [check] according to its terms at the time it was issued, or if not issued, at the time it first came into possession of a holder . . . . This obligation is owed to a person entitled to enforce the draft or to an indorser who paid the draft under section 3-415.

To recover from Dan, Depository Bank must establish that it is either a person entitled to enforce the check or that it is an indorser who paid the check under revised section 3-415. Any optimism that section 3-415 provides Depository Bank with an easy way out is quickly squashed upon a review of its criteria. After detailing the obligations of an indorser to pay a dishonored instrument, revised section 3-415 provides: "The obligation of the indorser is owed to a person entitled to enforce the instrument or to a subsequent indorser who paid the instrument under this section." No additional guidance is offered as to what criteria must be met before an indorser may be deemed to have "paid" an instrument under the section. In the absence of further explanation "paid" must be construed in this context to refer to payment by an indorser made in response to a demand for payment under the indorser contract obligation provisions of revised section 3-415. Constrained in this manner, Depository Bank fails to qualify as an indorser who paid the check under section 3-415.

Depository Bank may, nonetheless, recover from Dan under his drawer's contract if it can show it is entitled to en-

95. See supra note 72.
96. U.C.C. § 3-414(b) (1990 Revision).
97. U.C.C. § 3-415(a) (1990 Revision) (emphasis added).
force the check. The pertinent language in revised section 3-301 provides: "'Person entitled to enforce' an instrument means (i) the holder of the instrument, [or] (ii) a nonholder in possession of the instrument who has the rights of a holder . . . ."98 Like its predecessor, to enforce a check under revised Article 3, the aspiring enforcer must either qualify as a holder or be vested with the rights of a prior holder.99 Further, as was true under the pre-revision, an indorsement by the named payee on a check is required under the revision before a subsequent transferee can qualify as its holder.100

In our scenario, Sally has forged Janet's indorsement, but Janet has not indorsed the check. Unlike the pre-revision, the revision clearly permits Depository Bank to utilize section 3-406 to preclude Dan from asserting the forgery of Janet's signature against it. The pertinent portion of section 3-406 provides: "[a] person whose failure to exercise ordinary care substantially contributes to . . . the making of a forged signature on an instrument is precluded from asserting the . . . forgery against a person who, in good faith, pays the instrument or takes it for value or collection."101 Depository Bank both took the check for value102 and for collection.103 As a person entitled to enforce the instrument, Depository Bank may recover from Dan on his drawer contract obligations.

C. Warranty Liability

Unlike contract liability, warranty obligations on a check arise, not as a result of signing the instrument, but upon the movement of an instrument. These movement warranties are of two types: presentment warranties104 and transfer

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98. U.C.C. § 3-301 (1990 Revision).
99. See U.C.C. § 3-203(b) (1990 Revision); and U.C.C. § 3-201(1) (Pre-revision 1990).
100. "'Holder' with respect to a negotiable instrument, means the person in possession if the instrument is payable to bearer or, in the case of an instrument payable to an identified person, [the identified person] if the identified person is in possession." U.C.C. § 1-201(20) (1990 Revision). See supra notes 43-44 and accompanying text.
101. U.C.C. § 3-406(a) (1990 Revision) (emphasis added).
102. See U.C.C. §§ 3-303(a), 4-210(a) (1990 Revision).
104. The governing provisions appear in section 3-417(1) and section 4-207(1) of the pre-revision and in section 3-418 and section 4-208 of the revision.
warranties. Presentment warranties arise any time presentation of an unaccepted check is made to the drawee for payment or acceptance and is honored by the drawee. Presentment warranties are made not only by the presenter at the time of presentment but by all previous transferors at the time of their transfer of the check. Transfer warranties, on the other hand, attach any time a check is transferred for consideration. Thus, regardless of whether a person signs the check, if a person other than the issuer passes a check along to someone else and receives consideration, acceptance, or payment, the recipient of the check becomes the beneficiary of a number of implied warranties.

Among the warranties made upon presentment is the warranty that the presenter is a person, or is acting on behalf of a person, entitled to enforce the instrument. Implicit in this warranty is the assurance that the instrument contains no unauthorized or forged signatures which will give rise to a conversion action or recoupment claim against the payor or acceptor.

105. The governing provisions are set out in pre-revised section 3-417(2) and section 4-207(2) and revised section 3-416 and section 4-207.

106. See U.C.C. §§ 3-417(1), 4-207(1) (Pre-revision 1990); U.C.C. §§ 3-417, 4-208 (1990 Revision).

107. Under the pre-revised version of Article 3, transfer warranties could be disclaimed by transferring the instrument "without recourse." U.C.C. § 3-417(3) (Pre-revision 1990). Under the revised version, these warranties may no longer be disclaimed where checks are concerned. See U.C.C. § 3-416(c) (1990 Revision).

108. Revised section 3-203(a) provides that: "An instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument." U.C.C. § 3-203(a) (1990 Revision).

