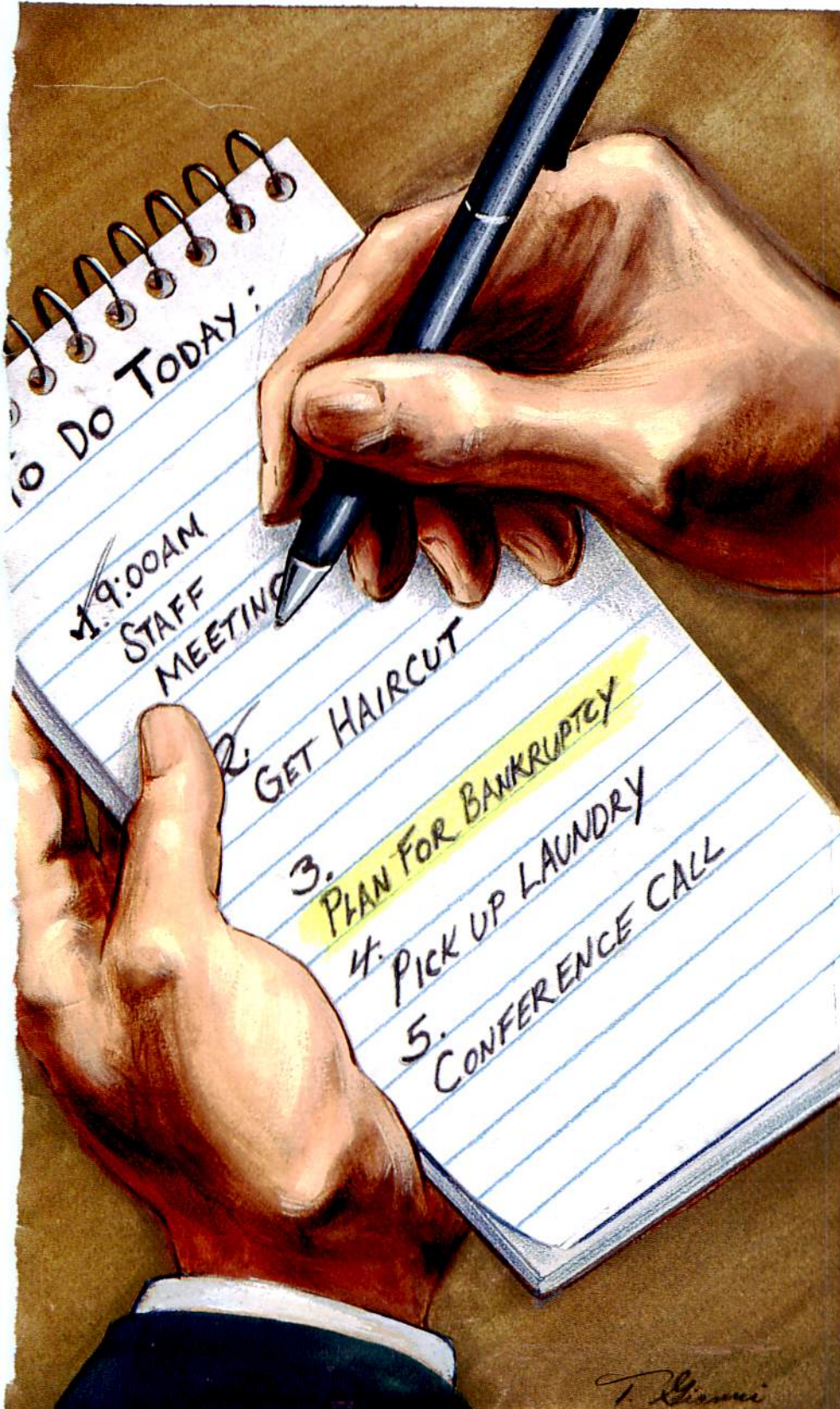


BULLETIN

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**Prefiling
considerations for
business debtors**

**An International
Bankruptcy Code:
Has the time
arrived?**



COMMERCIAL LAW LEAGUE OF AMERICA ®

Dishonesty in the Workplace: Stolen Instruments and Allocation of Loss—This Loss May Be Yours, Alone*

by David J. Cook**

Let's tour a successful commercial collection law firm and its handling of accounting operations. The firm receives weekly around 15 to 20 checks ranging between \$2,500.00 and \$80,000.00 from various debtors, title companies and attorneys, writes dozens of vendor checks to various providers, such as process services, microfilm and subpoena services and deposition services, along with normal expenses such as payroll, rent, taxes, health care and office supplies. This grand success breeds indifference to details, left to underlings. In many smaller firms, virtually all accounting and cash management functions are delegated to one person for complete disposition of deposits, payments of bills, check writing and payroll along with trust funds disbursements, which means client, attorney and vendor checks and a typewritten accounting.