109. Revised section 3-303(b) defines consideration as "any consideration sufficient to support a simple contract." U.C.C. § 3-303(b) (1990 Revision).

110. An issuer is the drawer of a check.

111. See U.C.C. §§ 3-417(a), 4-208(a) (1990 Revision). The pre-revision contained a warranty that the presenter and prior transferors had good title to the instrument or were authorized to obtain acceptance or payment on behalf of someone who had good title. See U.C.C. § 3-417(1)(a) (Pre-revision 1990); U.C.C. § 4-207(1)(a) (1990 revision). The warranty of good title posed serious problems when dealing with bearer instruments since a person could become a holder in due course by unwittingly taking a bearer instrument from a thief.

112. Revised section 3-301 provides that:

"Person entitled to enforce" an instrument means (i) the holder of the instrument, (ii) a non-holder in possession of the instrument who has the rights of a holder, or (iii) a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 3-309 [providing for enforcement of lost, destroyed or stolen instruments]
Transfer warranties are similar to presentment warranties in that they include a warranty that the transferor is a person entitled to enforce the instrument. Transfer warranties include the guarantee that the instrument contains no unauthorized or forged signatures. Further, unlike presentment warranties, transfer warranties encompass the assurance not only that all indorsements are authorized but that the drawer's signature is also authorized.

Under both the presentment and transfer warranty provisions, in addition to expenses and lost interest, a person to whom the warranties run may recover from the warrantor an amount equal to the loss suffered as a result of the breach of warranty up to the face amount of the check.

While both presentment and transfer warranties arise upon movement, apart from the necessity of the warrantor's signature on the instrument, presentment warranties arise solely by the movement of the instrument independent of whether the warrantor indorsed the check or received consideration. As previously noted, transfer warranties only

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U.C.C. § 3-301 (1990 Revision).
114. Revised section 3-416 provides in pertinent part that:
(a) A person who transfers an instrument for consideration warrants to the transferee and, if the transfer is by indorsement, to any subsequent transferee that:
(1) the warrantor is a person entitled to enforce the instrument;
(2) all signatures on the instrument are authentic and authorized;
(3) the instrument has not been altered;
(4) the instrument is not subject to a defense or claim in recoupment of any party which 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.

U.C.C. § 3-416 (1990 Revision). Revised section 4-207(a) uses slightly different language to provide for identical warranties made by bank customers and collecting banks who receive settlement or other consideration on an item. U.C.C. § 4-207(a) (1990 revision).
115. See U.C.C. §§ 3-416, 4-207(a) (1990 Revision).
116. See U.C.C. §§ 3-416(b), 3-417(b) (1990 Revision). The pre-revision contained no comparable provisions concerning the appropriate measure of damages for breach of warranties.
117. Revised section 3-417 provides that:
(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
arise if the transferor receives consideration when passing the check along to someone else regardless of whether the transferor indorses the check. However, the class of beneficiaries to which transfer warranties extend is directly dependent upon whether, in addition to receiving consideration, the warrantor's transfer of the instrument is accompanied by an indorsement. In the absence of an indorsement, transfer warranties extend only to the transferor's immediate transferee. However, if the transferor indorses the instrument, the warranties extend to all future transferees.

The drafters' rationale for including an indorsement requirement in the transfer warranty provisions is unclear. The official comments offer no explanation for inclusion of the indorsement requirement other than to say that "[i]f there is an indorsement[,] the warranty runs with the instrument and the remote holder may sue the indorser-warrantor directly and thus avoid a multiplicity of suits." The perceived need for an indorsement in order to avoid shifting of the loss to the appropriate warrantor through multiple lawsuits where transfer warranties are concerned is particularly perplexing given the absence of this requirement in the presentment warranty provisions. The presentment warranty provisions allow the warranty of a previous transferor to ex-

(ii) a previous transferor of the draft, at the time of transfer, warrant to the drawee making payment or accepting 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 drawer of the draft is unauthorized.

U.C.C. § 3-417 (1990 Revision). Using slightly different language, the 1990 amended version of section 4-208 provides for identical warranties made by bank customers and collecting banks. Substantially the same warranties are contained in the pre-revision. See U.C.C. §§ 3-417(1), 4-207(1) (Pre-revision 1990).

118. See supra text accompanying notes 107-09.

119. See supra note 114.

120. U.C.C. § 3-416 cmt. 1 (1990 Revision); U.C.C. § 3-417 cmt. 7 (Pre-revision 1990). As explained by the drafters of the April 15, 1948 Proposed Final Draft, under former Negotiable Instrument Law, the warranties of a transferor who did not indorse the instrument ran only to the immediate transferee. See 6 ELIZABETH KELLY, UNIFORM COMMERCIAL CODE DRAFTS 36 (1984).
tend to the drawee who is farther removed from the prior transferor-warrantor than any transferee.\textsuperscript{121}

It is clear that under the provisions imposing contract liability on an indorser,\textsuperscript{122} before liability arises, a person's signature must appear on a check in the capacity of indorser.\textsuperscript{123} Under the transfer warranty provisions, it is equally clear that a person who transfers a check and receives consideration makes implied warranties to the immediate transferee regardless of whether the transferor additionally indorses the check. As an indorsement is unnecessary for the attachment of warranties, the indorsement language in the transfer provisions may create confusion as to whether liability based solely on breach of warranty is at issue, or whether liability arising out the indorser's contract obligations is also an appropriate basis for granting a remedy.

D. Negligence and Liability in Forged Indorsement Cases

The proper role of an indorsement becomes even more confusing when the indorsement is forged. Moreover, where negligence has contributed to the forgery, a quagmire emerges in which sound reasoning and application of section 3-406 and related provisions are often lost. A review of two decisions addressing this issue highlights the confusion and provides some insight into the often obscure rationale of courts regarding the ability, or lack thereof, of a party to avail itself to the preclusion of section 3-406 under contract principles versus warranty principles. In the first case, \textit{Park State Bank v. Arena Auto Auction},\textsuperscript{124} the check was dishonored but the ultimate loss was shifted to the negligent drawer under contract liability principles. In the second, \textit{Girard Bank v. Mount Holly State Bank},\textsuperscript{125} the check was honored by the drawee and the court held that section 3-406 could not form the basis for an affirmative action by a depository bank to shift the ultimate loss to the negligent drawer.\textsuperscript{126}

\textsuperscript{121} See supra note 117 and accompanying text.
\textsuperscript{122} See U.C.C. § 3-414 (Pre-revision 1990); U.C.C. § 3-415 (1990 Revision). See supra note 57 and accompanying text.
\textsuperscript{123} See supra note 58 and accompanying text.
\textsuperscript{125} 474 F. Supp. 1225 (D.N.J. 1979).
In *Park State Bank*, the drawer, Arena Auto Auction, drew a check payable to Plunkett Auto Sales. The check was erroneously delivered to Plunkett Auto Sales located in Illinois rather than to Plunkett Auto Sales located in Alabama. Although the Illinois dealer had never done business with Arena Auto Auction, the dealership owner, Tom Plunkett, fraudulently indorsed the check then cashed it at Plaintiff's bank.\(^{127}\) Prior to payment of the check by the drawee, the mistake was discovered. Upon presentment of the check to the drawee by Park State, it was dishonored in compliance with Arena Auto Auction's stop payment order.\(^{128}\) Park State sued Arena Auto Auction and, utilizing section 3-406 to preclude Arena Auto Auction from asserting the forgery of Plunkett's signature, was awarded judgment in the face amount of the check. Presumably, the court based its holding on Arena Auto Auction's drawer's contract obligation.\(^{129}\) However, the court's opinion neither articulated the basis of Arena Auto Auction's liability to Park State nor discussed Park State's qualification as a holder in due course or other payor so as to avail itself to the preclusion of section 3-406.

In *Girard Bank v. Mount Holly State Bank*,\(^{130}\) the drawer (Penn Mutual Life Insurance Company) drew a check payable to its insured and gave it to its agent for delivery to the insured. Instead of forwarding the check directly to the insured, the insured's indorsement was forged by the agent and the check deposited into her personal account with Defendant, Mount Holly. The drawee (Girard), paid the check upon presentment. The forgery was later discovered but only after the forging agent had been permitted to withdraw the funds. Girard brought a successful action against Mount Holly and was permitted to shift the loss to Mount Holly

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\(^{127}\) Even though the names of both dealerships were identical, an indorsement by Tom Plunkett is considered a forgery under Article 3 since Tom Plunkett knew he was not the intended payee. *See U.C.C. § 3-406 & cmt. 3 (1990 Revision).*

\(^{128}\) *See U.C.C. § 4-403 (1990 Revision)* (the 1990 amendments did not materially affect this section).

\(^{129}\) *See U.C.C. § 3-413 (Pre-revision 1990); and supra note 56 and accompanying text.*

under the theory that Mount Holly had breached its present-
ment warranty of good title.\textsuperscript{131}

In a third-party action, Mount Holly attempted to shift 
the loss to Penn Mutual, the negligent drawer, on the theory 
that under section 3-406, Penn Mutual was precluded from 
asserting the agent's forgery of the payee's signature because 
it was Penn Mutual's negligence in sending the check to the 
agent rather than to the payee which made the forgery possi-
ble.\textsuperscript{132} The court refused to allow Mount Holly's claim, la-
menting that section 3-406 could not be used to shift the loss 
to a negligent drawer by way of an affirmative action by a 
depository bank even though the depository bank is liable to 
a drawee under the warranty provisions of Articles 3 and 
4.\textsuperscript{133} Thus, Mount Holly was stuck with the entire loss even 
though Penn Mutual could have easily prevented the forgery 
and subsequent loss had it exercised reasonable care and sent 
the check directly to the payee.