Let's presume that the bookkeeper decides to share in this bounty. Fortune smiles on the diligent but winks at the mischievous. The bookkeeper steals settlement checks and endorses both attorney and client names as payees and deposits these checks in a personal account, steals outgoing vendor checks and likewise deposits them in a personal account, creates and purloins by mail fictitious payee vendor checks, and finally forges the names of the managing partner on the firm checks (both trust and general) and absconds with the money.

Let's unwind this mess. Assuming the firm lacks fidelity insurance, we'll

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start looking for other parties to share these losses. Let's take each incident and see if Divisions 3 and 4 of the Uniform Commercial Code can help.

The Uniform Commercial Code (UCC) provides the primary legal framework for negotiable instruments, commonly checks, in Division 3 and banking relations in Division 4. An average litigant is the drawer (the owner of the account) or payee (to whom the check was written) who sues the collecting bank (the bank which accepted the check for deposit) or the drawee (paying bank) which is the bank who paid the check from the drawer's account.

As a beginning overview, an aggrieved payee whose endorsements have been illicitly endorsed and who has never received the check may proceed against the original obligor. However, if the check was received, the payee seeks to shift liability to banks on theories of conversion, usually against the collecting, but sometimes paying bank. Aggrieved makers whose signatures have been forged may contractually proceed against their own bank for paying on forged endorsements, a reasonably successful remedy, but with a short statute of limitations, or sometimes may proceed in conversion against the collecting bank in only certain states. Similarly aggrieved makers whose payees' endorsements have been forged have a claim against their own bank. The overwhelming issue in these cases is whether the signature (maker or endorsement) was genuine, authorized, ratified, or if forged, statutorily excluded from liability.

Recent changes to the UCC through Sections 3405, 3406, 3307 and 4406 radically shift liability in part from the banks to their customers and third parties. These results follow.

Allocating the losses: Stolen settlement checks. Example No. 1: Bookkeeper purloins title company check, endorses name of attorney and client, deposits check in personal account.

Attorney sues collecting or paying bank and or title company. Attorney loses this action against all parties under Commercial Code Section 3405 which validates a forged endorsement if affixed by a "re-

sponsible employee" of the employer. Section 3405 states that an endorsement by a responsible employee, such as a full charge bookkeeper, who is authorized to affix endorsements for incoming checks for deposit, is valid against the employer, and the collecting bank (bookkeeper's bank) and paying bank (drawee on the check) would be free to pay on the check. Comparative negligence may mitigate the losses depending upon the level of fault. Sections 3405(b) and 3406. Further ameliorating this loss is Section 3307 which effectively prohibits a bank from knowingly processing a stolen check. Score: Tie (all sides share the loss).

Client sues collecting bank or paying bank and title company. Does Section

3405 validate an errant endorsement by the bookkeeper of the client's name as payee on the title company check? No. The bookkeeper is not the employee nor independent contractor nor subject to daily control of the client. Section 3405 only validates errant endorsements by employees on the theory that an employer could have avoided the loss through supervisory control, such as daily monitoring, security measures and audits, which are usually beyond the scope of most client and attorney relationships.

Does an attorney have an implied right to endorse the client's endorsement on the settlement check? Absent a power of attorney, usually buried in a retainer agreement, an attorney does not have an

actual or implied authority to affix the client's endorsement. An attorney has a license to practice law, not practice client endorsements on settlement checks. A powerful attorney is not a power of attorney, or an attorney at law is not an attorney in fact.

In reverse order, the client probably would lose against the title company who was authorized to deliver the check to the attorney as the client's agent. Absent a power of attorney, a client would prevail against one of the banks. Commercial Code Section 3420. In some states a client must elect a remedy between collecting and paying banks, or sue only the paying bank, i.e., Minnesota prohibits a direct action against a payee directed

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against a collecting bank. Score: Client 1, Banks 0.