In both cases the drawer was negligent in delivering the 
checks to someone other than the true payees. In both cases 
negligence substantially contributed to the forgery of the pay-
ees' indorsements. However, in Park State, the court permit-
ted the presenter to use section 3-406 to shift the loss to 
the negligent drawer, while in Girard the court ruled that section 
3-406 could not be used by the presenter to shift the loss to 
the negligent drawer.\textsuperscript{134}

The primary factual distinction between these two cases 
is that, in Park State the presenter maintained possession of 
the check because it was dishonored by the drawee,\textsuperscript{135} while 
in Girard the presenter lost possession of the check because it 
was honored by the drawee.\textsuperscript{136} The legal consequences of this 
distinction on the ability of the presenter to shift the loss to

\begin{itemize}
\item 131. The pre-amended version of section 4-207 provides that:
  (1) Each customer or collecting bank who obtains payment or accept-
ance of an item and each prior customer and collecting bank war-
rants to the payor bank or other payor who pays the instrument 
that
  (a) he has good title to the item or is authorized to obtain payment or 
acceptance on behalf of one who has a good title . . . .
\end{itemize}

U.C.C. § 4-207 (Pre-revision 1990).


133. Id. at 1235-36.

134. Id. at 1238-39.

135. See supra note 6.

136. See supra note 6.
the person whose negligence substantially contributed to the forgery of the payee's indorsement are both profound and unjustified. The contradictory outcomes rest on an inequitable difference in loss allocation under the rules governing contract liability versus warranty liability.

As these two cases demonstrate, where the drawee dishonors a check bearing a forged payee's signature, the availability of depository banks and other transferors to utilize section 3-406 to shift the loss to a negligent drawer is remarkably different than where it is honored. Where the check has been dishonored and recovery is sought based on the contract obligation of a drawer or payee, section 3-406 may be used, not merely as a shield to avoid liability but as a sword with which a plaintiff\(^\text{137}\) may arm itself and affirmatively assert a claim against a negligent drawer. In cases where the check was honored and recovery is being sought from a negligent drawer or payee because a transferor or presenter has been required to pay a subsequent transferee or drawee under a warranty claim, the preclusion under section 3-406 is viewed as inapplicable.

Rules which permit loss allocation to turn on whether a check is honored or dishonored are both inequitable and inconsistent with the Code's overall loss allocation scheme. If a check bearing a forged payee's indorsement is honored by the drawee, the drawer can demand that the drawee recredit the amount paid to the drawer's account.\(^\text{138}\) Under the pre-revised presentment warranty provisions, even though the drawer's negligence was a substantial contributing factor in causing the forgery, the drawee could elect not to invoke the preclusion provision of section 3-406 against the drawer and choose instead to recredit the drawer's account.\(^\text{139}\) The drawee could then recover the amount of the check from the presenter, or from a prior transferor\(^\text{140}\) of the check, under a

\(^{137}\) The term "plaintiff" as used here is intended to include any party to a lawsuit who occupies the same position as a plaintiff would in a two party suit, such as a defendant who files a counterclaim or an interpleader.

\(^{138}\) See U.C.C. § 4-401 (1990 Revision) (the 1990 amendments did not materially affect this section).


\(^{140}\) To perhaps state the obvious, a transferor is a person who transfers an instrument. The term "transfer" is not defined in the pre-revision. However, revised section 3-203(a) provides that: "An instrument is transferred when it is
breach of warranty claim. Unlike revision, the pre-revision contained neither a requirement nor an incentive for a drawee to utilize section 3-406 as a defense to recrediting a negligent drawer’s account. This was particularly true where the check had passed through either a depository or collecting bank prior to reaching the drawee bank.

A warrantor (warrantor E) compelled to pay a drawee under a breach of presentment warranty claim could, assuming it received consideration, shift the loss to its transferor (warrantor D) under the transfer warranty provisions. If each transferee received consideration when the instrument was taken, the loss could be shifted back down the chain in this manner to prior transferors under a breach of warranty theory to the point that the loss rests with the person (warrantor B) who took the check from the forger. However, because the named payee never actually transferred the check, but only enabled the thief to transfer it, the payee has not made any warranties. Warrantor B, therefore, is unable to further shift the loss to the negligent payee even though the payee was in a superior position to B to have prevented the forgery and subsequent loss.

The warranty scheme of loss shifting facilitates the general policy and goal of placing the ultimate loss attendant to forgeries on the person in the best position to have prevented the loss in the absence of negligence. It falls short of achieving success, however, where the forged indorsement is occasioned by the drawer’s or payee’s negligence. Moreover, the ultimate loss is allocated differently under the warranty principles where the check is honored than it would have been had the check been dishonored. Had the check in the above situation been dishonored by the drawee when presented and delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument.” U.C.C. § 3-203(a) (1990 Revision). In the majority of cases the presenter or transferor upon whom the loss ultimately falls is another bank.

141. See U.C.C. § 3-417(1) (Pre-revision 1990).

142. Section 3-417(c) of the revision removes the drawee’s discretion in situations where the drawer’s negligence substantially contributes to the forgery of the payee’s signature by permitting a warrantor to invoke the preclusion in section 3-406 as a defense against the drawee.

143. Under warranty principles, unless they expressly disclaim liability, prior transferors may be held liable even though they had no knowledge or notice of the forgery. See U.C.C. § 3-417(2) (Pre-revision 1990); U.C.C. § 3-416 (1990 Revision).
B compelled to pay the check under its indorser's contract obligation,\textsuperscript{144} B would have the ability to further shift the loss to the negligent payee under the payee's indorser's contract obligation.\textsuperscript{145} Had the check been dishonored, B would be entitled to demand surrender of the check upon payment.\textsuperscript{146} Thereafter, B could demand payment from the payee under the payee's indorser's contract obligations. Even though the payee's signature was forged, the payee would be estopped under section 3-406 from asserting the forgery and the forgery would be treated as a valid indorsement by the payee.

The inconsistencies in loss allocation that were dependent upon whether a check was honored or dishonored were particularly harsh under the pre-revision when the forgeries resulted from the negligent acts of an ostensible party to the instrument. Section 3-417(1) of the pre-revision provides that: "Any person who obtains payment or acceptance and any prior transferor warrants to a person who in good faith pays or accepts that (a) he has good title to the instrument or is authorized to obtain payment or acceptance on behalf of one who has good title. . . ."\textsuperscript{147} Under this provision, negligence contributing to a forged signature is irrelevant in warranty actions because liability is premised on the physical transfer or movement of the instrument and not on the validity or genuineness of the signature incident to that transfer.

Because the drawee could avoid the ultimate loss by recovering from the depository or collecting bank in a warranty action, from a practical business standpoint, it was generally viewed as far wiser for the drawee to pursue a warranty claim against a competing bank than to antagonize its customer-drawer.\textsuperscript{148} Further, the collecting or depository bank could not utilize the preclusion rule under section 3-406 be-

\textsuperscript{144} See supra note 57 and accompanying text.
\textsuperscript{145} See supra note 57 and accompanying text.
\textsuperscript{146} Both versions of Article 3 require a person making presentment to surrender the instrument to a person paying the instrument in full if so requested. See U.C.C. § 3-501(b)(2) (1990 Revision); U.C.C. § 3-505(1)(d) (Pre-revision 1990).
\textsuperscript{147} U.C.C. § 3-417(1) (Pre-revision 1990).
cause they were considered neither holders in due course,\textsuperscript{149} drawees, nor other payors.\textsuperscript{150}

IV. IMPORTANT CHANGES UNDER THE 1990 REVISION AND AMENDMENTS

The drafters of the 1990 revision of Article 3 and amendments to Article 4 attempted to remedy much of the confusion and inconsistencies inherent in the pre-revised provisions concerning loss allocation involving negligence of a party to the instrument. Two major problems are solved under the revisions. Revised section 3-406(a) now provides: "[a] person whose failure to exercise ordinary care substantially contributes to . . . the making of a forged signature on an instrument is precluded from asserting the . . . forgery against a person who, in good faith, pays the instrument or takes it for value or collection."\textsuperscript{151} By extending the ability to utilize the preclusion to a person who acquires a check in good faith and gives value for it or processes it for collection, depository and collecting banks are now afforded the same protection under section 3-406 previously reserved for holders in due course, drawees and other payors. It is unlikely that this change will be construed as providing the basis for an affirmative action by a depository or collecting bank against a negligent drawer or payee. The change will, however, aid a transferor who does not have the rights of a holder in recovering, under drawer and indorser contract liability, from a person whose negligence caused a forgery on the instrument.

\textsuperscript{149} Prior to the 1990 amendments, "holder" was defined in section 1-201(20) of the Code as "a person who is in possession of . . . an instrument . . . drawn, issued, or indorsed to him or his order or to bearer or in blank." U.C.C. § 1-201(20) (Pre-revision 1990). Further, under section 3-302, in order to qualify as a holder in due course, one must first qualify as a holder. Consequently, where a signature necessary to the chain of title is forged, transferees subsequent to the forged signature do not become holders and, ergo, cannot qualify as holders in due course.


\textsuperscript{151} U.C.C. § 3-406(a) (1990 Revision).
The problem of permitting a drawee bank to recredit the account of a drawer whose negligence substantially assisted in the forgery of a payee's indorsement, and then to shift the loss to a depository or collecting bank under a warranty claim, is also remedied under the revisions. Under revised section 3-417(c), a warrantor may avoid liability to a drawee by establishing, without limitations, the effectiveness of the indorsement through the use of sections 3-404 and 3-405. However, the ability to escape liability in a warranty action by invoking sections 3-404 and 3-405 is limited to situations involving fictitious payees, impostors and employers who have entrusted responsibility of the check to a dishonest employee.