The attorney or insurance carrier would reimburse the client, receive an assignment of client's rights as payee and sue all banks. Attorney (or insurer) probably would lose under equitable principle, which states that in allocating losses an assignee/subrogee stands in the shoes of the assignor, and if guilty of negligence or could have prevented the loss, would not recover against the tortfeasor, who, even if technically liable, is free of any culpable negligence. Score: Attorney 0, Banks 1.

Stolen vendor checks. Example No. 2: Bookkeeper forges names of payees on genuine outgoing vendor checks.

Attorney vs. Collecting or Paying Banks. Attorney again would lose this case as Bookkeeper was authorized to insert the name of payee on outgoing checks. Section 3405 immunizes subsequent takers of the checks if the responsible person was authorized to insert the name of the payee, such as traditional check preparation. Again comparative negligence and bank culpability may soften the blow. Score: Attorneys 0, Banks 1.

Fictitious payee checks. Example No. 3: Bookkeeper provides fictitious names of payee on firm checks and uses the mails to obtain possession.

Attorney sues collecting or paying banks. Attorneys would lose this action. This fact mirrors a typical fictitious payee or padded payroll rule which validates under Commercial Code Section 3404 endorsements by an employee who supplied the fictitious name. Since the bookkeeper was a responsible person, the banks would also claim an endorsement defense under Section 3405. Score: Bank 1, Attorney 0.

Forged maker checks to fictitious or genuine payees. Example No. 4: The bookkeeper forges the name of the maker to firm checks.

Attorney sues paying bank. Attorney would have a better claim against the pay-

ing bank who is only authorized to pay checks with a valid signature under Commercial Code Section 3403. Further, the account is chargeable only against properly payable items under Section 4401; furthermore the attorney must promptly report these losses under Section 4406; any tardiness would be fatal. Watch for contractual reporting limitations.

The bank would defend on the theory of actual or implied authority (Section 3403), timeliness and comparative negligence (Section 4406), and finally risk allocation (comparative negligence) under Commercial Code Section 3406. Watch for endorsement issues under Section 3405.

Comparative negligence under Commercial Code Section 3406 allocates losses on forged maker checks. A jury could consider such factors as a failure to reconcile bank statements, inspect cancelled checks or account for lost or missing checks, inattention to accounting and financial reporting and the lack of any monitoring procedures as damaging to the attorney's case. Nonetheless, the jury has the final decision in this matter, but its vote will be close in allocating blame between the neglectful attorney or bank who mindlessly processed the check. Score: Attorney 1, Bank 0.

Large dollar disbursements and deposits. Example No. 5: Bookkeeper steals a vendor outgoing check or incoming trust check, forges endorsement and deposits in personal account. The amount is over \$50,000.00.

Attorney sues collecting and paying bank. The overall concept is "bizarre." Is it rational for a bookkeeper to deposit a \$50,000.00 check, written from an employer, payable to a commercial entity, in a personal account? How about a deposit of \$50,000.00 title company check in a personal account? Paying a credit card bill with a firm check? Cashing a firm check? Cashing a trust check? Cashing a trust check at a check cashing service and demanding \$20's? Are these transactions bizarre? Commercial Code Section 3307 imposes liability upon banks who knowingly process checks for fiduciaries who

are breaching their duties. Cashed title company checks (through check cashing services—popular in Los Angeles) impose liability as this check cashing scheme could only indicate an illicit purpose. Watch for risk allocation rules. Section 3406. Score: Attorney 1, Banks 0.

Conclusion. Uniform Commercial Code Sections 3405, 3406, 3307 and 4406 effectively imbue responsible firm employees with the virtual power to exploit general and trust funds. Simply stated, the firm's endorsement stamp now coins the common currency of the realm. These recent UCC changes therefore impose business maturity in check handling, and any lapse could be quantifiably measured under comparative negligence concepts.

Security is found in (1) double signatures for any check in excess of \$500.00, (2) personal supervision over all disbursements, (3) check counting to avoid missing or lost checks, (4) integration of cash functions with management and, finally (5) fidelity insurance. □