Section 3-417(c) further permits a warrantor to avoid liability in a warranty action by a drawee by showing that a drawer is precluded from asserting that an indorsement is unauthorized under section 3-406. However, under section 3-417(c), the ability to raise the preclusion under section 3-406 as a defense in a warranty action is limited to those instances in which an indorsement has been forged due to the negligence of the drawer. Revised section 3-417(c) does not extend its coverage to permit a warrantor to defend itself against a drawee in a warranty action by establishing that the payee's negligence substantially contributed to the forgery of his or her indorsement on the instrument. Thus, in a situation where a payee's negligence leads to the making of an unauthorized indorsement, unless the forger obtains the check by impersonating the payee, is a fictitious payee, or is an employee of the payee entrusted with responsibility for the instrument, the warrantor cannot escape liability to a drawee who brings a warranty action even though the war-

152. In pertinent part, revised section 3-417(c) provides: "If a drawee asserts a claim for breach of warranty under (a) based on an unauthorized indorsement . . . the warrantor may defend by proving that the . . . drawer is precluded under Section 3-406 . . . from asserting against the drawee the unauthorized indorsement . . . ." U.C.C. § 3-417(c) (1990 Revision).

153. See U.C.C. § 3-404 (1990 revision). This section governs two discrete types of situations. The first is one in which an imposter dupes a drawer into issuing a check to the imposter, payable to the person whose identity is being usurped. The second is where the drawer, or the drawer's cohort, issues a check payable to a fictitious payee.

154. See U.C.C. § 3-405 (1990 Revision). This section governs situations where an employer has entrusted an employee with certain responsibilities involving an instrument and the employee fraudulently indorsed the instrument.
rantor can prove the forgery of the payee's signature was substantially, or even totally, caused by the payee's own negligence. The problem which remains unsolved under the revision can best be illustrated by the following hypothetical scenario and discussion.

HYPOTHETICAL: Depository Bank [Depository] accepts for deposit a paycheck issued by Diane Drawer, payable to the order of Paul Payee. Depository forwards the check to Drawee Bank [Drawee] who pays it. Depository subsequently permits withdrawal of the proceeds of the check. It turns out the check was stolen by Sam Plumber who forged Payee's indorsement to the check. Upon demand by Drawer, Drawee recredits Drawer's account and brings a warranty action against Depository based on Payee's forged indorsement. Depository Bank has credible and conclusive evidence to prove the forgery occurred because Payee negligently left his paycheck, along with his checkbook containing carbon reproductions of his signature, lying in open view on the kitchen counter while Sam Plumber was permitted unaccompanied access to Payee's home to repair the kitchen sink.

Depository Bank will not be able to use this proof in mounting a defense against Drawee. By its terms, section 3-417(c), extends the preclusion protection of section 3-406 to those situations in which the drawer is precluded from asserting an unauthorized indorsement. Because Payee's negligence rather than Drawer's negligence was responsible for the forgery of Payee's signature, section 3-406 would preclude Payee from asserting that the indorsement was unauthorized. However, as section 3-406 serves only as a shield to estop the negligent person from asserting the forgery of his or her own signature, section 3-406 would not preclude Drawer from asserting that Payee's indorsement was unauthorized.

A payor or drawee155 may only charge against the customer's or drawer's156 account those items which are properly payable.157 In the above scenario, under Article 4 of the Code, Drawer could require that Drawee recredit her account. Section 4-401(a) states that: "A bank may charge against the account of a customer an item that is properly payable."

155. Under Article 3, a bank in this situation is called a drawee.
156. Under Article 3, a customer in this situation is referred to as a drawer.
157. See U.C.C. § 4-401(a) (1990 Revision).
payable from the account . . . . An item is properly payable from the account if it is authorized by the customer and is in accordance with any agreement between the customer and the bank.\textsuperscript{158} A check which is cashed over a forged payee's signature is regarded as being unauthorized by the customer and therefore not properly payable.\textsuperscript{159}

Where a drawee pays a check which is not properly payable and debits the drawer's account, the drawer may demand the amount be credited back to the account.\textsuperscript{160} Where the drawer makes this demand, unless the drawee can avail itself to the subrogation provisions of section 4-407,\textsuperscript{161} the drawee is obligated to credit the drawer's account in the amount of the check.\textsuperscript{162} Subrogation rights under section 4-407, however, may only be exercised where recrediting the drawer's account will result in unjust enrichment.\textsuperscript{163} Even then, subrogation is not available to a drawee to permit refusal to recredit drawer's account unless the only means of preventing a loss to the drawee is by refusing to recredit the account.\textsuperscript{164} In situations where the drawee can avoid the loss by shifting it to a depository or collecting bank via a warranty

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{158} U.C.C. § 4-401(a) (1990 Revision).
\item \textsuperscript{160} See U.C.C. § 4-401(a) (1990 Revision).
\item \textsuperscript{161} Section 4-407 provides that:

If a bank has paid an item over the order of the drawer or maker to stop payment, or after an account has been closed, or otherwise under circumstances giving a basis for objection by the drawer or maker, to prevent unjust enrichment and only to the extent necessary to prevent loss to the bank by reason of its payment of the item, the payor bank is subrogated to the rights

(1) of any holder in due course on the item against the drawer or maker;

(2) of the payee or any other holder of the item against the drawer or maker either on the item or under the transaction out of which the item arose; and;

(3) of the drawer or maker against the payee or any other holder of the item with respect to the transaction out of which the item arose.

U.C.C. § 4-407 (1990 Revision).
\item \textsuperscript{163} See U.C.C. § 4-407 (1990 Revision).
\item \textsuperscript{164} See id.
\end{enumerate}
\end{footnotesize}
action, the drawee will not suffer a loss by recrediting drawer's account.

As previously indicated, section 3-417(c) does not permit the use of the preclusion under section 3-406 in a warranty action by a drawee unless the drawer's negligence has made the forgery possible. In the above hypothetical, since it was Paul Payee's negligence and not Diane Drawer's negligence which caused the forgery of Payee's indorsement, Depository Bank will be unable to avoid liability to Drawee in a warranty action.\(^{165}\) The drafters' purpose for this gap in the loss allocation scheme is unclear. One plausible reason for excluding a negligent payee from the newly created warrantor defenses under section 3-417(c) might be the concern of placing the drawee bank in the precarious position of recrediting the drawer's account and being unable to recover in a warranty action because the depository bank proves the payee was negligent when the drawee attempts to pass the loss back down the chain. However, research efforts failed to substantiate this as a possible concern.

At first blush, a loophole which allows this result may seem equitable. After all, one might surmise that since the drawer was not negligent, the drawer should not bear the loss. However, permitting the warrantor to utilize section 3-406 to avoid liability in a situation such as this, does not result in a loss to the drawer. If the warrantor were permitted the use of section 3-406's preclusion, the loss would fall squarely on Payee — the negligent person, and the person in the best position to have prevented the loss. By issuing the check to Payee, Drawer lost all rights to the check.\(^{166}\) Revised section 3-420 expressly provides that: "An action for conversion of an instrument may not be brought by (i) the issuer . . . of the instrument."\(^{167}\) Further, Drawer fully expected the bank to pay the check and debit the amount of the check from her account. This is precisely what Drawee has done. Thus, Drawer has lost nothing. Further, while Drawer probably anticipated Payee would benefit from the proceeds of the check, as an instrument payable to Payee's order, Drawer had no ability to ensure or require that Payee use the check for a beneficial or intended purpose. Additionally, if

\(^{165}\) See U.C.C. § 3-417(c) (1990 Revision).
\(^{166}\) See U.C.C. § 3-420(a) (1990 Revision).
\(^{167}\) U.C.C. § 3-420 (1990 Revision).
Payee had indorsed the check in blank rather than negligently leaving the means to enable that indorsement to be readily forged by Plumber and Plumber had then stolen and cashed the check, the loss would clearly fall on Payee with no recourse other than to recover from Plumber. Drawer would not be entitled to demand that Drawee recredit her account, therefore no warranty action would arise and Depository would not be liable to Payee in conversion.  

If a negligent payee brings a conversion action against either the drawee bank or depository bank, the bank may defend by invoking the estoppel provision under section 3-406. If Payee in the above scenario brings a conversion action against Depository, by utilizing section 3-406 to preclude Payee from asserting that his indorsement was unauthorized and establishing it was Payee’s own negligence that substantially contributed to the making of the unauthorized indorsement, Depository could escape liability to Payee. Unable under section 3-406 to assert Plumber’s forgery of his indorsement because of his own negligence, Payee would be barred from recovery. The loss would then properly be borne by Payee who is the person who could have best prevented the loss occasioned by the forgery.

The problem in the above hypothetical is further compounded under the current provisions of Article 3 by a judicial consensus which interprets section 3-406 as not including an affirmative right of action which would allow a depository bank to bring a direct action against the negligent payee. Supported by the official comments to section 3-406, a warrantor, such as Depository Bank, who is required to reimburse a drawee under the warranty provisions cannot utilize section 3-406 as a basis for bringing an affirmative action.

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168. A check which is endorsed in blank becomes a bearer instrument making whomever is in possession of the check a holder. See U.C.C. § 1-201(20) (1990 Revision). Under section 3-301 of revised Article 3, a holder is entitled to enforce the instrument. Section 3-301 was revised to clear up misunderstanding under the pre-revision regarding the ability of a person in possession of a stolen bearer instrument to qualify as a holder. See U.C.C. § 3-301, & cmt. (1990 Revision).

against Paul Payee. Furthermore, it appears that most jurisdictions do not recognize a common law negligence right of action in these situations.

Another solution to the problem posed by the above scenario is to deny a drawer the ability to require that a drawee recredit her account for checks properly issued by her, but paid over a forged payee's indorsement. Under the current interpretation of the applicable rules, Drawer, in the above hypothetical, can choose to assist the negligent payee in circumventing the basic loss allocation scheme of placing the loss on the person who could have best prevented it, by simply requiring Drawee to recredit her account. She can then issue the negligent Payee another check and neither she nor Payee suffers a loss. In this scenario, Depository, if unable to recover from thief, must bear the entire loss.

If Payee were to bring a conversion or recoupment claim against Depository, by utilizing revised section 3-406 Depository could prevent Payee from recovering for any portion of the loss due to the forgery, which was substantially caused by his negligence. This result is not only equitable but is consistent with the provisions of the Code which prohibit Drawer from bringing a conversion action in this situation. To disallow Drawer the ability to recover from Depository in a direct action but to allow recovery through a loophole is untenable. After all, since it is the negligent payee who lost possession of the check, it is far more appropriate to require the payee to take appropriate steps to recover payment than to shift the loss to a depository or collecting bank who is left with no recourse against the negligent payee. Further, having issued and delivered the instrument to the payee, the drawer has no claim to the instrument and has not suffered any loss as a result of payment by the drawee.

170. Official Comment 1 to revised section 3-406 states that the section "does not make the negligent party liable in tort for damages resulting from the [forgery]." U.C.C. § 3-406 cmt. 1 (1990 revision).

171. Girard Bank v. Mount Holly State Bank, decided by a federal district court construing New Jersey law appears to be the only published decision which interprets the Code as not having displaced a common law action grounded in negligence. 474 F. Supp. 1225 (D.N.J. 1979).

172. Revised section 3-406(b) provides for recovery based on comparative negligence principles. U.C.C. § 3-406(b) (1990 Revision).

Finally, denying Drawer the right to have her account recredited is not unsupported by the Code. While section 4-401 limits a bank's ability to debit its customer's account to those items that are properly payable, there is a valid basis for the proposition that payment in the above situation falls within section 4-401's properly payable limitations.

Consider the following: Diane Drawer directed Drawee to pay the check in accordance with Paul Payee's instructions. The method through which Payee provides Drawee with the instruction as to who should receive payment is by indorsing the check. A blank indorsement by Payee instructs Drawee to pay the check to its bearer. Payment by Drawee to any person who possesses the check, if done pursuant to an effective indorsement by Payee, is a payment which is properly payable. The issue then becomes whether the forgery of Payee's signature is effective as his indorsement.

Under revised section 3-406, Payee, because his negligence substantially contributed to the forgery of his signature, is precluded from asserting the forgery against Depository who took the check for value and collection. Through operation of revised section 3-406, the signature purporting to be Payee's is effective as his indorsement as far as it affects Depository. As Payee's effective signature, it is effective as an indorsement which causes Sam Plumber's transfer to Depository to result in a valid negotiation and further causes Depository to become not only a mere holder, but a holder in due course. While the notion that a check bearing a forged indorsement is not properly payable appears to enjoy wide, if not universal support, nothing in the actual provisions of the Code mandates such a conclusion. Indeed, application of the provisions in the above manner is not only entirely consistent with the actual language of the provisions, but is the

174. See supra notes 155-60 and accompanying text.
175. See supra notes 30-33 and accompanying text.
176. See supra text accompanying note 46.
177. See supra notes 48-49 and accompanying text.
178. See U.C.C. § 3-406(a) (1990 Revision).
179. See supra note 43 and accompanying text.
180. Revised section 3-302 indicates that a holder in due course is a holder to whom the instrument was negotiated or issued who took in good faith, for value, without notice of any unauthorized signatures on it, and without notice of any claims to it or defenses to its enforcement. U.C.C. § 3-302 (1990 Revision).
181. See supra note 159 and accompanying text.
better reasoned application of all the provisions when taken as a whole.

V. CONCLUSION

Under current application of the Code, if requested, a drawee must recredit the drawer’s account for payment of a check bearing a forged payee’s indorsement, even though the payee’s negligence substantially contributed to the forgery. The drawee is then permitted to shift the loss to the depository bank under warranty rules. Unable to shift the loss to the negligent payee under Code provisions, the depository bank must bear the entire loss while the negligent payee completely escapes liability. This loophole in the loss allocation scheme severely thwarts the goal of placing the loss on the person who is in the best position to prevent the loss resulting from the forgery. Unless inadvertently created, the drafters’ rationale for incorporating this loophole is unclear.

By prohibiting the drawer from demanding recredit from the drawee and requiring the payee to pursue a conversion or recoupment claim this loophole will be eliminated. A payee who is free from negligence will be able to recover and the warranty provisions will operate to properly place the ultimate loss on the person who took the instrument from the wrongdoer. Where negligence of a payee substantially contributed to the forgery and subsequent loss, the appropriate portion of the loss will be properly placed on the payee by denying recovery to the extent the payee’s negligence contributed to the loss. This result can be achieved by interpreting the rules under Revised Articles 3 and 4 as construing “properly payable” to include payment in accordance with any instruction by the payee deemed effective under the provisions of the revised Code.